CSIS INDONESIA
LEADING IN STRATEGIC THINKING

# Seizing Gains from a Transformative Agreement:

## *A Study on the Indonesia-EU Comprehensive Economic Partnership Agreement*

ARISE+ Indonesia
Trade Support Facility
Funded by the European Union

With the active support of
Kementerian PPN/ Bappenas

**Seizing Gains from a Transformative Agreement:**
**A Study on the Indonesia-EU Comprehensive Economic Partnership Agreement**



First Edition 2021


Centre for Strategic and International Studies (CSIS) Jakarta
Jalan Tanah Abang 3 No. 23-27, Gedung Pakarti Centre
Jakarta Pusat, 10160
Indonesia
Email: csis@csis.or.id
Website: http://www.csis.or.id

**Seizing Gains from a Transformative Agreement:**
**A Study on the Indonesia-EU Comprehensive Economic Partnership Agreement, 2021**

The report has been developed by the Jakarta based Centre for Strategic and International Studies with the active involvement of BAPPENAS and support from the Ministry of Trade and other relevant ministries, government agencies and private sector organisations.

**About ARISE Plus-Indonesia**

ARISE Plus-Indonesia is a four-year technical assistance programme funded by the European Union, that started in January 2019. The programme aims to strengthen the capacity of government institutions and stakeholders on a wide range of areas within international trade, competitiveness and business environment. It is coordinated by BAPPENAS, the Indonesian National Development Planning Ministry, which is also an implementing agency, together with the Ministry of Trade and additional ministries, government agencies and stakeholders that have a direct interest in the areas covered by the Programme.

This publication was produced with the financial support of the European Union. Its contents are the sole responsibility of the authors and do not necessarily reflect the views of the European Union.

CSIS INDONESIA
LEADING IN STRATEGIC THINKING

# SEIZING GAINS FROM A TRANSFORMATIVE AGREEMENT:

## *A STUDY ON THE INDONESIA-EU COMPREHENSIVE ECONOMIC PARTNERSHIP AGREEMENT*

AUTHORS:
YOSE RIZAL DAMURI, DANDY RAFITRANDI, DENI FRIAWAN, FAJAR B HIRAWAN, HARYO ASWICAHYONO, IRA S TITIHERUW, LESTARY J BARANY

WITH TECHNICAL ASSISTANCE:
FADLI JIHAD DAHANA SETIAWAN, DEWA AYU WIDIA LESTARI

**2021**

## TABLE OF CONTENTS

## LIST OF FIGURES

## LIST OF TABLES

## LIST OF BOXES

# EXECUTIVE SUMMARY

**IN RECENT YEARS,** Indonesia has intensively entered into trade agreements with various partners. As of early 2021, Indonesia has entered into 40 trade agreements and at least 11 other agreements which are expected to be completed soon[1]. One of the trade agreements currently under negotiation is with the European Union (European Union, hereinafter abbreviated as EU). The Indonesia-European Union Comprehensive Economic Partnership Agreement (IEU CEPA) negotiations officially began on 18 July 2016 and have completed nine rounds by the end of 2020. With this agreement, it is hoped that access of Indonesian exports to the European Union will be more open and the competitiveness of Indonesian products will increase.

But more than that, the meaning of this agreement is increasingly relevant in the context of economic reform, especially to jump start economic recovery amid a crisis due to the Covid-19 pandemic. The Indonesian economy recorded a contraction of 2.09 percent in 2020. Considering the limited government budget to support economic recovery, Indonesia needs to increase the country's productivity to sustain economic growth in the long run. In this case, the IEU CEPA presents an opportunity to increase Indonesia's productivity. It is also expected that through the implementation of the IEU CEPA, Indonesia will gain better access to the market thus encouraging trade in services and investment which both play a crucial role in economic recovery.

Furthermore, several parts of the agreement encourage improvements of the regulatory framework. These policy reforms focus on improving the business climate, establishing a more flexible labor market, formulating more secure and non-discriminatory economic policies, and implementing a more open trade and investment policy. These policy reforms will complement various efforts to improve infrastructure and quality of human resources that have been carried out so far.

This study aims at examining the potential impact of the IEU CEPA on the Indonesian economy using quantitative and qualitative methods. Quantitative analysis uses two main instruments: international trade indicators and economic model simulations. In the analysis of economic modelling, this study looks at the potential impact of the IEU CEPA agreement which is estimated at the macro, sectoral, regional, to socio-economic levels. The economic model used is a Computable General Equilibrium (CGE) model, such as the Global Trade Analysis Project (GTAP) and IndoTERM, and a micro-simulation model to analyse the impact of the agreement on socio-economic indicators. Meanwhile, qualitative analysis utilizes in-depth interviews and focus group discussions with various stakeholders, including government, associations, business actors at the central and regional levels.

The structure of this report begins with a discussion of the patterns, barriers and potential opportunities from trade in goods and services, as well as investment between Indonesia and the European Union. Following the discussions, the study analyses the simulation

1 Based on *Asia Regional Integration Center* (ARIC) database and Kontan (11 January 2021) *Kemendag Akan Fokus Menyelesaikan 11 Negosiasi Perjanjian Dagang pada 2021* accessed on 13 January 2021.

results of the CGE model and microsimulation. The findings in these four chapters are then elaborated deeper using the global value chain framework in the proceeding chapter. This report also features on other principal issues in the negotiations such as the issue of investment protection, intellectual property and business competition. Finally, this study concludes with recommendations for several policy adjustment options to better optimize the potential benefits of the IEU CEPA agreement in the future.

## TRADE IN GOODS

Trade in goods liberalization is one of the most important cornerstones in any economic cooperation agreement. Its role is quite crucial and strategic. It affects, in one way or another, the functioning of other elements of the cooperation such as trade in services, investment, and participation in global value chains. Therefore, this study begins with a discussion of trade in goods in the context of the IEU CEPA which includes the pattern of trade, tariff and non tariff barriers, and conditions for competitiveness as well as the potential for diversification.

The EU is one of Indonesia's main trading partners. Since 2010, Indonesia's trade balance with the EU has always recorded a surplus, although the value fluctuates considerably. During 2010-2019, the average value of Indonesia's exports to the EU reached USD 16 billion, while the average value of Indonesia's imports from the EU was USD 12 billion.[2] Of all the EU Member Countries, the Netherlands is the main destination for Indonesian products with an average export value during 2017-2019 reaching USD 3.7 billion. Meanwhile, Germany is the main source of Indonesian imports with a trade value of USD 3.5 billion in the same period.

Indonesia and EU has a relatively high degrees of complementarity and hence the IEU CEPA has a great potential to increase the intensity of trade in goods between the two economies. Trade Complementarity Index of Indonesian exports and EU imports is relatively high, which is 0.6 of 1. Moreover, of the 500 main export products of Indonesia to the world, 74 percent are the main import products of the European Union. Differences in socio-economic backgrounds, economic and technological development, and comparative advantage, are factors that explain this complementary nature. In addition to being complementary to each other, the two economies are also not direct competitors in the global market as shown by the relatively low Export Similarity Index, which is 0.3 out of 1. Indonesia tends to export primary sector products to the European Union market, while the European Union tends to export secondary sector products - generally high-tech - to the Indonesian market.

However, trade relations between the two parties are not optimal because Indonesian products encounter tariffs and non-tariffs barriers both in Indonesia and in the European Union. Several domestic regulations hinder a further expansion of trade between the two economies, such as, the Local Content Requirement (TKDN), export duties, and horticultural import policies. Meanwhile, in the EU, policies such as Rules of Origin (ROO), Sanitary and Phytosanitary (SPS) and special product licenses are also hindering market access for Indonesian products. In terms of tariffs, the implementation of the Generalized System of Preference (GSP) -which exports of many Indonesian products depend on- needs special attention from the government. Indonesia needs to prepare a strategy for when the GSP will

2 The moving average is calculated from a 3-year average. For example, the 2012 moving average is calculated from the averages of 2010, 2011 and 2012. Meanwhile, the 2019 moving average is calculated from the averages of 2017, 2018 and 2019.

no longer be applicable. It is in this context that the IEU CEPA is important because it offers lower preferential import duties than Most Favoured Nations (MFN).

Furthermore, the IEU CEPA is expected to reduce various trade barriers so that Indonesian products will become more competitive and diversified. IEU CEPA can increase the competitiveness of Indonesian products through access to quality inputs needed by domestic industries, especially in the manufacturing sector. Indonesia's participation in this agreement is also important to maintain its competitiveness in the EU market and to prevent a further erosion of its market share due to competition with other countries, such as Vietnam, that have agreements with the EU. In addition, the IEU CEPA is expected to be able to provide opportunities for product diversification so that Indonesia's export resilience will be strengthened. The diversification of Indonesia's exports is becoming increasingly urgent in light of the stagnation of the country's commodities export to the EU and world markets, as shown by the relatively high Spearman correlation coefficient (0.7 out of 1).

Finally, this agreement will be mutually beneficial even during crisis. Like its impact on the global economy, the Covid-19 pandemic has also had a negative impact on trade between Indonesia and the EU. Until November 2020, Indonesia's exports to the EU had decreased by 1.3% compared to the previous year, while imports from the EU had decreased by 11.9% compared to the same period from the previous year. However, there is a great opportunity for the two economies to improve their relationship by taking advantage of their fairly high complementarity. Slowing down industrial activity in China at the outbreak of the Covid-19 pandemic will lead to a restructuring of global supply chains, which previously depended heavily on production in China. Multinational companies will consider diversifying their investment and production to other areas so that they are not relying on one point. Indonesia perceives this situation as an opportunity to be more involved in global supply chains by becoming a destination country for multinational companies' production and investment.

## TRADE IN SERVICES

The strategic role of the service sector in the Indonesian economy can be observed through four aspects. First, the proportion of the service sector in GDP has continued to increase, from 45% in the 2000s to 55% in recent years. Second, an increase in the Indonesian workforce in various service sectors and a shift in the workforce to more productive service sectors such as finance, telecommunications, as well as professionals and business. Third, the more developed the economy, the more economic activity will depend on the quality and reliable output of the service sector. Fourth, with the massive development of technology and globalization, services are considered to be tradable products and have the potential to increase Indonesia's trade balance and current account.

In the economic relations between Indonesia and the European Union, trade in services is an important aspect. Indonesia is consistently a net importer of services from the European Union. Indonesia imports several services from the EU in sizable amount, such as transportation, communications, computers and information technology, finance and other services. This is in line with the characteristics of the Indonesian economy which requires multiple services to support economic activity. However, Indonesia was still able to record a surplus in the travel sector and in legal and management services. Surplus in the travel

sector is in the range of € 590 million - € 1.2 billion, while in the legal and management sector, ranges approximately € 90 million - € 200 million.

The low proportion of services in Indonesia's exports is likely to be one of the factors behind the low competitiveness of the country's export products. An analysis of the demand and supply of services in Indonesia shows that there is high excess demand for various important services such as telecommunications, transportation, finance as well as business and administrative support services. Without sufficient availability, production and economic activities will not be optimal, while productivity will be low. As a result, Indonesian products tend not to be able to compete in the world market. Imports of services, especially from high quality service producing countries such as the European Union, are imperative and benefit the economy.

However, imports of services are quite restricted. The Services Trade Restriction Indicators (STRI) score shows that Indonesia applies higher restrictions compared to other countries. This restriction is primarily in the form of restricting the entry of foreign service providers which makes the provision of services more difficult in the Indonesian economy. IEU CEPA opens opportunities for Indonesia to be able to take advantage of trade in services more optimally.

This opportunity can take the form of a potential export of Indonesian services to European Union countries. The Indonesia Services Dialogue Council (ISD) identified several services from sectors in Indonesia that have the potential for export (2018)[3], for example, construction, business services, and tourism-related services. In addition, IEU CEPA can also be an opportunity for Indonesia to meet excess demand in various service sectors and improve overall export performance. There are two ways to improve export performance. First, imports of services can boost the performance of the domestic service industry as a result of its exposure to global competition. Second, imports of services provide an option for cheaper service inputs, thereby driving cost efficiency.

Finally, it is expected that this agreement will facilitate trade in services activities in four ways. First, the agreement on trade in services will expand market access for cross border flow of services between the two economies. Second, this agreement will provide greater flexibility for investment in services sectors from Indonesia and European Union countries. Third, this agreement will facilitate and open up flexibility over the movement of individual service providers, whether related to companies or individuals. Fourth, this agreement is also expected to create a better service sector regulatory framework by taking into account principles of transparency and avoiding practices that are burdensome to the business world.

## INVESTMENT

Although fluctuating, the number of projects and the value of foreign direct investment (FDI) inflows from EU countries to Indonesia increased in the last decade. The value of FDI inflows increased from US $ 900 million in 2010 to more than US $ 2.6 billion in 2019 or has nearly tripled in the last ten years. In terms of composition, there has been a sectoral shift in FDI from the European Union. During the 2012-2015 period, the secondary sector

3 ISD, Roadmap for Mapping of Priority Service Sectors in Supporting and Enhancing National Economic Development and Competitiveness

(manufacturing sector) dominated FDI from the European Union to Indonesia. However, since 2016, European Union's FDI shifted to the tertiary sector (service sector) and the primary sector (mining). This is due to increased competition in the manufacturing sector, particularly in relation to labor costs, from China, Vietnam, India and Bangladesh. As a result, Indonesia's labor-intensive manufacturing sector, such as textiles, garments and footwear, has become less attractive to foreign investors, including those from European Union countries.

The Indonesia-EU CEPA places investment as one of the most important objectives. This agreement is expected to increase the flow of foreign direct investment into Indonesia, as well as become an export and import platform for Indonesia. With regard to investment potential, there is a large enough probability for an increase in exports from Indonesia to the EU when Indonesia receives higher FDI inflows from the EU, and vice versa. One possible explanation for this is that foreign investors originating from the EU will tend to invest in sectors that have significant exports to EU countries. This is related to the type or motive of investment entering Indonesia, which mostly tends to be vertical investment, rather than horizontal investment. In addition, companies investing in Indonesia also benefit from being able to import quality input goods or parts and components from the European Union. These companies can also access a larger market, not only in Indonesia but also in other ASEAN and East Asian countries that have trade and economic cooperation with Indonesia.

Although the IEU CEPA is expected to increase FDI inflows from the European Union to Indonesia, the real impact of this agreement will depend on the final outcome of the negotiations and its implementation. This includes how Indonesia is able to overcome various investment problems and barriers. This agreement is expected to help accelerate and expedite economic reform in Indonesia. To strengthen the impact of the investment clause, regulatory reform in line with negotiation objectives of the CEPA will be particularly important. In this context, the Omnibus Law issued by the Indonesian government can expand the impact of the IEU CEPA that is currently being negotiated. The Job Creation Law can also help Indonesia to make improvements and adjustments to economic regulations and policies in the future when the IEU CEPA is implemented. The regulatory reform resulting from the Job Creation Law has become even more important in the context of the Covid-19 crisis which has caused world investment to fall significantly, as competition in attracting investment will be tighter. However, this law alone is not sufficient to increase foreign investment. There is need for policy adjustments as well as a proper implementation of this law. In the end, the IEU CEPA, regulatory reforms and economic policies are expected to increase Indonesia's competitiveness and help expand Indonesia's comparative advantage.

## ANALYSIS OF ECONOMIC IMPACT

The results of economic modelling simulations show that the impact of trade liberalization from this agreement is that Indonesia will gain an increase in the percentage of real GDP that is greater than the EU. Assuming that this agreement applies a reduction in trade tariffs to zero for almost all products and reduces the NTM by half in the goods and services trade sector, Indonesia's real GDP growth will increase by 0.19% and the EU by 0.01%. This growth will increase welfare for both parties. Under this scenario, compared to baseline

conditions, the income increases by USD 2.8 billion for Indonesia and USD 2 billion for the European Union. Increased welfare is closely related to increased productivity due to lower prices for raw materials and intermediary inputs. The main increase in output is expected to occur in the clothing, vegetable oil and food sectors with a respective magnitude of 9.23%, 0.57% and 0.39%. Overall, Indonesia's total industrial output is expected to increase by 0.1% against the baseline.

This increase gives Indonesia more capacity to increase its export volume to the EU. Indonesian exports to the EU are estimated to increase by 57.76% and EU exports to Indonesia is projected to increase by 76.17%. In contrast to real GDP and welfare, the increase in EU exports to Indonesia was higher than Indonesia's exports to the EU. This is because the EU has a larger market share compared to Indonesia's market share in the EU, as evidenced by the fact that the EU is in the third position as Indonesia's trading partner. Meanwhile, Indonesia's position as EU's trading partner is in 32nd position. Clothing and services are the sectors registering the highest increase in Indonesia's exports to the EU.

Meanwhile, the sectors likely to have the highest import growth in Indonesia are forestry at 13.4%, followed by dairy and clothing at 11.8% and 9.95%, respectively. The demand for imports comes from private households and companies. The increase in imports by private households indicates an increase in household consumption. On the other hand, import demand from companies indicates that there is an increased demand for intermediate goods to be used for production. In other words, an increase in demand for imported goods from companies will increase domestic production, making the Indonesian industry more competitive.

Further examination at regional level shows that this agreement is expected to have a different impact on different provinces in Indonesia. Overall, there are 10 provinces that will experience an increase in real GRDP upon implementation of the agreement, while the remaining 24 provinces will suffer a decrease in this indicator. The five provinces with the highest real GRDP growth are Banten (0.13%), Central Java (0.06%), Riau Islands (0.05%), West Java (0.04%), and North Sumatra (0.034%). The sectors that grow the fastest in the five provinces are clothing and textile. Meanwhile, the five provinces with the largest decrease in real GRDP are South Sulawesi (-0.10%), West Kalimantan (-0.07%), Central Sulawesi (-0.068%), West Sumatra (-0.066%), and South Sumatra (-0.05%). The sector that is projected to have the largest decline in those five provinces is machinery. Even though there is an imbalance in economic growth geographically, there is actually no region that is really worse-off following the implementation of the IEU CEPA. This is because on each island, there are provinces that experience GDP growth from the agreement.

As for the socio-economic aspect, the IEU CEPA implementation brings opportunities to improve Indonesia's poverty conditions. This policy encourages trade liberalization with positive prospects for GDP and wages that can help increase household purchasing power. The results of the static comparative analysis show that this policy can reduce the percentage of the population below the poverty line. The reduction in poverty with this cooperation agreement can reach 0.01 percentage points of number of people living in poverty. The poverty gap index is also estimated to be lower, although the difference is not significant.

However, the benefits of cooperation do not have an equal impact on all groups of society. Inequality with the IEU CEPA could increase by 0.038 percentage points. The reason is that this cooperation agreement tends to increase the demand for skilled workers which

in turn has the potential to increase their wages. The bottom 20 percentile group is adversely affected by less than 0.1%. People above the poverty line receive a positive effect, with the upper level getting a larger increase.

## GLOBAL VALUE CHAINS PERSPECTIVE

Export development and industrial deepening can also be seen from the Global Value Chain perspective. GVC is closely related to aspects of trade in goods and services, and investment. ASEAN is an important hub of GVC originating from the European Union. However, currently, Indonesia's position in the value chain originating from European Union countries is weak or not optimal. In total, only 0.58% of the EU's forward value added (FVA) passes through Indonesia. Similar figures are also shown for the manufacturing sector. Even for several production sectors that have higher GVC characteristics, such as electronics and vehicles, the figure only reaches 0.3%. This figure tends to be small compared to the numbers of other countries in ASEAN. For example, Malaysia is becoming a more important hub because it contributes 2.4%, as well as Thailand. For several other production sectors, Vietnam and the Philippines are more important hubs than Indonesia.

With IEU CEPA, there are many opportunities to improve relations between the two economies, including to further integrate Indonesia in GVC formed by companies from Europe. Trade barriers that are expected to decrease will facilitate the flow of goods, encourage the availability of quality services, and increase investment. These three aspects are crucial in increasing Indonesia's participation in the GVC from the European Union or from other countries. Of course, this agreement is not a panacea that can directly encourage Indonesia's participation in the GVC. Various actions, both at the policy level and capacity building must be taken to support the creation of a better business environment.

## OTHER NEGOTIATION ISSUES

As a comprehensive trade agreement, the scope of issues discussed in the IEU CEPA negotiations is indeed broader than most of the FTAs that Indonesia has participated in. Apart from trade in goods, trade in services and investment already described, this study also discusses aspects of investment protection, intellectual property (IP) and business competition.

First, the negotiation process must deal with challenges related to the proposed investment provision and protection issues. The EU tends to emphasize liberalization and broader deregulation aspects, especially those related to trade and investment in the service sector. Protection of service providers/investors from the EU is likely to overlap with dimensions of public interest, human rights and the environment in Indonesia. The investment protections that are currently being proposed are still expressed in broad terms and are therefore open to interpretation. Therefore, several laws and regulations can be considered a violation of the principle of fair and equal treatment for foreign investors such as national treatment of domestic investors could have implications for compensation.

Second, the IEU CEPA is an opportunity for Indonesia to carry out reforms in the Intellectual Property (IP) Rights. However, this is not easy matter because of the intersection

of Indonesia's national and strategic interests. It is also necessary to understand the significant differences in the level of economic development and awareness on IP issues between the two parties. Discussions on IP issues in the IEU CEPA are often compared with the chapters that have been agreed by Vietnam in the Vietnam-EU Free Trade Agreement (FTA). However, it must be remembered that Vietnam has made preparations for regulatory harmonization through CP-TPP commitments which are the highest standards in the IP agreement. Indonesia is not a member of the CP-TPP so it requires a transition time to make regulatory adjustments and reforms. In addition, the issue of IP is increasingly challenging because it touches on many other issues outside of international trade, thus requiring more comprehensive coordination between Ministries / Agencies.

Third, both economies are aware of the contribution of business competition policy towards creating conducive, stable and predictable trade flows. This is increasingly important for investors who decide to invest in Indonesia. Several aspects related to business competition will also influence the success of policy implementation. For example, the issue of subsidies that have the potential to harm trade and investment. Therefore, regulations that include transparency, consultation, and certain conditions are needed for the most distorting types of subsidies. Another aspect of business competition is the issue of regulation and treatment of State-Owned Enterprises (SOEs) to ensure a level playing field between private companies and SOEs. Cooperation and agreements in the field of business competition in the IEU CEPA are expected to increase the implementation of better business competition in Indonesia.

## POLICY ADJUSTMENTS AND OPTIMIZATION STRATEGIES

In implementing and optimizing the IEU CEPA negotiations, there are several important notes regarding policy adjustment options, especially those related to the Export Quality Infrastructure (EQI), business sector competitiveness, especially MSMEs, good regulatory practice, and coordination between Ministries / Agencies.

First, Indonesia's Export Quality Infrastructure (EQI) needs improvement. In the medium term, Indonesia can encourage regulatory convergence with the European Union through the Mutual Recognition Agreement (MRA) which covers the same application of standards, certification and testing. Thus, certificates that have been obtained by business actors in Indonesia can be valid in the European Union and vice versa. In addition, Indonesia can provide incentives for the European Union to invest in building testing laboratories and certification bodies in Indonesia that comply with EU standards. This will contribute to increasing the capacity of supporting equipment and human resources in the EQI system in Indonesia. Indonesia can include a more intensive and effective capacity building program related to EQI in the discussions of the IEU CEPA negotiations. In particular, capacity building for Conformity Assessment Agency/*Lembaga Penilai Kesesuaian* (LPK), private sector and policy makers that aims at increasing awareness, capacity and compliance with European Union standards and other international standards.

Second, Indonesia needs to increase the competitiveness of the business sector, especially MSMEs. The key is how to increase the internationalization of MSMEs in Indonesia both in terms of export contribution and support to domestic value chain. Adjustment and optimization policies can also focus on increasing access and cost affordability to achieve

international product standards, especially for MSMEs. The objective is to increase the level of production to achieve sufficient business scale, reduce losses from products that do not comply with standards and ensure the sustainability of the supply of MSMEs. Cooperation with the European Union in the context of access to information, training and assistance in terms of product quality and standards is expected to be one of the important points in the IEU CEPA negotiations. Hopefully, IEU CEPA can facilitate technology transfer opportunities from manufacturing companies from the European Union.

Third, regulatory flexibility needs to be encouraged and good regulatory service (GRP) needs to be strengthened. Some of the issues discussed in the IEU CEPA negotiations are entirely new issues for the Indonesian government. Even for some issues, there is no regulatory basis either at the national level or international (multilateral) consensus, for example, the issue of trade and sustainable development, digital trade (including data protection) and issues related to State-Owned Enterprises (SOEs). This is a challenge in itself for the negotiation team and related Ministries / Agencies (K / L) in determining the negotiation position, not to mention at the time of implementation later. The analysis and study findings underline the importance of certainty and transparency of regulations in Indonesia. The Job Creation Law, as discussed earlier, provides a breath of fresh air for changes to the regulatory framework. However, there are many regulatory aspects that cannot be fully accommodated in the Law, which hinder the realization of the benefits of the IEU CEPA.

Finally, optimal benefits can be achieved if there is harmonious coordination between the agencies involved in implementation. Internal coordination between Ministries / Agencies (K/L) is very important in the process of planning, negotiating and implementing international trade agreements. One of the problems in implementing trade agreements is a lack of knowledge regarding trade agreements. The utilization of certificates of origin/ *Surat Keterangan Asal* (SKA) in Indonesia to obtain preferential access is still relatively small compared to other countries. One input that can be considered is the importance of having a national comprehensive Standard Operating Procedure (SOP) related to the socialization process of a more comprehensive and inclusive international trade agreement. The Ministry of Trade and related K / L usually include related business associations and actors in this socialization. Not only that, improvements, especially in terms of monitoring and evaluation, are needed to increase transparency and also to promote support from stakeholders. As of now, there are no provisions for the socialization, monitoring and evaluation of trade agreements.

# 1.

# INTRODUCTION

OVER THE PAST few years, Indonesia has extensively entered into trade agreements with various partners. As of early 2021, there were 40 trade agreements established at the bilateral and regional levels, with at least 11 other agreements to be completed soon. Some agreements take the form of limited trade agreements covering only several products, commonly known as Preferential Trade Agreements (PTAs). Several others, especially with major trading partners with high complementarity, take a more comprehensive form and include many aspects outside of trade.

One major trade agreement currently under negotiation is with the European Union (European Union, hereinafter abbreviated as EU). Assessments of this agreement have been conducted since 2007. Five years later, Indonesia and the European Union agreed to start the preparatory negotiating process based on the Framework Agreement on Comprehensive Partnership and Cooperation. Finally, the Indonesia-European Union Comprehensive Economic Partnership Agreement (IEU CEPA) negotiations officially began on July 18, 2016 and, by the end of 2020, completed ten rounds.

There are several areas of economic cooperation in the IEU CEPA. They are expected to improve economic relations between the two parties. Cooperation is not limited to trade in goods and services but also includes facilitating investment, accelerating technology transfer and boosting productivity, which in turn will further encourage Indonesia's economic development. Accelerating economic development is becoming increasingly important amid the crisis generated by Covid-19. The Indonesian economy recorded a contraction of 2.09 percent in 2020. Trade and investment have also decreased due to falling demand and the tendency of businesses to reduce activities due to the pandemic and uncertainty.

With vaccines and tighter regulations in 2021, it is expected that the spread of Covid-19 will be more manageable. But even with the outbreak under control, economic recovery will still be challenging and take time. The World Bank estimates that the world economy's potential output in the long run will be below the level should the pandemic had not occurred. The average growth potential for the 2020-2029 period, which prior to the pandemic was expected to reach 2.1%, fell to 1.9% (World Bank 2021). Until 2025, the world economy will lose 5% of potential output, even assuming that the economic recovery starts in 2021. In the worst scenario, the potential output loss could reach more than 11%. The same is true for the Indonesian economy. It is estimated that by 2024, Indonesia's GDP will be up to 10% lower due to the crisis.

Economic recovery will need to be supported by macroeconomic policies, with conducive fiscal and monetary interventions. With the support of the government budget of IDR 619

trillion and a deficit of up to 5.7 percent in 2021, Indonesia's economic recovery is projected to take place more quickly. But in the longer term, it is difficult to expect that the government budget can sustain a large deficit in order to continue supporting economic recovery. The economy must be able to achieve higher productivity in order to grow more rapidly and sustain economic recovery.

For this reason, policy reforms must be implemented immediately. These reforms should include improving business climate and investment licensing regime, creating a more flexible labor market, formulating more certain and non-discriminatory economic policies, and implementing more open trade and investment policies.

These policy reforms will complement various efforts to improve infrastructure and improve the quality of human resources that have been carried out so far. The importance of the IEU CEPA can be seen in the context of reforms to support economic recovery. Apart from increasing market access for Indonesian products in the European Union, which has the potential to increase Indonesia's exports, this agreement will also offer opportunities in line with Indonesia's needs in carrying out policy reforms. In addition, this agreement will affect trade in services as well as investment which will be an important part of economic recovery. Some parts of the agreement will also encourage improvements in the regulatory and policy framework.

This study aims at examining the potential impact of IEU CEPA on the Indonesian economy. The analysis carried out is much broader than looking at the potential for increased market access and Indonesian exports to the European Union. International trade indicators as well as economic model simulations are used to see the potential from a quantitative side. This study also uses a Computable General Equilibrium (CGE) economic model, such as the Global Trade Analysis Project (GTAP), IndoTERM, and a micro-simulation model to analyze the impact of the agreement at the macro, sectoral, regional, and socio-economic levels.

Meanwhile, qualitative analysis utilizes in-depth interviews and focus group discussions with various stakeholders, including government, business associations, business players at the central and regional levels. This is intended to get a deeper sense for the potential opportunities that can be achieved and how to optimize them. In addition, the analysis is also embedded in the global value chain (GVC) framework, which will support the development of Indonesia's industrial sector.

The structure of this report begins with a discussion regarding the patterns, barriers and potential benefits of the agreement on trade in goods and services, as well as investment between Indonesia and the European Union. The discussion is followed by the analyses of simulation results from CGE models and microsimulation. Findings are then elaborated further using the GVC framework. This report also touches on other important issues in the negotiations such investment protection, intellectual property and business competition. Finally, this study concludes with the recommendations on several policy adjustments, which are needed to further optimize the potential benefits of the IEU CEPA agreement.

# 2.

# INDONESIA-EU TRADE IN GOODS

**THE EUROPEAN UNION** is one of Indonesia's main export destinations. Trade relations between the two economies have grown more intensively in the past decade. Since 2010, Indonesia's trade with EU has been recording a surplus with an average value of total trade reaching USD 28 billion[4]. One of the factors that has strengthened economic relations between the two parties further is the initiation of a trade and investment cooperation agreement. The negotiations officially began on July 18, 2016. As of February 2021, the Indonesia-EU Comprehensive Economic Partnership Agreement (IEU CEPA) negotiations have completed ten rounds.

Trade in goods liberalization is one of the most important cornerstones in any economic cooperation agreement. Its role is quite crucial and strategic as it affects the functioning of other elements of the cooperation. For example, the intensity of trade in goods is closely related to increasing trade in services (Chapter 3), promoting investment (Chapter 4), and encouraging participation in global value chains (Chapter 6). This chapter specifically discusses trade in goods in the context of the IEU CEPA by focusing on the following three main findings.

First, the IEU CEPA has a great potential to increase the intensity of trade in goods between the two economies because of the relatively high levels of complementarity and suitability. This is indicated by relatively high Trade Complementarity Index of Indonesian exports and EU imports (0.6 of 1) and the level of coverage of Indonesia's main export products, which is more than 70 percent. Differences in socio-economic backgrounds, economic and technological development, and comparative advantage, are factors that explain this complementary nature. In addition to being complementary to each other, the two economies are also not direct competitors in the global market as shown by the relatively low Export Similarity Index, which is 0.3 out of 1. Indonesia tends to export primary sector products to the European Union market, while the European Union tends to export secondary sector products -generally high-tech- to the Indonesian market. These factors have further strengthened trade between the two parties.

Second, the trade relations between the two parties are still not optimal because Indonesian products encounter both tariffs and non-tariffs barriers both in Indonesia and in the European Union. Several domestic regulations hinder a further expansion of trade between the two economies, such as, the Local Content Requirement (TKDN), export duties, and horticultural import policies. Meanwhile, in the EU, policies such as Rules of Origin (ROO), Sanitary and Phytosanitary (SPS) and special product licenses are also hindering the entrance of Indonesian products. In terms of tariffs, the implementation of the Generalized System of Preference (GSP) - in which many Indonesian products depend on - needs special

4 The calculation uses a three-year moving average for the 2010-2019 period

attention from the government. Indonesia needs to prepare a strategy for when the GSP will no longer be applicable. It is in this context that the IEU CEPA is important because it offers preferential import duties that are lower than Most Favored Nations (MFN) duties.

Third, the IEU CEPA is expected to reduce various trade barriers so that Indonesian products will become more competitive and diversified. IEU CEPA can increase the competitiveness of Indonesian products through access to quality inputs needed by domestic industries, especially in the manufacturing sector. Indonesia's participation in this agreement is also important to maintain its competitiveness in the EU market and to prevent a further erosion of its market share due to competition with other countries, such as Vietnam, that have agreements with the EU. In addition, the IEU CEPA is expected to provide opportunities for product diversification so that Indonesia's export resilience will be strengthened. The diversification of Indonesia's exports is becoming increasingly urgent in light of the stagnation of the country's commodities exports to the EU and world markets, as shown by the relatively high Spearman correlation coefficient (0.7 out of 1).

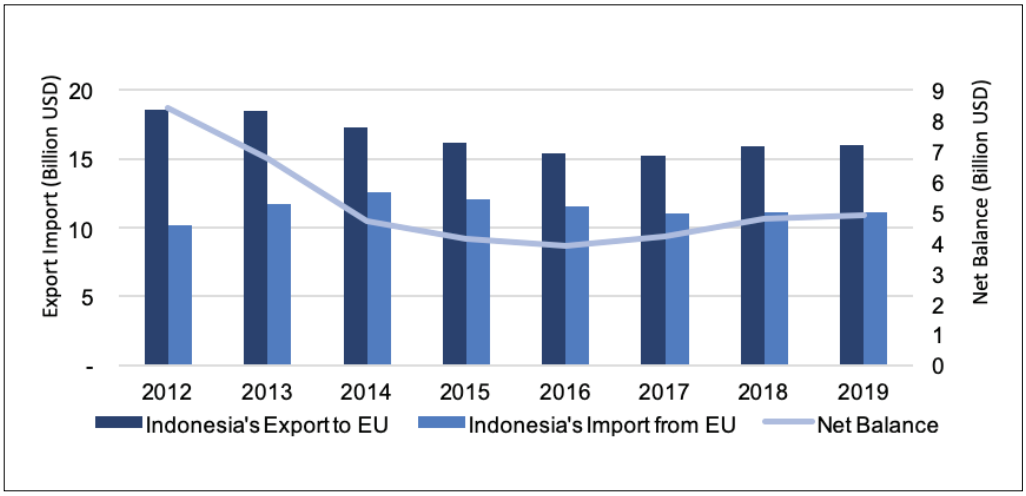
For further elaboration, this chapter is divided into four parts. First, the analysis will begin by looking at trade patterns between the two economies and their evolution. It is important to note that the product classifications observed in this chapter are, in general, very specific depending on the level of aggregation of available data and inputs from stakeholders. In the second part, the analysis provides an overview of the existing trade barriers in both parties, especially from the point of view of Indonesia's export products to the European Union market. Third, this study discusses the condition of competitiveness of Indonesian products and the potential for diversification. Finally, this chapter will wrap up with a discussion pertaining trade potential for the two parties, both in the context of exports and imports.

## PATTERNS OF TRADE IN GOODS BETWEEN INDONESIA AND THE EUROPEAN UNION

The EU is one of the largest trading economies, accounting for 15-16 percent of the world trade. The EU is also one of Indonesia's main trading partners. Trade relations between Indonesia and the EU have tended to increase in recent years. Since 2010, Indonesia's trade balance with the EU has always recorded a surplus, although the value fluctuates considerably. Using the moving average method[5] during 2010-2019, the average value of total trade between the two parties reached USD 28 billion, in which the average value of Indonesia's exports to the EU reached USD 16 billion, while the average value of Indonesia's imports from The EU in the same period reached USD 12 billion. **Figure 2.1** below shows that Indonesia has consistently experienced a trade surplus with the EU.

5 The moving average is calculated from a 3-year average. For example, the 2012 moving average is calculated from the averages of 2010, 2011 and 2012. Meanwhile, the 2019 moving average is calculated from the averages of 2017, 2018 and 2019.

Figure 2.1 Indonesia-EU Trade Balance 2012-2019 (moving average in USD billion)

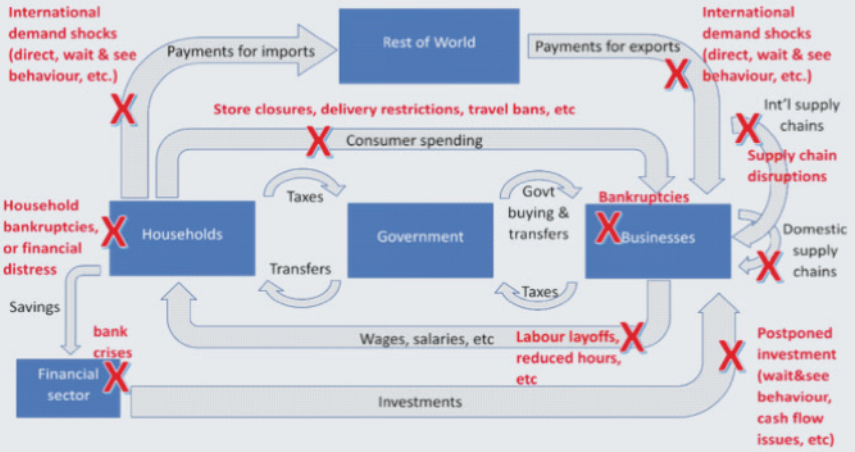



Source: WITS (calculated)

The global economic crisis due to the Covid-19 pandemic has caused a sharp decline in trade between Indonesia and the EU. As of November 2020, Indonesia's exports to the EU have decreased by 1.3 percent, while imports from the EU have decreased by 11.9 percent compared to the same period the previous year. Nevertheless, the impact of the pandemic on the economy and trade is not as heavy as it was previously thought. **Box 2.1** provides further explanation of the impact of the Covid-19 pandemic.

## Box 2.1 Impact of Covid-19 on World and Indonesia's Trade

Figure 2.2 Covid-19 Disruption to Economic Revenue Circular Flow




Source: Baldwin and Mauro (2020)

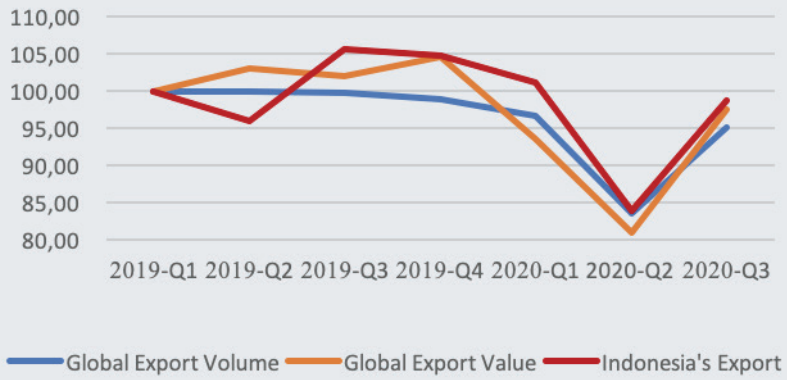
Figure 2.2 above illustrates how Covid-19 distorts international and domestic economic circular flows (Baldwin and Mauro, 2020). Disruption at one point will slow down overall economic activity, including the connectivity of goods, services and people movement from one economy to another.

The impact of the pandemic on trade has become clear after nearly a year. According to WTO statistics, the value of world trade until the third quarter of 2020 fell by more than 10.8 percent compared to the same period in 2019. This decrease was caused by a drop in the volume of goods traded as much as 8.1%, as well as a decrease in the price of goods. A deeper drop in volume indicates that there is a decline on both the demand and production sides due to a disruption in supply chains.

**Figure 2.3** provides an overview of the global trade situation from first quarter of 2019 up to the third quarter of 2020, both in terms of export value and export volume. The figure shows that there was a sharp decline in global trade in the second quarter of 2020. Trade performance improved again in the third quarter of 2020, even though it was still below the 2019 level.

The decline in demand and the disruption of production also affected trade relations between Indonesia and the EU. For example, export value of apparel until October 2020 has decreased by 12 percent compared to the same period the previous year, as was the case for textile exports which fell by 21.5 percent. In general, however, the situation is not so bad, as total exports have only fallen by 1.3 percent. Several export products, such as palm oil products, footwear and shoes, even experienced an increase of 33 and 12.7 percent, respectively.

Figure 2.3 Performance of World and Indonesia's Exports




Source: WTO *Trade* Data and BPS

The crisis due to the Covid-19 pandemic has indeed had a negative impact on Indonesia and the world economy, including the economy of the EU. However, there is a great opportunity for the two economies to improve their relationship by taking advantage of their high complementarity. The slowdown in industrial activity in China during the Covid-19 outbreak is likely to lead to a restructuring of the global supply chain, which previously depended heavily on production in China. Multinational companies will consider diversifying their investment and production to other areas so as not to focus on one point. Indonesia needs to see this situation as a new opportunity to be more involved in the global supply chain by becoming a destination for shifting production and investment. Opportunities arising from global supply chain restructuring and the necessary effort Indonesia must undertake as a complement to the IEU CEPA, will be discussed later in this report.

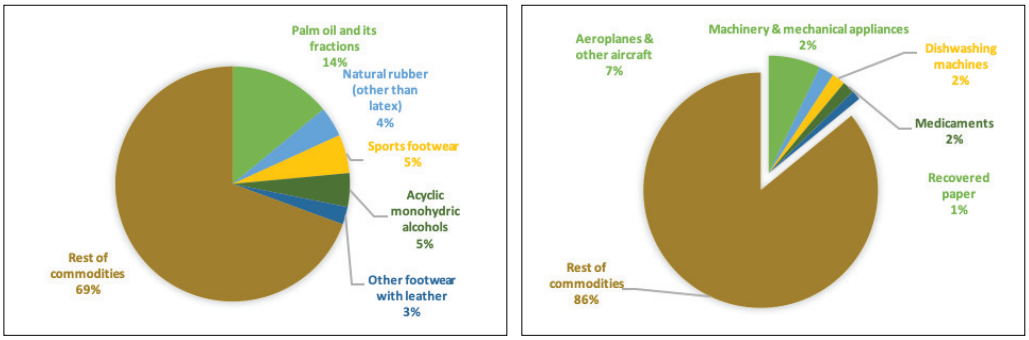
For Indonesia, the EU remains a top export destination. It is immediately below China and the United States, and above Japan and India. The main products that Indonesia exports to the EU market include vegetable oil products, electronic machinery, footwear, rubber and chemical products. One of the major products for Indonesia's exports to the EU market is palm oil, which in 2019 contributed 10 percent of the total value of Indonesia's exports to the EU. Meanwhile, footwear is another top export product which has experienced an almost 8 percent increase in growth from 2018 to 2019.

Of all the EU Member Countries, the Netherlands is the main destination for Indonesian products with an average export value during 2017-2019 reaching USD 3.7 billion. Indonesia's exports with the highest demand in the Netherlands are mainly palm oil, chemicals and tin. The export value of palm oil alone reaches USD 627 million After the Netherlands, Indonesia's exports mostly went to Germany, Spain, Italy and Belgium. Exports to these countries account for half of the total value of Indonesia's exports to the European Union.

Although the EU is one of Indonesia's main trading partners, Indonesia is not among the most important EU trading partners. Indonesia ranks as fifth EU trading partner in ASEAN

and 32nd in the world. In general, EU products that have high demand in the Indonesian market are high technology products such as machinery. Additionally, Indonesia imports medicines from the European Union. **Figure 2.4** illustrates the proportion of the five main products that Indonesia exports to the EU (left) and EU exports to Indonesia (right).

Figure 2.4 Proportion of Top Five Indonesia's Exports to the EU and EU Exports to Indonesia 2017-2019 (Average)




Source: WITS (calculated)

Germany is the main source of Indonesian imports with a trade value of USD 3.5 billion over the last three years. German superior products that are in great demand by Indonesians are mechanical machinery and equipment, motorized vehicles and dishwashers. The average import value of these three products reached USD 313 million. Furthermore, Italy, France, the Netherlands and Belgium are also important trading partners for Indonesia to meet its import demand. These countries sell high-tech products to Indonesia and dominate EU exports to Indonesia.

### The Evolution of Indonesia-EU Exports and Imports

Apart from export and import trends, there are several aspects that can be seen in the evolution of trade between Indonesia and the EU, such as the composition of goods exported and the level of coverage of Indonesian exports. Both of these will further strengthen the arguments on how important the position of each party is as a trading partner.

The composition of Indonesia's exports tends to remain constant. We compare the pattern of exports between two periods, by calculating the correlation coefficient in the first period which includes the 2001-2003 average and the second period 2017-2019 at the 6-digit HS detail product level[6]. The composition of the export pattern in the two periods has a fairly high correlation coefficient (see **Table 2.1**). This means that the commodities exported by Indonesia to the EU and world markets did not experience much change in the two periods. The correlation coefficient tends to be high compared to many other ASEAN countries, especially Vietnam, the Philippines and Cambodia. This indicates that Indonesia tends to be unable to expand the variety of its products exported to the EU market, compared to other ASEAN countries.

6 We use averages for the analysis of trading patterns to reduce the annual variation commonly seen in detailed trading data. The period 2001-2003 was chosen because at that time the Indonesian economy had stabilized after the 1997/1998 Asian financial crisis. HS is a grouping of trading products based on the Harmonized System, where the 6 digit HS is the most detailed grouping with a description of about 5000 types of products

Table 2.1 Correlation Coefficient of Trading Partners' Exports to EU and Global Markets, 2001-2003 and 2017-2019

| TRADING PARTNERS' EXPORTS TO THE EU | | TRADING PARTNERS' EXPORTS TO GLOBAL MARKET | |
|---|---|---|---|
| **Reporter** | **Spearman Rank Correlation Coefficient** | **Reporter** | **Spearman Rank Correlation Coefficient** |
| Japan | 0.89 | Indonesia | 0.80 |
| USA | 0.88 | Cambodia | 0.26 |
| China | 0.85 | Vietnam | 0.71 |
| Thailand | 0.78 | Malaysia | 0.84 |
| Singapore | 0.75 | Philippines | 0.70 |
| Indonesia | 0.68 | Singapore | 0.88 |
| Malaysia | 0.67 | Thailand | 0.85 |
| Vietnam | 0.56 | USA | 0.92 |
| Philippines | 0.54 | China | 0.85 |
| Cambodia | 0.19 | Japan | 0.93 |

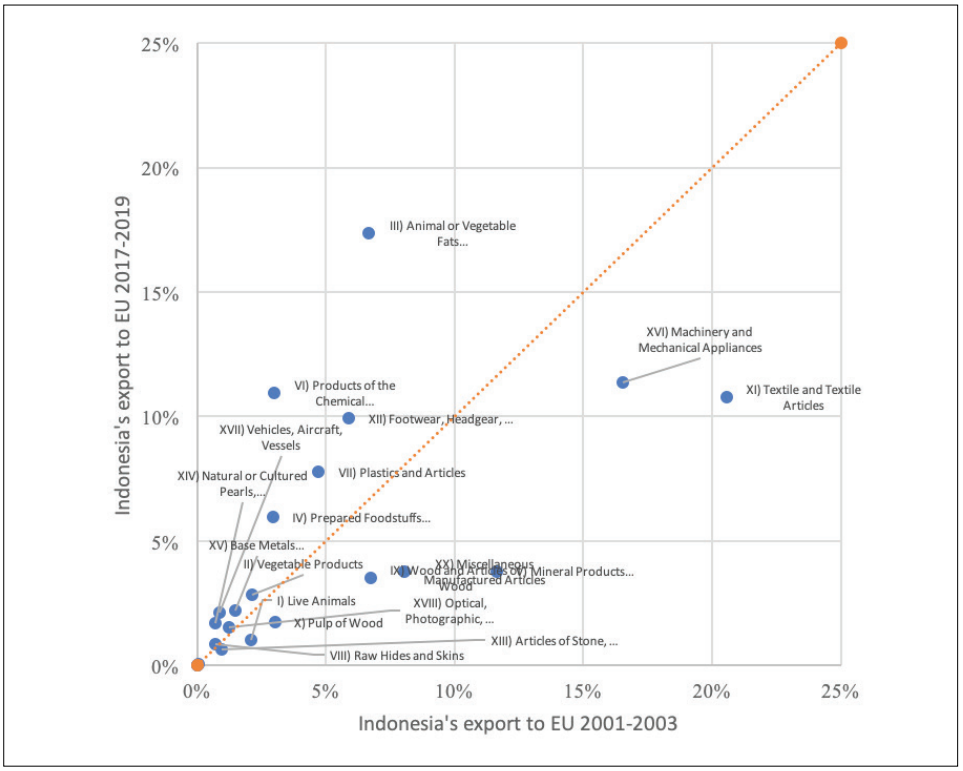
Source: WITS (calculated)

**Table 2.1** also shows that the correlation coefficient for Indonesia's exports to the global market is higher than the correlation coefficient for the EU market. This indicates that reasons for the low diversification of Indonesian exports tend to come from the production side in Indonesia, compared to the demand in the EU market. These figures also show that Indonesia has the potential to diversify its exports to the EU, particularly products originating from the secondary sector or the manufacturing industry.

The findings of the Spearman correlation coefficient are elaborated in **Figure 2.5**, which shows a scatter plot of the proportion of Indonesian export products for the two periods 2001-2003 and 2017-2019[7]. The coordinates for each product indicate their proportion in Indonesia's exports to the EU. For example, footwear and headgear products, have a proportion of about 6% in the first period and increase to 10% in the second period. The 45° line indicates no change in the proportion of exports. Products located above the line indicate an increase, while those that are below indicate a decrease, between the two periods. Of the 20 categories, more than half were the 45° line, indicating no change. Several products experienced a decrease in the proportion of exports, such as textiles, machinery, and manufactured products, while vegetable fat products, especially palm oil, dominate Indonesia's exports to the EU.

7 Products are grouped into 20 major groups which are commonly referred to as HS Sections, based on Harmonized System grouping

Figure 2.5 Composition of Indonesian Export Commodities to the EU, 2001-2003 and 2017-2019




Source: WITS (calculated)

In short, it can be said that the composition of Indonesia's exports to the EU market tends to change only a little, although the proportion of some products has increased and decreased. In general, manufactured products tend to decline, although heavy industrial products, such as chemical products and plastics, have experienced an increase. The unchanged composition and structure of Indonesia's exports actually leaves room for further diversification of Indonesian exports in the future.

Apart from the composition of exports, an interesting aspect to discuss is the extent to which Indonesian products can maintain their market shares in EU countries. Thus, it is also important to look at the penetration of Indonesian exports to the EU and compare it with world markets. This is illustrated in **Table 2.2**.

Table 2.2 Market Share of Indonesian Products in the European Union and World Markets (%)

| HS SECTION | DESCRIPTION | EU MARKET | | WORLD MARKET | |
|---|---|---|---|---|---|
| | | 2001-2003 | 2017-2019 | 2001-2003 | 2017-2019 |
| I | ANIMAL PRODUCTS | 0,2 | 0,1 | 0,9 | 0,7 |
| II | VEGETABLE PRODUCTS | 0,8 | 0,4 | 1,6 | 2,1 |
| III | FATS AND OILS | 7,7 | 10,1 | 10,3 | 22,0 |
| IV | PREPARED FOODSTUFF | 0,4 | 0,5 | 1,2 | 1,6 |
| V | MINERAL PRODUCTS | 2,4 | 0,3 | 3,6 | 1,5 |
| VI | CHEMICAL PRODUCTS | 0,1 | 0,3 | 0,4 | 0,7 |
| VII | PLASTIC AND RUBBER | 0,7 | 0,9 | 1,7 | 2,2 |
| VIII | LEATHER PRODUCTS | 0,4 | 0,3 | 0,6 | 0,6 |
| IX | WOOD PRODUCTS | 3,0 | 2,5 | 3,9 | 2,6 |
| X | PULP OF WOODS | 0,8 | 0,1 | 2,2 | 2,8 |
| XI | TEXTILE AND TEXTILE ARTICLE | 0,8 | 0,5 | 1,3 | 1,3 |
| XII | FOOTWEAR | 1,9 | 2,4 | 2,0 | 3,4 |
| XII | ARTICLE OF STONE | 0,3 | 0,2 | 0,9 | 0,6 |
| XIV | PEARLS AND PRECIOUS STONE | 0,0 | 0,1 | 0,7 | 1,0 |
| XV | BASE METAL ARTICLE | 1,1 | 1,7 | 2,1 | 3,6 |
| XVI | ELECTRICAL AND MECHANICAL EQUIPMENT | 0,3 | 0,2 | 0,6 | 0,4 |
| XVII | VEHICLE | 0,1 | 0,1 | 0,1 | 0,6 |
| XVIII | PRECISION INSTRUMENT | 2,1 | 3,5 | 2,7 | 4,5 |
| XIX | ARMS AND AMMUNITION | 2,1 | 0,6 | 0,0 | 0,0 |
| XX | MISC MANUFACTURE ARTICLE | 0,4 | 0,3 | 1,2 | 0,9 |
| | TOTAL | 0,5 | 0,4 | 0,1 | 0,4 |

Source: WITS

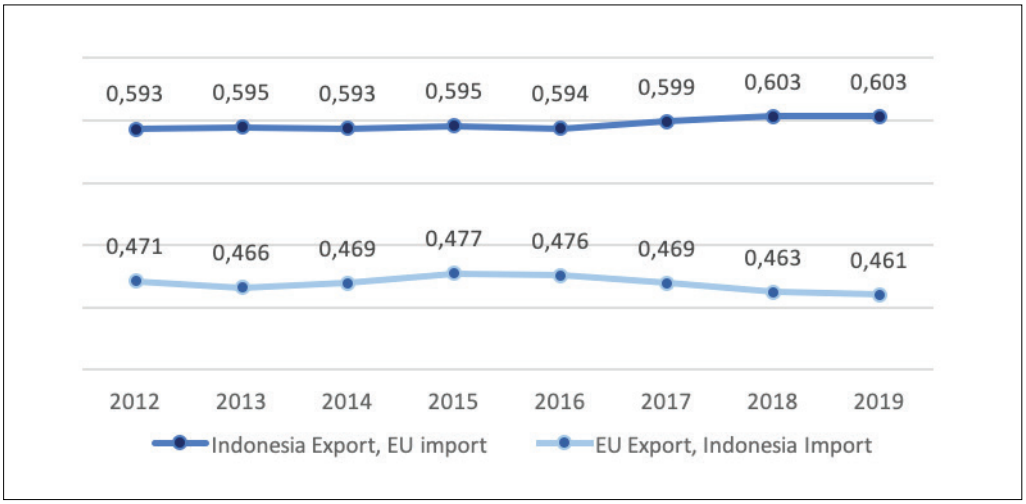
In general, the market share of Indonesian products in the EU declined from 0.5 percent in the early 2000s to only 0.4 percent during the 2017-2019 period. This decline is experienced by many of Indonesia's export products to the EU. There are only eight groups of goods whose market share has increased in the European market, such as vegetable and animal fats, processed foods and footwear. Meanwhile, products such as textiles and garments and wood products suffered a decline.

The picture is somewhat different in the world market, where Indonesia has been able to increase the market share of its products, especially in several commodities where Indonesia has a comparative advantage. Many products that have a comparative advantage failed to even maintain their market share in the EU. One reason is competition from other countries that took up a larger market during this two-decade period, such as Vietnam and some South Asian countries. Another factor is trade barriers and policies which will be discussed later in this chapter.

### Trade Complementarity between Indonesia and The EU

Naturally, trade between Indonesia and the EU should complement each other because of the differences in socio-economic backgrounds between Indonesia and the EU, as well as the difference in the comparative advantages of each party. These conditions should ideally be able to produce promising trade relations. Indonesia is a tropical country with diverse natural resources, making it possible to supply animal and vegetable products to the EU market. On the other hand, the EU comprises of countries capable of producing goods with advanced technology, such as aircraft, machinery and electrical products, which are very much in demand for the development of infrastructure and upstream industry in Indonesia.

Figure 2.6 Trade Complementarity Index (TCI) between Indonesia and EU27




Source: WITS (calculated)

The complementarity index between the two parties has stayed more or less the same in recent years, as can be seen in **Figure 2.6**. Trade Complementarity Index (TCI) of Indonesian exports and EU imports is, on average, hovering 0.6 from 2012 to 2019[8]. Meanwhile, the complementarity between EU exports and Indonesian imports is in a relatively lower figure in the range of 0.4. Nevertheless, TCI itself has not been able to capture the complementarity of the main commodities traded between Indonesia and the European Union in more detail. Therefore, this study calculates the coverage rate in order to see a more detailed description of these commodities in **Table 2.3**.

In general, the coverage rate is the percentage value of a country's main exports to a particular market. In the context of this study, this means the percentage of Indonesia's main exports to the EU. The coverage analysis looks at the number of products in certain sectors that are among the top 500 of Indonesia's main exports[9] which, at the same time, are also the main imports of the European Union. To get the coverage level value, this figure is divided by the number of products in the sector which are part of the top 500 Indonesian exports. For the food and live animal sector, for example, there are 132 products included in

8 The TCI value ranges from 0 to 1, where a value of 0 indicates that there is no match between the export and import products of the two countries, and a value of 1 indicates a perfect suitability of trade patterns.

9 The calculation is carried out by grouping the products in the four-digit classification of SITC Revision 4 which includes about 1200 types of products. The calculation of the top 500 products uses the average trade value for 2017-2019

Indonesia's 500 main exports, of which 35 also the main EU imports. The coverage rate of the food and live animal sector is 26.5%.

The results of this calculation indicate that, of the 500 main export products of Indonesia to the world, 74 percent are the main imports of the European Union. **Table 2.3** shows that there are three main sectors whose coverage exceeds 50 percent, namely machinery and transportation equipment, manufactured goods. This value indicates a relatively high compatibility between Indonesian exports and European Union imports. In other words, products in this sector are generally in high demand in the EU.

Table 2.3 Coverage Rate for SITC 1 Category

| Sector (SITC 1) | No of Products | Coverage Rate |
|---|---|---|
| 0) Food and live animals | 35 | 26.5% |
| 1) Beverages and tobacco | 4 | 3.0% |
| 2) Crude materials, inedible, except fuels | 18 | 13.6% |
| 3) Mineral fuels, lubricants and related materials | 8 | 6.1% |
| 4) Animal and vegetable oils, fats and waxes | 2 | 1.5% |
| 5) Chemicals and related products | 59 | 44.7% |
| 6) Manufactured goods | 79 | 59.8% |
| 7) Machinery and transport equipment | 88 | 66.7% |
| 8) Miscellaneous manufactured articles | 73 | 55.3% |
| 9) Commodities and transactions | 2 | 1.5% |
| Total | 370 | 74% |

Source: WITS (calculated)

The high compatibility of Indonesian exports to the EU imports for these sectors also indicates that there is good potential for the development of Indonesian exports to the EU. Indonesia's production capacity, however, needs to be increased in order to take advantage of the of the high level of compatibility between the two economies. It is interesting to see that the compatibility of the Animal and Vegetable Oil sector tends to be very low, only 1.5%, although this sector dominates Indonesia's exports to the EU, especially for palm oil products. This shows that the current structure of Indonesia's exports tends to be concentrated in a few products which actually do not show a high level of compatibility. It is expected that the CEPA can increase potential gain of this compatibility.

Based on the various analyzes and indicators discussed here, there are several issues that can be underlined. **First**, the composition of Indonesia's exports to the EU tends not to change even though some commodities have experienced changes in their contribution to Indonesia's total exports. It is clear that Indonesia tends to export products from the primary sector to the European Union, while the European Union exports a lot of products from the secondary sector (manufacturing) to Indonesia. **Second**, the penetration of Indonesian exports to the EU tends to decline while the penetration of Indonesian exports to the world tends to increase. This could be due to the competition faced by Indonesian products when entering the EU market, for example with products from Vietnam. **Third**, the level of compatibility between Indonesian exports and EU imports is actually relatively high. This indicates that with cooperation that will remove various barriers, the two economies will have more opportunities to reap the benefit from trade. Therefore, in the next section,

trade barriers and potential opportunities between Indonesia and the EU need to be discussed further in order to provide direction in optimizing trade performance between the two parties, particularly in the context of the IEU CEPA.

## BARRIERS TO TRADE IN GOODS BETWEEN INDONESIA AND THE EUROPEAN UNION

In relation to trade in goods, there are indeed some tariff and non-tariff barriers that make trade between Indonesia and the EU less efficient. Also, there are common issues for several products like palm oil and other extractive products that resulted in the ineffective role of international trade in supporting economic growth for both parties. This agreement also discusses new aspects that do not exist in other economic cooperation, for example related to environmental aspects which are briefly discussed in **Box 2.2.**

### Box 2.2 *Green Deals* and the Indonesia-EU CEPA

At the trade and investment working group meeting in Brussels in 2019, the Indonesian and European parties acknowledged that the IEU CEPA was a transformative agreement. There are many new aspects in this agreement that Indonesia has never discussed in other economic cooperation, one of which is environmental aspects. As the European Union society have a good understanding of environmental and climate issues, this is an important aspect and must be addressed. Of course, this cannot be separated from the dynamics of trade politics and environmental politics that have occurred in Europe.

In this regard, the European Union launched Green Deals which is a new growth strategy with the aim at creating a sustainable EU economy. One of the targets of this pact is to become carbon neutral by 2050. Green Deals offers an approach that matches the demand for goods and services with the necessity to reduce the consumption of natural resources and to minimize waste that pollutes the environment. In order to achieve this objective, the EU will encourage its economic sectors to adopt environmental-friendly production and technology, decarbonize, and raise global environmental standards.

This environmental aspect can be both an obstacle and an opportunity for economic and trade cooperation between the two parties. One of the conditions in which this aspect is an inhibiting factor is in the trade of palm oil commodities (see **Box 2.3**). In general, Indonesia faces challenges in implementing a green economy. The Indonesian Chamber of Commerce (KADIN) believes that business actors lack understanding of this issue and do not have sufficient capital and human resources to adopt efficient green technology. From a regulatory perspective, policy adjustments are needed to accommodate and provide incentives related to the circular economy model. However, the environmental aspects discussed in this agreement also present opportunities, such as the drive to create responsible and

sustainable trade. The policy pursued by the EU has implications for partner countries. The European Union has the ability to provide financial support and technical assistance on aspects related to the green economy. In Indonesia, the areas covered by EU-Indonesia technical cooperation and dialogue so far include ecosystems and biodiversity, low-pollution circular economy approaches, transportation and urbanization, and initiatives to reduce deforestation and land degradation.

`One example of a sector that has yet to realize its potential due to trade barriers is Indonesian fishery products. The EU is one of the main export destinations for Indonesian fishery products, besides the United States, China, Japan and ASEAN. The export contribution of Indonesian fishery products to the EU reaches 5.36 percent of the total export value of fishery products[10]. Some of the main export commodities of fishery products to the EU include shrimp, skipjack tuna, cuttlefish and octopus and seaweed. Unfortunately, these products are subject to relatively high import duties, reaching 4-7 percent for shrimp and 18.5-20.5 percent for tuna. The import duty tariff for Philippine fishery products to the EU is currently at 0%. In addition, Indonesian fishery products must also deal with non-tariff barriers, particularly related to quality and safety issues, sustainability, third party certification, and traceability.

When examined further, in the EU tariff structure, there are at least three aspects that need more attention. First, Most Favored Nation (MFN) which is used for each member of the WTO. The EU MFN average rates are high for a wide range of agricultural and food products ranging from 6-16 percent. In addition, tariffs are also relatively high for products that are highly competitive for Indonesia, such as textile and footwear products, which average 7-8 percent.

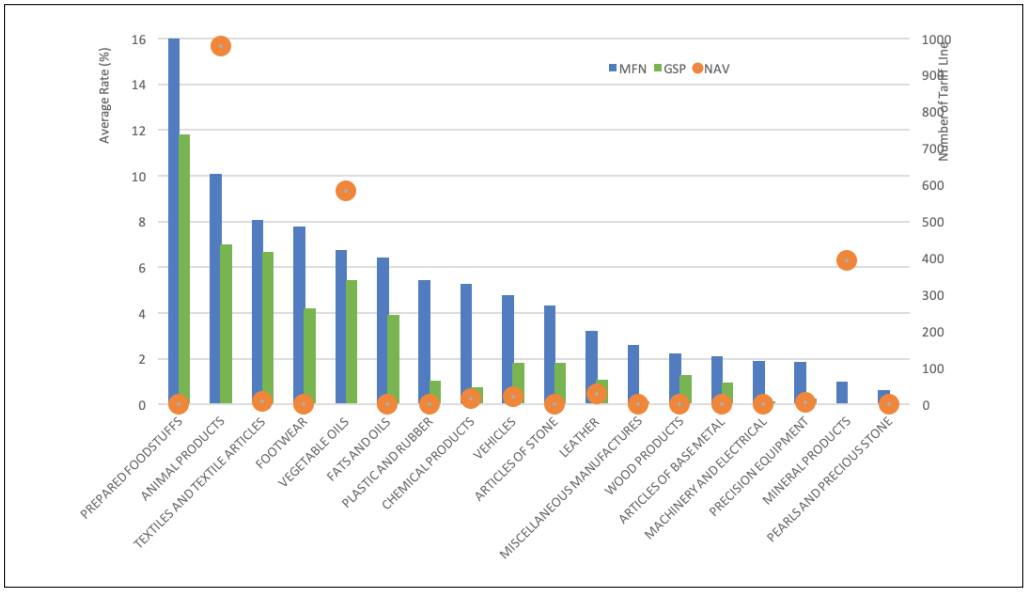
Second, the Generalized System of Preference (GSP), which is intended for developing and less developed countries, is lower than the MFN rate. The difference in rates can be as high as 30 percent as in the case for food products. In sectors such as minerals, the average GSP tariff is closer to 0%. However, GSP is relatively high in sectors that tend to be protected by the EU. GSP rates for many manufactured goods are also significantly lower. For Indonesian products, the EU applies MFN or GSP rates, depending on the development of the sector. This benefits Indonesia as well as encourages Indonesia to get ready for when the country will no longer be eligible to the GSP scheme.

Third, the Non-Ad Valorem (NAV) tariff, whose value is not set as a percentage of the price. This type of tariff is still commonly applied by the European Union for food products, which amount to more than 900 types of products (tariff lines). In addition, such tariff is mostly applied to agricultural products. This type of tariff needs a little more attention. The effect of NAV to trade is relatively higher than the regular ad-valorem ones, since it is not based on price and value of the products, but using other aspects, such as weight, length, or number of units. The effect is more significant to low-quality and low-priced products, which result in higher tariffs.

10 Based on information obtained from the Deputy for Maritime and Natural Resources, BAPPENAS

**Figure 2.7** shows the average MFN and GSP tariff rates from the European Union grouped at the HS Section level. This figure also provides information on the percentage of tariff lines that apply NAV.

Figure 2.7 European Union Tariff Structure 2019




Source: WITS (calculated)

In general, GSP plays an important role for Indonesian products in accessing the European Union. **Table 2.4** shows the proportion of EU imports from Indonesia that received GSP facilities to total EU imports during 2017-2019. As many as 42 percent of Indonesia's total exports use this facility. When animal and vegetable oil products (such as palm oil), which cannot obtain GSP, are excluded from the calculation, this proportion rises to 50 percent. This is much higher than the average utilization rate by other countries which is only 4 percent. The products that make the most use of this facility are footwear (91 percent) and leather (85 percent). However, it can also be seen that the use of GSP by some of Indonesia's leading products, such as textiles, seems to be decreasing. During 2017-2019, the average proportion of exports with GSP was 62 percent, decreasing from the 2010-2012 period of 98% percent (CSIS, 2015).

This indicates that Indonesia also needs to prepare an export strategy for the European Union market by taking into account the conditions without GSP that may occur in the next few years[11]. With the high dependence on GSP, Indonesia needs to seek other preferential import duties that are lower than MFN. Preferences based on reciprocity between Indonesia and the EU, as per the IEU CEPA, need to be encouraged so that the potential for trade in goods between the two parties will be maintained.

11 Since 2012 the European Union has set limits on exporting countries that can still receive GSP, namely countries classified as lower-middle income. Some developing countries that have "graduated" from this group no longer receive the GSP, such as Thailand in 2015.

Table 2.4 EU Imports from Indonesia (2017-2019 Average)

| HS SECTION | DESCRIPTION | INDONESIA | | OTHER COUNTRIES | |
|---|---|---|---|---|---|
| | | GSP (% TOTAL) | TOTAL IMPORT (€ Million) | GSP (% OF TOTAL) | TOTAL IMPORT (€ Million) |
| 1 | ANIMAL PRODUCTS | 79,61 | 195.69 | 10,26 | 26.856,16 |
| 2 | VEGETABLE PRODUCTS | 5,22 | 435,46 | 2,48 | 56.086,17 |
| 3 | FATS AND OIL | 0 | 2.188,12 | 9,49 | 9.041,98 |
| 4 | PREPARED FOODSTUFFS | 52,94 | 776,23 | 6,37 | 41.980,95 |
| 5 | MINERAL PRODUCTS | 0,1 | 578,31 | 0,01 | 343.450,45 |
| 6 | CHEMICAL PRODUCTS | 79,7 | 1.485,42 | 1,16 | 171.641,95 |
| 7 | PLASTIC AND RUBBER | 41,15 | 1.094,46 | 5,65 | 60.826,67 |
| 8 | LEATHER | 85,08 | 158,24 | 19,25 | 14.905,09 |
| 9 | WOOD PRODUCTS | 34,16 | 545,15 | 2,64 | 13.514,78 |
| 10 | PULP OF WOODS | 0 | 279,68 | 0 | 16.541,33 |
| 11 | TEXTILE AND TEXTILE ARTICLES | 62,33 | 1.578,94 | 31,06 | 111.942,86 |
| 12 | FOOTWEAR | 91,42 | 1.639,39 | 33,95 | 23.705,30 |
| 13 | ARTICLES OF STONE | 64,66 | 77,79 | 4,31 | 14.504,90 |
| 14 | PEARL AND PRECIOUS STONE | 53,69 | 52,61 | 0,12 | 79.273,62 |
| 15 | ARTICLE OF BASE METAL | 7,65 | 900,65 | 1,75 | 113.546,06 |
| 16 | MACHINERY AND ELECTRICAL | 36,03 | 2.103,71 | 1,14 | 442.589,24 |
| 17 | VEHICLES | 59,32 | 333,21 | 0,7 | 113.634,77 |
| 18 | PRECISION EQUIPMENT | 58,5 | 341,14 | 0,92 | 71.672,95 |
| 19 | ARMS AND AMMUNITION | 0 | 0,16 | 0 | 1.093,86 |
| 20 | MISCELLANEOUS MANUFACTURES | 31,06 | 652,56 | 2,62 | 50.058,40 |
| 21 | WORKS OF ART, ANTIQUITIES | 0 | 1,38 | 0 | 3.839,63 |
| | TOTAL | 42,32 | 15.418,30 | 3,87 | 1.780.707,12 |

Source: Eurostat (calculated)

Meanwhile, in terms of Non-Tariff (see **Table 2.5**), several issues regarding various requirements, such as, labeling inspection, product quality and performance, certification, and many other non-tariff components are, in a significant way, adversely affecting products from EU trading partners, including Indonesia. These substantive barriers need to be negotiated away so that trade activities between the EU and its trading partners can be more effective in driving economic growth in both markets.

Table 2.5 Non-*Tariff* Components Applied by the EU

| Measure | NTM Coverage Ratio | NTM Frequency Ratio | NTM-Affected Product Count | NTM-Affected Trade |
|---|---|---|---|---|
| Labelling Requirement (B310) | 72,79 | 70,37 | 3.645 | 1.375.659.312 |
| Inspection Requirement (B840) | 60,03 | 42,43 | 2.198 | 1.134.527.750 |
| Product Quality or Performance Requirement (B700) | 57,53 | 47,2 | 2.445 | 1.087.378.138 |
| Certification Requirement (B830) | 54,86 | 50,83 | 2.633 | 1.036.848.669 |
| Registration requirement for importers for TBT reasons (B150) | 50,87 | 30,5 | 1.580 | 961.370.007 |
| Prohibition for TBT reason (B110) | 42,83 | 32,92 | 1.705 | 809.568.778 |
| Authorization requirement for TBT reason (B140) | 37,51 | 34,81 | 1.803 | 709.022.463 |
| Testing Requirement (B820) | 36,55 | 35,39 | 1.833 | 690.703.488 |
| Packaging Requirement (B330) | 34,24 | 24,67 | 1.278 | 647.071.762 |
| Restricted use of certain substances (B220) | 30,74 | 29,34 | 1520 | 581,040,748 |

Source: WITS

The presence of these tariff and non-tariff barriers directly affects the performance of trade in goods between the two economies. Therefore, the IEU CEPA can be a starting point to at least reduce the existing barriers. Export diversification will also occur if trade barriers can be reduced. The comparative advantage between the two parties, which has tended to be static, can be directed into a more dynamic comparative advantage by reducing trade barriers.

## COMPETITIVENESS OF INDONESIA'S PRODUCTS

One important aspect for higher export diversification is competitiveness. This section will look at the level of competitiveness of Indonesian products, as well as the possibility for further improvement. The analysis will look at Indonesia's comparative advantage with the pattern of trade with the EU as a background. The comparative advantage does not imply there is no opportunity to diversify trade in the future, especially for Indonesia which wants to encourage exports of high-value processed products. Therefore, the analysis carried out also looks at how the IEU CEPA may provide an opportunity to increase Indonesia's export diversification.

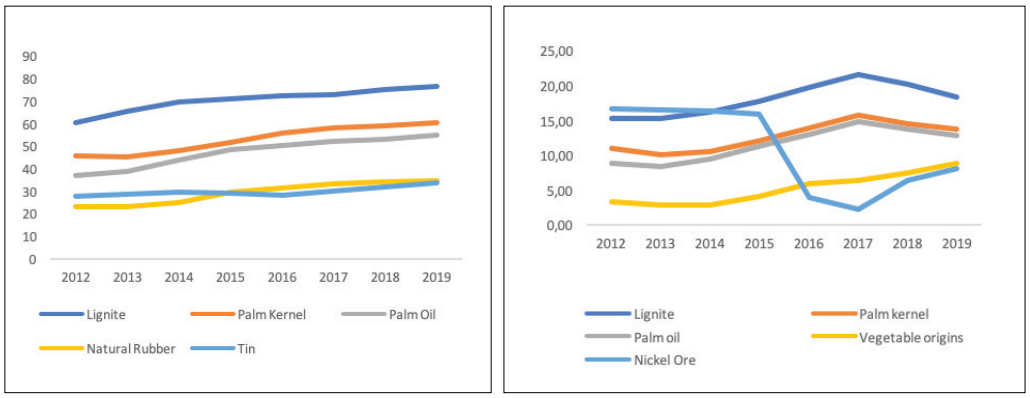
### Revealed Comparative Advantage (RCA)

To understand the competitiveness of Indonesian and EU products, this study calculates the Revealed Comparative Advantage (RCA) index. This indicator compares how important a product is in a country's export basket to the world market. If the RCA index for a certain product is greater than one, it means that Indonesia's share of exports for that product is higher than the exports of other countries for the same product. Generally, if a product has a

comparative advantage or has an RCA value of more than 1, it can be said that the product is competitive in the world market.

As shown in the left-hand panel of **Figure 2.9**, the RCA value of Indonesia's and EU's leading products tends to increase even though the magnitude is insignificant. Indonesia's most competitive export products in the global market are coal, palm oil products, rubber and tin. The increase in the RCA index indicates that, in terms of trade value, these products are experiencing an increase in the market share every year. It can be seen here that the pattern of Indonesian trade tends to follow the pattern of its comparative advantage. Palm oil, which accounts for about 11 percent of Indonesia's trade, has a high comparative advantage value, around 40. Similar for other products such as coal, rubber and tin.

Figure 2.8 RCA Trend of Indonesian Products Based on Trade Value and Volume




Source: WITS (calculated)

This observation is supported by looking at patterns of comparative advantage based on trading volume. Productivity is not the only main driver of competitiveness; another factor that may affect competitiveness is price (price effect). The calculation of RCA using the trading volume is an attempt to adjust the price effect. The results of the calculation of the RCA indicator based on net weight or volume are illustrated in the right panel of **Figure 2.9**. We can see that by taking the price factor into account, the analysis gives the same result. Palm oil as well as coal remain products with high comparative advantages.

When calculated using volume, Indonesia's more competitive products belong to the primary sector. This indicates that Indonesia is dependent on commodity exports. Furthermore, the RCA index based on trading value is higher than the calculation by volume. In general, this implies that the increase in the share of Indonesian exports to the world in terms of value is due to a price effect rather than an increase in competitiveness.

Although the RCA index is very good at providing an overview of competitiveness in the global market, this indicator fails to capture the competitiveness of Indonesian exports in the EU market. Therefore, this study is also complemented by calculations using Constant Market Share Analysis (CMSA) to observe the competitiveness of exports from other countries.

### Constant Market Share Analysis

CMSA is a trade analysis that provides information about the competitiveness of the country or region being analyzed (Tyszynski, 1951; Zebregs, 2004; Athanasoglou et al., 2010). With CMSA, trade value can be decomposed based on four criteria: competitiveness

effect, regional/market effect, product/commodity effect, and adaptation effect or world growth (Leamer and Stern, 1970; Gilbert, 2010; Spence and Karingi, 2011).

**Table 2.6** provides a brief description of CMS analysis. By decomposing trade value, several conclusions can be drawn regarding trade and product competitiveness. Furthermore, this analysis can provide insight at the product level. The results of the CMSA analysis for each product can be grouped into four categories which can be placed in four quadrants as shown in Figure 2.10. This assessment is based on the level of product competitiveness (horizontal axis) and trade growth (vertical axis), which shows the growth in demand in the world which is calculated based on the growth in the value of world exports to the EU market.

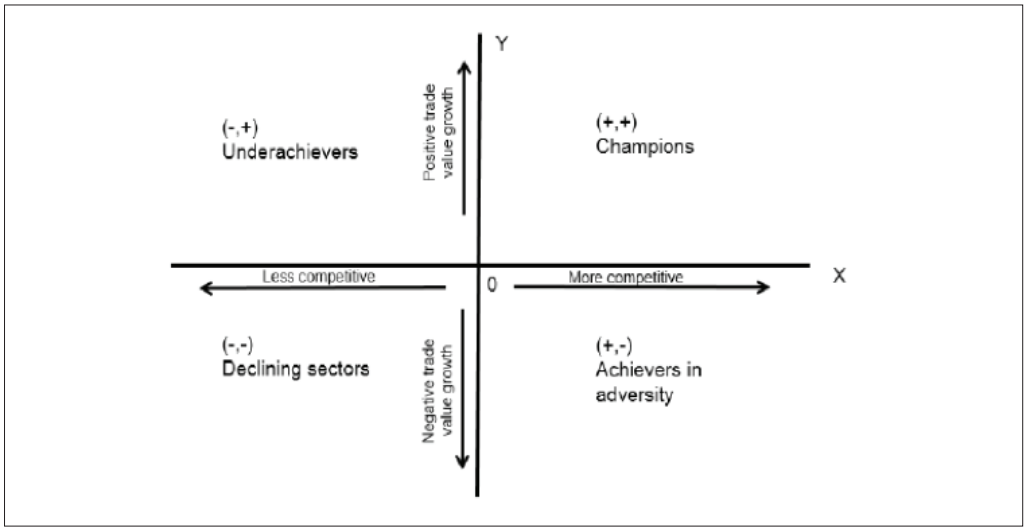
Table 2.6 Brief Description on Constant Market Share Analysis (CMSA)

| **Effects** | **+** | **-** |
|---|---|---|
| Competitiveness Effect | The certain product is competitive | The certain product is not competitive |
| Initial Effect | | |
| Country Effect | Positive demand of certain product because of the high demand from the specific country or region | Negative demand of certain product because of the low demand from the specific country or region |
| Product Effect | Positive demand of certain product because of the high demand from the world as a whole | Negative demands of certain product because of the low demands from the world as a whole |
| Adaptation Effect | Positive response or adaptation | Negative response or adaptation |

Source: Adapted from various sources

If a product is in quadrant 1, where the competitiveness is high with positive trade growth, then the product can be categorized as a champion. If it is in quadrant 2, the product can be categorized as underachievers because it is less competitive despite having a positive growth in trading value. Products in quadrant 3 can be categorized as declining sectors, which are less competitive, and have negative growth in trade values. Quadrant 4 contains achievers in adversity products with competitive characteristics but negative trade value growth.

Figure 2.9 Product Classifications based on CMSA Analysis




Source: International *Trade* Centre (ITC)

The results of the CMSA analysis are presented in **Table 2.7** by providing a summary of the 20 largest Indonesian products (classified based on the 4-digit SITC) in the world market and the EU market. From the composition, it can be seen that there are similarities between Indonesian products that are traded on the world market and the EU market. This similarity is especially evident in the 5 top products, most of which are products from the primary sector, such as palm oil products, coal products, rubber and tin.

**Table 2.7** also shows that of Indonesia's 20 leading export products, the majority are competitive products with low demand growth in the EU or world markets. For example, palm oil and rubber are in the achievers in adversity category. There are also Indonesian products that are highly competitive and experienced high increase in demand, such as palm oil kernel and tin, which are Indonesian champions products in the European Union. In addition, there are Indonesian products that are in high demand, but are not competitive. Examples of these products are sports footwear and furniture which fall under the under-achiever category for the EU. One of the factors that can explain why they are not competitive products are the existence of trade barriers, both those imposed from within the country or those applied in destination markets as described in the previous section.

There are also Indonesian exports that are not competitive and with a low demand growth. These products are classified as the declining sectors, such as tin ore and coal in the EU market. For products in the declining sector category, there are at least two strategic options that can be pursued. First, the government can gradually encourage a shift to champion products. This is because world demand for goods in the declining sector will most certainly further decline as Indonesia is not competitive in this category. This condition is known as the sunset industry. Second, the government can pay extra attention to these products. For example, by examining whether the decline conditions occurred due to market access barriers and whether the barriers come from within the country or the European Union. In-depth observation is needed if products in this category are to be developed because from the side of competitiveness and demand, these products are disadvantaged. Nevertheless, the picture presented here is based on a highly selective industry (top 20 exports by 4-digit SITC product classification) in the competitiveness-demand growth matrix. More detailed analysis of each industry is beyond the scope of this study.

Table 2.7 Top 20 Indonesian Products in (a) World Market and (b) EU Market

World Market

| | Low Demand Growth | High Demand Growth |
|---|---|---|
| | **Achievers in Adversity** | **Champions** |
| **Competitive** | Palm oil and its fractions | Lignite, whether or not pulverized |
| | Natural rubber (other than latex) | Palm kernel or babassu oild and frac |
| | Tin and tin alloys, unwrought | Chemical wood pulp, soda or sulphat |
| | Acyclic monohydric alcohols | Copper ores & concentrates |
| | Paper and paperboard | Motor vehicles for the transport of persons |
| | Natural gas, in the gaseous state | Other parts and accessories of the motor vehicles of groups |
| | Jewellery of gold, silver or platin | |
| | Crude petroleum | |
| | Gold, non- monetary | |
| | Crustaceans, frozen | |
| **Less Competitive** | **Declining Sectors** | **Underachievers** |
| | Natural gas, liquefied | Other coal |
| | | Sports footwear |
| | | Plywood, veneered panels and similar laminated wood |

EU Market

| | Low Demand Growth | High Demand Growth |
|---|---|---|
| | **Achievers in Adversity** | **Champions** |
| **Competitive** | Palm oil and itsd fractions | Palm kernel or babassu oild and frac |
| | Natural rubber (other than latex) | Tin and tin alloys, unwrought |
| | Yarn (other than sewing thread) of staple fibres | Cocoa butter, fat/oil |
| | Acyclic monohydric alcohols | Builders' joinery and carpentry of wood |
| | Monocarboxylic acids and their derivatives | Chemical products and preparations |
| | Other footwear with uppers of leath | |
| | Oil-cake and other solid residues | |
| | Other office machines | |
| **Less Competitive** | **Declining Sectors** | **Underachievers** |
| | Copper ores & concentrates | Sports footwear |
| | Coffee, not roasted | Furniture, n.e.s., of wood |
| | Other coal | Seats |
| | Reception apparatus of television | |

Source: WITS (calculated)

## IEU CEPA AND TRADE BETWEEN THE TWO ECONOMIES

The CEPA between the two economies will bring potential improvements in trade, especially since there is a high level of complementarity. One reason behind the difficulties in realizing the potential opportunities are the relatively high trade barriers. With the CEPA, it is expected that these obstacles will be reduced to optimize the benefits of cooperation.

### Indonesia's Export Potential to the EU

The analysis of the export potential in this study is based on the analytical tool developed by the International Trade Center (ITC). This approach consists of an export potential indicator (EPI) and a product diversification indicator (PDI). These indicators are conceptually based on the relationship between trade, supply, demand, and trade barriers. Export potential will also be discussed using a simulation with an economic model which will be further elaborated in Chapter 5 of this study.

Based on the Export Potential Indicator, Indonesia's export potential is still dominated by commodities from the primary sector. As shown in **Table 2.8**, Indonesia's greatest potential to the EU and Western Europe is palm oil and its derivatives, crude palm oil, and rubber. Palm oil products and derivatives have the largest absolute difference between export potential and actual exports in terms of trade value, leaving room for additional exports of USD 8.4 billion. Then followed by crude palm oil and rubber in the amount of USD 2.7-2.8 billion. Motor vehicle products also have considerable potential and there is room for USD 3 billion.

Table 2.8 Indonesia's Potential Exports to the EU and Western Europe (in USD billions)

| No | Product | Export Potential | Actual Export | Untapped Potential |
|---|---|---|---|---|
| 1 | Palm oil (excl. crude & fractions) | 20,8 | 12,4 | 8,4 |
| 2 | Crude palm oil | 6,8 | 4,3 | 2,7 |
| 3 | Technically specified rubber | 6,3 | 4,2 | 2,8 |
| 4 | Palm kernel & babassu oil | 2,5 | 1,5 | 0,9 |
| 5 | Newsprint & uncoated paper (-board) | 3,6 | 2,3 | 1,5 |
| 6 | Chemical wood pulp. soda/sulphate | 3,3 | 2,1 | 1,3 |
| 7 | Motor vehicles for the transport of persons | 4,5 | 2,9 | 3 |
| 8 | Unwrought tin | 3,4 | 1,7 | 1,7 |
| 9 | Fatty acids | 3,2 | 1,7 | 1,5 |
| 10 | Footwear, rubber/plastic soles | 2,6 | 1,8 | 1 |

Source: ITC Export Potential Map

The table above also confirms the results obtained from the calculation of RCA and CMSA, where Indonesia's export potential is limited to a number of products in the primary sector, where Indonesia has high competitiveness. It is one of the reasons why Indonesia needs to diversify its export products. It is important to remember that if the products a country exports tend to be limited, exports from that country will be vulnerable to external shocks.

The tendency of Indonesia's exports to be concentrated in primary commodities indicates the increasing importance to diversify. This becomes particularly important considering that some of Indonesia's major exports encounter problems in the EU, as palm oil

(See **Box 2.3**). For this reason, it is also necessary to identify products which have export potential.

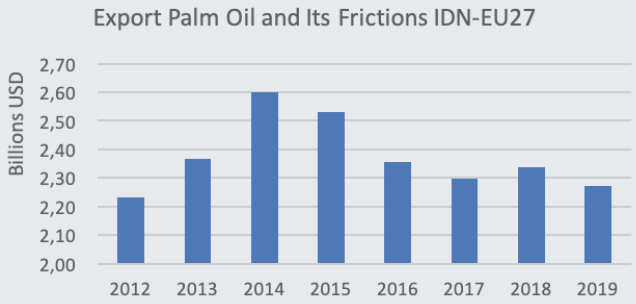
There are several factors related to diversification. One is to consider the domestic production capability for the product under consideration. This can be done by looking at whether the potential product and the old product are in one product space[12]. In addition, diversification opportunities might also depend on potential demand in export destinations. Apart from the demand aspect, this potential is also influenced by trade policies in the destination country such as import duties. The implication is that the list of potential products varies in each export destination market.

12 Product space is a concept developed by Ricardo Hausman and Cesar Hidalgo. The concept builds linkages between products by assessing how often these products are in the export baskets of countries.

### Box 2.3 The Future of Indonesian Palm Oil Exports to the European Union

As a strategic commodity, palm oil is demanded by various industrial sectors such as in the manufacture of cooking oil, cosmetic products, and biodiesel. Indonesia is the world's leading producer of palm oil, meeting more than half of global demand. About 15 percent of Indonesia's palm oil exports go to the European Union (Widyasanti and Yusuf, 2019). Trade statistics show that since 2014, Indonesia's palm oil exports to the European Union have suffered a downward trend (see **Figure 2.11**). On average, Indonesia's palm oil exports to the European Union in 2017-2019 decreased by 13 percent or the equivalent of USD 327 million from the 2012-2013 period. In the last five years, the main importers of Indonesian palm products were Spain, the Netherlands and Italy, where the value of palm oil exports to these countries ranged from USD 405-555 million in 2019.

Figure 2.10 Indonesia's Palm Oil Exports 2011-2018




Source: WITS, calculated (moving average)

Unfortunately, Indonesia's palm oil exports to the EU encounter a downside risk following the Renewable Energy Directive (RED II) regulation issued by the EU Parliament in January 2018.This regulation calls for a complete halt to palm oil by 2021 for renewable energy targets due to concerns over Indirect Land Use Changes (ILUC) in palm oil production. The volatility in the export of palm oil products is not only related to environmental issues, but also to government involvement. The highly competitive level of palm oil prices is accused of being the result of subsidies by the government. According to a report in Warta Ekonomi (2020), the European Union's lawsuit at the WTO regarding this matter has not been proven.

The complexity of the palm oil issue is requires further discussions and prompts questions about its potential future impact. Widyasanti and Yusuf (2019) estimate the impact of the EU palm oil import ban on the Indonesian economy. With this policy, Indonesia's world palm oil trade will fall by 2 percent. More specifically, Indonesia's palm oil exports will decrease by 7 percent and total exports by 0.06 percent. Regionally, the most affected provinces will be

Riau and Central Kalimantan, respectively, experiencing a decrease in Gross Regional Domestic Product (GRDP) by 0.3 and 0.4 percent. Even though the impact on the national GDP is relatively low, the potential import ban encourages Indonesia to actively diversify exports to Asia and Africa, and also to encourage diversification of exports as a whole.

One way to identify potential products for export diversification is through the Product Diversification Indicator (IDP) approach. This indicator looks at the extensive product margin. The IDP method identifies products that have not been exported competitively by an economy but have the potential to be developed because of the similarity to other products in the current export basket, both in that economy and in similar economies. This method was developed by the International Trade Center (ITC)[13]. Since we utilize the results of ITC calculations, the classification of products and market areas follows the data provided by ITC.

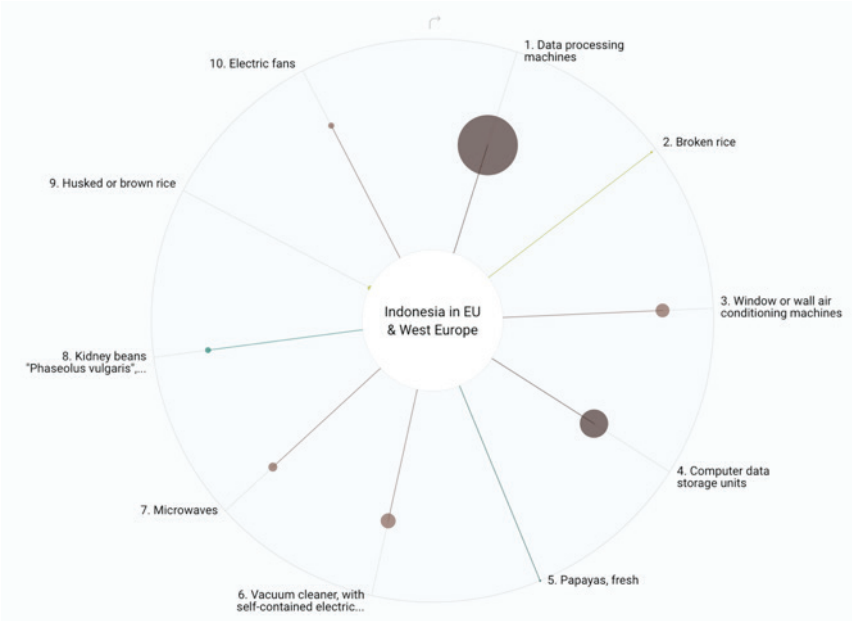
The calculation identifies a number of Indonesian products that have the potential for export diversification in the European Union. **Figure 2.12** illustrates 10 main products that can be diversified[14]. In order to understand this figure, there are several features that need to be understood, such as the size of the circle and the length of the line. The size of the circle reflects the size of the demand, which is a combination of projected import value and factors affecting the openness of destination markets to products exported by Indonesia. Meanwhile, the length of the line illustrates Indonesia's supply or capacity conditions. It reflects the relative proximity of the new product, in the product space, to one of the country's export products in which it has a comparative advantage.

Based on production capacity, Indonesia's agricultural and manufactured products are relatively easy to diversify. This can be seen from the relatively long line that reflects the closer proximity or similarity to the Indonesian export basket at this time. For example, the products most easily accessible to Indonesia are broken rice and papaya. These products are relatively easy to produce by Indonesia and are similar to the country's existing export products that have comparative advantages. Meanwhile, the products with the highest potential demand (reflected by the size of the largest circle) in the EU are related to data processing. The EU is estimated to have a large demand for data processing machines and computer data storage units.

13 For a further explanation of the methodology please see Decreux and Spice (2016).

14 https://exportpotential.intracen.org/en/products/diversification?fromMarker=i&exporter=360&toMarker=r&market=4&whatMarker=k accessed January 6, 2021. Data updating is done by ITC Export Map twice a year.

Figure 2.11 Potential Diversification Options for Indonesian Products in EU and Western European Markets




Source: ITC Potential Export Map

This analysis provides an overview of Indonesia's export potential based on the proximity of production and potential demand in the European Union. From the policy and strategic point of view, it will be more appropriate if the production is aligned with the existing potential demand. It should be noted that efforts to increase diversification do not imply the government should implement protective policies on certain commodities. On the other hand, the government has to provide appropriate policies to encourage the export of a product by improving its competitiveness. The trade agreement between Indonesia and the European Union will provide support for efforts to adjust Indonesia's production structure by increasing industrial productivity and competitiveness.

## Potential Impact of the IEU CEPA on Indonesian Imports

The Indonesia - EU cooperation will not only have an impact on the export side, but also on Indonesia's imports. Import aspect is important to discuss because there are concerns that the IEU CEPA will harm domestic business actors. However, the discussions and interviews with stakeholders during the study suggest the opposite. Businesspeople are not worried that this cooperation will bring competition from imports. On the contrary, business tend to see the agreement as an opportunity to increase access to quality inputs and capital, which are necessary to increase the productivity and competitiveness of Indonesia's exports.

### *Inputs Availability*

As discussed in the previous section, Indonesia and EU have different comparative advantages, which means goods traded between the two are complementary. in particular, Indonesia and the EU have different comparative advantages in agricultural products, where Indonesia is more inclined towards the plantation sector, while the EU is more towards

horticulture and livestock. Cheaper inputs from EU countries should be more profitable for the agricultural sector in Indonesia. Products such as soybeans, wheat, milk and animal feed are among commodities imported from the European Union for the development of domestic export-oriented food industries.

The availability of these inputs benefits not only the agricultural sector, but also the manufacturing sector. In general, multinational companies consider the difficulty in obtaining intermediate inputs as one of the main obstacles they face in Indonesia (JETRO, 2020). From the European Union, Indonesia imports capital goods needed in the manufacturing industry.

IEU CEPA also provides an opportunity for transfer of technology and to increase the competitiveness of Indonesian products, especially capital goods for the manufacturing sector. EU products tend to be of higher quality with higher price. The availability of such products is expected to improve the quality of domestic production and support several leading Indonesian industries, including chemicals, machinery, automotive and food. The IEU CEPA will also allow Indonesia to diversify the sources of inputs for domestic production and reduce its dependence on other countries, such as China.

*Competition from Imports*

From discussions with stakeholders for this study, it emerged that domestic business actors are not concerned about the IEU CEPA. This is due to differences in comparative advantages between domestic products and products imported from the EU, as well as high complementarity. Product differentiation and prices of EU products that tend to be more expensive for domestic consumers let domestic business actors to perceive that there are market differences between their products and those imported from the EU.

In general, domestic business actors expect improvements in trade facilitation and regulations, as well as better information regarding trade potential, from both Indonesia and the European Union. This expectation is voiced by both export-oriented businesses and businesses who use materials from abroad intensively. Meanwhile, businesses that produce similar products to those imported, hope that the government will be able to help improving the competitiveness of the domestic industry.

One concern from domestic business actors is related to logistics and transportation costs. Improvements in the quality of infrastructure, both in Java and in other islands, must be carried out equally. This is important to provide market access to the widest possible region and encourage an increase in the volume and value of domestic trade. Apart from infrastructure, the availability of services that support production is also very important in an effort to increase competitiveness. The next chapter will assess how the IEU CEPA will facilitate trade in services that have the potential to support competitiveness of Indonesian industries and products.

# 3.

# TRADE IN SERVICES BETWEEN INDONESIA AND THE EUROPEAN UNION

THE AGREEMENT ON trade in services is another important part of the IEU CEPA. The service sector, such as financial services, communications, transportation, trade, business services as well as tourism, has become an increasingly important part of the economy and international trade. Trade in services at the global level is estimated to have reached 7% of world GDP with growth reaching more than 7% per year before the pandemic period. This is higher than the growth of trade in goods. Following the pandemic, trade in service suffered a decline of up to 30% in the second quarter of 2020 compared to the same quarter in the previous year[15], especially due to declining tourism and restrictions in mobility. Meanwhile, trade through digital platforms has shown the most significant increase.

The agreement is expected to facilitate trade in services activities between the EU countries and Indonesia, in four different ways. First, the agreement will provide wider market access for the flow of services across borders between the two economies. Second, the agreement will provide greater flexibility for investment in the services sectors. Third, the agreement should facilitate and provide for a greater freedom of movement of individual service providers, whether related to companies or natural persons, from one economy to another. Fourth, this agreement is expected to create a better service sector regulatory framework by considering various transparency principles and avoiding practices that are burdensome to businesses.

This chapter discusses several aspects of the services agreement in the IEU CEPA by looking at the potential use of trade in services from an Indonesian perspective. Sections A and B discuss the role of services in fostering Indonesian economic activities and their contributions to the country's economy. Section C discusses the patterns of trade in service between Indonesia and the European Union and how trade in services can increase competitiveness, while Section D discusses various barriers to Indonesia's trade in services. Finally, Section E explores several issues pertaining service sector policies in Indonesia and challenges in the IEU CEPA agreement.

## THE ROLE OF SERVICES IN THE INDONESIAN ECONOMY

The role and contribution of the service sector in the Indonesian economy can be perceived from four different but related perspectives. The first aspect is the service sector's contribution to value-added creation in the economy, which is reflected in its contribution to GDP. In line with the progress of the Indonesian economy, the proportion of the services sector in GDP continued to increase. Since the early 2000s, the contribution of the services sector to GDP has been steadily increasing from 45% of GDP to 55% of GDP in recent years.

15 https://www.wto.org/english/news_e/news20_e/serv_22oct20_e.htm#:~:text=SERVICES-,Services%20trade%20drops%2030%25%20in%20Q2%20as%20COVID%2D19%20ravages,COVID%2D19%20and%20associated%20restrictions

The second aspect is its contribution to employment. Currently 55% of the Indonesian workforce work in various service sectors, a significant increase from less than 45% two decades ago. In addition to the increase, there has also been a shift in the workforce towards more productive sectors, such as financial, telecommunications, professional and business sectors, along with the rising demand for such services.

The third aspect of the services sector's contribution relates to its role in supporting activities in other economic sectors. This aspect becomes very important, because as the economy develops, economic activity will become more dependent on the quality and reliability of services. The agreement will ensure the availability of various services that are necessary but cannot be provided by domestic providers.

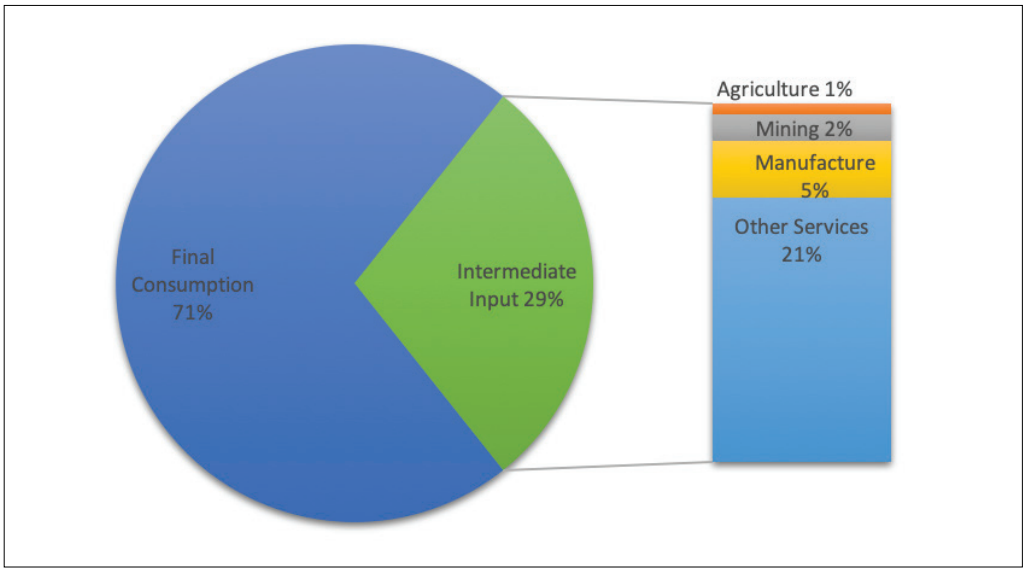
The fourth aspect of the service sector's contribution is tradable services. With massive increase in international trade accompanied by technological developments, services can no longer be considered as non-tradable goods. Highly competitive export of services can increase Indonesia's trade balance and current account.

This chapter attempts to look at the last two contributions. i.e., services in support of economic growth and in supporting trade, in an in-depth manner.

## SERVICES AS INPUTS IN ECONOMICS ACTIVITIES

Output from the service sector can be used directly as final consumption (without the need for further processing), or as input for other economic activities. Using the Input-Output (IO) Table of the Indonesian economy, we can see that 29% of the demand for services comes from sectors involved in production (Figure 3.1), while 71% of the demand of services comes from final consumers. The sector that uses the most services is the services sector itself which absorbs 21%, followed by manufacturing.

Figure 3.1 Output Proportion of Services Sector According to the Usage Type and Users




Source: Central Statistics Agency (BPS)

The portion of services used as intermediate input in production tends to be low relative to other countries in the region. In Thailand nearly 39% of services is used as intermediate input. In Malaysia, this figure reaches 45% while in China, 50% of services are used as intermediate inputs for other production[16].

There are several possible reasons that may explain the low proportion of the country's services used as intermediate input. On the one hand, this may indicate that most of the services produced in Indonesia are intended for end use by consumers. Note that the types of services used in production are usually different from those demanded by final consumers. In addition, the quality of services used as intermediate inputs in the production sector (industry grade services) tends to be higher. Note further that the productivity of companies offering industry grade services is also usually higher than the productivity of those offering consumer grade services.

The above claim is supported by the fact that a relatively high proportion of imported services are used as intermediate inputs. Approximately 62% of imported services are used as intermediate products, while only 38% are for final consumption. This indicates that the contribution of Indonesia's service sector to economic activity tends to be lower than that of its peers.

On the other hand, the low utilization rate of services in production also indicates that production sectors that require services are underdeveloped. A rapidly developing economy will increasingly need high quality services. Eichengreen and Gupta (2009) show that there are two waves of development in the service sector in various economies, where the second wave occurs in more developed countries due to the need to support the growth of various other sectors. Using the input-output linkages model, Lee and McKibbin (2014) show that productivity growth in the services sector encourages the development of other sectors in Asian economies.

To see in more detail the demand for services in the Indonesian economy, we use two indicators calculated using the Indonesian Input-Output Table 2010. Here we analyse several indicators based on total transactions at the base price for each sector in the Input-Output Table, such as total demand (code 3100), export of goods (code 3050), and export of services (code 3060). Domestic demand is obtained by eliminating the export component from the total demand. Furthermore, domestic output is defined as domestic production recorded in the component coded 7000. Thus, the proportion of domestic demand can be obtained by comparing the two values, as reflected in the following formula. If the value is greater than 100, then the sector is experiencing excess demand. Meanwhile, if the value is less than 100, then the sector is experiencing excess supply.

$$Proportion\ of\ Domestic\ Demand = \frac{Domestic\ Demand}{Domestic\ Output} \times 100\%$$

In addition, we also show how the service sector output becomes an input for other sectors. This is known as forward linkage (FL) which is the inverse of backward linkage and can be calculated using the equation below, where FL is the total value of forward linkage of the sector  product and  is the Leontief input-output coefficient. As sector with the total

16 This service sector proportion figure is calculated using the Input Output Table provided by the OECD, https://stats.oecd.org/Index.aspx?DataSetCode=IOTS

value of forward linkage (FL) of more than 1 indicates there is a high linkage between that particular sector and other sectors that use its product as an input in their production.

$$FL_i = \sum_{j=1}^{n} a_{ij} - 1$$

FL reflects the extent to which a sector's output is used by other sectors as input. It is a measure of how much the total value of output in all sectors will incase as a result of a per unit increase in the price of primary input in a certain sector. FL can also be interpreted as an effect of increasing costs. Any change in input cost of a particular sector will be transmitted throughout the economy and will ultimately change prices of the users' products as well. For example, with an FL of 2.2, an increase in costs of Rp.1000 in the banking financial sector will increase costs in all user sectors by Rp.2200. The more efficient the service sector with high forward linkage will further increase the competitiveness of the economy.

Table 3.1 shows the conditions of demand, supply, and forward linkage of 44 service sectors included in Indonesia's Input-Output Table. Out of 44 sectors, 23 experience excess demand, where the value of domestic demand is greater than domestic production, so imports of these services were necessary. Services that face the highest excess demand are environmental services and aircraft, which, respectively, reach 27- and 12-times domestic production.

This is in line with what has been explained above, that imported services tend to be used as intermediate inputs, especially for services which are in short supply domestically.

Table 3.1 Demand, Supply and *Forward Linkage* of Indonesia's Services Sector

| No | Sector | Proportion of Domestic Demand | Status | Total Forward Linkage |
|---|---|---|---|---|
| 1 | Land Transportation Services Apart from Rail Transportation | 100.18 | Excess Demand | 2.646 |
| 2 | Banking Financial Services | 102.16 | Excess Demand | 2.213 |
| 3 | Building & Installation of Electricity, Gas, Drinking Water and Communications | 100.02 | Excess Demand | 1.381 |
| 4 | Professional, Scientific and Technical Services | 113.19 | Excess Demand | 1.264 |
| 5 | Other Financial Services | 100.29 | Excess Demand | 1.201 |
| 6 | Broadcasting and programming services, films and sound recordings | 112.32 | Excess Demand | 1.152 |
| 7 | Computer and information technology consulting services | 110.76 | Excess Demand | 1.086 |
| 8 | Agriculture, Forestry and Fisheries Services | 100.01 | Excess Demand | 1.071 |
| 9 | Insurance services | 109.85 | Excess Demand | 1.020 |
| 10 | Agricultural Infrastructure | 100.10 | Excess Demand | 1.015 |
| 11 | Public Government Services | 100.09 | Excess Demand | 0.957 |
| 12 | Residential and Non-Residential Buildings | 100.07 | Excess Demand | 0.937 |
| 13 | Provision of Accommodation | 110.29 | Excess Demand | 0.881 |
| 14 | Transportation Support Services | 100.96 | Excess Demand | 0.849 |
| 15 | Air Freight Services | 105.07 | Excess Demand | 0.819 |
| 16 | Real Estate Services | 100.58 | Excess Demand | 0.787 |
| 17 | Ships and Repair Services | 181.25 | Excess Demand | 0.748 |
| 18 | Health Services & Private Social Activities | 103.26 | Excess Demand | 0.707 |
| 19 | Train and Repair Services | 188.00 | Excess Demand | 0.650 |
| 20 | Private Education Services | 101.72 | Excess Demand | 0.607 |
| 21 | Aircraft and Repair Services | 1245.77 | Excess Demand | 0.594 |
| 22 | Rail Transportation Services | 105.29 | Excess Demand | 0.538 |
| 23 | Waste, Waste and Recycling Management | 2782.73 | Excess Demand | 0.523 |

| | | | | |
|---|---|---|---|---|
| 24 | Maintenance and repair services for manufactured metal products, machines and equipment | 100.00 | Balance | 0.653 |
| 25 | Repair of Household and Other Personal Items | 100.00 | Balance | 0.561 |
| 26 | Pension Fund Services | 100.00 | Balance | 0.682 |
| 27 | Road, Bridge and Harbor | 100.00 | Balance | 0.657 |
| 28 | Other Buildings | 100.00 | Balance | 0.575 |
| 29 | Oil and natural gas mining services | 100.00 | Balance | 0.616 |
| 30 | Mining and other excavation services | 100.00 | Balance | 0.895 |
| 31 | Car and Motorcycle Repair and Maintenance | 100.00 | Balance | 1.091 |
| 32 | Government Education Services | 99.87 | Excess Supply | 0.531 |
| 33 | Other Services | 99.71 | Excess Supply | 0.847 |
| 34 | Government Health Services | 99.61 | Excess Supply | 0.534 |
| 35 | Provision of Food and Drink | 99.58 | Excess Supply | 0.969 |
| 36 | Other Government Services | 98.95 | Excess Supply | 0.515 |
| 37 | Telecommunication Services | 98.87 | Excess Supply | 1.783 |
| 38 | River Lake and Ferry Transportation Services | 98.02 | Excess Supply | 0.633 |
| 39 | Arts, Entertainment and Recreation Services | 95.71 | Excess Supply | 0.635 |
| 40 | Rental Services and Business Support Services | 93.57 | Excess Supply | 1.708 |
| 41 | Sea Freight Services | 92.53 | Excess Supply | 0.699 |
| 42 | Postal and Courier Services | 88.50 | Excess Supply | 0.599 |
| 43 | Car and Motorcycle Trade | 84.50 | Excess Supply | 1.273 |
| 44 | Trade other than cars and motorbikes | 84.50 | Excess Supply | 7.192 |

Source: Author's Calculation based on ***Input-Output*** BPS 2010

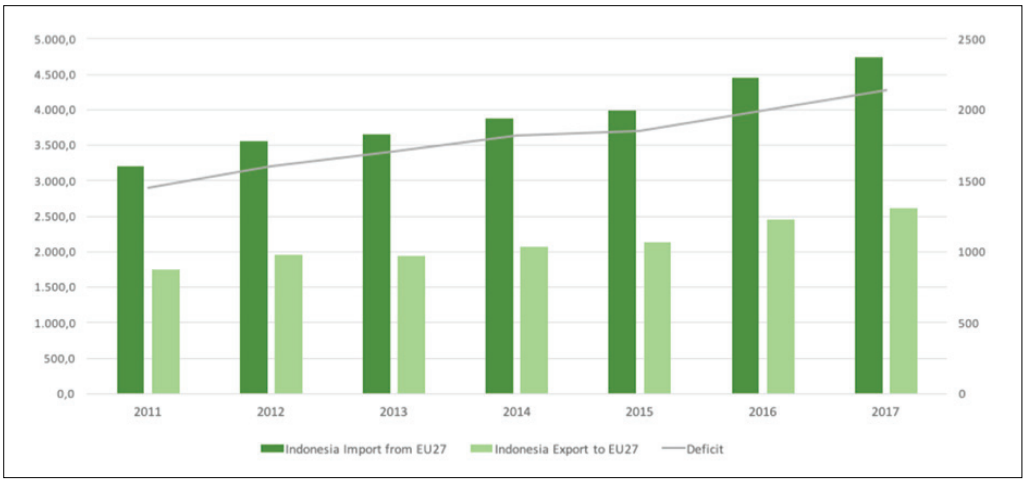
Furthermore, 10 out of 23 sectors with high demand have a significant role as input providers for other sectors. This is manifested in the FL value of more than 1. Land transportation services other than rail transportation and financial services have the highest forward linkages, namely 2.6 and 2.2, respectively. Professional and business services, which also have a high FL value, are not sufficiently available domestically.

Imports of various services are needed in order to support activities in other production sectors. The high barriers to imports of services will inevitably have adverse implications on the productivity of those sectors. This paper discusses the various barriers to trade in these services. But we will first discuss the role of the services sector in trade.

## TRADE IN SERVICES AND THE ROLE OF SERVICE SECTOR IN TRADE

Apart from trade in goods, trade in services is also an important aspect of economic relations between Indonesia and the European Union. Indonesia has consistently been a net importer with the EU in terms of trade in services. Based on Figure 3.2, both the value of EU service exports to Indonesia and the value of EU service imports from Indonesia have increased since 2011, although during the 2011-2017 period, Indonesia had a deficit.

Figure 3.2 EU-Indonesia Services Balance, 2011-2017




Source: Eurostat

Meanwhile, Table 3.2 shows that during the 2012-2018 period, Indonesia was able to record a surplus in the travel as well as legal and management services. The trade surplus in the travel sector was in the range of €590 million - €1.2 billion, while in the legal and management services sector it was €90 million - €200 million. However, Indonesia tends to depend on several services originating from the EU, including transportation, communications, computer and information technology, finance and other services sectors. In 2018, the largest deficit occurred in others service sector including research and development services, professional and management consulting services, operating leasing, trade-related services, and other business services.

Table 3.2 Export of Indonesia's Services to the EU, 2012-2018

| Service Sectors | Net Export of Indonesia to EU (in million Euro) | | | |
|---|---|---|---|---|
| | 2012 | 2014 | 2016 | 2018 |
| Transportation | -253.7 | -229.2 | -339.1 | -395.2 |
| Travel | 594.1 | 674 | 811 | 1,255.20 |
| Communication | -566.2 | -736.7 | -497.1 | -397.3 |
| Construction | -15.5 | -68.9 | -26.6 | -69.6 |
| Insurance | -99 | -78.6 | -75 | -66.7 |
| Financial | -174.8 | -196.3 | -143.7 | -154.7 |
| Computer and IT | -539.1 | -713.8 | -443 | -358.9 |
| Legal and Management | 232.8 | 140.5 | 94.3 | 163 |
| Engineering and Technical | -162 | -148.9 | -148.9 | -120 |
| Other Services | -93 | -121.4 | -905.8 | -1,900.60 |
| PCRS | 12.1 | -6 | -67.4 | 7.4 |
| Government | -87.6 | -27.5 | -31.1 | -24.1 |
| Total | -1,542.40 | -1,761.60 | -1,915.20 | -2,303.80 |

Source: Eurostat

Overall, based on Table 3.3, the value of trade in services between Indonesia and the EU has continued to increase since 2012 in almost all areas. The percentage change, both in the 2012-2014 period and the 2016-2018 period, indicates that the growth in service trade between Indonesia and the EU tends to be positive, albeit small. In 2018, the value reached € 7 billion, which was supported by other services, travel, transportation, communications, and information technology.

Table 3.3 Value of Indonesia's Trade in Services with the EU, 2012-2018

| Service Sectors | Total Trade Indonesia - EU (in million euro) | | | | % Change 2012-2014 | % Change 2016-2018 |
|---|---|---|---|---|---|---|
| | 2012 | 2014 | 2016 | 2018 | | |
| Transportation | 1,168.70 | 1,008.60 | 1,293.30 | 1,408.20 | -0.137 | 0.089 |
| Travel | 1,007.30 | 1,121.60 | 1,502.20 | 1,995.20 | 0.113 | 0.328 |
| Communication | 668.6 | 817.9 | 546.5 | 560.7 | 0.223 | 0.026 |
| Construction | 197.3 | 143.9 | 78.4 | 100 | -0.271 | 0.276 |
| Insurance | 140.6 | 109.8 | 105 | 110.3 | -0.219 | 0.05 |
| Financial | 227.6 | 276.1 | 340.7 | 219.7 | 0.213 | -0.355 |
| Computer and IT | 567.3 | 734.8 | 450.6 | 473.1 | 0.295 | 0.05 |
| Legal and Management | 232.8 | 140.5 | 94.3 | 163 | -0.396 | 0.729 |
| Engineering and Technical | 233.6 | 197.3 | 212.3 | 232.2 | -0.155 | 0.094 |
| Other Services | 580.6 | 626.2 | 1,774.80 | 2,256.40 | 0.079 | 0.271 |
| PCRS | 28.7 | 33.4 | 125.4 | 41.6 | 0.164 | -0.668 |
| Government | 184.6 | 96.1 | 94.7 | 107.5 | -0.479 | 0.135 |
| Total | 5,312.80 | 5,338.40 | 6,664.00 | 7,751.60 | 0.005 | 0.163 |

Source: Eurostat

There are two aspects that should be kept in mind when evaluating the statistics above. First, the statistics only represent the flows of trade in services across borders. In the international trade jargon, these statistics only represent Mode 1 trade in services, where services are traded across borders (for example, insurance services are sold across borders), and Mode 2, where consumers go to a different country to consume services (for example tourists going to other countries). The data do not include services trade data for Mode 3 and Mode 4.

Statistics for Mode 3 and Mode 4 trade in services are more difficult to measure and collect. However, EU countries have collected Foreign Affiliates Trade Statistics (FATS) data which can be interpreted as indicators of trade in services through Mode 3. Table 3.4 shows the turnover of companies originating from EU countries from 2010 to 2017. This can be interpreted as "exports" of EU services performed by these companies.

It can be seen that EU exports of services during the period under consideration tended to be stable at the level of 6 to 8 billion euros. It involves mostly retail and wholesale trade and the financial sector, which accounts for about 80% of services trade conducted by EU companies in Indonesia. From an Indonesian perspective the figures represent its "import" of services from the EU through Mode 3.

Table 3.4 Foreign Affiliate Trade Statistics as Mode 3 Trade in Service (€ Million)

| Service Sectors | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 |
|---|---|---|---|---|---|---|---|---|
| Construction | 127 | 238 | 273 | 322 | 409 | 333 | 340 | 286 |
| Wholesale and retail trade; repair of motor vehicles and motorcycles | 2,164 | 2,461 | 1,924 | 1,586 | 1,878 | 2,233 | 2,193 | 2,315 |
| Transportation and storage | 466 | - | - | 568 | 473 | 534 | 639 | - |
| Accommodation and food service activities | 16 | 42 | 68 | 37 | 38 | 45 | 45 | 37 |
| Information and communication | 698 | 137 | 114 | 84 | 120 | 549 | 678 | 522 |
| Financial and insurance activities | 2,897 | 3,274 | 3,945 | 3,285 | - | 3,126 | 4,271 | 4,006 |
| Professional, scientific and technical activities | 201 | - | - | 463 | 371 | 582 | 798 | 605 |
| Total | 6,569 | 6,152 | 6,324 | 6,345 | 3,289 | 7,402 | 8,964 | 7,771 |

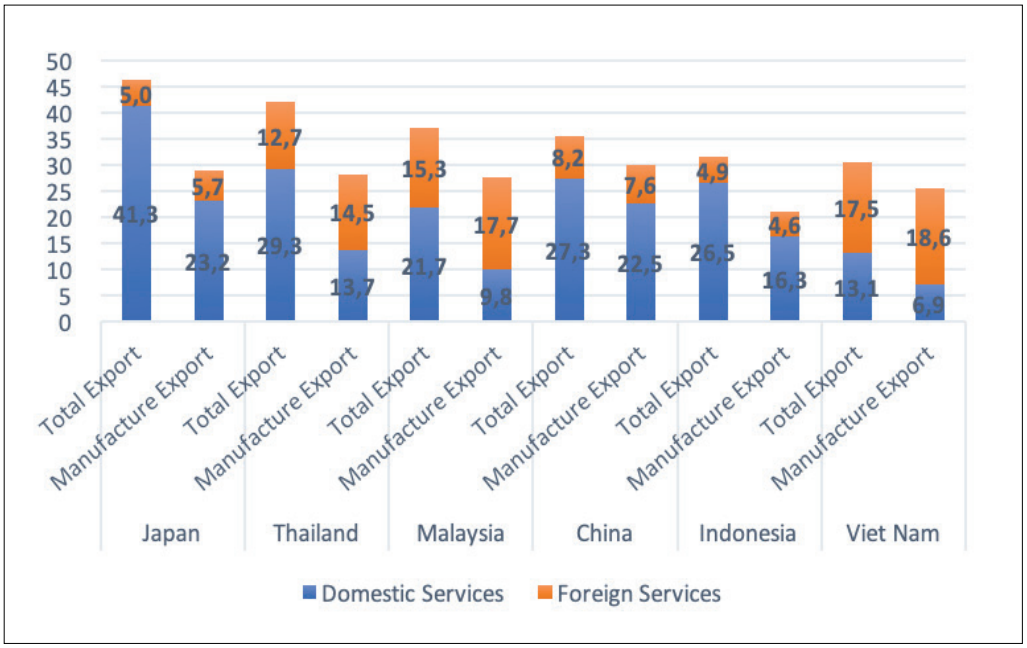
Furthermore, services are also traded indirectly. With the increasingly complex production process, services have become an inseparable part of goods products, including exported and imported goods. The proportion of services in the tradable goods depends on the level of complexity and quality of the goods being traded. The higher the quality of the goods, the higher the proportion of services used in their production and consumption.

Figure 3.3 provides an illustration of the proportion of services contained in the exports of several countries in East and Southeast Asia, including Indonesia, in 2014-2016. There are several insights that can be learnt from the information in this Figure. First, the proportion of services in Indonesia's exports (31%) is relatively small compared to other countries in the region, except Vietnam. Second, the proportion of services in Indonesia's exports of manufactured products (21%) is lower than in its total exports, even when compared to

Vietnam (26%). This indicates the low complexity and quality of Indonesian manufactured products compared to other countries.

In addition, data show that the origin of the services contained in export products, i.e., either come from within the country or from abroad. Except for Japan, which is a mature economy, most countries in the region rely on services from abroad to support their exports. Indonesia's export products, however, tend to rely more on the domestic service sector, while as explained earlier, most of Indonesia's service sectors are unable to meet the demand of various economic sectors. The low proportion of services from abroad is clearly manifested in manufactured export products where the proportion is only about 5%, while other countries can reach over 15% such as Thailand and Vietnam. Even China, with a large economy, still recorded 8%.

Figure 3.3 Proportion of Services in Exports 2014-2016 (%)




Source: OECD TIVA Database

The low proportion of services from abroad in Indonesia's exports is one possible factor that may explain the low competitiveness of the country's exports. The low proportion of "imported" services in Indonesia's exports is related to restrictions on imports of services, which tend to be quite high. As a result, the Indonesian production sectors, including manufacturing, have difficulties to acquire the required services, in contrast to the production sectors in other countries that can utilize services from abroad.

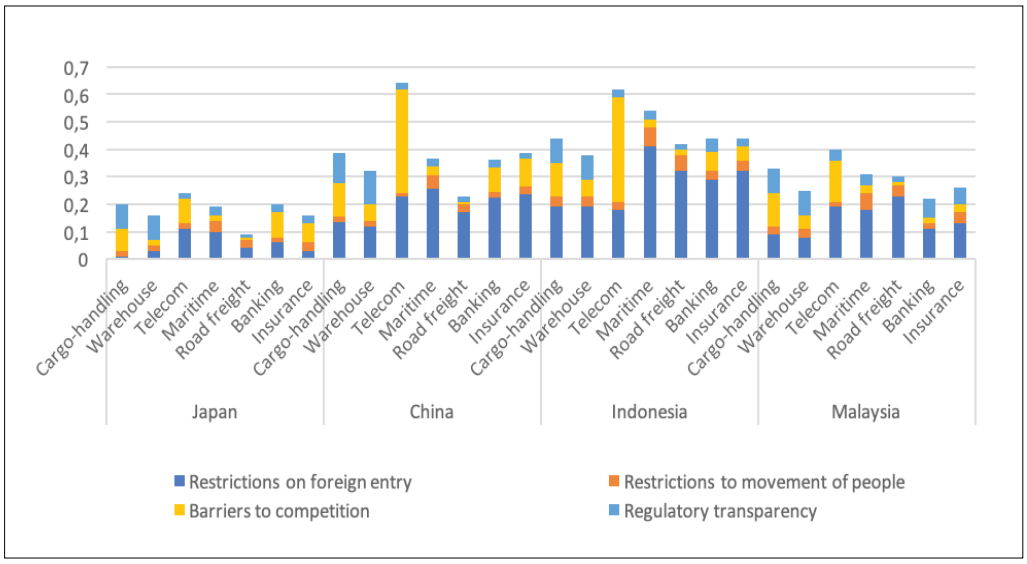
## BARRIERS TO TRADE IN SERVICES IN INDONESIA

The Organization for Economic Cooperation and Development (OECD) issues Services Trade Restriction Indicators (STRI) that measure policies and restrictions that affect trade in services in an economy. The various indicators are grouped into five main categories:

(i) restrictions on the entry of foreign service providers, (ii) restrictions to movement of people, (iii) barriers to competition, (iv) regulatory transparency, and (v) other regulations. Figure 3.4 provides information on restrictions in several important service sectors that play an exceptionally large role in production and trade, for example logistics and warehousing, maritime services, finance, and telecommunications for several countries in the region, including Indonesia.

It is clear from Figure 3.4 that, in almost all of these services, Indonesia applies higher restrictions compared to other countries, except for the telecommunications sector, where China tends to impose very strict restrictions. This indicates the difficulty in importing services to Indonesia, which, in turn, makes it difficult for the production sectors to obtain services. It can also be seen that the main barrier comes in the form of entry restrictions to foreign service providers which, in turn, further inhibit the provision of services in the Indonesian economy.

Figure 3.4 STRI of Several Countries and Sectors in Southeast and East Asia




OECD STRI Database

Telecommunications is one of the most important service sectors, especially with the increasing importance of digital economy and internet. Unfortunately, the telecommunications sector in Indonesia faces numerous restrictions. In the past, this sector was monopolized by state-owned enterprises (BUMN). But the government has opened the sector and provided opportunities for cooperation with foreign partners, especially in the field of cellular telecommunications and data networks. Even so, there are still many obstacles, including regulation on market access and domestic regulations, that inhibit trade in the telecommunications services. Foreign participation in investment in this area, for example, is limited to 65%. Domestic regulations also often do not support the development and trade of telecommunications services, such as the construction and use of telecommunications towers, or regulations regarding the price of telecommunications services.

The ratification of the Job Creation Law (Ciptaker) or Omnibus Law in October 2020 has given positive sentiment to business actors in this sector. The Infrastructure Sharing concept outlined in the regulation allows both small and large companies to utilize existing

infrastructure to expand their networks. Furthermore, the telecommunications sector will also be more open to foreign investors. Several telecommunications services will be excluded from the latest 2020 Negative Investment List (DNI) and will be open to investors, including those from abroad.

Transportation, which is also especially important in supporting production and trade, also tends to be restricted. In terms of foreign participation, this sector limits foreign ownership to 49%. Some sub-sectors, such as land transportation and small-scale sea transportation are completely closed to foreign operators. In addition, the cabotage principle, which requires inter-island sea transportation services to be provided only by domestic operators, is still enforced and, hence, prevents competition from more efficient foreign providers.

The Job Creation Law brought several changes in the transportation sector. The law changes various regulations that apply to sea, air and land transportation. In addition, several sub-sectors will also be taken out of the DNI and provide wider flexibility for investment.

Another sector that deserves attention is the financial sector, which can be said to be the pulse and heart of the economy. This sector is relatively open in terms of foreign ownership participation in financial institutions. For example, foreigners can own up to 80% of insurance companies and 85% of multi-finance companies. However, in the banking sector both domestic and foreign shareholders can control only up to 40% a bank's equity ownership. In addition, financial services regulators tend to limit market access for foreign service providers who carry out their services from abroad (Mode 1 delivery). The regulator's concerns are related to the difficulty in providing consumer protection and applying prudential principles.

At the time of writing there is an on going deliberation among government and parliament officials to prepare a Financial Sector Omnibus Law which is designed to further develop and strengthen the country's financial sector. In addition to resolving various issues pertaining stability of the financial system, it is likely that the proposed legislation will address several problems concerning ownership, including allowing for greater foreign ownership in the banking sector as well.

## OPPORTUNITIES FROM THE AGREEMENT ON TRADE IN SERVICES

IEU CEPA provides an opportunity for Indonesia to expand its services economy, by increasing its exports of services to the EU. Even though Indonesia is still experiencing a deficit in services trade, there are several services sectors that have the potential to increase their exports to the EU as a result of the agreement.

The Indonesia Services Dialogue Council (ISD) identified several services from Indonesia that have a potential for export (2018). Services such as construction, business services, and tourism-related services all have the potential to be exported.

Indonesian construction services sector, for example, is growing rapidly with a growth rate of almost 7% annually, higher than that of the national economy. Although it experienced a sharp decline in 2015, due largely to a domestic shift, nevertheless exports of construction services have continued to increase over the last four years, including to European Union countries. The main problem facing Indonesia's construction service exports is the sector's limited capacity, both in terms of technical competency and, the range and types of services offered. Moreover, large construction service exports usually also include financing

facilities, which Indonesia has not been able to provide. As a result, construction companies are still finding difficult to increase the scale and types of their exports. In addition, they face another constraint, most of their workers do not possess internationally recognized professional certificates.

Indonesia has the potential to increase its exports of professional services. These services include various support services for economic and business activities, such as computer-related services, research and development, and back-office services. Although it is relatively small, the prospect for further expansion is quite good, especially with the emergence of digital technology, more and more of these services are being traded through digital platforms. The main impediments against this prospect are low quality of human resources, i.e., lack of foreign language proficiency and international professional certification, and regulatory constraints. Most business services are still on the Negative Investment List (DNI) which prevents international businesses to establish their service hubs in Indonesia. In addition, services exports are also subject to value added tax, although more and more are receiving a tax rate of 0%.

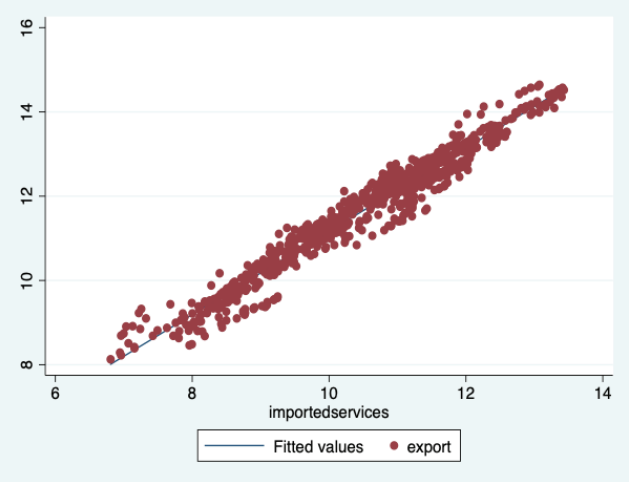
Tourism and hospitality has export potential. In addition to relying on the domestic tourism sector to "export" its services, there is also an opportunity for tourism business actors to expand their activities abroad. This includes providing opportunities for workers in the Indonesian tourism sector to work and provide services abroad, including in European Union countries. Once again, international professional certification is an important prerequisite to realizing this potential. Indonesia's experience as a party to several mutual recognition agreements for professionals in the tourism sector will greatly help improve the capabilities and competitiveness of the sector.

Indonesia can also make use of services imported from European Union countries to enhance the productivity of its production sectors. As the country's economy advances, demand for quality services will increase. As noted earlier, services are not only for final consumption but also have become intermediate inputs in production sectors and other economic activities. The goods and services sectors are increasingly in need of services, including in the production process, distribution and sales processes, as well as post-sales services. As mentioned earlier, the rising demand for services will be difficult to be met domestically, hence imports of services has become a necessity to support the country's economic development.

Countries with a high level of service imports tend to be highly competitive and have high export performance (Damuri, Atje, & Soedjito, 2014). This is evident from the Trade in Value Added (TiVA) statistics from 2005-2016. It shows that there is a strong correlation between service imports and export performance (**Figure 3.5**[17]).

17 Simple regression with pooled data yields R2 = 0.9520 and 0.8268 for each indicator

Figure 3.5 Relationship between Services Exports and Imports




Source: Author's Calculation

There are at least two ways in which import of services can improve overall export performance. First, imports of services can boost the performance of the domestic service industry as a result of its exposure to global competition. Second, imports of services provide an option for cheaper service inputs, thereby promoting cost efficiency. Both can boost the expansion of companies' output, including export-oriented ones.

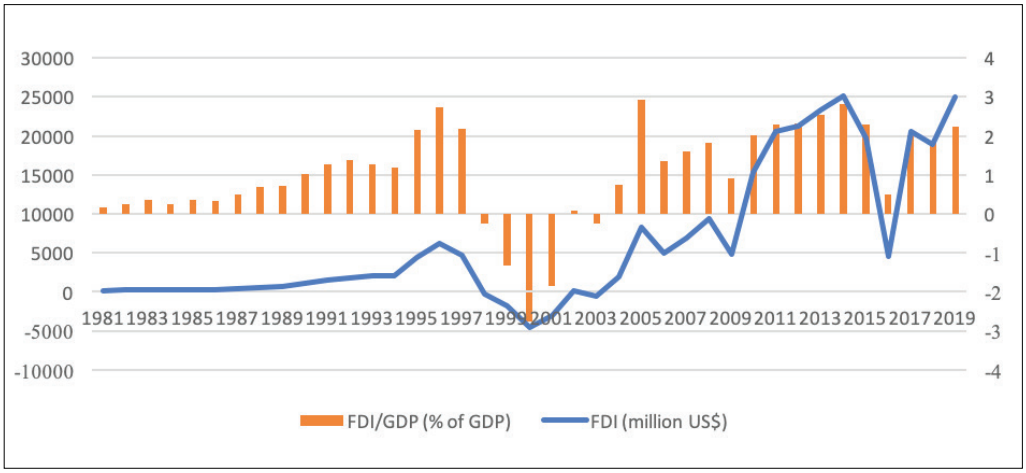
The agreement between Indonesia and the European Union countries must be able to facilitate trade in services activities, either by providing opportunities for Indonesian exports to Europe or, for Indonesia to take advantage of the various opportunities discussed earlier.

# 4.

# INVESTMENT AND THE INDONESIA-EU CEPA

FDI HAS BECOME one of the key factors in driving economic development and industrialization in Indonesia (e.g., Pangestu 1997 and Aswicahyono et al. 2010). Various policy reforms in the mid-1980s led to a significant increase in FDI inflows to Indonesia, mainly driven by export-oriented FDI in the labour-intensive manufacturing sector, such as textiles, garments and footwear. Despite suffering a reversal during the 1997-98 Asian financial crisis, further reform policies along with macroeconomic and political stability have helped to restore FDI inflows to Indonesia and has surpassed its pre-1997/98 crisis levels in recent years. Nevertheless, some elements of protectionism and restrictions of various forms still exist today, as can be seen in the Negative Investment List (DNI).

Figure 4.1 FDI Inflows to Indonesia




Sources: World Development Indicator (WDI), World Bank (2020)

The Indonesia-EU Comprehensive Economic Partnerships Agreement (IEU CEPA) puts investment as one of the most important issues and objectives. The agreement is expected to increase the inflow of foreign direct investment into Indonesia. Reduction in trade and investment barriers resulting from the agreement is expected to encourage foreign investors, particularly those from the European Union to invest in Indonesia. The IEU CEPA can serve as an export and import platform for Indonesia. With the IEU CEPA, companies investing in Indonesia can import quality inputs / parts and components from the European Union more easily and competitively. These companies can also cater a wider market that includes not only Indonesia but also other ASEAN and East Asian countries that have trade and economic cooperation with Indonesia.

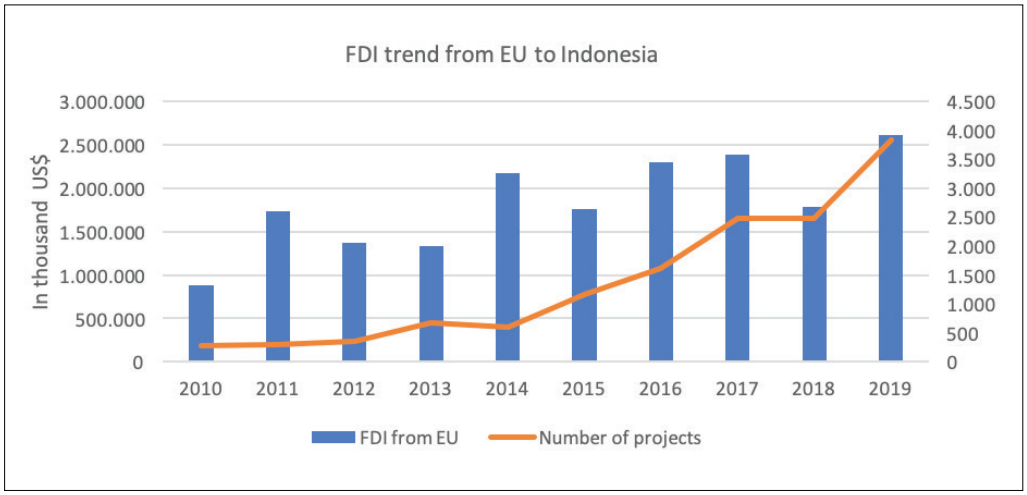
Furthermore, the agreement is expected to help accelerate the implementation of economic reform in Indonesia. Indonesia may have to undertake regulatory reforms so as to ensure that its investment regulations are in accordance with what will be agreed in the investment chapter of the IEU CEPA. In this context, the promulgation of the Omnibus Law by the Indonesian government could be positive for the IEU CEPA agreement, as it may help accelerate the negotiation process. In addition, the law can help Indonesia to further improve and adjust its economic regulations and policies in the future when the agreement is implemented. In the end, the IEU CEPA, together with regulatory and economic policy reforms carried out by the Indonesian government, is expected to increase Indonesia's competitiveness and help expand the country's comparative advantage, so that it will be able to reduce its reliance on natural resources and cheap labour.

Based on the above description, this chapter discusses various issues related to FDI, free trade agreements (FTA) and economic reforms, particularly those that are related to the ongoing negotiations of the IEU CEPA. The discussion begins with an explanation of the patterns and developments of European Union's FDI in Indonesia. Furthermore, it explores the driving and inhibiting factors for EU's FDI to Indonesia. Then the analysis is followed by a discussion about the potential benefits of the IEU CEPA in increasing FDI flows into Indonesia, supporting economic reform and development. Finally, there is an explanation regarding the optimization strategy of the IEU CEPA and policy adjustments.

## PATTERNS AND PROGRESS OF INDONESIA-EU INVESTMENT COOPERATION AGREEMENT

Although fluctuating, the number of projects or the value of FDI inflows from EU countries to Indonesia has increased in the last decade. Based on the number of projects, FDI from the EU to Indonesia grew from less than 300 projects in 2010 to nearly 4 thousand projects in 2019. The value of FDI also increased from US$900 million in 2010 to more than US$2.6 billion in 2019.

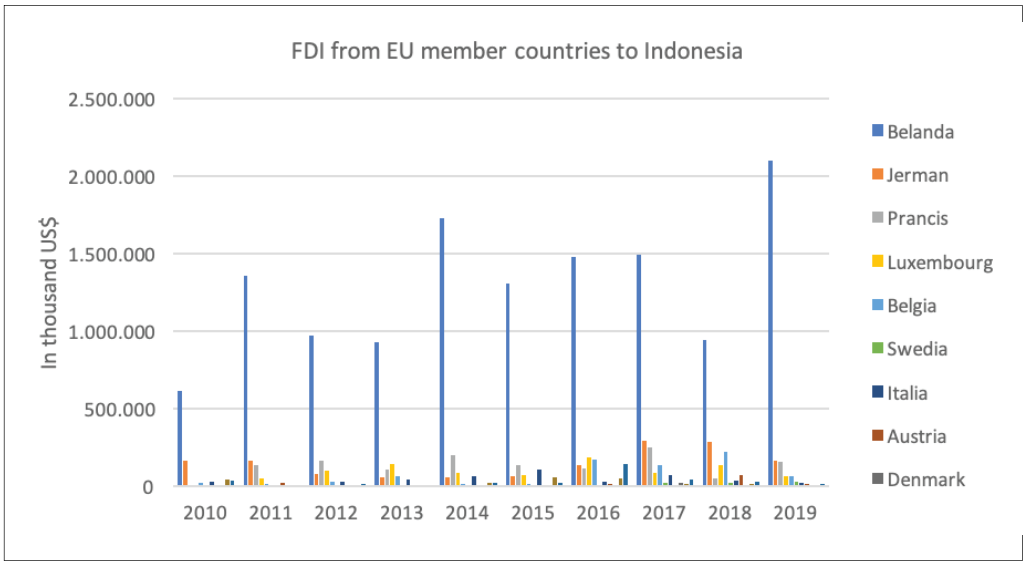
Figure 4.2 FDI From the EU to Indonesia, 2010-2019




Source: BKPM

FDI from the European Union to Indonesia is dominated by investment from the Netherlands, Germany and France. Since 2010, these countries were the three EU countries with the largest investment in Indonesia. In the past decade, FDI from the Netherlands to Indonesia increased from US $608 million in 2010 to US $2 billion in 2019, albeit with very large annual fluctuations. In 2019 direct investment from the Netherlands was accounted for more than 80 percent of total FDI coming from the EU, up from 68 percent in 2010. Germany and France have the next largest investment after the Netherlands, where each contributed 6.2 percent and 5.8 percent of total FDI from the EU to Indonesia in 2019, respectively.

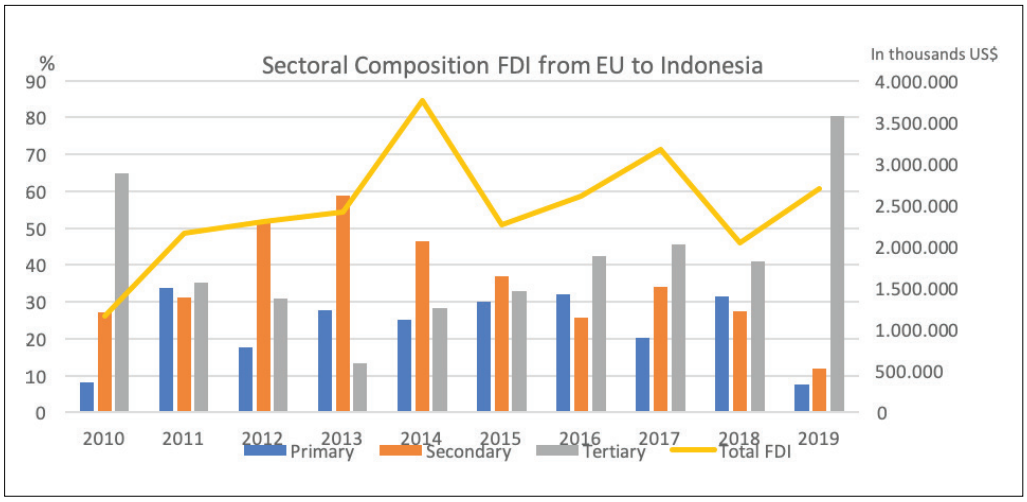
Figure 4.3 Breakdown of EU's FDI to Indonesia Based on Countries of Origin, 2010-2019




Source: BKPM

In recent years there has been a shift in the sectoral composition of FDI originating from the European Union to Indonesia from the secondary sector to the tertiary sector. **Figure 4.4** shows that during the 2012-2015 period, the secondary sector (manufacturing sector) dominated the sectoral destinations of FDI from the EU to Indonesia. However, since 2016 there has been a shift in the destination of FDI from the EU to Indonesia toward the tertiary sector (service sector) and the primary sector (mining). One possible explanation for this structural change is the increased competition from other countries such as China, Vietnam, India and Bangladesh for investment in the manufacturing sector. These countries are considered to be more competitive than Indonesia in terms of labour-related costs. As a result, Indonesia's labour-intensive manufacturing sectors, such as textiles, garments and footwear have become less attractive to foreign investors, including those from European Union countries.

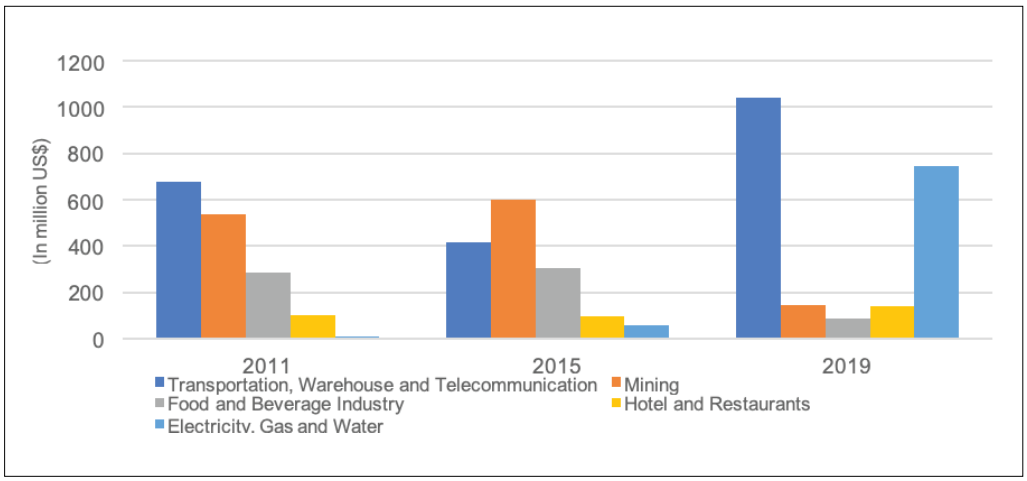
Figure 4.4 Sectoral Composition of FDI from the EU to Indonesia, 2010-2019




Source: BKPM

Transportation, warehousing and communications, electricity, water and gas sector and the mining sector are the main economic sectors in Indonesia that received most of the FDI from the EU in recent years. They received more than 38 percent of total FDI from the EU to Indonesia in 2019. At the same time the share of the mining sector in the total FDI from the EU to Indonesia has tended to decline, while the share of the electricity, gas and water sectors have experienced a significant increase. In 2019, investment in the electricity, gas and clean water accounted for 27.7 percent and the mining sector accounted for 5.4 percent of the total FDI from the EU to Indonesia. Meanwhile, in the manufacturing industry, the largest recipients of FDI from the EU were the chemical and pharmaceutical industry sub-sector, the food and beverage industry sub-sector, as well as the machinery, electronics, medical instruments, electrical equipment, precision, optics and clock industries sub-sector. Figure 4.5 shows the 10 main economic sectors receiving the largest FDI from the EU to Indonesia in 2011-2019.

Figure 4.5 Top Five Economic Sectors Receiving FDI from the EU, 2011-2019




Source: BKPM

The data above shows that direct investment from the EU to Indonesia has been dominated by investment in the service sector and the capital-intensive manufacturing sector. Both sectors have grown rapidly in Indonesia in recent years. These are economic sectors in which the EU has an advantage. In addition to those sectors, direct investment from the EU to Indonesia has mostly occured in economic sectors where traditionally Indonesia has comparative advantages due to its endowment factor (natural resources) such as mining.

## POTENTIAL CONTRIBUTION OF THE IEU CEPA TO FDI IN INDONESIA

The size of investment flows into a destination country depends on many factors. It is especially affected by decisions taken by multinational companies. Companies' decision to serve foreign markets through production by their affiliated companies instead of exporting is based on a number of different motives. At the company level, Dunning (1993) identified four motives for a company to invest abroad, namely: access to resources, access to markets, benefits from efficiency and acquisition of strategic assets. Similarly, Shatz and Venables (2000) suggested two main reasons why a company wants to become a multinational company, namely, to better serve the local market and get lower input costs.

FDI that aims at serving local markets is commonly referred to as "horizontal" or "market-seeking" FDI, while FDI that seeks lower input costs is often referred to as "vertical" or "production cost-minimizing" FDI. The motive of horizontal FDI is to reduce costs associated with market services (such as tariffs or transportation costs) or to respond to changing conditions or preferences in the local market. Meanwhile, the motive for vertical FDI is to minimize production costs more efficiently either by cutting out or splitting vertical production chains and relocating part of the production to low-cost locations. Therefore, international differences in production factors and prices of raw materials and production technology will tend to encourage vertical FDI (Shatz and Venables, 2000).

In addition, there are many economic factors at country level that may serve as the main determinants of FDI inflows to a destination country. They are associated with the potential profits that a company may gain and with the company's ability to access local market. Among such determinants are macroeconomic variables, such as economic growth (Bevan and Estrin, 2004; Biswas, 2002; Blonigen and Piger, 2014); the size of labor force and human resources (Blomstrom et al., 2003; Globerman and Shapiro, 2002); exchange rates (Bevan and Estrin, 2004); inflation (Asiedu, 2002); international trade (Liu et al., 2001; Moore, 1993); financial development (Hermes and Lensink, 2003); and infrastructure development (Armah and Fosu, 2018; Cuyvers et al., 2011). In addition, the quality of government institutions and policies also plays a role in determining the inflow and outflow of foreign investment in a country (Aziz, 2018; Benassy-Quere et al., 2007; Biswas, 2002; Blonigen and Piger, 2014; Schneider and Frey, 1985).

The IEU CEPA is expected to increase FDI inflows from the EU to Indonesia. Neverthless, the real impact of the agreement remains to be seen. The agreement is still in the negotiation stage. Its impact will depend on the final outcome of the negotiations and how the agreement will be implemented. It also depends on Indonesia's ability to overcome various problems pertaining investment including the existing investment barriers.

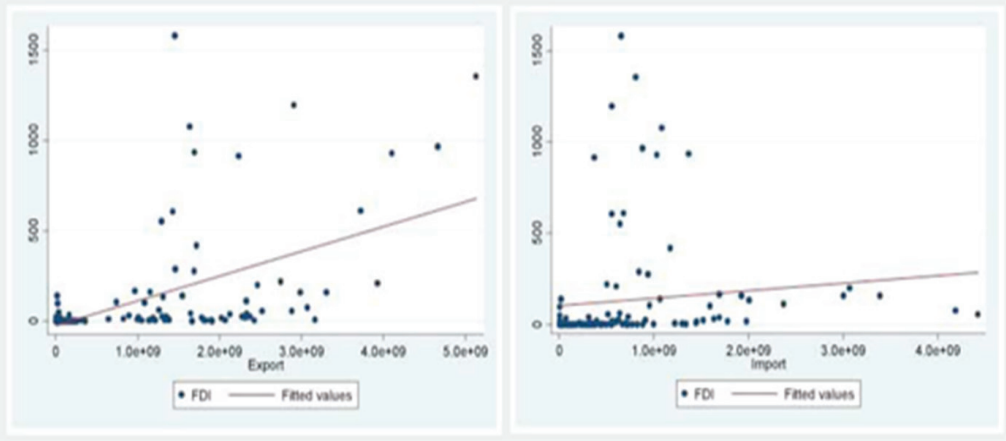
Theoretically, the impact of free trade areas (FTA) agreements such as IEU CEPA on FDI flows is related to the types and underlying motives of the FDI. For vertical FDI, the relationship between FDI and trade will be complementary (Helpman, 1984, Helpman and Krugman, 1987). In other words, a decrease in trade costs such as a reduction in tariffs due to FTA will induce multinational companies to increase FDI. From a company's perspective, there is a potential gain from a reduction in the costs of importing final goods and exporting intermediate goods. Several studies show that regional free trade agreements have a positive impact on foreign investment flows to developing countries (Yeyati et al., 2003; Velde and Bezemer. 2006; Jang, 2011).

Meanwhile, in horizontal FDI, the impact of FTA on FDI and trade can be either substitution or complementary. When there is a decrease in trade costs due to FTAs, a company will choose to export rather than undertaking horizontal FDI. Several studies support the substitution relationship between export and horizontal FDI, i.e., there is a positive relationship between trade costs (FTA) and horizontal FDI (Oberhofer and Pfaffermayr, 2012; Jang, 2011). In other words, reduction in tariffs due to FTAs will lower foreign investment in destination countries that have trade cooperation with the FDI home country.

On the other hand, other studies, such as Blomström and Kokko (1997), show that FTA can increase horizontal FDI because it expands the common market between its member countries and encourages the creation of FDI-friendly economic environment by the inclusion of an investment provision in the free trade agreement. Furthermore, Irarrazabal, et al. (2009) argue that the existence of intra-firm trade between the company's head office in the FDI home country and its affiliated companies in the FDI destination country will tend to increase horizontal FDI. With the reduction in tariffs due to FTAs, horizontal FDI can increase because multinational companies will find easier to send intermediate goods to their affiliated companies in FTA partner countries.

Based on the above studies, there are several potential channels for an increase of FDI inflows from the EU to Indonesia. First, the high level of complementarity between Indonesia and the EU and the large market for both parties. It is hoped that the growth of FDI inflows would first increase the volume of trade between the two parties which would then stimulate further investment flows between them. The magnitude of the potential increase of FDI flows from the EU to Indonesia as a result of the IEU CEPA can be estimated from the simulation results of investment-trade correlation. Figure 4.6 shows that there is a very high correlation between EU direct investment (FDI) in Indonesia and Indonesia's exports to the EU market. Interestingly, the relationship is higher than the correlation between EU direct investment (FDI) in Indonesia and Indonesia's imports originating from the EU. Based on these findings, there is a reasonably high probability for an increase in exports from Indonesia to the EU when Indonesia receives an increased inflow of FDI from the EU, and vice versa. It is because there is a tendency for foreign investors from the EU to invest in sectors that have significant exports to EU countries. That is, the type or motive of investment entering Indonesia tends to be vertical investment, rather than horizontal investment.

Figure 4.6 FDI and Trade Correlation between Indonesia and the EU




Source: Author's Calculation

The second potential channel for an increase FDI from the EU to Indonesia after the IEU CEPA implementation is the investment provisions in the agreement. The chapter on the investment provisions aimed at increasing the flow of investment between the two parties, regulates general provisions, investment protection and liberalization, as well as issues related to resolution of dispute settlement. The investment protection part is related to export compensation and provisions, while the liberalization part is related to the negative list of investments, where Indonesia has a schedule of commitment on market access. This is different from the EU which uses positive lists. In short, the investment chapter is expected to be beneficial by way of increasing investment cooperation between the two parties.

Nonetheless, empirical evidence suggests that the positive impact of FTAs on investment requires several preconditions. The Neumayer and Spess study (2005) shows that an increase in the number of bilateral investment treaties (BITs) involving a developing country can increase the flow of FDI inflows to that country. They argue that at a certain level BITs ensure that there is a certain standard of treatment for foreign investors who can be enforced through dispute resolution mechanisms outside the domestic justice system.

On the other hand, Hallward-Driemeler (2003) who looks at the investment of OECD countries in developing countries argues that the increase in FDI inflows come more from countries outside the agreement. She also considers the BITs rules as acting as a complement rather than a substitute for the quality of insitutions and adequate protection of property rights.

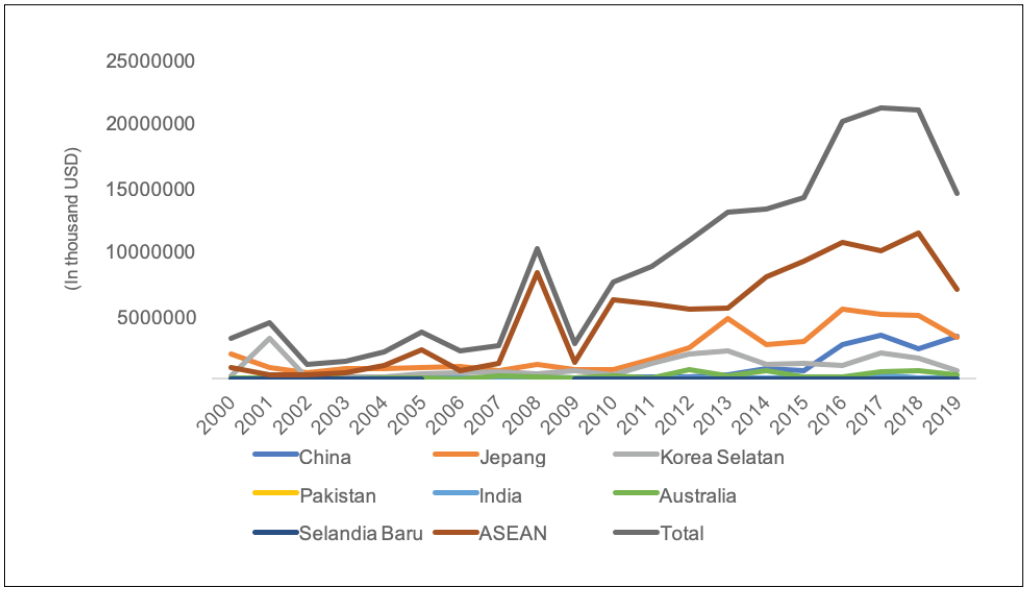
Notwithstanding the differences, the two studies discussed above implicitly share a same view regarding the importance of strong institutions to encourage investment. In order to attract investment, it is necessary for the government to protect ownership rights, including intellectual property rights, uphold the rule of law and fair competition.

Indonesia's own experience from various FTA agreements in which it is involved, shows that there is a tendency for an increase in FDI inflows after FTAs have been ratified and implemented. **Figure 4.7** depicts the progress of FDI from several FTA partner countries to Indonesia. Nevertheless, the causality of the increase in FDI inflows cannot be ascertained.

For example, there has been a significant increase in FDI originating from ASEAN countries after the ASEAN Framework Agreement on Services was signed and entered into

force in 1998. Similarly, FDI from ASEAN countries also increased after the ASEAN Trade in Goods was signed and took effect in 2010. A similar trend also happened after the 2012 ASEAN Comprehensive Investment Agreement was enacted. FDI originating from Japan has increased significantly since 2010 after the Indonesia-Japan Economic Partnerships Agreement (IJEPA) was signed and took effect in 2008. Likewise, FDI from China has increased since 2011, after the Agreement on Investment of the Framework Agreement on Comprehensive Economic Cooperation Between the People's Republic of China and the Association of Southeast Asian Nations was signed and entered into force in 2010.

Figure 4.7 FDI from Several FTA Partners of Indonesia, 2000-2019



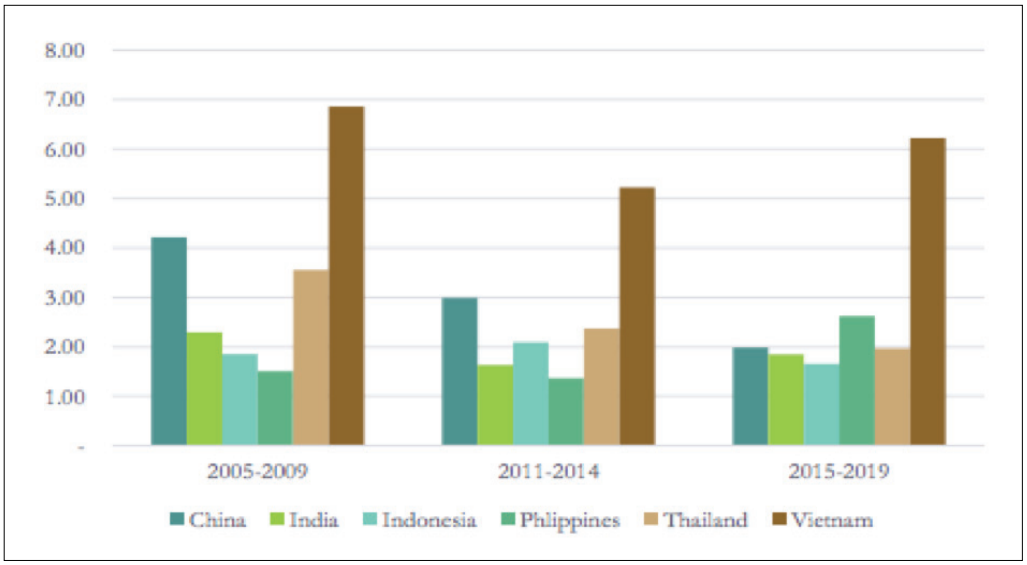

Source: BKPM

The IEU CEPA is expected to increase the inflow of foreign direct investment into Indonesia. The reduction in trade and investment barriers following the agreement is expected to encourage foreign investors, especially those from the European Union to invest in Indonesia. That will restore the position of the European Union as one of the main sources of FDI in this country. Further, the IEU CEPA agreement can transform Indonesia into an export and import platform where companies investing in Indonesia can import quality inputs / parts and components from the European Union easily and at lower cost. These companies can also expand their market to other ASEAN and East Asian countries that have trade and economic cooperation with Indonesia. No less important, the IEU CEPA is expected to be able to expand economic sectors that can attract foreign investors, to reduce the country's traditional reliance on sectors as the mining (coal, nickel, etc.) and plantations (palm oil, rubber, etc.) in which Indonesia has a comparative advantage.

## THE IEU CEPA AND ECONOMIC-INVESTMENT REFORMS IN INDONESIA

It has been described above that the IEU CEPA is expected to remove the obstacles that have hindered FDI to Indonesia. It is also hoped that the CEPA will be able to improve the investment climate in Indonesia. The increase in FDI inflows to Indonesia as a result is important; it will encourage technology transfer, foster economic growth, job creation and poverty reduction in Indonesia. The availability of FDI is deemed important for the Indonesian economy to continue developing in the future. However, as has been explained above, while there has been an increasing trend in the last few years, foreign investment inflows to Indonesia are nevertheless still relatively low. The share of FDI within the Indonesian economy tends to be lower than that of other countries in the region. **Figure 4.8** shows that during the 2015-2019 period, the percentage of FDI in the Indonesian economy was below other countries, including India and the Philippines, which are often considered as less investment friendly.

Figure 4.8 Percentage of FDI in Asian Economies (% of GDP)

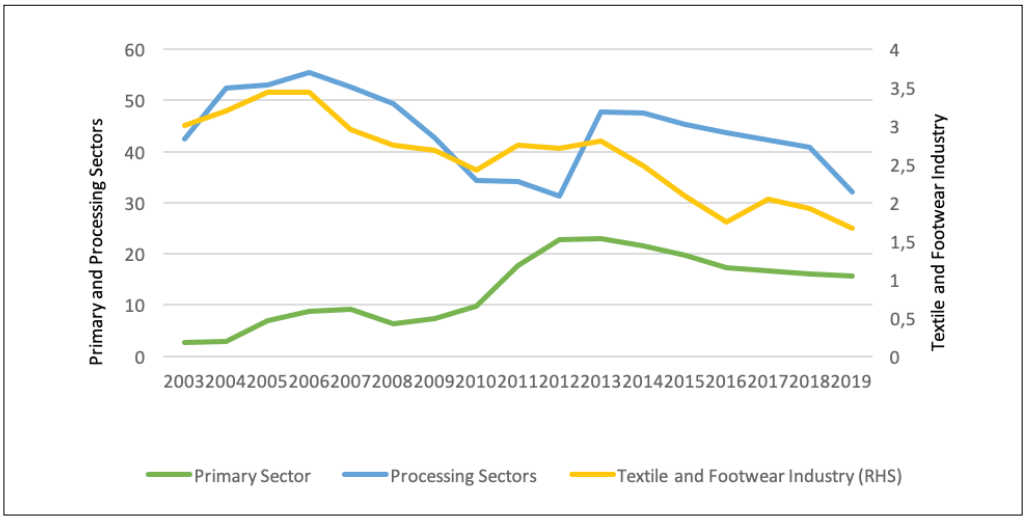



Source: Calculated from World Bank's World Development Indicators (Damuri, 2020)

Furthermore, the low share of FDI in the Indonesian economy is further exacerbated by the quality of investment inflows to Indonesia. As noted above, most of the investments, including those from European Union, in recent years have been dominated by investments in the primary (mining) and services sectors, which generally have a low capacity for job creation and productivity. **Figure 4.9** shows the development in the proportion of domestic and foreign investment in Indonesia in the last two decades. The share of investment in the primary sector has increased from just three percent of total investment in the early 2000s to more than 22 percent. On the other hand, the percentage of investment in the manufacturing sector continued to decline in the 2003-2012 period. Furthermore, although there has been an increase in the following period, the proportion of investment in the manufacturing sector has again tended to decline in recent years. The manufacturing sectors that experienced a major decline in investment were labour-intensive sector such

as textiles, garments and footwear, which dropped from 3.5 percent in the early 2000s to only 2 percent in recent years.

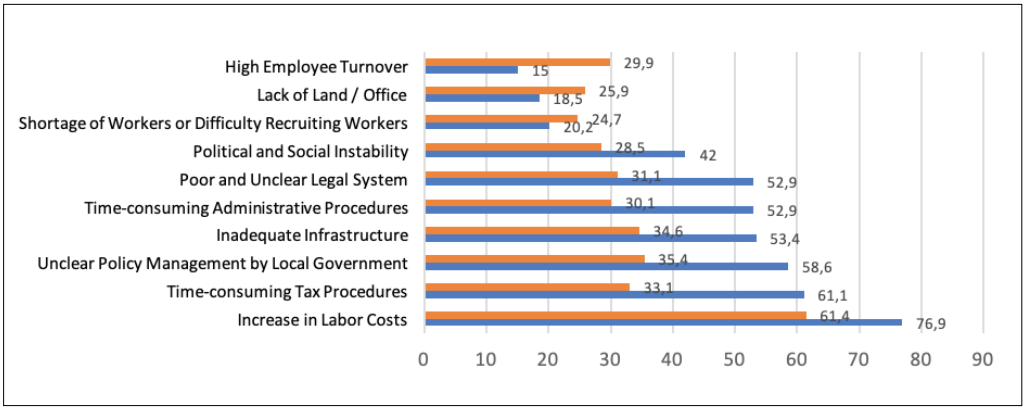
Figure 4.9 Sectoral Investment Proportion in Indonesia




Source: Calculated from BKPM Investment Realization Data (as in Damuri, 2020)

The country's investment condition described above is, to some extent, a result of the existing economic policy and regulatory frameworks which affect business. The low level of investment, including FDIs, is mainly due to the poor business and investment climate in Indonesia. The 2019 Global Competitiveness Report from the World Economic Forum gives Indonesia a score of 58/100. The survey ranks Indonesia 51st in terms of institutions related to the business climate and 85th in terms of labour regulation. Those numbers indicate that the existing investment climate in Indonesia is considered burdensome for business and economic activities. Meanwhile, the Japan External Trade Organization Survey (JETRO, 2020) also shows that wages, regulatory certainty and taxation are the top three investment risks affecting business activities in Indonesia (**Figure 4.10**).

Figure 4.10 Investment Risks in Indonesia and Other Asian Countries, Perception by Japanese Companies



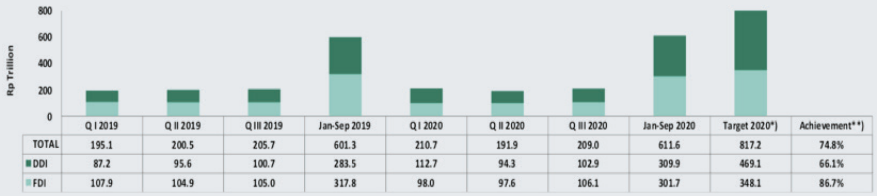

Source: JETRO (2020)

Based on the explanation above, economic reform in the form of regulatory simplification and regulatory changes is necessary to encourage investment and boost economic and business activities in Indonesia. Regulatory reforms brought about by the recently promulgated Job Creation Law are expected to increase the competitiveness of the Indonesian economy, increase investment, and increase job creation. This development is even more important in view of the Covid-19 pandemic which has caused world investment to fall significantly and, hence, competition to attract investment is expected to be tighter (**Box 4.1**).

### Box 4.1 Covid-19 and Investment in Indonesia

The Covid-19 pandemic has resulted in a significant reduction in investment and a setback in Indonesia's economic development. Based on BKPM data in Figure 4.12, the realization of foreign direct investment (FDI) during the three quarters of 2020 has decreased by 5%, down from IDR 317.7 trillion in 2019 to IDR 301.7 trillion in 2020.

Figure 4.11 Domestic and Foreign Investment Realization 2019 up to Q3 2020




| | Q I 2019 | Q II 2019 | Q III 2019 | Jan-Sep 2019 | Q I 2020 | Q II 2020 | Q III 2020 | Jan-Sep 2020 | Target 2020*) | Achievement**) |
|---|---|---|---|---|---|---|---|---|---|---|
| TOTAL | 195.1 | 200.5 | 205.7 | 601.3 | 210.7 | 191.9 | 209.0 | 611.6 | 817.2 | 74.8% |
| DDI | 87.2 | 95.6 | 100.7 | 283.5 | 112.7 | 94.3 | 102.9 | 309.9 | 469.1 | 66.1% |
| FDI | 107.9 | 104.9 | 105.0 | 317.8 | 98.0 | 97.6 | 106.1 | 301.7 | 348.1 | 86.7% |

Source: BKPM

To revive the economy from the negative impact of the Covid-19 crisis, it is important that the country is able to attract new investment. But it will not be easy. The United Nations Conference on Trade and Development (UNCTAD) recorded a decline in global investment by 49% in the first half of 2020 compared to the first half of 2019. It also estimates that for 2020, there will be a decline in investment of up to 40%. The competition to attract investment will therefore become tighter. Furthermore, the growing uncertainty has prompted businesses to be more cautious and risk averse in investing. They demand substantive reforms that can accommodate their investment.

The global health crisis caused by Covid-19 has also intensified the trend of shifting production and procurement of goods away from China. Before the pandemic, the trade war between the US and China had prompted many companies to seek alternative locations for their business to avoid increased tariffs. Furthermore, this global pandemic has disrupted the global supply chain, thus creating a higher pressure on multinational companies to diversify their production supply chains away from China.

Apart from returning their production bases to their countries of origin, many multinational companies are also evaluating the economic benefits to relocate

their production facilities from China to countries in Southeast Asia. This is driven by the availability of both cheap labor costs and investment incentives. The Japanese government has allocated more than US $ 200 million to diversify production throughout Southeast Asia. With this trend of business reallocation, the Covid-19 crisis may bring opportunities to Southeast Asian countries from the exodus of companies from China.

This may be positive for Indonesia as the largest country in the region. Nevertheless, compared to other countries, Indonesia is less attractive to foreign investors due to various investment constraints, inadequate infrastructure and high labor costs. This is evident, for example, from the fact that out of 33 companies relocating from China in 2019, none of them have moved their production to Indonesia. Based on this experience, Indonesia should make serious efforts to remove or lower its investment barriers .

In this context, the Indonesian government's decision to issue the Omnibus Law on Job Creation is deemed relevant and important. It is hoped that the law is an initial step towards a more substantive and significant reform of the country's investment policy framework. Moreover, to attract more foreign investment requires further policy adjustments, including implmenting regulatios of the law as well as ensuring a proper implementation of the law.

More importantly, Indonesia should simplify and reduce bureaucracy resulting from too many overlapping and complex regulations, both at the central and regional levels, which can hinder the entry of foreign investment into the country. It is hoped that the Omnibus Law will provide support in this direction.

The latest economic reform initiative taken by the Indonesian government, namely, the promulgation of the Job Creation Law (Omnibus Law) in 2020 is particularly important and relevant to the IEU CEPA. On the one hand, the reform can accelerate the negotiation process and streamline the implementation of the IEU CEPA agreement. Based on interviews with various parties involved in the discussion of the IEU CEPA negotiations, FTA negotiations are often hampered by laws and regulations that are in contradiction with the objectives of the agreement under negotiation. The ongoing reform is expected to allow negotiators to produce a better outcome compared to previous agreements.

On the other hand, the IEU CEPA can help Indonesia to improve and adjust its economic regulations and policies in the future when the agreement will be implemented. In the context of the Job Creation Law, the existence of the IEU CEPA can help create a better business climate in Indonesia through the creation of better technical regulations, Government Regulations (PP) and Ministerial Regulations, under the Job Creation Law. If this can be done, the regulatory reform will send a positive signal to investors and businesses, especially to foreign investors and investors in labour-intensive industries.

One of the potential benefits of the Job Creation Law on the IEU CEPA currently being negotiated, is regarding the recruitment of foreign workers. Previously, a company that wanted to hire foreign workers and the foreign workers themselves had to obtain permits

from the government. After the promulgation of the Job Creation Law, only foreign workers need to obtain permits. Meanwhile, a company that plans to hire foreign workers does not need to get a permit and approval from the government. All it needs is to have a plan of employing a certain number of foreign workers. This new provision will undoubtedly have a positive impact on the inflows of FDI to Indonesia, especially those from the EU. So far, foreign investors from the EU have complained about the difficulty to bring in skilled workers (experts and senior managers) from abroad, regardless of the fact that foreign workers serve as a channel for transferring knowledge and technology and for increasing company productivity.

# 5.

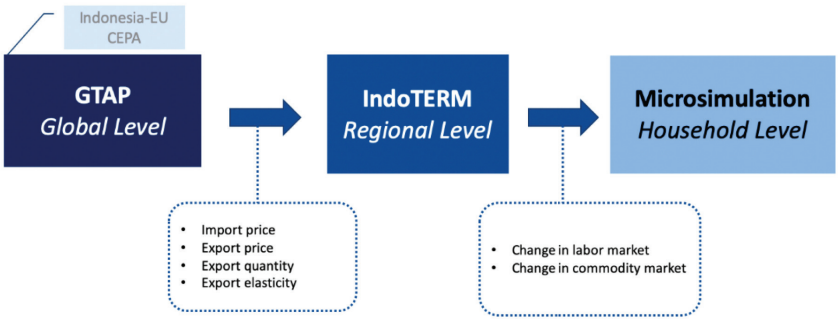
# ECONOMIC MODELLING ANALYSIS OF THE IEU CEPA

**IN THIS STUDY,** we conduct an economic modelling analysis to quantify the impact of the IEU CEPA on the Indonesian economy at the macro, sectoral, regional, and micro levels. Two of the three tools used in this analysis are the Computable General Equilibrium (CGE) model. The model measures the impact of various external factors on all components in the economy including industrial production, household expenditure, workers' wages, commodity prices, and so on. The two CGE models used are the Global Trade Analysis Project (GTAP) model, a global-level general equilibrium model that focuses on cross-country trade, and IndoTERM, a multi-sector and multi-regional national-level general equilibrium model. Both models are used to gauge the impact of the IEU CEPA on several macroeconomic indicators, the performance of economic production in each sector, as well as various regional economic variables. The third economic model is the microsimulation model for Indonesia which uses data from the Indonesian Family Life Survey (IFLS). The results can be used to analyse the impact of the IEU CEPA on microeconomic indicators such as poverty levels and economic disparities.

## SIMULATION DESIGN

The simulation is conducted in three sequential stages associated with the three types of the model, namely global, regional, and household. The GTAP model acts as a global model which produces results, some are analysed directly, while the other used as input to the IndoTERM model. Likewise, the IndoTERM model produces output that are analysed directly or used as input to the Microsimulation model. The GTAP outputs that are analysed directly include various macroeconomic indicators such as GDP growth and changes in the trade balance, while the inputs to the IndoTERM model include changes in price, quantity, and elasticity of various export and import commodities. The IndoTERM model is used to analyze the impact of the IEU CEPA agreement on regional economic variables such as gross regional domestic product (GRDP) of each province. Furthermore, the IndoTERM model also provides inputs in the form of changes in commodity prices for households, changes in capital prices, and changes in workers' wages and demand for workers. Finally, the Microsimulation model produces outputs in the form of changes in poverty levels and levels of economic inequality. The figure below illustrates the flow of the simulations we use in this study.

Figure 5.1. Economic Modelling Simulation Design for IEU CEPA Studies




Source: Authors

## METHODOLOGY

### Analysis using Global Trade Analysis Project (GTAP)

GTAP is a multi-regional and multi-sector Computable General Equilibrium (CGE) model which assumes perfect competition and constant returns to scale. The model provides data on global trade and economy, enabling us to analyze the impact of Indonesia's EU-CEPA trade liberalization on macroeconomic variables in each country. The GTAP database used in this simulation comes from GTAP version 10 of 2014 with an aggregation of 141 countries and 65 sectors. For simulation purposes, we reconstruct the country and sector aggregation into 19 countries and 20 sectors which we present in detail in Appendix 1.

### Analysis using IndoTERM

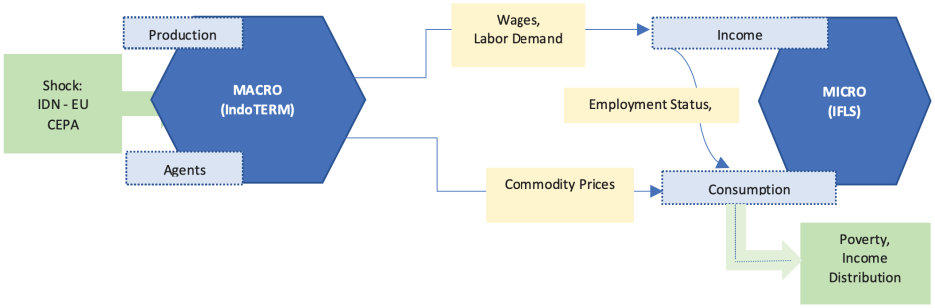
In this study, apart from analyzing the regional impact of the IEU CEPA, IndoTERM also acts as a link from the GTAP model to the Microsimulation model. Therefore, IndoTERM produces two sets of results, one set will be analyzed directly, while the other will be used as input variables for the Microsimulation model. The inputs to IndoTERM come from the GTAP model including, import price variable as well as several parameters taken to generate a variable that represents a change in Indonesia's export demand. The same variables have been used in two previous studies that connect the GTAP model to the national model, namely, Horridge and Zhai (2006) and Widyasanti and Yusuf (2019).

### Microsimulation

The microsimulation of the effects of policies on economic actors is performed by combining the results from GTAP and IndoTERM. This combination demonstrates the relationship between macro and micro economies as illustrated in **Figure 5.2**. The figure shows how macro and micro economic conditions are linked through two main transmission routes, namely the labour market and commodity prices. For example, the implementation of the IEU CEPA will improve macroeconomic indicators and brings benefits to certain sectors. This may lead to an increase in the demand for workers or improve job status and, hence, wages or income of workers in those particular sectors. In this model, individuals can change jobs or even lose their jobs. In addition, the liberalization brought about by IEU CEPA also affects the price of goods consumed by households which, ultimately leads to

changes in consumption patterns. These changes in income and consumption patterns will, in general, have implications for households' welfare, poverty rate and inequality between social groups.

Figure 5.2. Illustration of Top-down Microsimulation



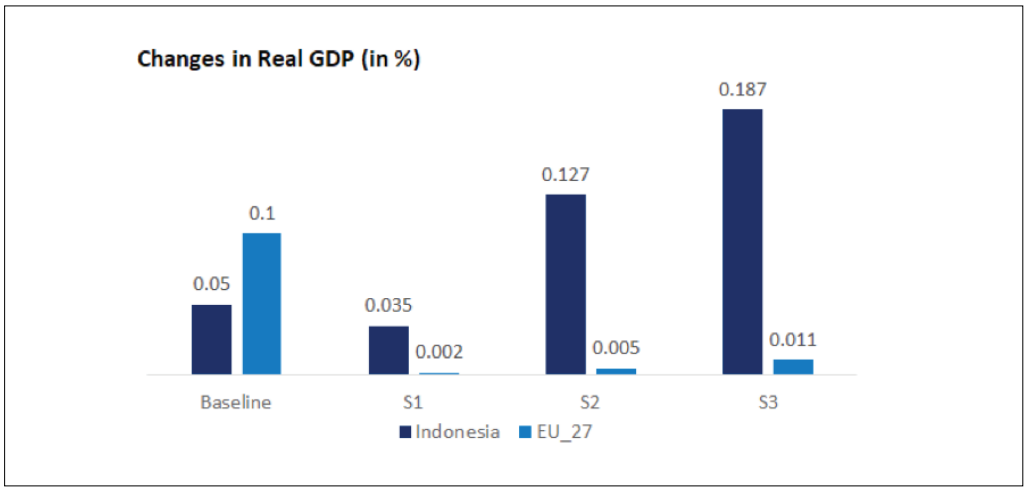

Source: Adapted from Tiberti, Cicowiez, and Cockburn (2017)

## SIMULATION RESULTS

### Macroeconomic Indicator

The impact of trade liberalization brought about by the IEU CEPA on the macroeconomic performance of the two countries is analyzed using several indicators including real GDP, welfare (measured by the Equivalent Variation variable in GTAP), exports and imports, and industrial output. There are three scenarios in this simulation. *Scenario 1* assumes a reduction in tariffs on goods traded bilaterally between Indonesia and the EU. In this scenario, the tariff reduction granted by the EU for goods imported from Indonesia is the same as for goods imported by the EU from Vietnam, at the end of the tariff schedule. Meanwhile, the tariff reduction for goods imported by Indonesia from the EU is equivalent to the tariff reduction for goods imported from Australia to Indonesia, at the end of the tariff schedule. *Scenario 2* assumes that, in addition to tariff reduction as in the first scenario, there is also a reduction in the ad-valorem tariff equivalent (AVE) of Non-Tariff Measures (NTM) on goods by 50 percent. *Scenario 3* assumes that, in addition to reductions in tariff and AVE on goods, as in the Scenario 2, there is also a reduction in AVE for Non-Tariff Barrier (NTB) on services by 50 percent.

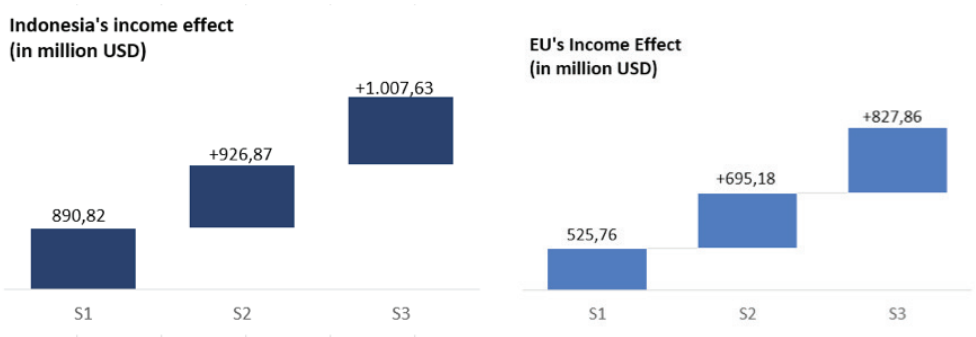
Figure 5.3 The Impact of the IEU CEPA on Indonesia's and EU's GDPs (in %)




Source: Results from GTAP

As trade between Indonesia and the EU opens up due to the IEU CEPA, there will be benefits to both economies in the form of, but not limited to, an increase in real GDP. This is essentially what the results of the simulation are suggesting. In particular, the results of the three simulation scenarios show that Indonesia's real GDP will experience a larger percentage increase than the EU. In Scenario 1, where there is a liberalization of trade in goods with tariff of almost zero for all products, Indonesia will experience a real GDP increase of 0.035%, and 0.002% for the EU. Meanwhile, in Scenario 2, where, in addition to setting tariff on all goods to almost zero, there is also a reduction in NTM for goods by half, the real GDP gain is 0.127% for Indonesia and 0.005% for the EU. If the EU-CEPA applies Scenario 3, which is to reduce trade tariff to almost zero for all products and reduce NTM for goods and services by half, Indonesia's real GDP gain will reach 0.187% and 0.011% for the EU. This growth is in line with achieving better welfare for both parties, as shown in **Figure 5.4.**

Figure 5.4 The impact of the IEU CEPA on Welfare in Indonesia and the EU (in million USD)



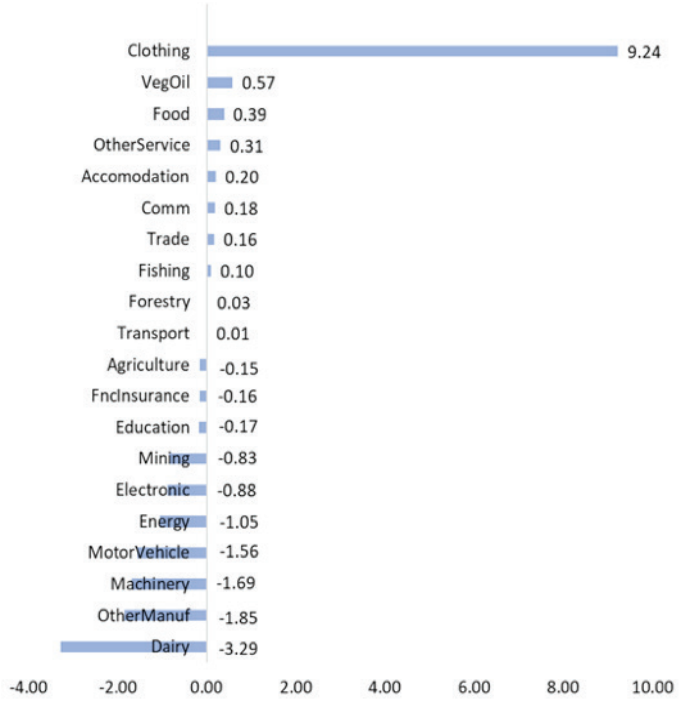

Source: Results from GTAP

The figure above shows that open trade between Indonesia and the EU will improve welfare of both parties by way of income effect. Overall, the increase in Indonesians real income will be higher than that of the EU citizens. In Scenario 3, the income effect of the IEU-CEPA will increase Indonesians welfare by USD1007.63 million compared to Scenario

2 or, by USD 2825.33 million against the baseline. In the same scenario, the welfare of EU citizens will increase by USD827.86 million against Scenario 2 or, by USD2048.8 million compared to the baseline.

In addition to a change in welfare, there will also be gains to productivity due to lower prices of raw materials and intermediate goods. Overall, Indonesia's total industrial output will increase by 0.1% against the baseline. There will be an increase in exports of several sectors, although demand for industrial output is dominated by demand from the Indonesian domestic market.

Figure 5.5 Changes in Indonesian Industrial Output (in %)




Source: Results from GTAP

**Figure 5.5** shows that the increase in output will take place mainly in the clothing, vegetable oil and food sectors which experience a gain of 9.23%, 0.57% and 0.39%, respectively. The increase in production of the clothing sector is due to an increase in export demand for clothing by 22.24%, of which 13.82% comes from the EU.

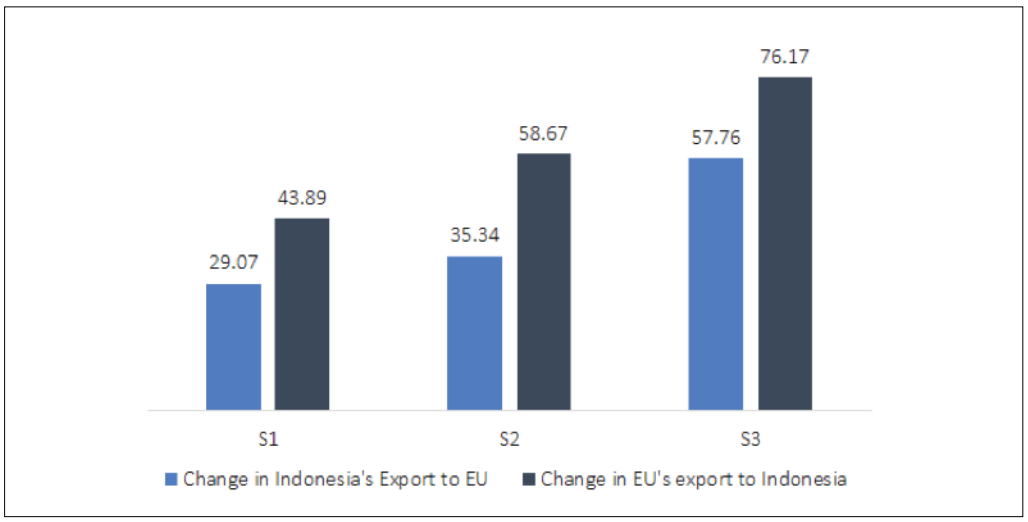
In addition, some services sectors will also experience an increase in their output, including accommodation, communications, trade and transportation sectors, each experiences an output increase by 0.20%, 0.18%, 0.16% and 0.01%, respectively. Most of the demand for services comes from the domestic market. For example, 99.47% of the demand for trade sector's output comes from domestic market. Meanwhile, export demand for the communications and transportation sectors will experience an increase of 10.33% and 6.66%, respectively.

On the other hand, output of dairy products will experience a decline by -3.29% due to a drop in domestic demand by -3.44%. The reduction in domestic demand has a significant effect on the output of these products since domestic demand accounts for 97.6% of the total dairy production.

Apart from dairy products, there are nine other sectors that will face a drop in their production. Three of them are other manufacturing (-1.85%), machinery (-1.69%) and motor vehicles (-1.56%). This decrease occurs due to a falling demand from both export and domestic markets. A decomposition of the reduction in domestic demand for other manufacturing sector reveals that the decrease is due to a reduction in the demand from the business sector by 2.16%, from the government sector by 1.95% and from households by 0.73%. A similar pattern is observed with a drop in demand for machinery, which is mainly due to a drop in the demand from the business sector by 3.6%, and, from government and households by 1.13% and 0.82%, respectively. As for motor vehicles, there will be a decrease in demand from households by 1.6% and from the business sector by 0.87%.

Notwithstanding the decline in several sectors, overall, the total industrial output in Indonesia will increase by 0.1%. This increase implies Indonesia will have more capacity to increase its export volume to the EU. **Figure 5.6** shows that there will be an increase in Indonesia's export to the EU after the reduction in trade barriers is implemented.

Figure 5.6 Changes in Indonesia-EU Bilateral Exports (in %)




Source: Results from GTAP.

Trade openness resulting from the implementation of the agreement will certainly increase bilateral trade between Indonesia and the EU. In scenario 3, Indonesia's export to the EU will increase by 57.76% and the EU's export to Indonesia will increase by 76.17%. Hence, unlike with the real GDP and welfare discussed earlier, the EU will experience a higher increase in its export to Indonesia than that of Indonesia to the EU. This is because the EU has a larger market share in Indonesia compared to the Indonesian market share in the EU, as indicated by the fact that the EU is in the third position[18] as Indonesia's trading partner. Meanwhile, Indonesia is in the 32nd position among EU's trading partners. The clothing and service sector is the sector with the highest increase in Indonesian exports to the EU, as shown in the table below.

18 https://ec.europa.eu/trade/policy/countries-and-regions/countries/indonesia/index_en.htm

Table 5.1 Changes in Indonesia's Exports to the European Union (in %)

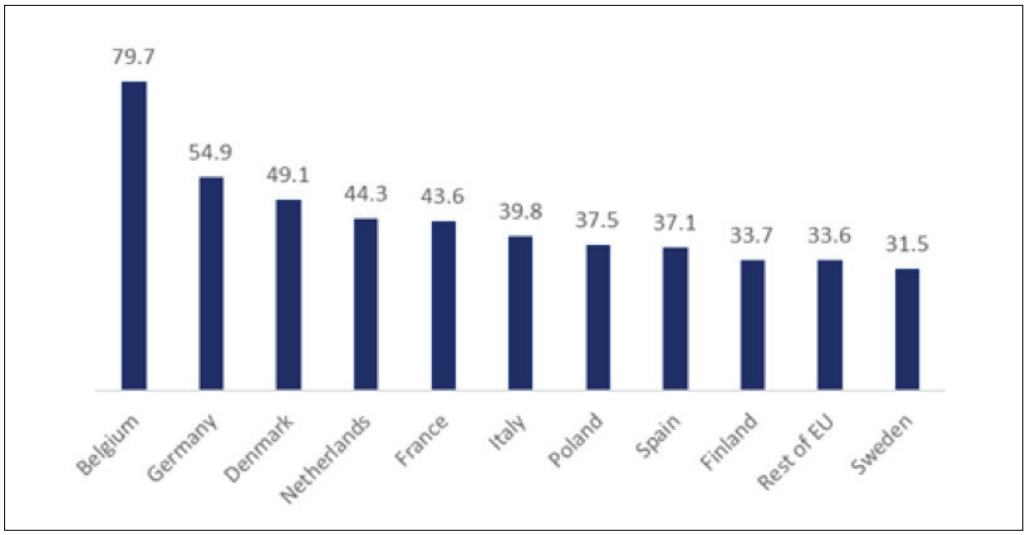
| Sector | Change in Total Indonesian Exports to the EU | Changes in Total Indonesian Exports |
|---|---|---|
| Agriculture | 15.90 | -1.20 |
| Forestry | -5.03 | -4.85 |
| Fishing | 22.63 | -1.41 |
| Energy | 1.52 | -1.59 |
| Food | 71.59 | 3.89 |
| VegOil | 34.41 | 1.09 |
| Dairy | 32.77 | 3.36 |
| Clothing | 152.31 | 22.24 |
| OtherManuf | 29.30 | -1.71 |
| Mining | 24.27 | -3.03 |
| MotorVehicle | 54.83 | -2.94 |
| Electronic | 15.55 | -0.40 |
| Machinery | 41.22 | -0.34 |
| OtherService | 98.26 | 4.82 |
| Comm | 68.63 | 10.33 |
| FncInsurance | 125.13 | 5.53 |
| Transport | 93.43 | 6.66 |
| Trade | 77.98 | 4.48 |
| Accommodation | -3.58 | -3.61 |
| Education | -4.23 | -4.28 |

Source: Results from GTAP

Overall, Indonesia's total export will increase by 1.65%. The sector that experiences the highest export increase is the clothing sector (22.24%), followed by Communication (10.33%) and the other service sector (4.82%), as well as food (3.89%), dairy products (3.36%) and vegetable oil (1.09%). Meanwhile, there are several sectors that experience a decline in their export such as forestry (-4.85%), mining (-3.03%), energy (-1.59%), fisheries (-1.41%) and agriculture (-1.2%). Aligned with Indonesia's total increase in export, there are numerous sectors which will see an increase in export to EU countries, such as clothing (152.31%), financial services and insurance (125.13%), as well as other service (98.26%). However, there are three sectors that will experience a decline in exports from Indonesia to the EU, namely forestry (-5.03%), education (-4.23%) and accommodation (-3.58%).

Meanwhile, if we decompose Indonesia's exports based on export destination countries in the EU, the destination countries with the highest export growth will be Belgium, Germany, Denmark and the Netherlands, as shown in **Figure 5.7**.

Figure 5.7 Changes in Indonesia's Exports to EU Countries (in %)




Source: Results from GTAP

Based on WITS data, the ten EU countries above were the countries with the highest export value from Indonesia to the EU in 2018. In the simulation, Indonesia's export to Belgium will increase by 79.7%, due primarily to an increase in clothing exports by 145.56 %. Note that clothes and shoes account for 49% of Belgium's imports from Indonesia. In this simulation, the clothing sector consists of textiles, clothing, leather and shoes. Meanwhile, Indonesia's export to Germany, will experience a growth of 54.9%, followed by Denmark and the Netherlands which will grow by 49.1% and 44.3%, respectively.

Table 5.2 Changes in Indonesia's Imports based on Total Demand from Business Actors, from High to Low (% change)

| Sector | Total Imports* | Private House-holds** | Com-panies*** | Sectors with the highest import demand from companies | The pro-portion of IDN imports from the EU**** |
|---|---|---|---|---|---|
| Forestry | 13.4 | 7.9 | 92.1 | OtherManuf, Forestry, OtherService | 114.6 |
| Dairy | 11.8 | 87.6 | 12.4 | Dairy, Food, Accommodation | 149.0 |
| Clothing | 9.9 | 11.6 | 88.4 | Clothing, OtherService, Trade | 46.8 |
| Comm | 9.9 | 23.1 | 76.9 | Trade, OtherService, FncInsurance | 111.5 |
| Trade | 9.8 | 43.6 | 56.4 | OtherService, Trade, Accommodation | 100.3 |
| OtherService | 8.7 | 10.3 | 86.7 | OtherService, Trade, Transport | 104.7 |
| FncInsurance | 7.6 | 14.2 | 85.8 | OtherService, Trade, FncInsurance | 86.9 |
| Transport | 7.2 | 53.8 | 46.2 | OtherService, Trade, OtherManuf | 110.4 |
| OtherManuf | 5.4 | 17.8 | 82.2 | OtherManuf, Clothing, OtherService | 149.5 |
| Food | 3.3 | 48.22 | 51.8 | Food, Agriculture, Accommodation | 53.8 |
| Agriculture | 3.2 | 18.9 | 81.1 | Clothing, Food, VegOil | 14.1 |
| VegOil | 3.0 | 33.6 | 66.5 | VegOil, Food, Accommodation | 9.9 |
| MotorVehicle | 2.5 | 57.3 | 42.7 | MotorVehicle, OtherService, Machinery | 162.6 |
| Education | 2.3 | 61.8 | 3.9 | OtherService, Comm, Trade | 21.8 |
| Accommo-dation | 2.2 | 89.6 | 10.4 | OtherService, Trade, Transport | 33.3 |
| Mining | 2.1 | 0.9 | 99.1 | OtherService, Mining, OtherManuf | 104.7 |
| Fishing | 1.8 | 71.9 | 28.1 | Food, Accommodation, Fishing | 3.2 |
| Machinery | 1.6 | 13.7 | 86.3 | OtherService, Energy, Mining | 387.3 |
| Electronic | 1.0 | 37.8 | 62.2 | OtherService, Clothing, Trade | 170.3 |
| Energy | 0.4 | 53.6 | 46.4 | Clothing, Transport, OtherService | 45.8 |

*) Change in Indonesia's total imports
**) The proportion of imports by Private Households to changes in Indonesia's total imports
***) The proportion of imports by Companies to changes in the total imports of Indonesia
****) The proportion of EU imports to Indonesia to changes in Indonesia's total imports

Source: Results from GTAP

The sector that will experience the highest import growth in Indonesia is the forestry sector at 13.4%, followed by dairy products and clothing at 11.8% and 9.95%, respectively. Meanwhile, the machinery, electronics and energy sectors will experience only a slight increase, each by 1.6%, 1% and 0.4%, respectively.

The demand for import comes from households and companies (business sector). The increase in the demand for imports by households indicates an increase in household consumption. Meanwhile, import demand from companies indicates that there is an increase in demand for intermediate goods for production purposes. In other words, an increase in demand for imported goods from companies will lead to an increase in their production, which implies that the country's industries are becoming more competitive.

Import demand from the household sector has a larger share in Indonesia's aggregate import growth than the business sector in 8 sectors, namely dairy products, transportation, motor vehicles, education, accommodation, fisheries, and energy. Meanwhile, the business sector has a larger share than the household sector in the increase of the demand for imports in 13 out of 20 sectors, namely forestry, clothing, communications, trade, other services, insurance and finance, manufacturing, food, agriculture, vegetable oil, mining and machinery. In other words, the 13 sectors have better competitiveness, as increase in import of intermediate goods implies an increase in production. The increase in demand for import by companies can be further scrutinized by identifying sectors that are responsible the most for the increase. For example, three sectors that are most responsible for the 92.1% share of the business sector in the increase of the demand for forestry products are other manufacturing, forestry and other services.

Imports from the EU contribute significantly to changes in Indonesia's total import in a number of sectors such as motor vehicles (162.59%), dairy products (148.99%), forestry (114.61%), and all sectors in the service sector.

Table 5.3 Changes in Indonesian Imports based on Exporting Countries (% change)

| Sector | Changes in Indonesia's Total Imports | Changes in Indonesia's Imports from ASEAN | Changes in Indonesia's Imports from East Asia | Changes in Indonesia's Imports from the Rest of World | Changes in Indonesia's Imports from the EU |
|---|---|---|---|---|---|
| Agriculture | 3.21 | 2.67 | 2.83 | 2.72 | 36.52 |
| Forestry | 13.40 | -9.42 | -9.56 | -9.55 | 80.22 |
| Fishing | 1.83 | 1.67 | 1.82 | 1.78 | 15.95 |
| Energy | 0.39 | 0.15 | 0.20 | 0.20 | 47.78 |
| Food | 3.27 | 1.00 | 1.04 | 0.98 | 31.74 |
| VegOil | 2.98 | 2.38 | 2.74 | 2.70 | 36.09 |
| Dairy | 11.79 | -11.62 | -11.55 | -11.59 | 77.22 |
| Clothing | 9.99 | 4.87 | 4.82 | 4.79 | 251.41 |
| OtherManuf | 5.44 | -4.26 | -4.32 | -4.37 | 89.34 |
| Mining | 2.01 | -0.26 | -0.29 | -0.37 | 67.85 |
| MotorVehicle | 2.55 | -2.23 | -2.19 | -2.23 | 113.87 |
| Electronic | 1.00 | -0.76 | -0.82 | -0.91 | 52.56 |
| Machinery | 1.57 | -5.61 | -5.62 | -5.70 | 51.78 |
| OtherService | 8.70 | -5.34 | -5.42 | -5.45 | 129.07 |
| Comm | 9.90 | -7.42 | -7.47 | -7.51 | 113.46 |
| FncInsurance | 7.58 | -3.47 | -3.55 | -3.60 | 186.09 |
| Transport | 7.15 | -5.17 | -5.17 | -5.22 | 130.68 |
| Trade | 9.83 | -4.88 | -4.96 | -5.00 | 108.40 |
| Accommodation | 2.16 | 2.24 | 2.21 | 2.16 | 2.08 |
| Education | 2.33 | 2.50 | 2.40 | 2.35 | 2.22 |

Source: Results from GTAP

The first column shows the change in Indonesia's total imports in percentage, followed by changes in Indonesia's import from four regions (ASEAN, East Asia, EU and other countries). The increase in Indonesia's total import shows creation of trade after the implementation of the IEU CEPA. Trade creation takes place particularly in 8 sectors, where there is an increase in the total import as well as import from all the four regions. These sectors include agriculture, fisheries, energy, food, vegetable oil, clothing, accommodation and education. In addition, 12 out of 20 sectors experience trade creation involving a shift of imports from other regions to the EU, as evident from the fact that while total imports increase, imports from ASEAN, East Asia and other countries decrease. For example, in the forestry sector, Indonesia's total imports experience an increase of 13.4%, due primarily to an increase of imports from the EU by 80.22%. At the same time, there is a reduction in imports from ASEAN (-9.42%), East Asia (-9.56%) and other countries (-9.55%). The same phenomenon can be observed in the dairy products, other manufacturing, mining,

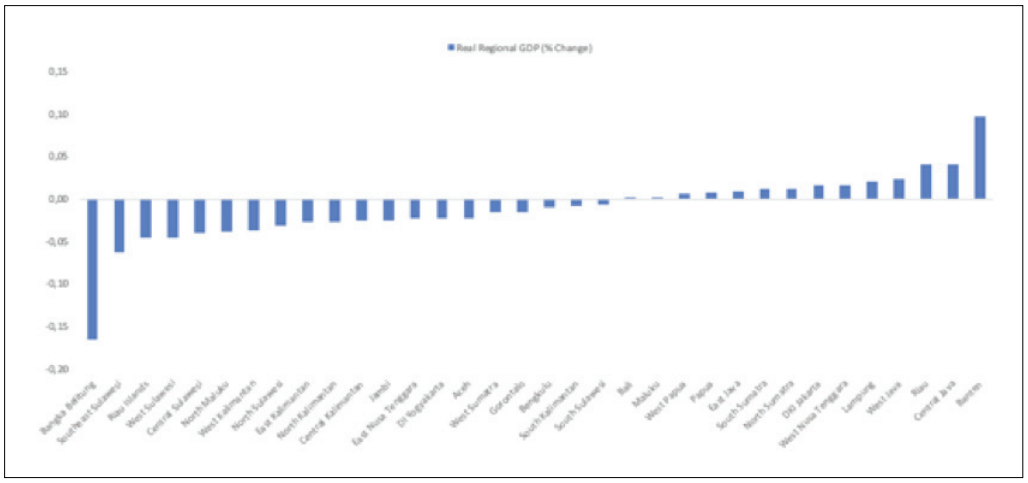
motor vehicles, electronics, machinery, other services, communications, finance and insurance, transportation and trade sectors.

Finally, the GTAP analysis shows that Indonesia will benefit from the implementation of the IEU CEPA, thanks to the improvement of the country's macroeconomic performance, such as, the increase in real GDP, welfare and bilateral trade (exports and imports). Note, however, that Indonesia's imports from the EU will increase at a higher rate than its exports to the EU, as illustrated in **Figure 5.6**. It should also be noted that this simulation does not capture the impact of non-tariff barriers imposed by the EU on Indonesian palm oil due to data limitation. The data that we used is for 2012-2016, while the NTB on palm oil came into effect only in 2018.

### Regional Impact

The IEU CEPA has a different impact on each province in Indonesia. Overall, based on the IndoTERM simulation, there are 14 provinces that will experience an increase in real GRDP after the agreement is implemented, while the remaining 20 provinces will experience a decrease in their real income. The five provinces with the highest real GRDP increase are Banten (0.13%), Central Java (0.06%), Riau Islands (0.05%), West Java (0.04%), and North Sumatra (0.034%). The fastest growing sector in the five provinces under consideration is clothing and textile which grows 1.53%, on average. This is in line with the result of the GTAP model. Meanwhile, the five provinces with the largest decrease in real GRDP are South Sulawesi (-0.10%), West Kalimantan (-0.07%), Central Sulawesi (-0.068%), West Sumatra (-0.066%), and South Sumatra. (-0.05%). The sector that will experience the largest decline in these five provinces is the machinery sector which will contract -1.25%, on average. This is also in line with the finding of the GTAP model. **Figure 5.8** below shows the impact of the agreement on the GRDP of all provinces in Indonesia.

Figure 5.8 The Impact of the IEU CEPA Scenario on Real GRDP per Province (% Change)

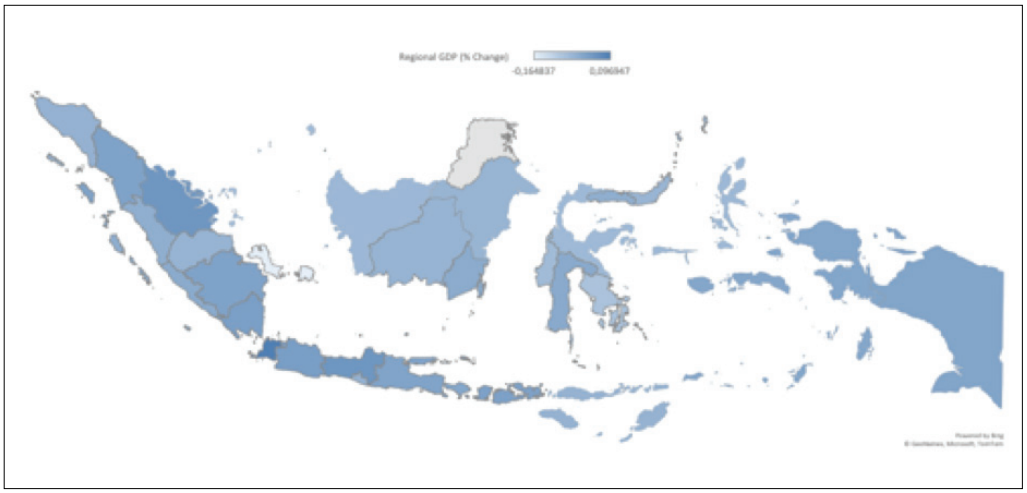



Source: Results from IndoTERM

Note that most of the provinces that will experience real GRDP growth are Java and Sumatra. On the island of Java, only DI Yogyakarta (-0.02%) and East Java (-0.01%) experience negative real GDP growth. From an expenditure side perspective, each component of the GRDP is growing more rapidly in Java and Sumatra than in other parts of the country.

On average, household consumption and export in Java and Sumatra will increase 0.13% and 1.01%, respectively. In other parts of the country these variables will increase, on average, by 0.09% and 0.66%, respectively. Meanwhile, investment will experience a drop in all provinces. However, it will decrease only by -0.04% for all in Java and Sumatra, while it will decrease by -0.09% in other provinces. For visualization purposes, the figure below shows a map of the impact distribution of the related scenario to the real GRDP per province.

Figure 5.9 Distribution of the Impact of the IEU CEPA on Real GRDP by Province (% Change)

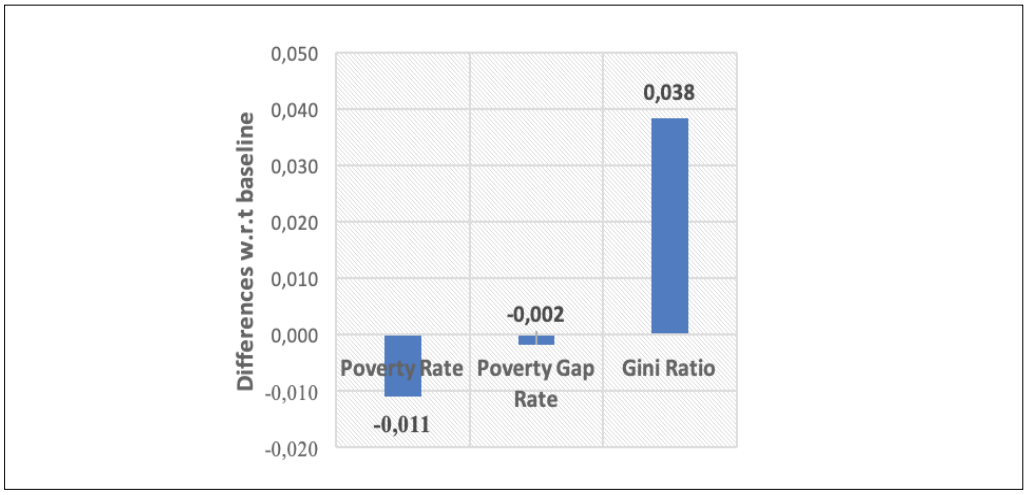



Source: Results from IndoTERM

### Social-Economic Impact

In this analysis, the baseline and simulation scenarios are defined the same as that in the CGE model. The implementation of the IEU CEPA encourages trade liberalization with positive prospects for GDP and wages. Specifically, this policy can help increase the purchasing power of Indonesian households. **Figure 5.10** illustrates the difference in socio-economic indicators between the simulation and baseline conditions. The results of the static comparative analysis show that the agreement has a negative impact on poverty, namely that IEU CEPA can reduce the fraction of the population below the poverty line. The difference in poverty rate with the agreement in place can reach 0.01 percentage points of number of people living in poverty. The driving force behind the reduction in the poverty rate is the change in real wages. There is also a potential improvement in the poverty gap rate, which measures how unequal spending is between the poor. With the agreement, the poverty gap rate can be reduced, although the difference is close to 0. In other words, the agreement provides an opportunity to improve Indonesia's socio-economic conditions in terms of poverty alleviation, but only marginally.

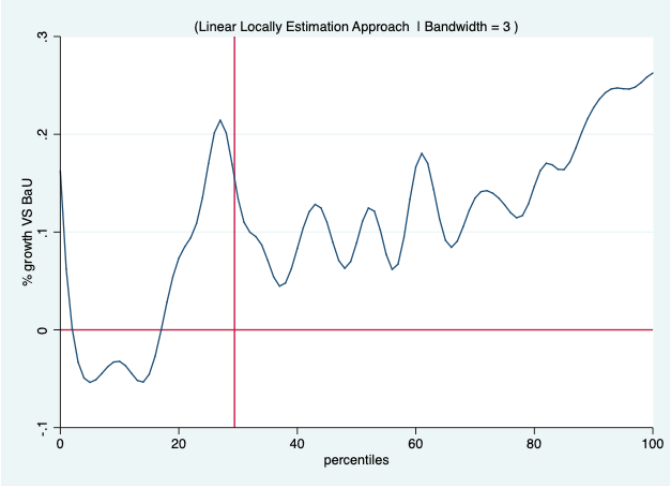
Figure 5.10 Differences in Social-Economic Indicators




Source: Microsimulation Calculation

However, the agreement does not bring equal benefits to all income groups in the society. This can be seen from a positive difference between the Gini coefficient generated by the simulation and that of the baseline. With the IEU CEPA in place inequality will increase (Gini coefficient) by 0.038 percentage points. One explanation for the rising inequality is that the agreement tends to increase demand for skilled workers which earn higher wages than the unskilled ones. **Figure 5.11** illustrates a Growth Incidence Curve that illustrates the percentage change in consumption under a simulation scenario. The bottom 20 percentile group is negatively affected by less than 0.1%. For people who are above the poverty line, all groups get a positive impact with the upper-level group tends to get a bigger increase. This finding is in line with a World Bank study (2019) which estimates that the EU-CEPA and other cooperation agreements such as FTAAP and TPP-15 will reduce poverty but increase inequality. Furthermore, the study explains that although revenue increases from EU-CEPA are higher than other agreements, the upper percentile enjoys a higher increase than the lower 40th percentile.

Figure 5.11 Growth Incidence Curve




Source: Microsimulation Calculation

Although this study can illustrate the potential distributive effects of the IEU CEPA, it is also important to understand the limitations of the data used. While the data used in the micro simulation, namely IFLS, can be analyzed as cross-section data, it is nevertheless longitudinal data. As a result, the data may not be as accurate in capturing the actual poverty condition in Indonesia as the National Socio-Economic Survey (*Susenas*) data. However, IFLS has relatively more complete data sets covering income, employment, and expenditure variables, which are required to run the micro-simulation model.

# 6.

# GLOBAL VALUE CHAIN PERSPECTIVES IN THE IEU CEPA AGREEMENT

THE ANALYSIS IN Chapter 2 and the model simulations in Chapter 5 show that the comparative advantage of Indonesian products tends to be concentrated in natural resources-based products, such as plantation products and minerals, and products of labor-intensive industries. The composition of Indonesia's exports, both to the world and to Europe, has not changed much in the last two decades, although the diversification of export products is more visible in the European market. The simulation in Chapter 5 also shows that most sectors of the economy that will benefit from the IEU CEPA are compatible with this comparative advantage. The discussion on investment in Chapter 4, as well as an explanation of the services sector in Chapter 3 also reinforces this.

This certainly raises several questions: Does Indonesia have the opportunity to diversify its export products and deepen its industry? And how can the IEU CEPA help this process? The Report also discusses potential development as a result of the implementation of the IEU CEPA and the policy changes it induces. In this chapter, the potential for the development of Indonesia's industry and production sector is discussed through the perspective of the Global Value Chain (GVC), which is closely related to the trade, service sector and investment issues discussed earlier. The discussion starts by looking at the GVC and its role in economic and industrial development, followed by looking at Indonesia's position, before discussing how the IEU CEPA can provide opportunities for Indonesia's wider participation in the GVC.

## GLOBAL VALUE CHAIN AND ITS ROLE IN ECONOMIC DEVELOPMENT

One of the main characteristics in the development of world industry since the last thirty years is the massive fragmentation of production at the global and regional levels. Production is no longer carried out in one place in a country but is broken down into various levels of production. Production of parts and components, or production of finished goods, are carried out at different locations and in different countries. The choice of the parts to be produced in a particular location is determined by the characteristics of the product in question and the comparative advantage of that location. The fragmentation process, also known as GVC, is driven by international businesses, both large multinational businesses that establish production networks and SMEs (small and medium enterprises) that are part of the production networks.

From a commercial perspective, the international business community has benefited substantially from the development of production networks and value chains, in terms of increasing efficiency and managerial skills, and innovation[19]. From the perspective of

19 See various studies from Gereffi, Humphrey, & Sturgeon (2005) and Humphrey & Schmitz (2002), or iPod case study (Linden et al., 2009) or Lenovo and HP (Dedrick et al., 2010).

economic and industrial development, a country's participation in GVC development and in various international production networks provide an opportunity to increase economic activity. For developing countries this can constitute an industrial development strategy to catch up with developed economies as there will be faster and more consistent flows of goods, capital and knowledge among participating countries (Baldwin 2016).

Since World War II there have been several industrial development strategies adopted by various developing countries to guide their industrial policy. One that has received the most attention is the Import Substitution (IS) strategy, which was widely adopted in the 1950s. This strategy is based on a policy to replace imported manufacturing goods mostly from more developed countries with domestically produced goods. This strategy is associated with the economic independence narrative which is also in line with the spirit of decolonization after World War II, which may explain its popularity among many developing countries in the 1960s (Todaro and Smith, 2014).

The IS strategy is highly dependent on the size of domestic market and the available economies of scale. A country with a large enough domestic market is expected to be able to absorb the goods produced by the import substitution industry. To enable domestic products to compete with imported products, restrictive trade policies are imposed. The expectation is that after a certain period, the protected industries will achieve economies of scale and cost efficiency based on learning-by-doing. This strategy requires consistent policies with a clear timeframe, as well as the selection of the right industrial sectors. The problem is that these three policy prerequisites are often not attainable.

By the 1970s, there were signs that the IS strategy had failed to stimulate industrialization in developing countries. Moreover, it appears that this policy had become a source of inefficiency and economic distortion instead, Little et.al (1970) and Krueger (1997). As a result, developing countries began to abandon the strategy. Indonesia itself had implemented the IS strategy since the late 1960s by building various upstream industries that were considered important; some of these industries are still being protected today.

Another strategy that has been widely adopted by developing countries, especially in East Asia, is Export Promotion (EP). Just as with the IS, this strategy is also a policy applied to few selected industries. However, in contrast to that of IS, the EP policy emphasizes more on driving selected industries to export, since the world market is much bigger than the domestic market. The EP policies focuses on providing those industries with assistance to penetrate international markets, such as marketing assistance, cheaper inputs and subsidies in production. This strategy rarely uses an element of protection for imported goods. With the failure of the IS strategy, many developing countries have switched to export strategy, instead.

Although this strategy requires the same policy prerequisites of the IS, its outcome is often considered more in line with industrial development goals. The successes of the Four Asian Tigers, Singapore, Taiwan, South Korea and Hong Kong are often associated with the EP strategy. This strategy forces the government to implement required policies consistently, because any losses from the failure of this strategy will be borne by the government, not by the economy and consumers as in the IS strategy. However, EP also has many weaknesses, including the need for large capital and other resources including technology. The EP strategy may also fail to pick the right industries (winners) to support. In addition, the strategy also creates distortions because the rewards for factors of production, such as the level of wages, must be pushed below the level of comparative advantage.

The development of the GVC provides developing countries with an option to adopt an alternative industrial development strategy that is more efficient, more targeted and more consistent. By participating in GVCs, developing countries can benefit from world markets just like the EP strategy, but with less burdensome prerequisites such as technology and capital, and subsidies. Investment associated with GVC could provide more capital, technology and know-how as well as market for the resulting products. The risk of failure with great costs no longer has to be borne by the government and the economy, but by the multinational that manages the production network.

Participation in the GVC also provides the economy with an opportunity to achieve its industrial deepening goals as aspired by IS strategy by way of value-chain upgrading, although it requires various policies and a favourable environment (Gereffi, 2016). From a macroeconomic perspective, participation in the GVC also has a positive effect on value added and productivity. Kummritz (2016) estimates that a one percent increase in participation in GVC will increase value added between 0.1% - 0.6%, and 0.3% in labor productivity.

Participation in the GVC itself is determined by various factors at the global, regional and national, even sub-national levels. Although there are large variations between each economy, participation in the GVC depends on the fundamental aspects of the GVC and the fragmentation of production itself, namely trade, investment and supporting services, as described by Baldwin (2011) as trade-investment-services nexus.

As an international production network, free trade is the main condition for better participation in GVC. Therefore, in addition to a more open trade policy, various trade-related infrastructure, logistics and trade facilitation are the main factors for a robust participation in such networks. Lanz and Piermartini, (2016) find that countries in such circumstances tend to have industries that depend on value chains and international supply chains.

Trade and, most notably, investment policies are also important as multinationals use FDI as the main conduit to expand their value chains. Kowalski et al. (2015) find that countries that have trade agreements and open investment regime tend to have higher participation in GVC, especially in backward linkages. The same study also finds that the quality of institutions, protection of intellectual property rights, and the ability to absorb and use technology determine such participation. Damuri (2012) also finds that countries that participate in comprehensive trade agreements, such as CEPA, have more trade in input products than otherwise, an indication of their participation in value chains. The availability of quality services is also a main requirement for participation in the GVC as described in Chapter 3.

### Indonesia's Participation in GVCs

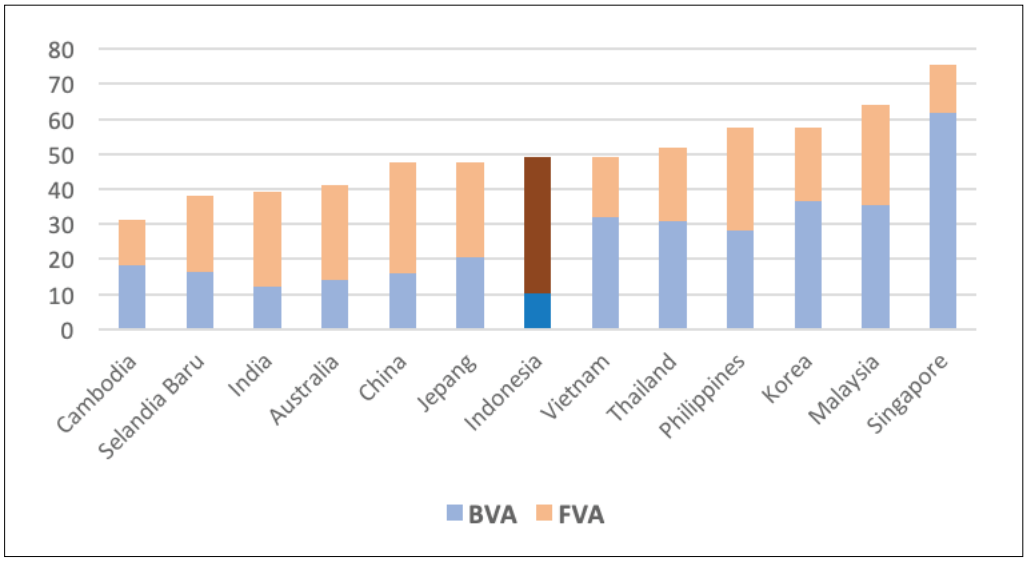
There are different ways to assess the extent to which an economy is participating in a GVC. Involvement in GVC is the relationship between business units in one economy and business units in other economies, whether they belong to a same company, such as between a holding company and its subsidiaries, or between suppliers and buyers. Therefore, at the micro level, an economy's participation in GVC can be analyzed by looking at the patterns of interaction between firms in that particular economy and firms in other economies, i.e., whether such interaction is related to international production activities. This is usually done by reviewing several case studies at the company or industry level.

While providing excellent detail, case studies cannot provide an overview at the macro level. Therefore, much of the current analysis looks at the involvement at macro level. Apart from being able to provide a more comprehensive picture, macro analysis can also produce recommendations on basic policy pertaining GVC. The analysis can be done by reviewing trading patterns such as the analysis in Chapter 2, but the results do not provide the necessary insight. An alternative is to use trade in value added analysis, which can provide information on the role that foreign value added plays in domestic production and export, as well as to what extent domestic value added plays a role in the production of other countries.

Various methods have been developed using value added statistics to evaluate the involvement of an economy in the GVC. Two basic indicators are the backward value added (BVA) indicator in exports and forward value added (FVA). BVA measures the extent to which the export value of an economy incorporates added value originating from abroad, usually compared to the gross export value. The higher the BVA, the higher the role of imports in the economy's exports, which indicates a higher level of participation in GVC. The FVA, on the other hand, measures the extent to which an economy's exports is incorporated in other countries' exports. An economy with a high FVA implies it has a significant role in world production and export.

**Figure 6.1** provides an illustration of the two indicators mentioned above. At first glance, Indonesia's involvement is not much different from other countries, including Vietnam, Thailand, and even China. The most basic difference between these countries and Indonesia is the type of involvement. Indonesia's BVA only reaches 10%, much smaller than that of other countries, including India. It implies the value added of imports used in Indonesia's exports is relatively small compared to other countries such as Vietnam, which reaches 32%, or Thailand (30%). Even compared to countries with more mature industries, such as Japan, Korea and China, the added value of imports in Indonesia's exports tends to be smaller.

Figure 6.1 GVC Participation for Several Countries 2018 (% Gross Export)




Source: IORA Database

On the other hand, Indonesia has a high FVA indicator, even higher than other countries in the region. Economies that have a high FVA are usually associated with mature industries that become the main source of input for production and exports in other countries. But the numbers for Indonesia need to be interpreted with caution. The high FVA is due more to the contribution of various resource-based products which are also the key to Indonesia's export products. In more detail, almost 40% of the value added comes from mineral, metal and energy products. FVA from other primary sectors such as plantations, forestry and others are also very high. Only about 11% of the value added comes from the manufacturing sector with high international network characteristics, such as textiles and garments, electronics and motor vehicles. Indonesia's high FVA ratio, in fact, does not accurately reflect Indonesia's participation in GVC, especially in GVC for manufactured products.

As mentioned earlier, a country's participation in the GVC has a positive correlation with its economic and industrial development. If one looks at the BVA indicator above, high participation in GVC can also be interpreted as high import content in the export value.

This seems to be incompatible with the goal often promoted by the Indonesian government to increase local content from production and imports. Various policies have been launched to support this goal, such as the provision of the Local Content Level (TKDN), which requires a minimum level of local content for goods produced in Indonesia. The TKDN policy is to be discussed further in Chapter 8. But it is worth mentioning here that such a policy is not compatible with the strategy of further participation in the GVC.

Figure 6.2 GVC Participation and Industry Development

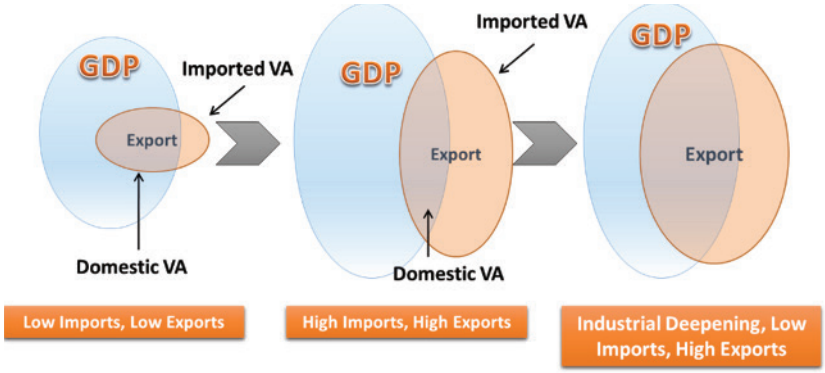


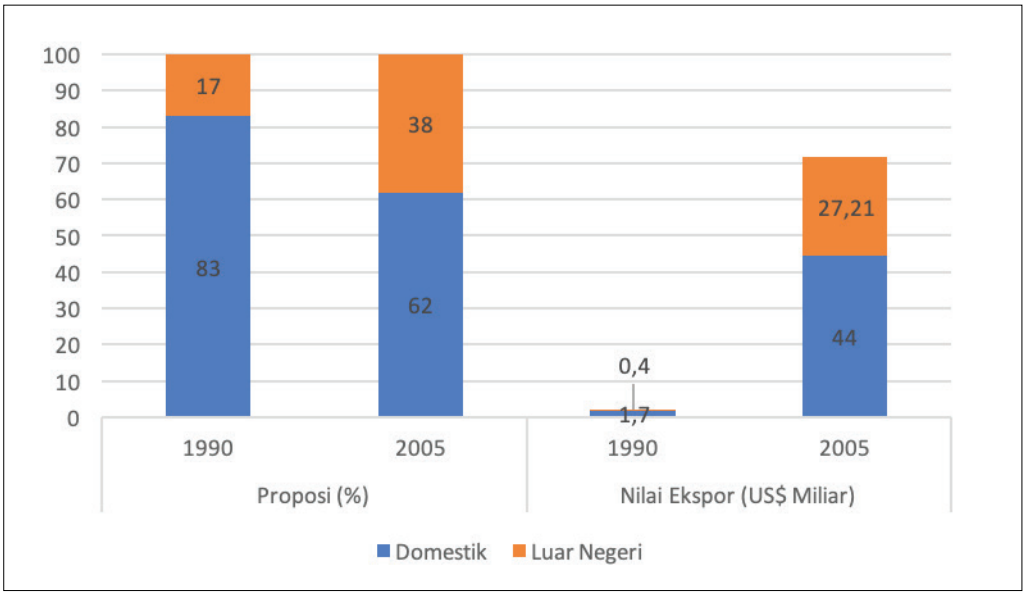

**Figure 6.2** provides a simple scheme of how participation in GVC and import content will drive industrial and economic development. In the early stages with low participation, the portion of import value added in export tends to be small, because it is dominated by high local content. But at this stage, the export value is also limited. As the country joining GVC, as seen in the second phase, the portion of import content will increase while the portion of local content in its export is reduced. But this is followed by an increase in the nominal value of exports, so that even though the portion is decreasing, the value added of local content is actually increasing, including its contribution to the economy. In the next stage, the industry will go through deepening with the ability to produce intermediate inputs for both own production and production in other countries. Hence, export grows with the support of higher local content.

Lopez-Gonzales and Holmes (2011) and Baldwin (2012) document this development by noting that countries with a GDP per capita below US $20 thousand tend to receive input

supply from abroad. Once their GDP per capita surpass that value, they tend to provide input supply to other countries.

It should be noted that the decreasing portion of local content after participating in GVC does not imply that the value itself decrease, as well. In fact, it is likely that the value will increase instead. **Figure 6.3** illustrates the situation of China's exports of computer and communication products, between 1990 and 2005. In the first period when China's participation in electronic GVC was still low, the share of local content in the products reached 83%. When China's participation increased, the share of local content in the products fell to 62%, while import content contributed 38%. However, the value of local content in 2010 was 25 times higher than that of fifteen years earlier, because the export value had increased 34 times during the same period. This illustration shows how China's communications and computer equipment industries were able to use imported parts and components, as part of their GVC participation, to improve their products and export competitiveness. In the subsequent development, Chinese industries are also increasingly capable of producing components not only for domestic industries, but also for industries in other countries.

Figure 6.3 Local and Import Content of China's Computer and Communication Products




Source: Calculated from EORA-GVC Database

In a report published in 2019, ADB evaluated Indonesia's position on the GVC during the 2000-2017 period. There are several main points raised by the report. First, production in Indonesia is more oriented towards the domestic market, using inputs that are also obtained from the domestic economy, as discussed above. Second, Indonesia also tends to aim at developing "downstream" production, in contrast to countries that participate in GVC, which tend to aim at "upstream" production. But Indonesia has established a strong link with Asian countries, which can help Indonesia to increase its participation in GVC in the future.

## POTENTIAL IMPACT OF THE IEU CEPA TO PARTICIPATION IN GVCS

One potential benefit that Indonesia can get from the IEU CEPA is an opportunity to increase its participation in GVC, especially in those GVC originating from EU countries. The European Union is the region with the highest degree of integration measured in terms of various indicators of GVC participation. European Union multinational companies, both in the manufacturing and service sectors, have long been acquiring intermediate goods and components from outside their countries, as well as running their operations overseas. In East and Southeast Asia, European companies have been operating and producing for a long time to serve markets in the region. They have been purchasing and producing intermediate materials based on the comparative advantages of the region.

Eurostat noted that although European companies still obtain more of their intermediate materials from countries within the EU, the proportion obtained from outside the region remains quite significant[20]. Apart from raw materials and intermediate materials in the form of components, European companies are increasingly active in outsourcing some of their business and administrative functions from other countries and regions. This development has been further enabled by the development of digital technology that allows various business activities to be carried out in different places. As such, GVC is no longer just about production and supply of intermediate goods, but also about provision of services. The development of service GVC also opens up opportunities for greater trade in services in the form of supplying business services and administrative support.

Indonesia has not yet attained an important position in the value chain originating from European Union countries. **Table 6.1** shows value added from the EU in Indonesia's export, as a fraction of EU's value added contained in world's export. This is equivalent to the FVA of EU countries passing through Indonesia, compared to the entire EU FVA. The higher a country's ratio the more important that country is in the GVC of the European Union. Or, it can be said that the country has become a hub of the European Union GVC. The table below also presents the position with other ASEAN countries as a comparison.

20 https://ec.europa.eu/eurostat/statistics-explained/index.php/International_sourcing_and_relocation_of_business_functions

Table 6.1 EU Value Added in ASEAN Countries Exports (% of EU FVA)

| | | Indonesia | Malaysia | Philippines | Thailand | Vietnam | ASEAN |
|---|---|---|---|---|---|---|---|
| Total | | 0.58 | 2.36 | 0.51 | 2.20 | 1.36 | 12.24 |
| Manufacturing | | 0.60 | 2.68 | 0.54 | 2.47 | 1.62 | 11.89 |
| | Food Products | 1.38 | 3.23 | 0.20 | 3.12 | 5.74 | 15.62 |
| | Textiles and Apparel | 1.72 | 0.59 | 0.14 | 1.55 | 7.69 | 12.02 |
| | Wood and Paper | 2.47 | 1.75 | 0.60 | 2.29 | 3.06 | 11.41 |
| | Chemicals | 0.51 | 2.14 | 0.09 | 2.63 | 0.90 | 11.90 |
| | Basic metals and products | 0.47 | 1.79 | 0.12 | 1.60 | 0.96 | 5.97 |
| | Electronics and Electrical | 0.32 | 5.77 | 1.47 | 2.64 | 1.02 | 17.81 |
| | Machinery | 0.63 | 1.61 | 0.15 | 1.91 | 0.63 | 8.73 |
| | Transport Equipment | 0.30 | 0.50 | 0.34 | 2.65 | 0.65 | 6.02 |
| | Other Manufacturing | 0.95 | 1.79 | 0.76 | 3.74 | 3.44 | 14.82 |

Source: Calculated from TiVA Database

In total only 0.58% of the EU's FVA passes through Indonesia. The figure for the country's manufacturing sector is not too different. Even for sectors that have significantly high GVC characteristics, such as electronics and vehicles, the numbers hovering only 0.3%. Indonesia's involvement in EU's GVC tends to be insignificant compared to the involvement of other countries in ASEAN. Malaysia, for example, is becoming a more important hub as it contributes 2.4%, as is Thailand. Vietnam and the Philippines have become important hubs for several production sectors. In aggregate, ASEAN is an important hub for the GVC originating from the European Union.

As explained in the earlier chapters, the CEPA between Indonesia and the European Union will open many opportunities to improve relations between the two economies. With this agreement, it is expected that Indonesia will also be able to become more integrated with the GVC established by companies from Europe. With this agreement, trade barriers will be lowered. It will facilitate freer flow of goods between the two. Quality services will also be more readily available through the reduction of barriers. Investment is also expected to increase along with trade and policy certainty. Trade, services and investment are the main factors to increase participation in GVC, not only those from the European Union, but also from other countries.

Surely, this agreement alone cannot increase Indonesia's participation in the GVC. Various actions, both at the policy and capacity building level, must be taken to support the creation of a better business environment. The next chapter discusses various policy recommendations needed to optimize this agreement in supporting the ongoing reforms in Indonesia.

# 7.

# OTHER ISSUES IN THE IEU CEPA

BEFORE DISCUSSING VARIOUS recommendations and policy adjustments in the context of implementing the IEU CEPA, this chapter first discusses the non-trade issues that are part of the agreement. **Table 7.1** summarises the issues discussed in the negotiations, which are likely to take part in this trade agreement. These issues are still likely to evolve in the negotiation process. They have never been negotiated by Indonesia in previous trade agreements. They include sustainable development and digital trade (including data flow and privacy). Negotiations are still at the initial stage and their development may still be quite dynamic. The issues listed below are not different from the Vietnam-EU CEPA, which was officially implemented in July 2020 except for several chapters like digital trade (including data flow and privacy), energy and raw materials.

Table 7.1 IEU CEPA Discussion Areas

| Trade in Goods | Public Procurement |
|---|---|
| **Rules of Origin** | State Owned Enterprises |
| **Customs and Trade Facilitation** | Energy and Raw Materials |
| **Sanitary and Phytosanitary measures (SPS)** | Sustainable Development |
| **Technical Barriers to Trade (TBT)** | Mutual Customs Assistance |
| **Trade Remedies Actions** | Good Regulatory Practice |
| **Services and Investment** | Transparency |
| **Intellectual property** | Management of preferential treatment |
| **Digital trading** | Exception |
| **Data flow between countries and protection of personal data and privacy** | Dispute resolution |
| **Business competition** | Final and Institutional Provisions |
| **Small and Medium Enterprises** | Special Note for the Motor Vehicle Sector |

Source: European Commission

This report examines four aspects of the agreement: (i) Investment Protection, (ii) Intellectual Property Rights, (iii) Business Competition, and (iv) Government Procurement. This chapter does not emphasize the negotiating position of the two countries but instead presents the background, opportunities and challenges at the negotiation stage for each issue. In particular, the discussion is focused on regulatory and policy challenges as well as future implementation.

## INVESTMENT PROTECTION

As mentioned in the previous chapter, one of the potential benefits of the IEU CEPA agreement is an increase in FDI from EU member countries to Indonesia. The increase may take place through two different channels or mechanisms. First, an increase in trade between the two parties can increase investment flows. Second, investment provisions included in the IEU CEPA are also expected to increase investment cooperation between the two parties. These provisions cover investment facilitation, promotion, and protection that consequently can increase foreign investors' confidence and trust, especially from the EU, to invest in Indonesia. It is expected that the IEU CEPA will provide a formal, well-defined mechanism to protect foreign investors' assets so as to increase the trust and confidence of investors.

However, up to now, some challenges and obstacles may still hinder the negotiation and implementation of investment provisions in the IEU CEPA. One of these challenges is Indonesia's intention to end all 60+ bilateral investment protection agreements (BITs), and since 2014 it has ended 20 BITs. Indonesia considers that the existing system upon which those BITs is based, has forced the country to retract some regulations that have been issued regarding environment, exemptions for foreign investment, and higher requirements for raw material processing.

Similar to some other developing countries, such as India and South Africa, Indonesia is also concerned that the investor-state dispute settlement mechanism (ISDS) contained in BITs provides too much protection to investors. Moreover, the existing ISDS may severely limit the government's freedom to create and carry out its development agenda. There is a risk that, in case of a dispute, investors may demand considerable compensation if more stringent regulations are enforced by the government (Knottnerus, 2018).

For this reason, the Indonesian government wants prospective investment agreements, including the IEU CEPA, to be negotiated based on the new BITs model. The rules are likely to significantly reduce protections for foreign investors and allow the government to determine the course of its national development. This will likely slow down and complicate the negotiations of trade and investment agreements, including provisions on investment protection proposed in the IEU CEPA.

In contrast, the EU's agenda in the IEU CEPA negotiations appears to be aiming at and emphasizing extensive liberalization and deregulation, especially in relation to trade and investment in the service sector. The EU wants IEU CEPA to adopt the same broad protections for service providers and foreign investors it has incorporated into the existing EU trade and investment agreements. Such protections are likely to have a significant impact on Indonesia's policy space and may limit the country's efforts to protect public interests, human rights, and the environment. Investment protections that are being proposed are framed in a broad manner and open to different interpretations and, therefore, many of the existing laws and regulations may be deemed as an infringement of the principle of fair and equal treatment for all investors, including foreign investors (national treatment), which could have implications for compensation.

The following are some examples of Indonesian domestic regulations that can be considered as deviating from, and violating, national treatment principles. First, consider a government regulation that aims at restricting foreign investors' access and provide a greater flexibility for domestic investors than for foreigners to invest in the economy.

The regulation is stipulated in Articles 3, 5 and 12 of Law no. 25 of 2007 on Capital Investment. Under this regulation, there are two business areas that are closed to foreign investment, namely the production of weapons, gunpowder, explosives, and military equipment, and business areas that are closed under the law.

Areas that are closed to foreign investment are further regulated through a Presidential Decree, in a form of the Negative Investment List (DNI). The criteria for the inclusion of certain sectors in the list are stipulated in Presidential Regulation No 76 of 2007 concerning Criteria and Requirements for Business Fields for Capital Investment. Criteria include the protection of natural resources, protection and development of micro, small and medium enterprises, and cooperatives, supervision of production and distribution, technological capacity development, domestic capital participation, and cooperation with government-appointed business entities. These criteria can be burdensome for foreign investors, and DNI itself contradicts national treatment principles.

Second, apart from Law no. 25 of 2007 and DNI, there are several regulations pertaining divestment, namely an obligation to reduce foreign ownership in business entities in some business fields, such as in the plantation and mining sectors. For example, Article 112 of Law no. 4, 2009, concerning Minerals and Coal Mining requires the company holding a mining operation permit (IUP) or a special mining operation permit (IUPK) owned by foreigners to sell their shares to the central government, local governments, state-owned enterprises, regional-owned enterprises, or national private enterprises. The obligation constitutes a discriminatory practice against foreign investors and will become a challenge during the negotiation process of the IEU CEPA.

Third, another potential problem concerning investment provision that can hinder the negotiation process and the implementation of the IEU CEPA is performance requirements or investment criteria. In addition to the criteria in Law no. 25 of 2007 discussed above, the rule regarding performance requirements is also found in Law no. 20 of 2008 concerning Micro, Small and Medium Enterprises (MSMEs). The rule requires large-scale businesses, including foreign companies, to cooperate with, and help develop MSMEs, under the supervision and control carried by the central and regional governments. As a result, many regional regulations have been issued pertaining the development of MSMEs, which may contradict the principle of national treatment. Another performance rule which obliges each investor to comply with principles of corporate social responsibility (CSR) is stipulated in the Article 15 of Law No. 25 of 2007. More detailed CSR regulation is also contained in Law no. 40 of 2007 concerning Limited Liability Companies that regulates CSR budgeting as part of the company's costs, whose obligations are legally binding.

## INTELLECTUAL PROPERTY RIGHTS

Intellectual property (IP) has become an increasingly inseparable subject in international trade. Protection of IP is considered to have an important role in innovation and competitiveness in the economy. Apart from contrasting the piracy of products, IP protection also guarantees consumers to identify the origin of the products they consume. Therefore, there are more and more discussions on bilateral, regional and multilateral agreements relating to Intellectual Property Rights (IPR) such as patents, brands, industrial design, copyrights and geographic indications. An example is the Comprehensive

and Progressive Agreement for Trans-Pacific Partnership (CP-TPP) which requires high standards in terms of IP.

The IEU CEPA negotiations also include IP as a chapter that is being discussed by both parties. EU countries that have a high level of awareness of this issue. European Union trade agreements with Canada, Japan, Singapore and Vietnam include IP as a separate chapter. On the other hand, Indonesia as a developing country is still at a different level of awareness, which combined to the inadequate enforcement of rules and protection of IPR, represent substantial obstacles. Therefore, this asymmetric condition has the potential to create problems in the conclusion of the negotiations and the implementation.

Indonesia has entered in two trade agreements which also have chapters related to IP: the Indonesia-Japan Economic Partnership Agreement (IJEPA) and the ASEAN-Australia New Zealand FTA. However, the level of commitments of these two agreements is below the CP-TPP and the CEPA with the European Union. In other words, the IEU CEPA has the potential to increase the convergence of IP regulations to international standards. In addition, Indonesia can also increase its commitments in the enforcement of IPR protection, which is positively related to Indonesia's innovation climate.

One of the frequently asked questions on IP is the relationship and role of IP in the economy. Falvey and Foster (2006) describe three roles of IP in the economy, which can be explained through the relationship between IP and economic growth, innovation and international technology diffusion. One study conducted by Kanwar and Evenson (2003) examined whether the level of IPR protection had an impact on research and development (R&D) spending. Using a 32-country panel estimation model from 1981-1995, they found that there was a significant positive relationship between IPR protection and R&D expenditure. This also strengthens the evidence that IPR protection has an indirect impact on increasing the level of output and the Total Factors Productivity (TFP) through R&D spending.

Indonesia is still lagging behind in terms of R&D expenditure as the climate for innovation is still poor. Indonesia only spends USD 2.13 billion (PPP) or 0.1% of total GDP for R&D. This number is the lowest among its peer countries such as Malaysia (1.3%), Thailand (0.5%), Vietnam (0.4%), and on par with the Philippines. This expenditure is dominated by the public sector, such as government and universities, while the private sector tends to be passive. This is also reflected in the Global Innovation Index (2020) ranking, which places Indonesia in 85th place out of 131 countries. The quality of institutions and business sophistication is Indonesia's main weaknesses in the competitiveness of the innovation climate.

Investment trends and global value chains also increase the role of IPR protection. With increasing production fragmentation from developed to developing countries, such as manufacturing, distribution, marketing, design, branding to R&D, investors want to ensure the existence of the IPR protection system. In addition, when viewed from the technological diffusion side, IPR protection can positively impact the transfer of knowledge/technology between developed and developing countries. The IPR protection system is aimed at creating a level playing field in both developed and developing countries in order to provide incentives for investment and R&D activities. IPR protection in developing countries allows access to a wider range of corporate proprietary knowledge from developed countries to accelerate R&D activities. Therefore, IPR protection is closely related to business and investment decisions as well as a climate of innovation, research and development.

Indonesia still has a lot of homework to do, especially regarding the mechanism and enforcement of IPR protection. This can be seen from the inclusion of Indonesia in the watch list report issued by the United States and the European Union in 2020. This annual

report contains several findings regarding IPR violations in other countries as well as recommendations for increasing IPR protection. Indonesia ranks second in the reports from both the United States and the European Union after China. **Table 7.2** below describes several important points discussed in the report on the enforcement of IPR protection in Indonesia.

Table 7.2 Important points on the protection of Indonesian intellectual property rights in the European Union and United States Watch List Report

| EU | US |
|---|---|
| Restrictive patent criteria make it difficult to enforce patent protection, especially with regard to pharmaceutical products and plant variety protection products<br><br>Indonesia still requires local working requirements in the Patent Law<br><br>There is suspicion of attempts to register a foreign mark by a domestic company, which results in excessive costs and court proceedings for companies holding foreign trademarks<br><br>The absence of an effective system related to undisclosed tests and the resulting data for obtaining marketing approval for pharmaceutical products and plant variety protection products<br><br>The problem of HAKI enforcement is still serious. One of the reasons is the absence of a Criminal Unit related to IPR that can enforce online copyright infringements, especially illegal camcording and live streaming piracy. | The patent law that is still being assessed is specifically related to the criteria for patented products such as incremental innovations, license obligation procedures and disclosure requirements for inventions in terms of traditional knowledge and genetic resources.<br><br>The impact of registering new Geographical Indications products on registered brands and having general product names<br><br>Lack of an effective protection system against unfair commercial use and unauthorized disclosure of undisclosed tests or data generated to obtain marketing for pharmaceutical products and chemical plant products<br><br>Lack of commitment and optimal enforcement in eradicating online piracy<br><br>The IP Protection Task Force, which consists of related ministries and agencies, is no longer active. In addition to reactivation, the Indonesian Police must be involved in its function as law enforcement |

Source: Report on the protection and enforcement of intellectual property rights in third countries by the European Commission, USTR 2020 Special 301 Report

In the last few years, Indonesia has experienced improvements, especially in developing websites that report online piracy. These are useful for minimizing instances of online piracy. The Indonesian government has also issued regulations to block 1745 sites involved in copyright piracy from 2017 to 2019[21]. In addition, the Ministry of Law and Human Rights has provided clarity on the procedures for compulsory patent licenses by issuing Ministerial Regulation No. 30/2019 which regulates the procedures related to the approval of Compulsory Patent Licenses. Finally, the efforts of the Ministry of Finance to strengthen piracy prevention, particularly in relation to border enforcement, also deserve appreciation.

One of the main problems in protecting IP in Indonesia is the enforcement of IPR, which still requires substantial improvement. Legal facilities related to IP that are sufficiently complete will not be meaningful without increased enforcement of IPR protection by law enforcement officials. In addition, the understanding and awareness of IP are also limited among the community. The consequences of this are limited innovation.

21 https://kominfo.go.id/content/detail/23767/kemkominfo-blokir-1745-situs-melanggar-hki/0/sorotan_media

The IEU CEPA offers an important opportunity for Indonesia to carry out reforms in the IP sector. However, this is not easy because it can be considered to be foregoing Indonesia's national and strategic interests. The European Union must consider that there are significant differences in the level of economic development and awareness on IP issues between the two countries.

In addition to the aforementioned issues, Geographical Indication (GI) has received substantial attention from both Indonesia and the European Union. Current IEU CEPA negotiations include a special chapter on GI including a list of 70 Indonesian products and more than 200 EU products expected to receive reciprocal protection. Before the 9th round of negotiations concluded in October 2019, Indonesia and the European Union published a list of their respective GI products to be protected through the IE CEPA Agreement. In the last round of negotiations which took place virtually in June 2020, there were several corrections and adjustments but no objections were raised from either side.

Despite the current conditions, Ministries / Institutions at both central and regional level as well as entrepreneurs are still struggling to bring local practices in line with international standards. As a result, exports of GI products are quite limited, domestic awareness tends to be low and the level of protection provided by regulations is insufficient to stimulate private sector investment.

In line with the considerations put forward regarding IP in general, the current law enforcement of GI is also considered weak. This is detrimental to the development of the domestic market for both local and international products. One of the reasons is that market supervision and monitoring on behalf of registered GI has not been implemented systematically. In addition, awareness among GI producers and the availability of accurate data needs improvements.

Local skills for surveillance, monitoring and reporting activities of the GI markets should continue to be developed. The actual information regarding the use of protected GI names versus 'GI-like names' and unfair marketing practices that erode the potential market share of genuine GI products should also be explored. Given the potential benefits of GI policies in supporting local producers and EU expertise in this area, Indonesia should seek support through technical assistance to strengthen skills and align practices with the EU.

Discussions on IP issues in the IEU CEPA are often compared with the chapters that have been agreed by Vietnam in the Vietnam-EU Free Trade Agreement (FTA). The chapter in the agreement is quite ambitious. However, it must be acknowledged that Vietnam has made preparations for regulatory harmonization through the CP-TPP commitments which provided the highest standards in IP. Indonesia is not a member of the CP-TPP so it needs a transition time to make regulatory adjustments and reforms.

Finally, the issue of IP has increasingly touched on many other issues outside of international trade. Therefore it requires more comprehensive coordination between Ministries/Agencies. Several Ministries/Agencies that have important roles are the Coordinating Ministry for Political, Legal and Security Affairs, the Directorate General of Intellectual Property (Ministry of Law and Human Rights), the Attorney General's Office, the Ministry of Tourism and Creative Economy and the Food and Drug Administration. The institutionalization of the working group or task force will facilitate the coordination and implementation of the IEU CEPA agreement and IP policies in general.

## BUSINESS COMPETITION

Competition policy facilitates the achievement of equality, justice, and non-discrimination principles for business actors in the economy. The ultimate goal of a business competition policy is to improve consumer welfare in the economy. A sound business competition will encourage higher efficiency and productivity, which in turn results in higher income levels and a higher growth trend in the medium-long term. Many countries have established competition policies based on widely agreed principles while adapting their application to business conditions and climate in their economies. Hence, in many FTA / CEPA negotiations between countries, the scope for competition policy is not always the same.

In a study conducted by the OECD (Laprévote, 2019), there are several clauses related to business competition in FTA / CEPA negotiations aimed at encouraging competition, adopting and maintaining Business/Market Competition Law, prohibiting and sanctioning certain practices and transactions of goods or services that distort competition, trade, and investment (cartels or monopoly by companies) and anti-competitive M&A.

Several FTA / CEPA negotiations also include clauses in the form of enactment of the Business Competition Law for state companies as this can encourage greater efficiency. Some negotiations agreed to ban certain types of state subsidies and assistance, which were deemed highly distorting, and affected trade and investment between the parties. Every FTA / CEPA includes different clauses according to the interests of each economy. In particular, the inclusion of business competition aspects in FTA / CEPA negotiations aim at:

1. Optimizing the Benefits of Trade Liberalization. Anti-competitive measures, regulated by both the state and the private sector, can derail the broad liberalization goals of the FTA / CEPA. Competition-related regulations are generally included in negotiations to support the objectives of reducing trade barriers (expanding market access) and preventing firms' dominance that block entry into certain sectors or undermine the competitive position of other firms intending to enter the market.
2. Achieving broader Economic Goals and Objectives, such as increasing economic efficiency and consumer welfare, enhancing the investment climate, supporting sustainable industrialization, facilitating efficient and functioning markets, and supporting economic development measures. By including the competitive aspect of the FTA / CEPA, it can send a signal to potential foreign investors that the country is ready to implement pro-market and pro-investment policies and at the same time indicate domestic companies to comply to competition principles.
3. Preventing antitrust strategies. Competition policy is often used to restrict trade as domestic firms seek alternatives to protect their market share, from increased foreign competition. Regulations in FTA / CEPA negotiations oblige parties to enforce their competition laws in a transparent and non-discriminatory manner. That way, it obliges each party to notify the other party before making a decision/ law enforcement action against one of its companies.

As mentioned above, the scope of the negotiations depends on the interests and needs of Indonesia and the European Union. Both economies are aware of the contribution of business competition policy towards creating conducive, stable and predictable trade flows, which are especially important for small-scale investors who decide to invest in Indonesia; so, it is important to forge closer cooperation in the field of competition policy, such as:

- Exchange of information on competition policy measures.
- Increase capacity building such as providing training, education, human resource development, and technical assistance, and staff exchanges or placements.

Several aspects related to business competition will also affect the successful implementation of this agreement. The issue of subsidies has the potential to harm trade and investment, therefore there must be rules that include transparency and consultation, and limit the circumstances in which subsidies can be applied. In the rules that apply to WTO members, it is stated that subsidies are allowed when they are applied in general or not specific. Another aspect of business competition is the matter of regulation and treatment of State-Owned Enterprises (SOEs). Good business competition should ensure equal business opportunities between private companies and SOEs. Unfortunately, Indonesia still provides many exclusive rights to SOEs, including monopoly rights for various production sectors which play a vital role in economic development. Cooperation and agreements in the field of business competition in the IEU CEPA are expected to improve business competition.

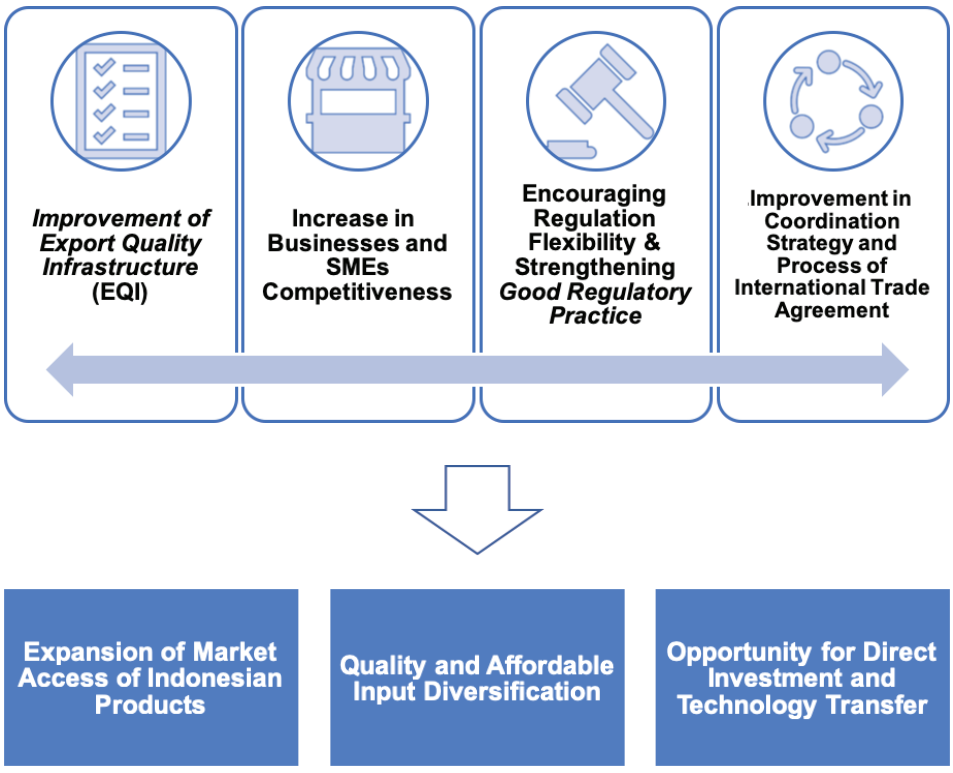
# 8.

# POLICY ADJUSTMENT AND OPTIMIZATION STRATEGY

ALL THE ANALYSES and discussions thus far suggest that the IEU CEPA is likely to have a positive impact not only on Indonesia's trade but also on investment, industry and services sectors, and the overall socio-economic development. To bring those potential benefits into reality, there are numerous prerequisites that have to be met. One of them is domestic policy adjustments. This chapter discusses a number of recommendations regarding policy adjustment options necessary in the implementation of the IEU CEPA, as well as a strategy to optimize the potential benefits of the agreement. As the last chapter of the report, this chapter also provides its conclusions.

The focus of recommendations for the implementation of the IEU CEPA is on four issues of policy adjustments (**Figure 8.1**). The first is concerning improving the Export Quality Infrastructure (EQI). The second is about increasing the competitiveness of the business sector, especially micro, small and medium enterprises (MSMEs). The third is about regulatory adjustments with a special emphasis on the implementation of Good Regulatory Practice (GRP). And the last is regarding enhancing internal coordination among relevant agencies dealing with international trade agreements. Together with the IEU CEPA, these four adjustments will support the expansion of market access and diversification of Indonesian products, diversification of inputs, participation in production networks, and investment opportunities.

Figure 8.1 Policy Adjustments and Optimization Strategy Framework



## IMPROVEMENT OF *EXPORT QUALITY INFRASTRUCTURE* (EQI)

The findings in one of the previous chapters underline problems facing Indonesian products in the European Union; the EU applies high standards compared to other Indonesian trading partner countries. Based on the Non-tariff Measure (NTM) profile, the European Union has a relatively higher coverage and frequency ratio[22] for import products at 94.31% and 93.88%, while other countries' averages are 71.98% and 43.04%, respectively.

Problems associated with standards are also reflected in the level of experience of Indonesian companies in comparison with companies from the EU. One of the findings from interviews with the business sector is that Indonesian products have a relatively high recall rate compared with other countries. It is substantially harder for Indonesia's products to be approved especially food and beverage products. This is also evident in the export of agricultural, forestry and fishery products, most of them are required to meet high sustainability standards. **Table 8.1** provides examples of some of the standards that exports of agriculture, forestry and fishery products have to meet in order to enter the EU.

Table 8.1 Certification in Agricultural, Forestry and Fisheries Sectors

| Type of Standard | Certification Example |
|---|---|
| General Standard | GLOBAL G.A.P (Food Farming System), HACCP, ISO 22000 (Food Manufacturing Systems), ISO 9001 (Quality Management), ISO 14001 (Environmental Management, SA 8000 & OHSAS 18001 (Employment and OHS) |
| Special Standard | EU Organic (Organic), Fairtrade, Rainforest Alliance, Kosher Check/Kosher (Kosher) |
| Product Specific Standard | C.A.F.E Practices (Coffee), MSC/ASC (Fish Products), Bonsucro (Sugar), Sustainable Spices Initiative (Herbs and spices), Forest Stewardship Council (Forest Products) |

Source: Several Sources

From stakeholder interviews we learnt that the fisheries sector is subjected to high NTM, especially with regard to packaging and other standards which are higher in the EU than in other countries. In addition, the European Union also applies a list of approval numbers on Indonesia's fishery products to ensure minimum standards of quality. The European Union provides several recommendations such as good handling certification for ship management, an audit quality inspector for fishing handling methods in each port, increase competency with regard to fishing technique, upgrading the quality management system, and a number of other issues.

The government has updated the regulations in accordance with the recommendations above, but until now many prospective exporters have not yet received an approval number. In comparison, Vietnam has three times as many approval numbers as Indonesia specifically for fishery products[23].

22 The coverage ratio is calculated by determining the value of imports of each commodity subject to NTMs, aggregating by applicable HS commodity group, and expressing the value of imports covered as a percentage of total imports in the HS commodity group. The frequency ratio accounts for the presence or absence of a NTM, and indicates the percentage of traded products to which one or more NTMs are applied

23 https://webgate.ec.europa.eu/sanco/traces/output/non_eu_listsPerCountry_en.htm

One explanation as to why Indonesian companies face a difficulty to achieve EU's product standards is due to inadequacy of the country's Export Quality Infrastructure (EQI). As one of the findings from stakeholder interviews suggests that the capacity of the country's testing laboratories and certification agency requires further improvement. In some cases, laboratories in Indonesia have not been able to carry out tests and analyses in accordance with the standards required by the EU. To enter the European Union, Indonesian companies have to rely on neighboring countries' laboratories to do the job. In addition, business operators in the region also point out that testing laboratories and certification bodies have not been evenly distributed throughout the country. The aforementioned problems imply Indonesian companies have to incur extra costs in order to enter the EU, another reason why Indonesian products are less competitive. **Table 8.2** below lists examples of issues in the EQI of the fisheries and furniture sector in Indonesia.

Table 8.2 Issues in Fisheries and Furniture EQI

| EQI Fisheries | EQI Furniture |
|---|---|
| **Commercial Fishing Trap**<br>• Temperature and cleanliness conditions for fishing boats and at ports<br>• Improve the quality and safety of food in ships, fishing ports and landing sites<br>• Limited inspection of ships for export<br>• The competent authorities inspect only a small number of vessels<br>• Ice blocks used by fishing boats have not met cleanliness standards<br>• The absence of good records related to fishing vessels at the central and regional levels<br>• Small fishing vessels usually have more severe problems related to cleanliness standards, ship area, fishing gear and storage that do not meet standards and lack of supervision<br><br>**Fish Processing**<br>• Exporters require company approval<br>• Several certificates and standards that must be owned include Good Manufacturing Practices (GMP), Grade A "Processing Eligibility Certificate" (SKP A) and Hazardous Analysis and Critical Control Point (HACCP)<br>• Fish processing requires a second party audit to ensure traceability of raw materials<br>• GMP and HACCP are still unable to guarantee hygiene and sanitation standards due to lack of audits and supervision | **Wood Purchasing and Lumbering**<br>• Issues in this sector are more related to the origin of wood<br>• Teak wood is the type most widely used and there are still many buyers who doubt the origin of the wood and are also related to illegal logging and sustainable forestry.<br><br>**Testing**<br>• Buyers in the European Union require safety tests for some furniture products. Testing can be carried out overseas such as at the Technischer Überwachungsverein (TÜV) or the Asian Pacific Inspection (API)<br>• In Indonesia, there is one testing agency, namely the Export and Import Goods Quality Testing Center (BPMBEI)<br>• Buyers still have a preference for using testing agency certificates outside Indonesia and of international standard because Indonesian testing agencies tend to be more expensive and time consuming |

Source: Lord, Oktaviani dan Ruehe (2010)

From 2016 to 2019, there was an increase of 14.7% in the number of Compliance Assessment Agency/Lembaga Penilai Kesesuaian (LPK) accredited by the National Accreditation Committee/Komite Akreditasi Nasional (KAN) or an increase of 539 LPK.

Most of the new LPK are testing laboratories, inspection bodies and calibration laboratories. Meanwhile, there are no additional HACCP Certification Bodies, Supply Chain Security Management System (SMKRP) / SNI ISO 28000: 2009 and Food Safety Management System / ISO 22000: 2018. Also of concern is the location of the LPK to ensure cost efficiency for business operators. In addition, the National Standardization Agency of Indonesia (BSN) has six Technical Service Offices (KLT) in Makassar, Palembang, Bekasi, Pekanbaru, Surabaya and Bandung which are expected to increase awareness concerning standardization and compliance assessment among regional stakeholders.

Table 8.3 Conformity Assessment Agency Accredited by KAN 2016-2019

| No | Conformity Assessment Agency (LPK) | 2016 | 2017 | 2018 | 2019 |
|---|---|---|---|---|---|
| 1 | Testing Laboratory | 1072 | 1170 | 1296 | 1366 |
| 2 | Calibration Laboratory | 230 | 249 | 274 | 291 |
| 3 | Medical Laboratory | 49 | 55 | 64 | 70 |
| 4 | Proficiency Test Organizing Institution | 11 | 13 | 17 | 24 |
| 5 | Reference Material Manufacturer | - | - | - | - |
| 6 | Inspection Agency | 53 | 80 | 91 | 114 |
| 7 | Greenhouse Gas Validation and Verification Agency | 2 | 3 | 3 | 3 |
| 8 | Product Certification Agency | 47 | 59 | 69 | 72 |
| 9 | Organic Certification Agency | 8 | 8 | 9 | 9 |
| 10 | Halal Certification Agency | 0 | 0 | 1 | 1 |
| 11 | Ecolabel Certification Agency | 2 | 2 | 2 | 2 |
| 12 | Timber Legality Verification Agency | 22 | 25 | 25 | 27 |
| 13 | PPIU Certification Agency | - | - | 2 | 13 |
| 14 | Tourism Business Certification Agency | 52 | 49 | 37 | 34 |
| 15 | Sustainable Forest Production Management Assessment Agency | 13 | 14 | 14 | 15 |
| 16 | Personnel Certification Agency | 7 | 11 | 16 | 18 |
| 17 | Biorisk Laboratory Management System Certification agency | 0 | 0 | 0 | 1 |
| 18 | Management System Certification Agency | 36 | 40 | 46 | 51 |
| 19 | Food Safety Management System Certification Agency | 8 | 8 | 8 | 8 |
| 20 | HACCP Certification Agency | 8 | 8 | 8 | 8 |
| 21 | Information Security Management System Certification Agency | 2 | 4 | 6 | 10 |
| 22 | Medical Device Quality Management System Certification Agency | 2 | 2 | 2 | 2 |
| 23 | Anti-Bribery Management System Certification Agency | 0 | 2 | 6 | 9 |
| 24 | Environmental Management System Certification Agency | 16 | 20 | 21 | 23 |
| 25 | Energy Management System Certification Agency | 1 | 1 | 2 | 2 |
| 26 | SMK3 Certification Agency | 0 | 0 | 0 | 3 |
| 27 | SMKRP Certification Agency | 0 | 0 | 0 | 1 |

Source: Badan Standardisasi Nasional (2020)

There are several actions that the government can undertake to increase the capacity and quality of EQI. First, in the medium term, Indonesia can achieve regulatory convergence with the European Union through a Mutual Recognition Agreement (MRA) which covers the application of the same standards, certification and testing. Thus, certificates obtained by companies in Indonesia are valid in the European Union, and vice versa. The government and the European Union can jointly identify sectors/ products that can be used as pilot projects, such as coffee products which are among Indonesia's superior products. Second, provide incentives to build testing laboratories and establish certification bodies in Indonesia that conform to the European Union standard. This will increase the capacity of the EQI system in Indonesia by way of supporting it with equipment and human resources.

Third, to include an intensive and effective capacity building program for EQI system in the IEU CEPA negotiations. The program should focus particularly on LPK, private sector and Indonesian policy makers aiming at increasing their awareness, capacity and compliance with EU standards and other international standards. For this reason, this idea may serve as an input for Indonesia and the European Union, especially in the negotiations of the chapter on economic cooperation which plays an important role in increasing the capacity of Indonesian companies.

## INCREASE BUSINESS COMPETITIVENESS, ESPECIALLY OF SMES

Lack of competitiveness remains a chronic problem that often arises in discussions on the implementation of international trade agreements. According to the 2019 Global Competitiveness Report (WEF, 2019), Indonesia is ranked 50th out of 141 countries or down from 45th in 2018. Some indicators were unchanged, such as adopting information and communication technology (ICT), healthcare, product markets, and the skilled labour market. Below Indonesia, Vietnam has significantly improved its overall ranking from 77th in 2018 to 67th in 2019. Indonesia's stagnant competitiveness has become an obstacle to realizing the potential benefits of IEU CEPA.

In general, manufacturing companies in Indonesia must deal with traditional competitiveness problems such as relatively high energy costs, difficulty in obtaining imported raw materials, relatively expensive logistics costs and problems in the labor sector such as wages that do not reflect the actual labor productivity. In addition, there are also sector specific problems, such as the use of old machines in the textiles and garments industries, or the problem of mastering technology in the electronics industry. All these problems must be solved in order to materialize the gains from IEU CEPA. The simulation results in one of the chapters above show that sectors such as electronics, automotive and other manufacturing have the potential to benefit from increased competition from EU products.

In terms of regulations, the 2020 Ease of Doing Business (EoDB) report shows that businesses in Indonesia face problems in starting a business, implementing contracts and trading across borders. With regard to international trade, **table 8.4** shows the costs, both in time and money, required to carry out exports and imports in two cities, Jakarta and Surabaya. The two perform relatively poorly compared to the East Asia and Pacific regional average and import costs also tend to be higher than export costs.

Table 8.4 International Trade Indicators in Ease of Doing Business (2020)

| No | Indicator | Jakarta | Surabaya | East Asia & Pacific |
|---|---|---|---|---|
| 1 | Time to export: Border compliance (hours) | 51 | 75 | 57.5 |
| 2 | Cost to export: Border Compliance (USD) | 207 | 225 | 381.1 |
| 3 | Time to export: Documentary compliance (hours) | 60 | 66 | 55.6 |
| 4 | Cost to export: Documentary Compliance (USD) | 130 | 170 | 109.4 |
| 5 | Time to import: Border compliance (hours) | 80 | 168 | 68.4 |
| 6 | Cost to import: Border Compliance (USD) | 384 | 376 | 422.8 |
| 7 | Time to import: Documentary compliance (hours) | 106 | 107 | 53.7 |
| 8 | Cost to import: Documentary Compliance (USD) | 160 | 180 | 108.4 |

Source: Ease of Doing Business Report (2020)

Several government policies, such as a closed trade regime and restricted investment, will further aggravate Indonesia's competitiveness in the future (Aswicahyono & Rafitrandi, 2018). This is also reflected in stakeholder interviews, where both business actors and policy makers were questioning the ability of Indonesian products to compete with products from other countries in the European Union, and to compete with European Union products in Indonesia. In addition, there is a negative perception toward foreign products and investment in the society.

The simulation in Chapter 5 finds that the socio-economic impact of IEU CEPA will be quite significant. The negative impact that must be anticipated is an increase in the income gap as a result of a significant increase in output in the services sector which is dominated by medium and high skilled workers. One policy adjustment that may be undertaken is to increase the competitiveness of business sector, especially MSMEs, which have a major contribution to the economy. If MSMEs can make good use of the IEU CEPA, then this will have a positive impact on improving competitiveness and more inclusive economic growth. The key is how to increase the internationalization of MSMEs in Indonesia both in terms of export contribution and to support the domestic value chain.

Indonesia is one of the countries with a low contribution from MSMEs to export value compared to other countries in the region (Yoshino & Wignaraja, 2015). According to Harvie, Narjoko and Oum (2015), the integration of MSMEs into global value chains is important to increase the benefits of regional integration and globalization. However, there are several lingering obstacles associated with barriers to information and human resources, distribution, logistics, promotion, financial, procedures and price that affect the contribution of Indonesian MSMEs to the global value chain (Revindo, Gan and Massie, 2018).

According to ERIA-OECD (2018), there are five policy options that may be taken in order to expand market access and to encourage internationalization of MSMEs. They are export promotion, global value chain integration, use of electronic commerce, quality standards and trade facilitation. With regard to market access and internationalization policies,

Indonesia performs relatively well, even though it is below the performance of Singapore, Malaysia and Thailand. Its policies concerning e-commerce and export promotion are the two with the highest scores. On the other hand, the lowest scores belong to policies pertaining trade facilitation and value chain integration. Several urgent policies that can be implemented include increasing value chain participation and access to standard certification services in order to increase competitiveness.

Policies concerning global value chain integration in Indonesia are limited. Some examples include business partnerships with multinational companies and large exporters, increasing linkages with external and intermediate suppliers, transfer of technology from multinational companies. The Ministry of Industry and the Ministry of Cooperative and Small and Medium Enterprises (KUKM) are the two relevant agencies responsible for these policies, especially in relation to the partnership program. This partnership can also be an input for the economic cooperation chapter which is in the negotiation stage.

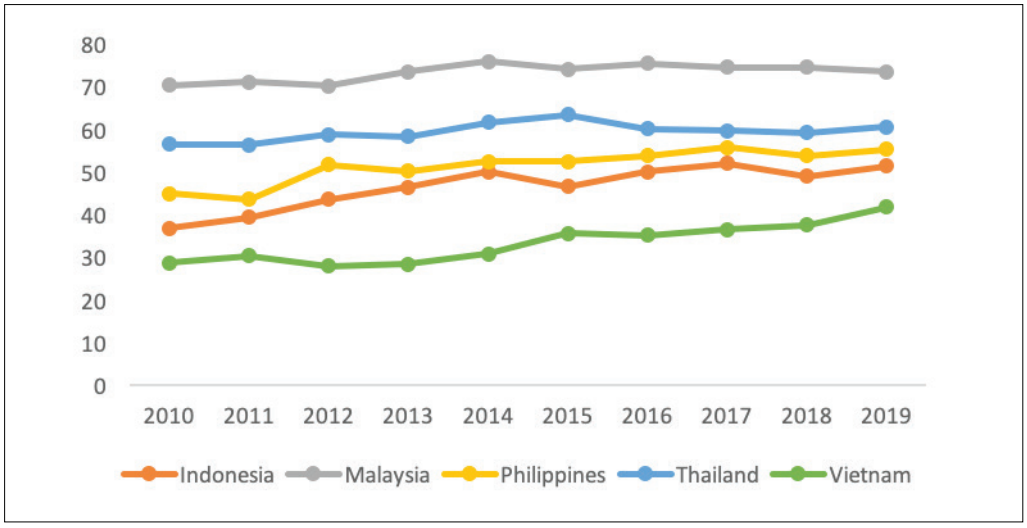
Adjustment and optimization policies can also focus on how to increase access and to minimize cost of attaining international product standards, especially for MSMEs. The findings in the previous chapters also highlight the additional costs that must be borne by MSMEs related to the scale of business and information costs. Therefore, MSMEs must increase the level of production to achieve sufficient business scale, reduce losses from products that do not comply with the required standards and ensure sustainability of supply for MSMEs. Cooperation with the European Union in the context of access to information, training and assistance in terms of product quality and standards is expected to be included as one of the important points in the IEU CEPA negotiations. It is hoped that the IEU CEPA will facilitate technology transfer from manufacturing companies in the European Union to Indonesian companies.

## ENCOURAGING REGULATION FLEXIBILITY AND STRENGTHENING GOOD REGULATORY PRACTICE (GRP)

As an economic cooperation with a high commitment target, the IEU CEPA will certainly require significant domestic regulatory adjustments and reforms. Regulatory changes at the national law (UU) level will take a long time because they must go through the national legislative process. Another option is to focus on regulatory adjustment and reform at the implementing regulation level such as ministerial regulations, which is a lengthy process. Hence, the implementation of the IEU CEPA will involve high political commitment.

**Figure 8.2** shows that Indonesia is lagging behind neighbouring countries in terms of perception of the government's ability to formulate policies and regulations with regard to fostering the development of the private sector.

Figure 8.2 Regulatory Quality Index Ranking: 0 lowest to 100 highest




Source: *Worldwide Governance Indicators* (2020)

This is also supported by a study on international regulatory cooperation which assess the advantages, challenges and problems of policy makers in harmonizing regulations (Gill and Setyadi, 2020). According to the Indonesian government, the biggest obstacle to regulatory harmonization is reform to be implemented by technical ministries. The problem is further exacerbated by insufficient awareness among stakeholders and the difficulty faced by policy makers to convey the benefit of policy harmonization.

There are several issues involving the IEU CEPA negotiations that are new for the Indonesian government. Some have no regulatory basis either at the national level or international consensus (multilateral), for example trade and sustainable development, digital trade (including data protection) and issues related to State-Owned Enterprises. This constitutes a challenge for the relevant Ministries / Agencies in determining the negotiating position, and later when the agreement will be implemented.

For this reason, this study stresses the importance of certainty and transparency of the prevailing regulations in Indonesia. The promulgation of the Job Creation Law discussed earlier, provides a breath of fresh air for changes to the regulatory framework. However, there are many regulatory issues that have not been fully accommodated by the Act, which may hinder the realization of the benefits of the IEU CEPA.

One example is regulations concerning Local Content Level (TKDN). These regulations cover important sectors, ranging from energy & mineral resources, government procurement, cellular telephone products, handheld computers & tablet computers, electronic and telematic products to pharmaceutical products. Regulations are quite controversial, and several countries have questioned their conformity with the trade principles that have been agreed upon at the WTO. For example, at the Committee on Trade-Related Investment Measures meeting, Indonesia has to explain the TKDN regulations, particularly the ones concerning the telecommunications sector, retail trade and pharmaceutical products, to its trading partner countries, such as the European Union, the United States, Japan and Taiwan.

One of the findings in the FGDs with the private sector also shows that the TKDN regulations are quite burdensome, especially for the automotive industry, which finds it difficult to secure sufficient supply of domestic input products to meet the TKDN

requirements. The main reason is that domestic suppliers are not yet mature, especially the medium-scale industries that have a competitive edge. **Table 8.5** below shows the TKDN regulations that are currently in effect in Indonesia.

Table 8.5 Local Content (TKDN) Related Regulations

| No | Regulations | Topic |
|---|---|---|
| 1 | Law No 3 Year 2014 | Industry |
| 2 | Government Regulations No 29 Year 2018 | Industry Empowerment |
| 3 | Presidential Decree No 146 Year 2015 | Implementation of Development and Development of Domestic Oil Refineries |
| 4 | Presidential Decree No 16 Year 2018 | Government procurement of goods / services |
| 5 | Presidential Decree No 55 Year 2019 | Acceleration Program for Battery Electric Vehicle for Road Transportation |
| 6 | Regulation of Ministry of Industry No 57 Year 2006 | Appointment of surveyors to carry out verification of the achievement of Local Content Level (TKDN) for domestically produced goods / services |
| 7 | Regulation of Ministry of Industry No 16 Year 2011 | Regulations and Procedures for Calculating Local Content Level |
| 8 | Regulation of Ministry of Industry No 54 Year 2012 | Use of Domestic Products for Electricity Infrastructure Development |
| 9 | Regulation of Ministry of Industry No 02 Year 2014 | Guidelines for Increasing the Use of Domestic Products in the Procurement of Government Goods / Services |
| 10 | Regulation of Ministry of Industry No 03 Year 2014 | Guidelines for Increasing the Use of Domestic Products in the Procurement of Government Goods / Services That Are Not Financed from the State Revenue and Expenditure Budget / Regional Revenue and Expenditure Budget |
| 11 | Regulation of Ministry of Communication and Information Technology No 27 Year 2015 | Technical Requirements for Telecommunication Equipment and / or Devices based on Long Term Evolution Technology Standard |
| 12 | Regulation of Ministry of Industry No 15 Year 2016 | Specifications and Price Standards for Transmission Towers and Domestically Produced Conductors in the Context of Accelerating the Development of Electricity Infrastructure |
| 13 | Regulation of Ministry of Industry No 05 Year 2017 | Amendments to the Regulation of the Minister of Industry Number 54 / M-IND / PER / 3/2012 concerning Guidelines for the Use of Domestic Products for the Development of Electricity Infrastructure |
| 14 | Regulation of Ministry of Industry No 04 Year 2017 | Regulations and Procedures for Assessment of Local Content Level for Solar Power Plants |
| 15 | Regulation of Ministry of Industry No 29 Year 2017 | Regulations and Procedures for Calculating Value of Local Content/ Component for Cellular Phones, Handheld Computers, and Tablet Computers |
| 16 | Regulation of Ministry of Industry No 06 Year 2018 | Amendments to the Regulation of the Minister of Industry Number 15 / M-IND / PER / 3/2016 concerning Specifications and Price Standards for Transmission Towers and Domestically produced Conductors in the Context of Accelerating the Development of Electricity Infrastructure |

| | | |
|---|---|---|
| 17 | Regulation of Head of BKPM No 6 Year 2018 | Guidelines and Procedures for Investment Licensing and Facilitation |
| 18 | Regulation of Ministry of SoEs No PER - 08/MBU/12/2019 | General Guidelines for the Procurement of Goods and Services for State-Owned Enterprises (SoE) |
| 19 | Regulation of Ministry of Communication and Information Technology No 4 Year 2019 | Technical Requirements for Telecommunication Equipment and / Devices for the Purposes of TV and Radio Broadcasting |
| 20 | Regulation of Ministry of Industry No 16 Year 2020 | Regulations and Procedures for Calculating Value of Local Content of Pharmaceutical Products |
| 21 | Regulation of Ministry of Industry No 32 Year 2020 | Fourth Amendment to the Regulation of the Minister of Industry Number 19 / M-IND / PER / 2/2010 concerning List of Domestically Produced Machinery, Goods and Materials for Industrial Development in Investment. |
| 22 | Regulation of Ministry of Industry No 22 Year 2020 | Regulations and Procedures for Calculating the Value of Local Content Level of Electronic and Telematic Products |
| 23 | Regulation of Ministry of Industry No 27 Year 2020 | Regulations on Specifications, Development Roadmap, and Calculation for Local Content Value for Domestic Motor Vehicles and Battery Electric Vehicles |

Source: Ministry of Industry (2020)

As stated in the FGD with business actors, Indonesia relies heavily on imported goods, especially input products, particularly for sectors that depend on global value chains as described in the previous chapter. A study by Amiti & Konings, (2007) finds that the business sector in Indonesia has gained in productivity due to cheaper and better-quality inputs from trade liberalization. In addition, Negara (2016) also finds that TKDN has not been effective yet in reducing demand for imported input goods, since they are the main determinant of the Indonesian manufacturing sector's competitiveness. Meanwhile, weak enforcement and supervision have hindered the implementation the TKDN. Restrictive TKDN only has a negative impact on competitiveness and limits business actors' access to technology and knowledge.

The TKDN regulations require reform and harmonization of trade and industrial policies and strategies in Indonesia. First, with the development of global value chains, countries that will benefit from trade and investment have a relatively high degree of supply-chain integration. EU investors will most likely be concerned by the country's cumbersome import process.

Second, Indonesia is an importer of innovation and technology. Imported goods with technology and knowledge contents are useful for Indonesia to increase its competitiveness. In other words, inhibiting the importation of input goods is equivalent to impeding potential technology spill overs.

Finally, the implementation of TKDN regulations also needs to be evaluated. Apart from not having an evidence-based planning and evaluation mechanism, the application process for TKDN assessment needs to be simplified further to reduce bureaucracy and cut costs. Evidence-based policies will also strengthen Indonesia's position in multilateral forums and future negotiations.

Apart from TKDN, regulatory adjustments in the investment sector, especially those related to the Negative Investment List/Daftar Negatif Investasi (DNI), are also discussed in the negotiations because they are deemed as critical for the successful implementation of the agreement. The discussions focus on sectors that are restrictive. Regarding DNI, the European Union wants 100 percent foreign equity participation and elimination of joint venture requirements. Of course, this will be difficult for Indonesia to comply because the list is regulated by the Presidential Regulation No. 44/2016.

It is unfortunate that the sector requiring substantial investment is the most restrictive sector, namely services. According to the OECD FDI Restrictiveness Index, the most restrictive service sub-sectors in Indonesia are accounting & audit services (0.66), business services (0.58) and retail trade services (0.54). Easing the restrictions in the services sector is likely to provide major benefits, especially in form of increasing the efficiency of the sector as a whole.

As mentioned earlier, the implementation of the IEU CEPA will increase productivity and improve the quality of the services sector, especially financial services, business services and transportation, in two different ways, namely by increasing market access for EU companies and by increasing potential investment from the EU in this sectors. Duggan et al. (2013) find that the impact of liberalization in direct investment in the services sector will have a positive impact on the productivity of manufacturing companies. Compared to other countries, Indonesia is very slow in opening up investment in the services sector and the trend has stagnated from 2006 to 2018.

Indonesia also restricts foreign workers' mobility. High mobility of workers and investment are two factors that encourage the creation and diffusion of innovation in the economy. According to the OECD (2020), Indonesia has the most restrictive rules regarding foreign workers, especially in business services, law and accounting and auditing. Compared to other countries in Asia, the number of overseas migrant residents in Indonesia is very small, only 0.13% with a declining trend since 1990. Even Vietnam has experienced a significant growth in recent years (IOM, 2019). Therefore, it is expected that regulatory reform concerning foreign workers mobility will increase the flow of foreign direct investment and improve innovation.

According to the government, the Job Creation Law has simplified/revised 79 law-level regulations covering 1,260 articles. In the investment sector alone, there are several breakthroughs in regulatory reform, including, (1) risk-based business licensing where low-risk businesses only require a Business License Number (NIB), (2) local governments apply service level agreement (SLA) standards in providing licensing services based on Norms, Standards, Procedures and Criteria (NSPK) which will be set by Central Government, (3) fiscal incentives, such as tax holidays, tax allowances, super tax deduction and (4) to transform the Negative Investment List (DNI) into the Investment Priority List (DPI). Some of the business sectors that will be opened to foreigners are listed in **Table 8.6.** below.

Table 8.6 Business Sectors to be Opened Under the Job Creation Law

| | |
|---|---|
| 1 | Lifting of valuable objects from the sinking of the ship's cargo |
| 2 | Manufacturing of Chlorine alkaline with mercury |
| 3 | Pesticide active ingredients industry |
| 4 | Alcoholic Drinks |
| 5 | Wine-based Alcoholic Drinks |
| 6 | Drinks containing malt |
| 7 | Operator of Land transportation passenger terminals |
| 8 | Operator of motor vehicles weighting |
| 9 | Shipping navigation facilities and Vessel Traffic Information System (VTIS) |
| 10 | Aviation navigation services |
| 11 | Motor Vehicle Type Testing Services |
| 12 | Motor vehicle type testing services |
| 13 | Operators of radio frequency and satellite orbit spectrum monitoring station |
| 14 | Government museum |

Source: Katadata (2020)[24]

In anticipation of regulatory reforms and the commitments required by the IEU CEPA, it is important to promote Good Regulatory Practice (GRP) mainstreaming in order to improve the quality of regulation and business certainty in Indonesia. The main issue in the formation of regulations in Indonesia is the planning and evaluation process, which often results in overlapping regulations. The World Bank recorded 6,300 Ministerial Regulations issued during 2015-2018 related to economic activity. Most of these regulations were issued to protect consumers, society, workers, the environment, business and the economy. However, these regulations have not been implemented properly and instead have imposed a burden on the economy and become an arena for abuse and a source of economic rent.

## STRENGTHENING COORDINATION IN THE IMPLEMENTATION OF INTERNATIONAL TRADE AGREEMENTS

Based on qualitative analysis, internal coordination between Ministries / Agencies is particularly important in planning, negotiating and implementing international trade agreements. One of the problems in the implementation of a trade agreement is the lack of knowledge/understanding of the agreement, from the parties involved. In Indonesia, the use of certificates of origin/Surat Keterangan Asal (SKA) to obtain preferential rates is relatively low compared to other countries.

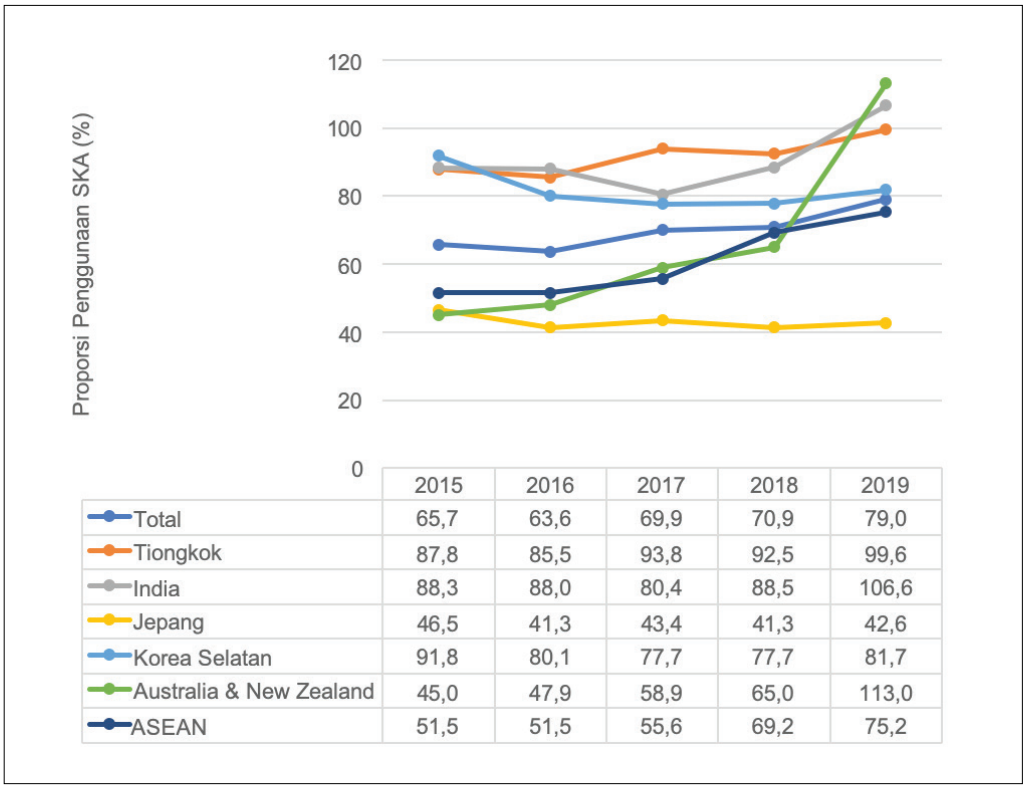
The Kazunobu (2015) study, using data from Japanese affiliated companies in ASEAN, states that the utilization of FTA in Indonesia is not optimal. A study conducted by CSIS (2013) also shows that only 43% of companies surveyed use preferential rates from trade agreements. SKA data in DKI Jakarta for 2017-2019 shows the SKA utilization rate is only 30-33%. Meanwhile, a study using data from a company-level survey in Yogyakarta, finds that the utilization rate is 44% (Nasution and Verico, 2019). One of the reasons for the low

24 https://katadata.co.id/pingitaria/finansial/5f7ddb0c60090/uu-cipta-kerja-buka-14-jenis-usaha-yang-sebelumnya-tertutup-bagi-asing

utilization rate of FTAs in Indonesia is the lack of information regarding market access in foreign countries, particularly for companies outside Java.

**Figure 8.3** shows the proportion of export value using SKA relative to the total export value in each destination country. From 2015 to 2019, in general, there was an increasing trend in the SKA utilization rate from 66% to 79%. When viewed from each trading partner country, the highest utilization rate was SKA Form AANZ (ASEAN-Australia-New Zealand) FTA, for export to Australia and New Zealand, reaching 113% in 2019. SKA Form D for export to ASEAN countries also experienced a significant increase. Meanwhile, Indonesia's exports using SKA only reached 42.6% for the IJEPA (Indonesia-Japan Economic Partnership Agreement) and AJCEP (ASEAN-Japan Comprehensive Economic Partnership) forms and tended to stagnate in the last five years.

Figure 8.3 Proportion of the use of COO/SKA to Total Exports by Destination Countries 2015-2019 (%)




| | 2015 | 2016 | 2017 | 2018 | 2019 |
|---|---|---|---|---|---|
| Total | 65,7 | 63,6 | 69,9 | 70,9 | 79,0 |
| Tiongkok | 87,8 | 85,5 | 93,8 | 92,5 | 99,6 |
| India | 88,3 | 88,0 | 80,4 | 88,5 | 106,6 |
| Jepang | 46,5 | 41,3 | 43,4 | 41,3 | 42,6 |
| Korea Selatan | 91,8 | 80,1 | 77,7 | 77,7 | 81,7 |
| Australia & New Zealand | 45,0 | 47,9 | 58,9 | 65,0 | 113,0 |
| ASEAN | 51,5 | 51,5 | 55,6 | 69,2 | 75,2 |

Source: E-SKA (calculated PDSI, Sekjen Kemendag and Puska KPI, BPPP)

Given the large number of stakeholders and central/regional sectors involved, it is necessary to strengthen overall coordination for trade agreements that are being carried out by Indonesia. This includes planning and negotiation strategy, followed by outreach, monitoring and evaluation. There are more than 20 ministries and agencies that play a role in the IEU CEPA negotiations, not to mention the other trade agreement negotiations that run in parallel. Indonesia is involved in 22 FTAs including seven trade agreements in the negotiation stage. Three have been ratified but are not yet implemented and 12 FTAs[25] are in effect. This requires better policy direction and priorities from policy makers given the limited resources.

25 Asia Regional Integration Canter (ARIC) database https://aric.adb.org/fta

With regards to the European Union, the stages and processes of negotiations of trade agreements must go through a robust mechanism and involve various stakeholders. Apart from the feasibility study carried out at the exploration stage, the government also needs to carry out an impact assessment during the negotiations. Furthermore, a sustainability impact assessment is also required, which involves the participation of more stakeholders. Regarding transparency, the European Union provides access to position papers, text of agreement proposals, background papers and factsheets that are open to the public. In the implementation period, a comprehensive ex-post evaluation is required to identify potential problems that may arise.

The Ministry of Trade should collect and create an integrated database which is accessible to all stakeholders, from relevant Ministries/Government Agencies. For example, FTA utilization data disaggregated by product (from Customs and Excise, Ministry of Finance), Certificate of Origin/SKA (from Ministry of Trade) and international trade data databases. This data can be useful for improving the FTA monitoring and evaluation process. Furthermore, the government needs to strengthen coordination with stakeholders in the regions. The government and stakeholders in the regions need to understand trade agreements substance. For example, industry associations / business actors need to ensure readiness of related sectors. They need to understand the export potential of MSMEs. The expansion and institutionalization of the FTA Center is deemed necessary because it is effective in coaching and training, and in socializing the existing FTAs to business actors, including MSMEs. In particular, support in the form of budget assistance and training to encourage exports as a national program is deemed crucial.

### Box 8.1 The Free Trade Agreement Centers

One of the pilot projects currently underway at the Directorate General of International Trade Negotiations of the Ministry of Trade is the FTA Center. The FTA Center itself provides services in terms of consultancy, education, and export advocacy. For consulting services, the FTA Center offers assistance in the use of FTAs (Free Trade Agreements), preparing companies, conducting market selection research, product preparation, pricing, and mapping of prospective buyers. Currently, FTA Centers are only available in a limited number of cities such as Jakarta, Bandung, Surabaya, Makassar, Medan and Semarang. To date, more than 90% of businesses supported by the FTA Centers are MSMEs.

To collect information related to export markets, the FTA Centers provide information from ITC, an access map module regarding tariffs and regulations in exporting and importing countries for each HS product, as well as an inter-ASEAN module and INATRADE data. The FTA Centers also help coordinate with relevant ministries and monitor the Indonesia National Single Window (INSW) for the latest regulations. For export destination countries, services vary depending on the exported products. For the mapping of export products, the FTA Centers focus on the more important products from each province which are then matched with the destination country.

FTA Centers are intended to be strategic partners that connect central, regional governments as well as business actors and academics. This one-stop solution concept is urgently needed by the business sector, especially MSMEs, which require substantial assistance. In this case, the role of the FTA Center can be expanded and institutionalized so that the benefits of this program can reach the regions.

Developing a national Standard Operating Procedure (SOP) for the socialization of international trade agreement in a comprehensive and inclusive manner is critical. The Ministry of Trade and related ministries / agencies usually include relevant business associations and actors in the socialization. However, a dedicated institution is needed in managing this process to ensure the effectiveness of the coordination between Ministries / Agencies and for socialization to take place in a systematic and sustainable way, until it reaches the government and business actors in the regions.

Finally, improvements of monitoring and evaluation of trade agreements are necessary to increase transparency and support from stakeholders. Until now, there is no provision for the socialization, monitoring and evaluation of trade agreements. The immediate implication is the absence of integrated data, for example, data and analyses of domestic production capacity, trade and foreign investment. No integrated data is available at macro and sectoral levels. Such data is useful to support Indonesia's position in the negotiation process so that

it is based on empirical evidence. Furthermore, there is no knowledge management system in place to take note and disseminate relevant lessons from trade agreements implemented by Indonesia. Lastly, there are no studies and research concerning the evaluation of the impact of international agreements in Indonesia.

# CONCLUSION

BASED ON THE findings in the previous chapters, it can be concluded that the economic relations between Indonesia and the European Union have not yet reached an optimal point. Indonesia's competitiveness in terms of trade and investment has been stagnant in recent years compared to other countries in the region. Therefore, the IEU CEPA provides opportunities for both parties to increase economic cooperation in terms of trade in goods, trade in services and investment. By analyzing the potential impact of implementing the IEU CEPA, this study provides a comprehensive discussion of the benefits and challenges that will be encountered by Indonesia in the future. The results of the analyses using trade data and economic model simulations provide additional information to previous studies. Additionally, perceptions from both central and local stakeholders enrich the study results and are useful for validating findings from secondary data.

To increase competitiveness in the global economy, this study underlines the importance of stakeholders' understanding of the GVC concept. Trade in goods and services as well as investment must be seen as a single essential unit. Reducing trade barriers without increasing the efficiency of the service sector will provide only limited benefits to the economy. Likewise, the liberalization of the services sector will not be effective if the deregulation of investment is carried out half-heartedly. The limited participation of Indonesia to global value chains is a sign of the limited understanding and attention from stakeholders regarding this concept. The acceleration and transformation of economic development will only be accomplished if Indonesia succeeds in increasing participation in global value chains and the IEU CEPA provides this opportunity.

IEU CEPA can become one of the factors driving Indonesia's economic recovery in the aftermath of the Covid-19 pandemic. Amid economic uncertainty and rising protectionism, the IEU CEPA has the potential to become a catalyst for a comprehensive economic reform in Indonesia. This is in line with Indonesia's urgent needs, particularly to improve regulations and the business climate. Based on the findings of economic model simulations, there is potential for a significant increase in output and welfare in both Indonesia and the European Union, which can become an important drive for economic recovery. IEU CEPA will also certainly strengthen the government's commitment to a more open trade and investment policy along with other trade agreements such as the IA CEPA and RCEP.

It must be acknowledged that results from the ongoing IEU CEPA negotiations are still very open. Differences in the positions between Indonesia and the European Union remain on the evolving issues and on new topics, and will require more efforts from both parties to be narrowed. However, these challenges are natural in the trade negotiation process.

Adjustments to regulations and policies discussed earlier should be seen as opportunities for reform intended to improve competitiveness and the business climate in Indonesia. Several studies show that convergence and regulatory flexibility will provide benefits and support for the business sector, especially in the context of the growing participation to GVCs.

In preparation for the implementation, policy adjustments are integral part of the trade agreement process. Improving the quality of infrastructure and harmonizing regulations are additional but essential activities that need to be carried out. In addition, strengthening coordination between Ministries / Agencies to increase awareness of the business sector throughout the country is also important during the negotiation process. Capacity building related to procedures and product standardization for the business sector, especially MSMEs, should be discussed when negotiating economic cooperation. Expanding information access aims at maximizing the future utilization of trade agreements. The government's effort in preparing for these matters is important for realizing the potential benefits of the IEU CEPA in the future.

# REFERENCES

Amiti, M., & Konings, J. (2007). Trade Liberalization, Intermediate Inputs, and Productivity: Evidence from Indonesia. American Economic Review, 97 (5): 1611-1638.

Athanasoglou, P., Backinezos, C., & Georgiou, E. (2010). Export Performance, Competitiveness, and Commodity Composition. *RePEc Working Paper no. 114 (May 2010)*

Armah, M.K., Fosu, P., 2018. "Infrastructure and foreign direct investment inflows: evidence from Ghana." *Management and Economic Journal* 93–106.

Asiedu, E., 2002. "On the determinants of foreign direct investment to developing countries: is Africa different?" *World Dev.* 30 (1), 107–119.

Aswicahyono H., Hill H. and Narjoko D. 2010. "Industrialisation after a Deep Economic Crisis: Indonesia." *The Journal of Development Studies*, 46(6),1084-1108.

Aswicahyono, Haryo, and Dandy Rafitrandi. 2020. "Emerging Technology in Indonesia's Manufacturing Sector". CSIS Working Paper. Jakarta: CSIS Indonesia.

Aswicahyono, H., & Rafitrandi, D. (2018). A review of Indonesia's economic competitiveness. CSIS Working Paper Series. Jakarta: CSIS Indonesia.

Aziz, O.G., 2018. "Institutional quality and FDI inflows in Arab economies." *Financ. Res. Lett.* 25, 111–123.

Baldwin, R. (2012). Global supply chains: Why they emerged, why they matter, and where they are going. *CEPR Discussion Papers 9103*.

Baldwin, R. (2016). The World Trade Organization and the Future of Multilateralism. *Journal of Economic Perspectives, American Economic Association*, vol. 30(1), pages 95-116.

Baldwin, R., & Mauro, B. (2020). Mitigating the COVID Economic Crisis: Act Fast and Do Whatever It Takes. CEPR, VoxEU.

Bevan, A.A., Estrin, S., 2004. "The determinants of foreign direct investment into European transition economies." *J. Comp. Econ*. 32 (4), 775–787.

Blomstrőm, M. and A. Kokko. 1997. "Regional Integration and Foreign Direct Investment: A Conceptual Framework and Three Cases," Policy Research Working Paper Series 1750, World Bank.

Blomstrom, M., Kokko, A., Mucchielli, J.L., 2003. "The economics of foreign direct investment incentives. In: Foreign Direct Investment in the Real and Financial Sector of Industrial Countries." *Springer*, pp. 37–60.

Blonigen, B.A., Piger, J., 2014. "Determinants of foreign direct investment." *Canadian Journal of Economics/Revue canadienne d'_economique* 47 (3), 775–812.

Biswas, R., 2002. "Determinants of foreign direct investment." *Rev. Dev. Econ*. 6 (3), 492–504.

Centre for Strategic and International Studies. (2015). Study of the Impact of an EU-Indonesia CEPA. *CSIS Jakarta*.

Cuyvers, L., Soeng, R., Plasmans, J., Van Den Bulcke, D., 2011. "Determinants of foreign direct investment in Cambodia." *J. Asian Econ.* 22 (3), 222–234.

Damuri, Y. (2012). International production sharing: insights from exploratory network analysis. *CTEI Working Paper, 2012-3*.

Damuri, Yose Rizal. 2020. "UU Cipta Kerja dan Upaya Reformasi Ekonomi Indonesia." *CSIS Commentaries* ECON-005-ID

Damuri, Y. R., Atje, R., Mugijayani, W., Anas, T., Setyoko, R., Rafitrandi, D., ... & Christian, D. (2014). Impacts of FTAs in Indonesia: Study and Business Perspective Survey Results 2013. Department of Economics, CSIS, Jakarta

Duggan, Victor; Rahardja, Sjamsu; Varela, Gonzalo. 2013. Service Sector Reform and Manufacturing Productivity: Evidence from Indonesia. Policy Research Working Paper;No. 6349. World Bank, Washington, DC. https://openknowledge.worldbank.org/handle/10986/13149

Dunning, John H, 1993, Multinational Enterprises and the Global Economy (Harlow:Addison-Wesley).

Eichengreen, B., & Gupta, P. (2009). *The Two Waves of Service Sector Growth.* Cambridge: NATIONAL BUREAU OF ECONOMIC RESEARCH.

Finger, J., & Kreinin, M. (1979). A Measure of 'Export Similarity' and Its Possible Uses. Economic Journal, Vol. 89, p. 905-91. https://doi.org/10.2307/2231506

Falvey, R., Foster, N., & Greenaway, D. (2006). Intellectual Property Rights and Economic Growth. *Review of Development Economics Volume 10, Issue 4*.

Gereffi, G., & Fernandez-Stark, K. (2016). Global Value Chain Analysis: A Primer, 2nd Edition.

Gilbert, J. (2010). Constant Market Share Analysis of the Pattern of Southeast Asian Export Growth in the 2000s. *Lecture Handouts at Utah State University.*

Gill, D. and E. Setyadi (2020), 'The Pervasiveness and Persuasiveness of International Regulatory Cooperation in the ASEAN and New Zealand – Research Findings', in Gill, Derek (ed.), Interconnected Government: International Regulatory Cooperation in ASEAN. Jakarta, Indonesia: Economic Research Institute for ASEAN and East Asia, pp.16-56.

Globerman, S., Shapiro, D., 2002. "Global foreign direct investment flows: the role of governance infrastructure." *World Dev*. 30 (11), 1899–1919.

Hallward-Driemeier, M. (2003), "Do Bilateral Investment Treaties Attract FDI? Only a bit…. and they could bite", World Bank Policy Research Paper WPS 3121. World Bank: Washington DC.

Harding, T. and Javorcik, B. S. 2011. "Roll Out the Red Carpet and They Will Come: Investment Promotion and FDI Inlows." *The Economic Journal*, 121,1445–1476.

Harvie, Charles, Narjoko, Dionisius and Oum, Sothea, (2010), Firm Characteristic Determinants of SME Participation in Production Networks, No DP-2010-11, Working Papers, Economic Research Institute for ASEAN and East Asia (ERIA)

Helpman, E. 1984. "A Simple Theory of International Trade with Multinational Corporations." *Journal of Political Economy* , vol. 92, no. 3, pp. 451-471.

Helpman, E. and P. Krugman. 1987. "Market Structure and Foreign Trade ". *Cambridge, MT*: MIT Press

Hermes, N., Lensink, R., 2003. "Foreign direct investment, financial development and economic growth." *J. Dev. Stud*. 40 (1), 142–163.

Horridge J.M., and F. Zhai. (2006). Shocking a single-country CGE model with export prices and quantitifes from a global model. In Thomas Hertel and L. Alan Winters (eds), Poverty and WTO: Impacts of the Doha Development Agenda. World Bank and Palgrave Macmillan, Washington D.C.

Huber, P., & Pfaffermayr, M. (2012). FDI versus Exports: Multiple Host Countries and Empirical Evidence. *The World Economy, Wiley Blackwell*, vol. 35(3), pages 316-330.

Irarrazabal, A., Moxnes, A. and L. Opromolla. 2009. "The Margins of Multinational Production and the Role of Intra-Firm Trade," CEPR Discussion Paper, no. 7145.

Jang, Y. 2011. "The Impact of Bilateral Free Trade Agreements on Bilateral Foreign Direct Investment among Developed Countries," World Economy , vol. 34, issue 9, pp. 1628-1651

Japan External Trade Organization (JETRO), 2020. Survei " Kondisi Bisnis Perusahaan Jepang Di Asia Dan Oseania" Tahun 2019 (Survei Tahun Ke-33) Mengenai Kondisi Perusahaan Jepang Di Indonesia. [online] < https://www5.jetro.go.jp/newsletter/ jkt/2019/Press%20 Release%20Indonesian.pdf>

Jong-Wha, L., & McKibbin, W. (2014). *Service sector productivity and economic growth in.* Tokyo: Asian Development Bank Institute (ADBI).

Kanwar, S., & Evenson, R. (2003). Does Intellectual Property Protection Spur Technological Change'? *Oxford Economic Papers*, 55(2):235-264.

Kazunobu, H. (2015). *Impacts of FTA Utilization on Firm Performance,* The B.E. Journal of Economic Analysis & Policy, De Gruyter, vol. 15(3), pages 1325-1352

Knottnerus, R. (2018). *Civil Society Statement on the EU-Indonesia Comprehensive Economic Partnership Agreement (CEPA).*

Kowalski, P., Gonzalez, J., Ragoussis, A., & Ugarte, C. (2015). *Participation of Developing Countries in Global Value Chains*. OECD.

Krueger, A. (1997). Trade Policy and Economic Development: How We Learn. *American Economic Review, 87, issue 1*, p. 1-22.

Kummritz, V. (2016). Do Global Value Chains Cause Industrial Development? *CTEI Working Papers series 01-2016,*, Centre for Trade and Economic Integration, The Graduate Institute.

Lanz, R., & Piermartini, R. (2018). Specialization within global value chains: The role of additive transport costs. *WTO Staff Working Papers ERSD-2018-05*.

Laprévote, F.-C. (2019). Competition provisions in trade agreements - Is there a Way Forward? *OECD Global Forum of Competitive Conference-Paris.* OECD.

Leamer, E., & Stern, M. (1970). Quantitative International Economics. *Aldine Publishing: Chicago.*

Lopez-Gonzalez, J. (2016). Using Foreign Factors to Enhance Domestic Export Performance: A Focus on Southeast Asia. *OECD Trade Policy Papers*, 191.

Moore, M.O., 1993. "Determinants of German manufacturing direct investment: 1980–1988." *Rev. World Econ*. 129 (1), 120–138.

Nasution, N. A., & Verico, K. (2019). Utilization of Free Trade Agreement in Indonesia:. *Economics and Finance in Indonesia*, 65 (2):169–185.

Negara, S. (2016). The Impact of Local Content Requirements on the Indonesian Manufacturing Industry. *Economics Working Paper*. Neumayer, E. and Spess, L. (2005), "Do Bilateral Invetsment Treaties Increase Foreign Direct Investment to Developing Countries?", LSE research Online, available at : http://eprints.lse.ac.uk/archive/00000627

OECD/ERIA (2018), SME Policy Index: ASEAN 2018: Boosting Competitiveness and Inclusive Growth, OECD Publishing, Paris/Economic Research Institute for ASEAN and East Asia, Jakarta. https://doi.org/10.1787/9789264305328-en

Pangestu, M., 1997. "Indonesia: Trade and Foreign Investment Linkages." In: Dobson, W., Chia, S.Y., (Eds.), *Multinationals and East Asian Integration.* Singapore: Institute of Southeast Asian Studies

Revindo, M. D., Gan, C., & Massie, N. W. G. (2019). Factors Affecting Propensity to Export: The Case of Indonesian SMEs. Gadjah Mada International Journal of Business, 21(3), 263-288.

Schneider, F., Frey, B.S., 1985. "Economic and political determinants of foreign direct investment." *World Dev.* 13 (2), 161–175.

Shatz, H., & Venables, A.J. 2000. "The Geography of International Investment". "*World Bank Policy Research Working Paper*. 2338

Spence, M., & Karingi, N. (2011). Impact of Trade Facilitation Mechanisms on Export Competitiveness in Africa. *African Trade Policy Centre Work in Progress No. 84, UNECA*.

Tiberti L., Cicowiez M., and Cockburn. (2017). A Top-down Behaviour (TBD) Microsimulation Toolkit for Distributive Analysis: A Manual. PEP toolbox. Partnership for Economic Policy (PEP)

Todaro, M. P., & Smith, S. (2014). *Economic Development, 12th Edition. Pearson.* World Economic Forum. (2019). *The Globa*l. Switzerland: World Economic Forum.

Tyszynski, H. (1951). World Trade in Manufactured Commodities, 1899-1950. *The Manchester School, Vol. 19, Issue 3*. https://doi.org/10.1111/j.1467-9957.1951.tb00012.x

UNCTAD. 2020. World Investment Report 2020, International Production Beyond Pandemic Key Messages and Overview. United Nation

Velde, D. and D. Bezemer. 2006. "Regional Integration and Foreign Direct Investment in Developing Countries," Transnational Corporations , vol. 15, no. 2, pp. 41-70.

Widyasanti A.A., and Yusuf A.A. (2019). The Impact of Oil Palm Restriction in EU to Indonesian Economy. 15th IRSA (Indonesian Regional Science Association) International Conference Banda Aceh 2019.

Widyastutik, W., Puspitawati, E., & Fawaiq, M. (2014). Analisis Dampak Implementasi Komitmen Indonesia di Sektor Jasa Konstruksi dalam Kerangka AFAS. Jurnal Ekonomi Dan Pembangunan Indonesia, 15(1), 41-56. https://doi.org/10.21002/jepi.v15i1.446

Yeyati, E., Stein, E. and C. Daude. 2003. "Regional Integration and the Location of FDI," IADB Draft.

Yoshino, N., & Wignaraja, G. (2015). SMEs Internationalization and Finance in Asia. Paper presented at the Frontier and Developing Asia: Supporting Rapid and Inclusive Growth IMF-JICA Conference Tokyo

Zebregs, H. (2004). International Trade in Emerging Asia. IMF Policy Discussion Paper PDP/04/01.

# APPENDIX

## APPENDIX 1 METHODOLOGY

### Literature Study

The study will identify and review studies that have been done on the impact of free trade agreements and other forms of economic cooperation. The literature study is aimed at preparing the research design and methodology for this study. In addition, CSIS will also review the regulatory framework for the Comprehensive Economic Partnership Agreement that Indonesia has signed. The study will also review existing comprehensive economic partnership agreements between the European Union and other countries (such as Vietnam) to learn from these agreements and to view them in the context of the IEU CEPA negotiations.

### Quantitative Data Analysis and Econometric Models

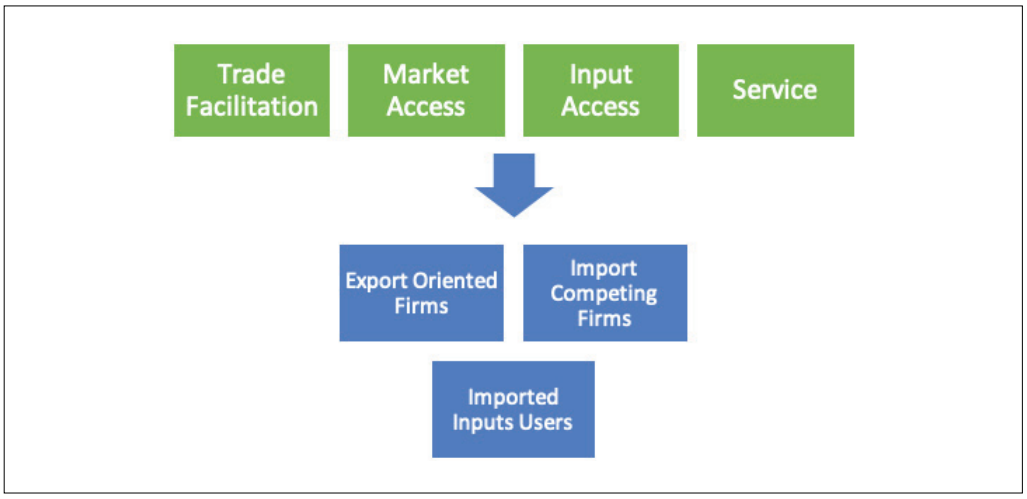
Quantitative analysis is intended to provide a better understanding of the economic and socio-economic impact of the IEU CEPA agreement. Using secondary data, this study will compile and analyze statistical data from various trade and investment indicators related to trade and investment relations between Indonesia and the EU. In addition, the analysis will use an econometric model approach to estimate the socio-economic impact of the IEU CEPA agreement using the CGE model, i.e measuring the impact of IE CEPA is in the form of job creation and increased efficiency by estimating increase in community welfare (distribution effect and allocation of economic resources). Estimates generated from quantitative analysis and econometric models will be used to formulate optimal strategies for utilizing the IEU CEPA agreement and to mitigate challenges.

### In-depth Interviews and Focus Group Discussions

Several interviews were conducted to enrich the results of this study. This is very important to obtain primary information / perceptions, especially from government officials and the business actors about the potential impact of the IEU CEPA. By conducting in-depth interviews, this research is expected to obtain information and direct views on the potential impact of the IEU CEPA from the various stakeholders involved and will be directly affected by the outcome of these negotiations.

FGDs were also conducted to discuss various issues and issues surrounding the IEU CEPA agreement, including potential opportunities and challenges in a larger platform with more participants. This activity will allow for an exchange of opinions, as well as capture the dynamics of various opinions. FGDs were conducted online in Jakarta, Medan and Makassar in collaboration with the FTA Center at the provincial level to look at problems at the regional level and discuss possible solutions.

Figure 1.1 FGD Thinking Framework for IEU CEPA Study




The selection of Medan and Makassar was based on geographic considerations where Medan represented the western part of Indonesia while Makassar was considered to represent the eastern part of Indonesia. It is hoped that an exchange of opinions will occur, in order to capture the dynamics of differences of opinion with these activities. During the implementation, visits outside Jakarta had to be replaced with FGDs and in-depth online interviews given the uncertain conditions of the Covid-19 pandemic.

### Internal Workshop and Needs Assessment

Throughout the research period, CSIS held internal workshops which actively involved representatives of the ministries in the framework of capacity building and to provide practical experience to conduct research on trade and investment related issues. In addition, this workshop is expected to obtain input and suggestions from government representatives in order to improve and enhance the quality of research.

There are six internal workshops during the study period. This workshop aims to discuss 1) direction of study; 2) other quantitative modeling and analysis approaches; 3) research instruments for qualitative data collection (interviews and FGD); 4) preliminary results from quantitative and; 5) modeling outputs and preliminary results from qualitative analysis. A final workshop will be held to discuss the overall study results and possible policy recommendations.

.In addition, the internal workshop will also collect information on the needs of relevant government agencies related to trade analysis such as data and instruments. A needs assessment will provide insights to support institutions with essential knowledge of trade analysis and to build internal institutional capacity. The focus of this assessment is to examine various international trading databases/tools including TradeMap, World Integrated Trade Solutions (WITS) and others, and how they fit into institutional needs.

## APPENDIX 2. RESULTS OF REGIONAL PRIVATE SECTOR FGDS (DKI JAKARTA, NORTH SUMATRA AND SOUTH SULAWESI)

| | Group 1 (Export Oriented Firms) | Group 2 (Import Competing Firms) | Group 3 (Imported Inputs Users) |
|---|---|---|---|
| **Perception** | Has a more transparent procedure compared to East Asian countries<br><br>Logistics costs, as well as customs & duties in EU countries, are considered as expensive<br><br>Tariffs are still high due to the absence of a trade agreement like with Australia<br><br>Indonesian products are often treated differently. For example, Thai products tend to have no obstacles while similar products from Indonesia have a greater chance of being recalled<br><br>Indonesian products are quite attractive even though they are relatively more expensive compared to other countries | There have been improvements in trade facilitation services, especially related to INSW i.e. digitization and integration of licensing to support transparency and predictability<br><br>The importing process for products from the European Union tend to be faster and safer compared to other countries such as China and India<br><br>There is no concern regarding increased market access for EU products due to product differentiation and product prices that are still affordable for the public<br><br>Cheaper imported goods are advantageous because some are essential input goods | It will be beneficial if EU products become cheaper because the quality of EU products is far above other countries, for example, China<br><br>It is very likely the products have to go through a physical inspection at EU customs<br><br>Machinery and equipment from the European Union are of good quality but more difficult to operate<br><br>Administrative processes at Indonesian customs tend to take a long time |

| | | | |
|---|---|---|---|
| **Identification of problems** | In the regions, standardization often remain as issues due to the unavailability of laboratories that meet the criteria to issue certificates to meet exports standards<br><br>The limited capacity of inspection bodies requires exporters to do inspections in Malaysia or Singapore, which are more expensive<br><br>Inspection certification is only valid for one year and must be renewed annually<br><br>Logistics process are not directly going to destination countries in Europe, which causes higher costs and longer delivery time (very crucial, especially for food/ beverages)<br><br>High tariffs and import duties (ex: wood products) | Tariff policies are still less competitive than neighbor countries such as Malaysia and Thailand<br><br>The phenomenon of the missing middle (production scale) of the domestic industry<br><br>There is TKDN regulation, yet domestic input products are not available to meet the required TKDN ratio. A more comprehensive strategy is needed to tackle this issue<br><br>Indonesian people have a mindset that imported products are better than local products<br><br>Export products are required to provide a lot of certificates to enter the EU compared to the US, especially for food product | ISO certification issued by Indonesia for export products has been accepted by the Dutch, but not necessarily accepted in other EU countries.<br><br>There is a constraint for licensing of foreign workers<br><br>Licensing for investment is also problematic. Some investors canceled the investment due to this issue<br><br>Machinery imports are still at high VAT costs and it is challenging to get VAT exemptions for machinery imports |

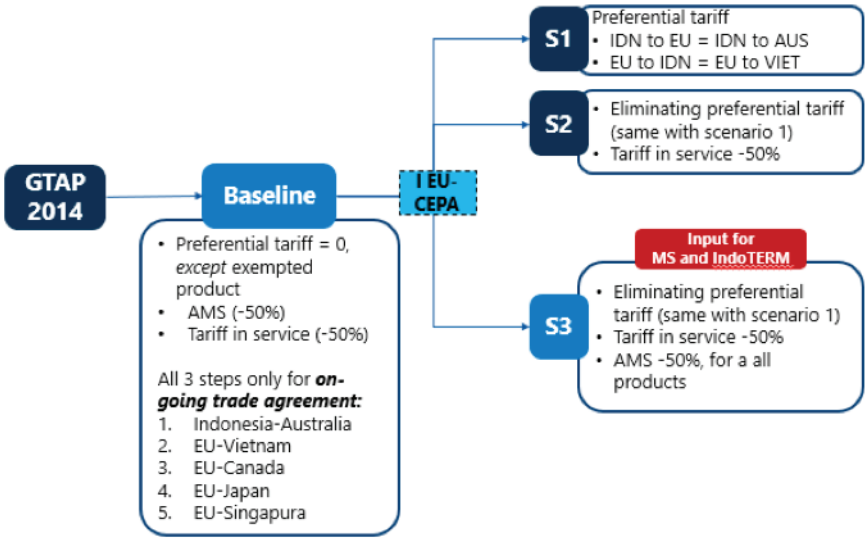
| | | | |
|---|---|---|---|
| **Aspirations** | More comprehensive information regarding market potential and regulation for the export procedure because each country in the European Union has different rules<br><br>The government should overcome the black campaign against palm oil. Palm oil substitution is expensive and has been widely used in the food industry from Indonesia<br><br>Certifications obtained in Indonesia have to be recognized in the European Union<br><br>There is a concern for small and medium entrepreneurs in terms of their competitiveness both in price and quality.<br><br>Imports should be a tool to boost domestic industrial growth | It is hoped that Indonesia will implement a self-certificate process as ASEAN did, to facilitate the process of exports and imports between Indonesia and the EU so it would speed up the flow of goods<br><br>Increasing the efficiency for export-import procedures, especially for fresh products like shrimp<br><br>Machinery/ production tools are still standard, with little production capacity, yet technically, they have mastered the processing techniques. Access to a large capacity production machine or to upgrade existing machines are needed | Customs have to conduct extensive and good socialization on import rules and policies<br><br>Encouraging digitization of licensing, especially in investment<br><br>For the service sector, it is necessary to facilitate labor mobility for knowledge transfer |
| **Recommen-dation** | Education/ socialization regarding the importance of certification<br><br>Certification subsidy scheme for MSMEs<br><br>Capacity building through training / mentoring and market information to MSMEs<br><br>Strengthening promotion policy through trade shows and exhibitions | Ensuring technology transfer<br><br>Increasing competitiveness of domestic products<br><br>Improvement of infrastructure quality and trade facilitation policies outside Java<br><br>Further socialization to the regions | Not complicate import facilitation because it is as essential as export facilitation<br><br>Opening market access for Indonesia's service sector<br><br>Giving incentives and facilitates imports of capital goods like machinery from the EU |

Source: Results of the Private Sector

## APPENDIX 3. ECONOMIC MODEL ANALYSIS USING GTAP

Trade liberalization indicates the ease of trade due to lower tariffs and non-tariff barriers. However, the GTAP database only provides tariff data and does not accommodate data on non-tariff barriers. Therefore, we use the tariff-equivalent estimates of non-tariff barriers in order to see the impact of trade liberalization in a broader scope. We will use this tariff-equivalent estimate for updating the tariff data in the GTAP database, according to the simulation run by Widyastutik et al. (2014) which updated the tariffs in the construction services sector to see the impact of Indonesia's commitment to the construction services sector in the AFAS commitment. We use the equivalent tariff calculation for Non-Tariff Measure (NTM) on goods with calculations from the World Bank[26], using the NTM data for goods from 2012 to 2016. We use the tariff-equivalent estimates of non-tariff barriers in service trade calculated by Fontagne et al. (2016 ) calculated by the reduction method in the gravity approach and using the 2011 GTAP database.

Figure 3.1 IEU CEPA GTAP Simulation Scenario




Source: Prepared by author

The baseline of the simulation scenario is formed from two stages. In the first stage, we adjust the tariff for goods and service equivalent rates in the 2014 GTAP database to the 2018 tariff using the Most Favored Nation (MFN) tariff data in the World Integrated Trade Solution (WITS) database. We have made this adjustment for bilateral trade between Indonesia and the EU, as well as five other bilateral trades that have entered the agreement period in the 2014-2020 period: 1) Indonesia-Australia, 2) EU-Vietnam, 3) EU-Canada, 4) EU-Japan and 5) EU-Singapore. In the second stage, we assume that the five bilateral trades have reached the end of the tariff schedule, in which almost all products have reached the zero tariff unless those products are agreed not to be fully liberalized. We also reduced the equivalent tariff on services and the equivalent tariff on the NTM of goods by 50%.

26 https://datacatalog.worldbank.org/dataset/ad-valorem-equivalent-non-tariff-measures

After the baseline was formed, we did simulations with three different scenarios to see the impact of trade liberalization on the IEU CEPA. *The first scenario* assumes that there is a reduction in tariffs on bilateral trade in goods between Indonesia and the EU. In this scenario, the reduced tariffs granted for imported goods from Indonesia in the EU are equated with Vietnamese imports in the EU at the end of the tariff schedule. Meanwhile, the reduction in tariffs on EU imported goods in Indonesia uses a lowered tariff for Australian imported goods in Indonesia at the end of the tariff schedule. *The second scenario* assumes that there is a reduction in tariffs as in the first scenario, plus a half reduction in the ad-valorem tariff equivalent of Non-Tariff Measures (NTM) on goods. *The third scenario* assumes that there is a decrease in the tariff on goods and the ad-valorem tariff which is equivalent to the NTM of goods as in the second scenario, as well as a decrease in the ad-valorem tariff from the Non-Tariff Barrier (NTB) on services by 50 percent. The results of the third scenario will be used as input for the simulation at the regional or provincial level in the IndoTERM model, which will be explained further in the next sub-chapter.

Table 3.1 GTAP Regional Aggregation

| No. | Country/Region | Composition |
|---|---|---|
| 1 | Philippines | Philippines |
| 2 | Indonesia | Indonesia |
| 3 | Malaysia | Malaysia |
| 4 | Thailand | Thailand |
| 5 | Singapore | Singapore |
| 6 | Vietnam | Viet Nam |
| 7 | OtherAsia | Hong Kong; Mongolia; Taiwan; Rest of Eat Asia; Brunei Darussalam; Cambodia; Lao People's Democratic Republ; Rest of Southeast Asia; Bangladesh; Nepal; Pakistan; Sri Lanka; Rest of South Asia |
| 8 | Japan | Japan |
| 9 | China | China |
| 10 | SouthKorea | Korea |
| 11 | USA | United States of America |
| 12 | Canada | Canada |
| 13 | Turkey | Turkey |
| 14 | India | India |
| 15 | Australia | Australia |
| 16 | NorwaySwitz | Switzerland; Norway |
| 17 | NewZealand | New Zealand |
| 18 | RestOfWorld | Rest of Oceania; Mexico; Rest of North America; Argentina; Bolivia; Brazil; Chile; Colombia; Ecuador; Paraguay; Peru; Uruguay; Venezuela; Rest of South America; Costa Rica; Guatemala; Honduras; Nicaragua; Panama; El Salvador; Rest of Central America; Dominican Republic; Jamaica; Puerto Rico; Trinidad and Tobago; Caribbean; United Kingdom; Rest of EFTA; Albania; Belarus; Russian Federation; Ukraine; Rest of Eastern Europe; Rest of Europe; Kazakhstan; Kyrgyzstan; Tajikistan; Rest of Former Soviet Union; Armenia; Azerbaijan; Georgia; Bahrain; Iran Islamic Republic of; Israel; Jordan; Kuwait; Oman; Qatar; Saudi Arabia; United Arab Emirates; Rest of Western Asia; Egypt; Morocco; Tunisia; Rest of North Africa; Benin; Burkina Faso; Cameroon; Cote d'Ivoire; Ghana; Guinea; Nigeria; Senegal; Togo; Rest of Western Africa; Central Africa; South Central Africa; Ethiopia; Kenya; Madagascar; Malawi; Mauritius; Mozambique; Rwanda; Tanzania; Uganda; Zambia; Zimbabwe; Rest of Eastern Africa; Botswana; Namibia; South Africa; Rest of South African Customs ; Rest of the World. |
| 19 | EU_27 | Austria; Belgium; Bulgaria; Croatia; Cyprus; Czech Republic; Denmark; Estonia; Finland; France; Germany; Greece; Hungary; Ireland; Italy; Latvia; Lithuania; Luxembourg; Malta; Netherlands; Poland; Portugal; Romania; Slovakia; Slovenia; Spain; Sweden. |

Table 3.2 GTAP Sectoral Aggregation

| No. | Sectors | Composition |
|---|---|---|
| 1 | Agriculture | Paddy rice; Wheat; Cereal grains nec; Vegetables, fruit, nuts; Oil seeds; Sugar cane, sugar beet; Plant-based fibers; Crops nec; Bovine cattle, sheep and goats; Animal products nec; Wool, silk-worm cocoons; Processed rice. |
| 2 | Forestry | Forestry. |
| 3 | Fishing | Fishing. |
| 4 | Energy | Coal; Oil; Gas; Minerals nec; Petroleum, coal products; Gas manufacture, distribution. |
| 5 | Food | Bovine meat products; Meat products nec; Sugar; Food products nec; Beverages and tobacco products. |
| 6 | VegOil | Vegetable oils and fats. |
| 7 | Dairy | Raw milk; Dairy products. |
| 8 | Clothing | Textiles; Wearing apparel; Leather products. |
| 9 | OtherManuf | Wood products; Paper products, publishing; Chemical products; Basic pharmaceutical products; Rubber and plastic products; Transport equipment nec; Manufactures nec. |
| 10 | Mining | Mineral products nec; Ferrous metals; Metals nec; Metal products. |
| 11 | MotorVehicle | Motor vehicles and parts. |
| 12 | Electronic | Computer, electronic and optic. |
| 13 | Machinery | Electrical equipment; Machinery and equipment nec. |
| 14 | OtherService | Electricity; Water; Construction; Warehousing and support activi; Real estate activities; Business services nec; Recreational and other service; Public Administration and defe; Human health and social work a; Dwellings. |
| 15 | Comm | Communication. |
| 16 | FncInsurance | Financial services nec; Insurance. |
| 17 | Transport | Transport nec; Water transport; Air transport. |
| 18 | Trade | Trade. |
| 19 | Accomodation | Accommodation, Food and servic. |
| 20 | Education | Education. |

Table 3.3 GTAP Aggregration of Factors of Production

| No. | Sectors | Composition |
|---|---|---|
| 1 | Land | Land. |
| 2 | UnSkLab | Clerks; Service/Shop workers; Agricultural and Unskilled. |
| 3 | SkLab | Technicians/AssocProfessional; Officials and Managers. |
| 4 | Capital | Capital. |
| 5 | NatRes | Natural Resources. |

## APPENDIX 4. ECONOMIC MODEL ANALYSIS USING INDOTERM

IndoTERM is a *Computable General Equilibrium* (CGE) model that describes the general equilibrium condition in the Indonesian national economy which was developed since 2006 by a collaboration between Padjadjaran University, Monash University, BAPPENAS, and ADB. This model is derived from Australia's national CGE model, namely TERM (*The Enormous Regional Model*), which treats the regions of the country as their own country. Therefore, IndoTERM also has similar characteristics, where the model is a "bottom-up" model of several regional economies in Indonesia. The data used by the latest version of IndoTERM is the 2010 Indonesian Input-Output data issued by BPS. In total, IndoTERM has 185 industrial and commodity sectors, 34 provinces, and 4 types of work divided based on workers' skills. The 185 sectors are aggregated into only 20 sectors following the same aggregation as GTAP. The aggregation is provided in the table below.

The variables that are subjected to a shock to the IndoTERM model are the price of Indonesian imports per commodity (pfimp) and also the increase in demand for Indonesian exports per commodity (xexpd). The latter variable is compiled based on the formula fp = p + q/ESUBM where p is the price of Indonesian exports to the world (pxw), q is the quantity of Indonesia's exports to the world (qxw), while ESUBM is the elasticity of related commodities, all three are derived from the output of GTAP model simulation. Meanwhile, the variable of Indonesia's import price per commodity is taken directly from the GTAP model through the pim variable which shows the same thing.

The simulation process at IndoTERM takes place in two stages. At the initial stage, the first shock that comes from the simulation output of the baseline scenario GTAP model is applied to the IndoTERM data. The results of this process will produce a new database for the Indonesian economy which tries to approximate the current conditions as described in the methodology section of the GTAP model. Then, for the next stage, a second shock that comes from the simulation output of the GTAP model in the IEU CEPA scenario is applied to the latest database. The result of this second shock is referred to as the final result, where the output will be used for two things, namely as a regional impact analysis tool for the IEU CEPA and also as an input variable for the microsimulation model. As for the former purpose, the variable analyzed was the percentage change in real expenditure GRDP in each province (xgdpexp). For the purposes of the GRDP decomposition, the sectoral output variables per province (xtot) as well as the final demand variable for each province (xfin) will also be analyzed in addition. As for the second purpose, the variables that are given as input to the microsimulation model are the wage for workers (plab), demand for workers (xlab), the price of production factors in the form of capital (pcap), and the final price of commodities for households (phou). Two comprehensive tables regarding the input and output variables of the IndoTERM model in this study are provided below.

Table 4.1 Aggregation Sector Model IndoTERM

| No. | New Sector | Old Sector |
|---|---|---|
| 1 | Agriculture | Rice, Corn, Sweet Potato, Cassava, Other Tubers, Peanuts, Soy, Other Nuts, Other Grains, Vegetables, Décor Plants, Cane, Tobacco, Plant Fiber, Other Plantation, Fruits, Plant Biophrom, Rubber, Coffee, Tea, Cocoa, Clove, Cashew, Agriculture Service. |
| 2 | Forestry | Wood, Other Forest Products, Sawmill, Plywood, Wood Building Material, Other Wood Products, Paper Pulp, Paper. |
| 3 | Fishing | Fish, Shrimp, Other Aquatics, Seaweed. |
| 4 | Energy | Coal Lignite, Crude Oil, Oil & Gas Ref. |
| 5 | Food | Abattoir, Meat Products, Dried Fish, Fish Products, Processed Vegetables & Fruits, Edible Crops, Copra, Dairy Products, Other Flour, Wheat Flour, Rice Milling, Bread & Biscuits, Sugar, Confectionary, Pasta Noodle, Coffee Processed, Tea Processed, Soy Processed, Other Foods, Animal Feeds, Alcoholic Beverages, Non Alcoholic Beverages, Cigarettes, Tobacco Products. |
| 6 | VegOil | Coconut Oil, Palm Oil |
| 7 | Dairy | Livestock, Fresh Milk, Poultry, Other Animal Products. |
| 8 | Clothing | Yarn, Textile, Ropes Carpets, Other Textile Products, Knitted Products, Apparel, Tanning, Leather Products, Footwear. |
| 9 | OtherManuf | Paper Products, Printed Products, Other Non Metal Products, Basic Chemicals, Fertilizers, Plastics, Pesticide, Paints, Varnish, Soaps, Cosmetics, Other Chemical Products, Pharmaceuticals, Traditional Medicine, Smoked Rubber, Other Rubber Products, Plastic Products, Glass, Clay-Cement Products, Cement, Weapons Ammo, Other Transport Equipments, Furniture, Jewelry, Music Instrument, Sports Equipment, Games & Toys, Medical Devices, Other Industrial Products. |
| 10 | Mining | Tin Ore, Bauxite, Copper, Nickel, Other Metal Products, Gold Ore, Silver Ore, Galian Products, Non Metal Minerals, Coarse Salt, Petrol, Other Mining Quarry, Basic Iron Steel, Non Ferr Metal, Foundry Products, Fab Metal Product, Dom Metal Products, Other Metal Products. |
| 11 | MotorVehicle | Tire, Motor Vehicle, Motorcycle. |
| 12 | Electronic | Electronic Products, Electronic Equipments, Electronic Motor Gen, Batteries, Other Electronic Equipments, Dom Electronic Equipments, Primary Mover. |
| 13 | Machinery | Office Machine, Other Machine Equipments, Ships, Railway Equipments, Aircraft. |
| 14 | OtherService | Electricity, Gas Distillation, Water Supply, Waste Management, Residential Building, Electronic Gas Infrastructure, Agriculture Infrastructure, Other Buildings, Transport Services, Real Estate Services, Prof Science Technology, Rental Services, General Governments, Governments Health, Other Government Services, Private Health, Arts Entertainments, Household Repairs, Other Services. |
| 15 | Comm | Postal, Publishing, Broadcasting, Telecommunication, Information Technology. |
| 16 | FncInsurance | Financial Services, Insurance Services, Pension Services, Other Financial Services. |
| 17 | Transport | Roads & Bridges, Rail Transport, Land Transport, Sea Transport, River Transport, air Transport. |
| 18 | Trade | Man Mtl Repair, Car Trading, Car Repair, Other Trades. |
| 19 | Accomodation | Hotels, Restaurants. |
| 20 | Education | Government Education, Private Education. |

Source: Results from IndoTERM

Table 4.2 Input Variables of the IndoTERM Model

| No. | Variable Description | GTAP | IndoTERM |
|---|---|---|---|
| 1 | Commodity Import Prices | pim | pfimp |
| 2 | Commodity Export Demand | pxw + qxw/ESUBM | xexpd |

Source: Results from IndoTERM

Table 4.3 Output Variables of the IndoTERM Model

| No. | Variable Description | IndoTERM | Uses |
|---|---|---|---|
| 1 | Real GRDP per Province | xgdpexp | Analysis |
| 2 | Sectoral Output per Province | xtot | Analysis |
| 3 | Final Demand per Province | xfin | Analysis |
| 4 | Labor Wages | plab | MS Input |
| 5 | Labor Demand | xlab | MS Input |
| 6 | Capital Prices | pcap | MS Input |
| 7 | Commodity Price for Household | phou | Input MS |

Source: IndoTERM, processed by author

## APPENDIX 5. MICROSIMULATION ANALYSIS

As explained earlier, the two CGE models can show results for the economy broadly. However, these models cannot capture the distributive effect at the individual or household level, so they need to be combined with a microsimulation model. This microsimulation follows Tiberti, Cicoweiz, and Cockburn (2017) who at least apply three main econometric models. The approach used in CGE-Microsimulation is top-down with behavior in which there are several econometric models that take into account the responses of economic actors to policy changes or shocks. First, the income generation model that estimates the diversity of household welfare as a result of changes in employment status and income. Second, an econometric model that predicts real changes in household consumption. Finally, an econometric model that estimates levels of poverty and inequality. In its implementation, this model assumes perfect mobility across occupational status and perfect rigidity across type of workers.

In practice, this study relates IndoTERM and the Indonesian Family Longitudinal Survey (IFLS) through four variables, namely *plab_id* (wages or labor prices), *pcap* (rental price for capital), *xlab* (labor demand), and *phou*[27] (household price index). These four variables are thought to capture aspects of changes in workers, wages/salaries, and commodity prices.

Furthermore, the micro data used in the simulation is IFLS 5 2014. This cross-section data is used to estimate the parameters of microeconomic behavior. This database was chosen because it was considered relatively more complete and richer (covering aspects of employment, income and expenditure) than other socio-economic data, and was able to capture the heterogeneity of individual and household behaviors. The IFLS 5 sample represents Indonesia's population in 2014 in the 13 provinces covered in the IFLS 1 survey in 1993. For this reason, this study performs a sample weighting calibration to make it more representative of the Indonesian population in 2019 in the province. The income variable

27 Agricultural commodity prices for the baseline are rounded to –0.99 for easy calculation.

is deflated using the price index ratio in 2019 and 2014. This microsimulation uses the national level of poverty line (PL) in March 2019. Skills are defined as the level of education completed28. To harmonize expenditures on micro data (IFLS) and macro data (IndoTERM), commodities in the expenditure variables are regrouped as in Table 5.1.

Table 5.1 Expenditure Classification

| Variable | Micro Data | Macro Data |
|---|---|---|
| exp_1 | Staple Foods | Agriculture |
| exp_2 | Vegetables/Fruits | Agriculture |
| exp_3 | Dried Foods/Cookies | Food |
| exp_4 | Meat | Food |
| exp_5 | Fish | Fishing |
| exp_6 | Other Dishes | Food |
| exp_7 | Milk/Eggs | Dairy |
| exp_8 | Spices | Food |
| exp_9 | Vegetable Oils | VegOil |
| exp_10 | Beverages | Food |
| exp_11 | Coffee | Food |
| exp_12 | Tea | Food |
| exp_13 | Cocoa | Food |
| exp_14 | Other Consumer Products | Food |
| exp_15 | Electricity | OtherService |
| exp_16 | Water | OtherService |
| exp_17 | Fuel | Energy |
| exp_18 | Telephone | Comm |
| exp_19 | Personal Toiletries | OtherManuf |
| exp_20 | Household items | OtherManuf |
| exp_21 | Domestic Services & Servant Wages | OtherService |
| exp_22 | Recreation and entertainment | OtherService |
| exp_23 | Transportation | Transport |
| exp_24 | Other nonfood items on regular basis | OtherService |
| exp_25 | Clothing | Clothing |
| exp_26 | Household supplies & furnitures | OtherManuf |
| exp_27 | Medical cost | OtherService |
| exp_28 | Taxes & ceremonies | OtherService |
| exp_29 | Other nonfood items on irregular basis | OtherService |
| exp_30 | Education | Education |

28 Skilled workers have the latest education. Meanwhile, unskilled workers have the latest education.

The Study analyses the potential impact of the Indonesia EU CEPA on the Indonesian economy. With both quantitative and qualitative methods, this study is expected to provide empirical inputs into the on-going IEU CEPA negotiations in order to maximise benefits and to mitigate risks. The scope of this study includes trade in goods and services, investment, global value chains, socio-economic analysis as well as adjustment policies and optimization strategies. The IEU CEPA negotiations open up opportunities for enhancing national competitiveness and encouraging economic reform efforts that are indispensable for the Indonesian economy, especially for supporting economic recovery following the Covid-19 pandemic.

CSIS INDONESIA
LEADING IN STRATEGIC THINKING

Centre for Strategic and International Studies (CSIS) Jakarta
Jalan Tanah Abang 3 No. 23-27, Gedung Pakarti Centre,
Jakarta Pusat, 10160
Indonesia
csis@csis.or.id
http://www.csis.or.id