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STUDY ON THE IMPACT OF AN EU-INDONESIA CEPA

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Table of Contents

Abstract	3
Executive Summary	5
Analysis on the Impact of Trade Liberalisation	6
Potential Impacts on Indonesia’s Services Development.....	8
CEPA and Foreign Direct Investment.....	9
Challenges and Policy Recommendations.....	9
1. Introduction	11
2. Indonesia – European Union Economic Relations:	
What Can We Learn from Trade Patterns?	15
2.1. The European Union as a Trading Power	15
2.2. Indonesia – EU Trade	17
Trade Importance	17
Trade Complementarity.....	18
Trade Complementarity Index	19
2.3. Bilateral Trade Composition	21
2.4. Indonesian Products in the EU Market.....	25
2.5. Market Access and Trade Policy.....	28
Trade Policy in the European Union.....	28
Trade Policy in Indonesia.....	31

2.6.	European Products and Indonesian Industrial Development.....	32
2.7.	Lessons Learned from Trade Relations.....	35
3.	Potential Impact of EU-Indonesia CEPA on Trade.....	37
3.1.	Trade Relations and Tariff Structures.....	38
	European Union Tariff Structures for Indonesian Products.....	38
	Indonesian Tariff Structures for European Union Products.....	41
3.2.	Modelling the Impact of Tariff Reductions on Trade.....	42
	A Brief Review on Modelling Methodology.....	42
	Simulation Exercises: Data and Scenarios of Tariff Reduction.....	43
	The Potential Impact on European Union Imports from Indonesia.....	44
	The Potential Impact on Indonesian Imports from the EU.....	50
3.3.	A Brief Discussion on Non-tariff Measures (NTMs) and Technical Regulations.	51
3.4.	Lesson Learned from the Modelling Exercises.....	53
4.	Trade in Services and EU-Indonesia CEPA.....	55
4.1.	Cross-border Trade in Services.....	55
4.2.	EU's Commercial Presence in Indonesia.....	58
4.3.	Recent Policy Developments in the Indonesian Services Sector.....	61
4.4.	Trade in Services and Potential Contribution of EU-Indonesia CEPA.....	64
	The importance of Trade in Services.....	64
	Potential Contribution of CEPA to the Indonesian Services Sector.....	66
4.5.	By Way of Conclusion: Where Should the Services Agreement Go?.....	67
5.	Foreign Direct Investment and EU-Indonesia CEPA.....	69
5.1.	FDI flow to Indonesia.....	70
5.2.	EU's FDI in Indonesia.....	73
5.3.	"Investment Climate in Indonesia".....	76
5.4.	Will EU-Indonesia CEPA raise FDI from the EU?.....	77
5.5.	FDI and Intellectual Property Right.....	79
6.	Political Economy Considerations and Policy Recommendations.....	81
6.1.	EU-Indonesia CEPA: Benefits at Stake.....	81
6.2.	Critical and Contentious Issues with regards to CEPA Negotiations.....	83
	Issues Related to Negotiation Process.....	83
	Intellectual Property Protection.....	85
	Government Procurement.....	86
	Other Areas of Partnership Agreement.....	87
6.3.	Policy Recommendations.....	88
	References.....	91
	Appendix.....	95
	Appendix 1.....	95
	Appendix 2.....	97

Abstract

A Comprehensive Economic Partnership Agreement between the European Union (EU) and Indonesia would improve the economic relations between these economies, while creating benefits for both. To start, such a CEPA would allow members of the European Union to gain access to the large and growing Indonesian market – and in particular, its diverse services sector. A CEPA would also create opportunities for European businesses to utilize Indonesia’s human resources as tools for future investments and economic activities. Meanwhile, the benefits of this agreement to the Indonesian economy would be even more substantial.

Since Indonesia will “graduate” from the EU’s Generalized System of Preference (GSP) program, the elimination of preferential tariffs through the CEPA would allow Indonesian exporters to maintain European market access for their products. Furthermore, the CEPA would serve as a catalyst to increase direct investment to Indonesia firstly through increased trade between Indonesia and the EU, which in turn would promote greater flows of investment between their economies, and secondly through the inclusion of investment provisions within the agreement, which would improve the predictability and transparency of Indonesia’s investment regime. Such a services agreement would also allow Indonesian consumers and industries to enjoy first class, high quality capital goods and services, and required as prerequisites for successful economic development. In short, although several challenges will have to be overcome in order to create such an agreement, the implementation of a CEPA would create a win-win solution for both parties.

Executive Summary

This study aims at measuring the potential impact of a CEPA on the trading of goods and services between the EU and Indonesia, and at addressing the issues that are considered to be impeding the conclusion of CEPA negotiations. In order to measure the potential impact of a CEPA on merchandise trade, this study looks at the tariff structures of both economies, and evaluates the potential impact of tariff elimination on the quantities of merchandise that both Indonesia and the EU import from each other. When looking at the services sector, this study conducts a descriptive analysis using data on cross-border trade, commercial presence, and FDI in services. The study also looks at recent developments in investment between the EU and Indonesia.

The study concludes that a CEPA would have a positive impact on both the Indonesian and European economies in the long run. First, differences in both GDP per capita and in economic endowments have ensured that trade between the EU and Indonesia remains highly complementary. If both economies successfully take advantage of their high complementarities, both will be more efficient, and will thus improve their competitiveness in the long run. Second, the Indonesian service providers would benefit from a more flexible arrangements on such topics as worker mobility, which would allow these service providers to expand their operations. Third, it is likely that a CEPA that increases bilateral trade and that includes provisions on investments will help boost European investments in Indonesia.

Nevertheless it is also important to note that while merchandise trade complementarities between the EU and Indonesia remains relatively high, Indonesia remains at a disadvantage for several reasons.¹ First, in contrast to the EU, where non-ad valorem (NAV) tariff rates remain

¹ Despite the strong complementarity, trade statistics shows that the relative importance of both economies to each other has been deteriorating as the share of Indonesia's merchandise exports serving the EU market is gradually falling, while the penetration of Indonesian products to the EU's market has been stagnant.

prevalent in the region's tariff structure, especially for agriculture and food products, Indonesia's tariff structures place more barriers on manufacturing products, especially motor vehicles, in addition to textiles and footwear. Second, many Indonesian producers find it difficult to meet many such regulations as sanitary measures, or technical requirements, as well as other non-tariff measures (NTMs).

It is therefore necessary for the CEPA to include NTMs and technical standards, while also providing assistance to Indonesian exporters to help improve their capacity to deal with European standards. This can be done by providing up to date and practical information on those regulations and standards, by setting up technical assistance programs to help directly increase exporter's capacity, as well as by reducing the cost for testing and complying.

Analysis on the Impact of Trade Liberalisation

The impact of trade liberalization is evaluated by simulating tariff elimination in partial equilibrium settings. Such an analysis shows that the proposed EU-Indonesia CEPA would not only increase Indonesia's exports to the EU, but more importantly that the tariff elimination under a CEPA would help Indonesia deal with tariff increases when the country is no longer eligible for GSP facilities. In addition, the CEPA would also help maintain Indonesia's competitiveness among the ASEAN countries, since they are also in the process of arranging similar trade agreements with the EU.

Before estimating the impact of a CEPA, it is important to understand the tariff structure that Indonesian products face when they enter the European market. Currently, around 70 per cent of Indonesia's exports to the EU face a tariff of lower than 5 per cent. However almost a half of these low-tariff exports were established under the EU's GSP program, which **temporarily provides lower tariffs that are designed to be withdrawn under a certain set of circumstances; for example, countries must be classified as low income or low-middle income countries in order to receive these tariffs, and they stand to lose them once their economies grow enough for them to be classified as upper-middle income countries. In the near future, it is inevitable that Indonesia will lose these GSP facilities given that it stands to become an upper-middle income country within the next three to four years.** It is thus important to understand the implications of a situation in which Indonesia's products are subjected to MFN tariff, instead of GSP tariffs.

An analysis on the impact of the elimination of existing tariffs on Indonesia's exports shows the following points:

- When the normal MFN rates are implemented in lieu of the GSP rates currently enjoyed by Indonesia's top exporters, **Indonesia will suffer a lost of almost 12 per cent (equivalent to €1.8 billion or US\$ 2.4 billion) to the amount of annual exports to the EU.**
- If the CEPA manages to eliminate tariff on all goods, the **annual quantities that the EU will import from Indonesia could increase by 5.4 per cent when compared to their current value – an increase equivalent to an additional €802 million or US\$ 1.1 billion.** 38 per cent of these gains would come from European imports of textiles and textile products, while palm oil and footwear products would follow closely behind. Around 60 per cent of the overall gains would emanate from trade creation, indicating that a CEPA would allow for

the EU to diversify its imports from Indonesia, rather than divert its trade to other countries. Additional gains of around **€9 million would also arise if Non-Ad Valorem (NAV) tariffs on Indonesian exports are eliminated**. It should be noted that this gain may even be underestimated, since the NAV tariffs are so high that Indonesia has thus far only managed to export a handful of products currently to the EU under this NAV tariff.

- **If Indonesia fails to secure preferential access to the EU, trade agreements between EU and other ASEAN countries will result in an 8 per cent fall, equivalent to €1.2 billion or US\$ 1.6 billion, in Indonesia's annual export value.** In this scenario, while the textile and footwear industries experience significant losses, the industries facing the largest losses would be the machinery and electrical businesses, since other ASEAN countries are also important suppliers to the EU. Furthermore, foodstuffs would experience a drop of almost 90 per cent of their current export level.

In conclusion, **if Indonesia fails to negotiate a CEPA with the EU in the near future, the country's trade balance will suffer a drop in exports of up to US\$ 2.4 billion due to the withdrawal of GSP tariffs, in addition to a loss of US\$ 1.6 billion caused by an erosion of competitiveness from EU's agreements with other ASEAN countries. A successful CEPA, on the other hand, will increase exports by up to US\$ 1.1 billion, while at the same time mitigating all other potential aforementioned risks.**

While this analysis is limited to simulating the effects of tariff reduction, we also recognize the importance of non-tariff measures (NTM) and technical regulations in facilitating or hindering trade. **We therefore note that the two partners in this agreement should pay greater attention to finding common grounds for cooperation on these issues, rather than abusing regulations in order to erect new non-tariff barriers on imports.**

The CEPA can serve this objective by being designed to take several principles into account. First, the CEPA must remain transparent. Information on NTMs must be easily accessible for all parties, and it should be made easy to attain all necessary materials such as the forms linked to official regulations, as well as detailed and practical information on how to meet standards and regulatory requirements. Second the CEPA must remain non-discriminatory. All measures must be implemented across all products, regardless of where they come from. Domestic producers cannot be exempted from necessary requirements since this would risk putting domestic consumers in jeopardy. Third, the CEPA must be based on principles of scientific-based evidence. Non-tariff measures and trade-related regulations should be designed based on scientific evidence to avoid unnecessary burden on producers. WTO agreements have set guidelines on various NTMs in accordance with this condition. The CEPA can thus emphasize the importance of these principles by developing a well-defined consultation mechanism for both parties to improve their understanding on the proper implementation of NTMs.

Overall, **a CEPA can promote a better understanding of the proper implementation of NTMs through technical assistance**, the majority of which would be needed in Indonesia. Since Indonesian exporters find it difficult to comply with regulations due to the lack of sufficient and reliable testing facilities at home, technical assistance provided through the CEPA can promote initiatives to develop and improve testing facilities in accordance with EU and international standards. More direct technical assistance provided to improve the capacity of Indonesian

producers to meet EU regulations might also facilitate at proper implementation of NTMs. Finally, greater harmonization and understanding on technical regulations would facilitate trade between the two economies and improve the competitiveness of Indonesia's products.

Potential Impacts on Indonesia's Services Development

This study also looks at the development of services trade between both economies based on cross-border trade and commercial presence. Looking at the cross-border data, there has been no change in services trade composition of both the EU and Indonesia. The EU has consistently recorded trade surpluses in services with respect to the world, while Indonesia has always recorded trade deficits, with the exception of the travel sector. Meanwhile, some notable observations concerning FDI in services from EU members with large commercial presence in Indonesia can be made. The trends for net FDI position and net FDI inflows to Indonesia were stable until 2008. Ever since, the net stock of the EU's major investor has risen, while **net inflows of FDI from the EU to Indonesia have decelerated and declined**. Even though net FDI stocks and net FDI inflows of EU's major investors have exhibited a negative relationship in Malaysia, Thailand and Philippines in the 2008-2010 period, the relationship between net FDI stock and net FDI investment inflows became positive after 2012. In contrast it continues to be negative in Indonesia to this day.

Access to high-quality business services is essential in order to support the active participation of countries in global value chains, and to upgrade their industrial performance and exports. Using trade statistics and trade in services value added from 56 countries in five period of time, we found that a strong correlation exists between the import of services and export performance. In 2009, the services-contents of Indonesia's export were less than 21 per cent, of which only a quarter came from imports. This is much lower than service-contents of exports of several other countries in the region, such as Thailand, where services constitute close to 30 per cent of its exports, of which half were imported. In order to increase its competitiveness, Indonesia needs to increase its services-contents of exports, particularly high-quality services that may be served, at least for the time being, from imports.

While the provision of greater market access for services from European countries under the proposed CEPA seems to benefit providers from the EU, this would also **open the possibility for the Indonesian economy and its industries to enjoy first class and high quality services**. In transportation and communication services, for example, the European countries contributed to 42 and 52 per cent of global trade in those sectors in 2012, wherein more than a half of these exports went to countries outside the European region. **By providing greater access for services from the European countries, Indonesian industries and consumers would have better options for transportation and communication than those currently supplied by either domestic suppliers or the service providers of neighbouring economies.**

Recent developments in the EU's trade in services have also shown the existence of untapped opportunities for Indonesia, since the EU's proportion of external trade is increasing, especially in Asia and ASEAN countries. Despite having the largest working-age population, Indonesia has not been the largest supplier of services to the EU among the ASEAN countries until now. In order to tap this opportunity, Indonesia needs to obtain competitive labour skills and develop a

long-term services sector. In addition to using the knowledge gained from continued commercial presence, skill transfers could also occur through the movement of natural persons across borders.

CEPA and Foreign Direct Investment

The study also observes the positive relationship between FDI and trade in the case of both trade between Indonesia and the EU, as well as trade between Indonesia and the world.

In general, the amount of FDI coming from the EU to Indonesia remains limited. To start, only 10 per cent of the EU's total overseas investments are sent to Asia, and most of these go to either Singapore or China. More generally, however, EU FDI trends have fluctuated in recent years, especially from the UK and the Netherlands; from 1993-2003, FDI from the EU accounted for 46 per cent of Indonesia's total FDI, but during 2004-2012 this figure had fallen to 16 per cent. Nevertheless, the EU remained the third largest foreign investor in Indonesia after Singapore and Japan. It must also be recognized that, on the Indonesian side of the equation, issues of limited policy transparency, lack of infrastructure development, and weak technological capabilities impede Indonesia's competitiveness in general, and make the country an unattractive investment destination.

Greater bilateral trade, as well as the inclusion of investment in the CEPA negotiation agenda should help boost investment between Indonesia and the EU. **Greater trade between Indonesia and EU would promote greater flows of investment between the two economies, as evidenced from the past positive relation between FDI and trade between Indonesia and the EU.** It is important to note that there is a stronger correlation between FDI and Indonesia's exports to the EU than between FDI and Indonesia's imports from the EU, suggesting that greater FDI to Indonesia would eventually lead to greater exports.

The CEPA would also assist Indonesia in attracting investors/manufacturing industry who are looking to set up a production base that plugs into Global Value Chains (GVC). The restructuring of the Chinese economy (and ageing population/increasing wage costs) provide Indonesia with an immense opportunity to attract labour intensive manufacturing jobs producing not just for the Indonesian market but also GVC. A CEPA with EU would ensure quality capital goods/components, which are vital for such manufacturing, can be imported more competitively and increase investor confidence.

Inclusion of investment issues in the CEPA would arguably be useful for promoting increased investment flows between the parties of the agreement. **Investment provisions inside the CEPA must aim at reducing discriminatory practices towards foreign investors, and at increasing the predictability and transparency of the existing investment regime.**

Intellectual property rights (IPR) could also contribute to the development of a positive investment climate. The literature on IPR largely confirms the importance of IPR in fostering investment in research and development. Furthermore, a UNDP report mentioned several cases of pharmaceutical and agro-industrial companies that have benefited from IPR protection. Thus, **it is important for the EU-Indonesia CEPA to take IPR into account, while also balancing other important issues, such as the need to ensure that access to the seeds originate from local varieties, as well as access to medicine is increased.**

Challenges and Policy Recommendations

Our analysis shows that the potential benefits of a CEPA are quite substantial, and that **the agreement is important for building confidence and trust, as well as improving communication between Indonesia and the EU. We recognize that the EU has a tendency of managing its economic relations through formal mechanisms**, which is different from the approach used by many of Indonesia's other trading partners, especially those in Southeast Asia and East Asia, which tend to favour informal dialogue between government officials to solve issues in economic relations. This notion ensures that the CEPA will be a crucial component for successful economic relations.

Despite the benefits of CEPA, there are challenges that continue to delay the conclusion of its negotiation. First, Indonesian negotiators consider the draft scoping paper as limiting the flexibility of the country to conduct negotiations. Second, obstacles will also arise from negotiations on IPR provisions and provisions on Government Procurement (GP). Third, both parties consider the agriculture sector to be sensitive, making discussions about market access for agricultural products difficult. Fourth, disagreements exist over the topic of labour mobility, since many members of the EU support greater restrictions than Indonesian negotiators would like. In addition to all of this, Indonesia, in contrast to the EU, has maintained a position opposing the inclusion of these non-economic issues in an FTA. Meanwhile, a recently enacted Indonesian trade law allows for the annulment of trade agreements, which has in turn increased the uncertainty surrounding the extent of the country's commitment to international agreements. Lastly, CEPA negotiations have been delayed after Indonesia discontinued expired Bilateral Investment Treaties (BIT), and postponed all negotiations for new BITs.

Given these conditions, this study concludes with the following recommendations:

- Concerning trade in goods, in addition to supporting its top exporters, Indonesia needs to focus on selling products that are currently covered under GSP tariffs. CEPA negotiation should aim to help mitigate the negative impacts of tariff elimination by ensuring that this elimination is done sequentially, thus initially eliminating tariffs for each party's least sensitive products, and then moving further progressively. Furthermore, the reduction of NAV tariffs and the transformation NAV tariff to ad-valorem tariffs might also increase Indonesia's exports to EU.
- Concerning trade in services, the CEPA should aim at producing a suitable trade framework in which skill transfer from the EU is prioritized, and should aim at improving market access. The EU should also increase access for Indonesian workers to work in the EU, including for training and professional jobs. Meanwhile, Indonesia should allow greater access for EU providers to the Indonesian market in order to increase the need for high quality services in Indonesia.
- In terms of investment, the CEPA should aim to facilitate, promote and also protect FDIs, and should do so by laying out a set of basic principles (without any specific obligations since investment decisions are made by the private sector) that the two economies need to agree on in order to promote investment. The issues of intellectual property rights, government procurement, labour movement and various non-economic issues should be resolved by giving each party more flexibility, while at the same time maintaining a future possibility for deeper commitments.

1. Introduction

Indonesia and the EU began talks on the preparation for the CEPA in 2012. The CEPA has been presented as having the ability to help both parties take full advantage of unexploited economic relations between the EU and Indonesia. The CEPA is expected to be a comprehensive agreement discussing various aspects of economic relations between the two economies, and thus has moved beyond being a simple agreement for removing trade barriers. While the liberalization of international trade in goods remains to be an important aspect of the CEPA, investment promotion and facilitation, the improvement of trade in services, and the creation of improved competition policy practices would also promote greater economic relations.

Indonesia expects at least three important contributions from the CEPA. The first and the most obvious one relates to the promotion of increased trade between Indonesia and the EU. The agreement's focus on trade liberalization would increase the intensity of trade relations by lowering trade barriers, and by facilitating trade.

Indonesia is likely to be directly impacted by improved access to the EU market, which has become more important in the wake of the EU's reform of its GSP program, and the fact that Indonesia will have to graduate from the framework once it reaches upper middle-income status. If Indonesia graduates from the GSP program without entering into a CEPA agreement that guarantees lower tariffs, its export competitiveness to EU countries would be further reduced due to preference erosion.

However, more indirect and less obvious impacts might come in other forms. By lowering trade barriers to imported products from the EU, Indonesian producers could gain from an increased availability and decreased costs of high quality intermediate inputs and capital goods, which would in turn reduce the costs of production and improve industrial performance, and eventually increase the competitiveness of Indonesian products. Such gains have the potential to be quite

extensive given that that the two economies are at different levels of economic development, thus ensuring that instead of competing with each other, they would find greater complementarity.

More open and easier trade would also increase opportunities for Indonesia's firms to join the global production network of EU producers, given that the latter would find it easier to supply parts and components to their Indonesian counterparts for further production. Since better participation in production networks involves extensive FDI, trade liberalization would also attract further foreign investment from the EU countries.

The second expected contribution of the CEPA concerns the impact of liberalization on trade and investments in services. In addition to measures that reduce border barriers, the agreement would also deal with non-trade issues covering various behind-the-border measures such as investment protection and facilitation, improved competition policy practice and IPR environment, as well as increased access to government procurement. These measures would increase the transparency and predictability of the economic regulatory environment, and thus provide an impetus for a further increase in FDI. Such provisions would improve the investment climate and create a more resilient and adaptive environment to deal with uncertain global economic challenges and increasing competition.

A more open environment for the services sector would contribute to better services, and would also provide necessary inputs to achieve a more competitive economic environment. Increased competitiveness will be one point of attraction of Indonesia to be a major investment destination, in addition to its already large market. Additionally, higher investment and the creation of a more efficient economy are the necessary conditions for job creation.

The third contribution of the CEPA is enhanced technology and skills transfer in the goods, services and investment sectors. The fact that investment goes hand in hand with trade liberalization is well documented in the literature, but it is important to recall that important benefits come with FDI liberalization of relevant sectors too. Capital investment, advanced technology, technical know-how and innovations, investment in R&D, as well as human resources and skills development could be gained through EU investments. This would contribute positively to the improvement of competition and competitiveness in the domestic market, as well as in the exporting industry. Therefore, it is important to view the CEPA in a framework that reaches beyond a simplistic mercantilist view of the global economy. As for now, the ratio of FDI to GDP ratio is 2.1 per cent in Indonesia. While Indonesia's performance in terms of attracting FDI is above the Philippines (1.4 per cent), Indonesia lagged behind many other countries in the Asia such as Thailand (3.3 per cent), China (3.8 per cent), Malaysia (3.7 per cent), Viet Nam (5.2 per cent), or Singapore (21 per cent).² The EU-Indonesia CEPA could be a good opportunity for improvement in the FDI sector, a fact which should be taken into consideration while looking at the impact of the agreement.

Despite all the potentials that could be realized through a CEPA, disagreements between the parties on certain issues, as well as continued concerns, especially in Indonesia, over the impact of the CEPA continue to impede negotiations. It is therefore crucial to analyse the potential impacts of a CEPA in a more detailed manner. This study is an attempt to provide a detailed analysis and discussion on various elements that will make up the CEPA. This study also examines the

2 Data from World Bank's World Development Indicator on FDI as percentage of GDP.

potential costs and benefits of CEPA, thereby providing background information that could be used by the Indonesian government and other stakeholders in their decision-making process. At the same time, this study will provide recommendations on the policies and actions necessary for making this agreement a success.

This report consists of five sections in addition to the introduction and conclusion. Two sections will be devoted to a detailed analysis of the patterns of trade between Indonesia and the EU, as well as of the CEPA's effect on trade performance. The third and fourth section will look at the potential contribution of CEPA in a broader perspective, including its impact on trade in services, and how the agreement will provide greater opportunities for more foreign direct investment. The last section discusses the possible challenges, including those relating to political economy, to negotiating and implementing the agreement.

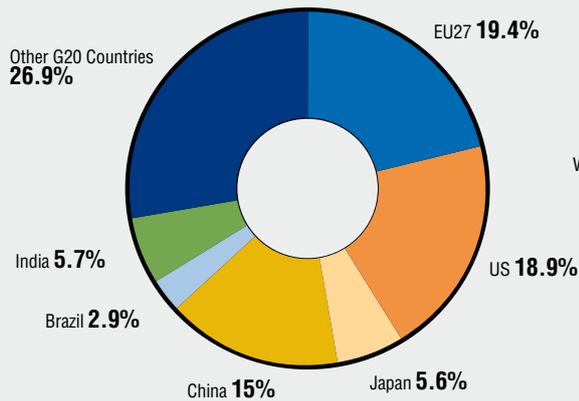
2. Indonesia – European Union Economic Relations: What Can We Learn from Trade Patterns?

The relations between Indonesia and EU member states have been marked by strong economic relations: the EU remains the third largest destination of Indonesian exports, and certain EU member countries have consistently been the main sources of foreign investment in Indonesia. Essentially, the two economies belong to different levels of economic development and technological capacity, and thus their relationship tends to be complementary rather than competing. This section provides an analysis of one important aspect of economic relations between both economies, namely international trade relations. This section attempts to obtain a better understanding of the possible impact of greater economic partnership between Indonesia and EU member states by looking at the various aspects affecting the recent trade patterns.

2.1. The European Union as a Trading Power

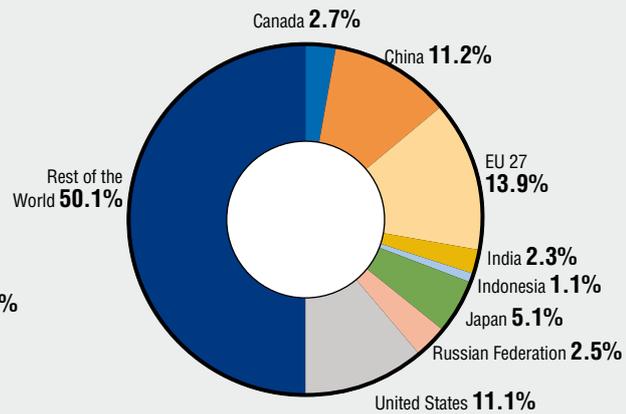
By 2012, the population of the EU reached 504 million and made up over 7 per cent of the world population (Eurostat, 2012). The EU is also recognized as a single entity by the World Trade Organization with a shared GDP in 2010 reaching 16.67 billion US\$ - larger than that of the US and China, and accounting for 19 per cent of the world GDP, as shown in Figure 1.a. Furthermore, its economies are more open to trade than the US-American or Japanese markets, as evident from the large share of total merchandise trade in its GDP of around 65 per cent in 2012 while at the same time, its imports and exports accounted for 14 per cent of all world trade (Figure 1.b). In consequence, the EU plays a very important role in defining global trade.

**FIGURE 1.A:
THE EU AND WORLD GDP**



Source: IMF World Economic Outlook

**FIGURE 1.B:
THE EU AND WORLD TRADE**



Source: UN COMTRADE

The EU countries are actively trading with other countries around the world, including Indonesia and other South East Asian countries. Based on UN COMTRADE data, the imports from ASEAN countries occupy around 5 per cent of total EU imports, of which Indonesia contributes 16 per cent. The EU is one of the largest importers of fisheries products, and also has high demand for vegetables, fruits, condiments and seasonings. Home appliances, data processing use, audio and video are among the top imported products in the machinery or electrical sectors. The EU is also the largest market for furniture, with top importers being the UK, Germany, the Netherlands and France. Many of the EU's imports are in line with Indonesia's export interests and potential, and thus an economic partnership agreement is beneficial for both economies, and will further increase Indonesia's ability to penetrate the EU's market.

The EU also hosts more than half of the world's largest transnational corporations, which in turn depend on foreign producers in their production processes (UNCTAD, 2007). Furthermore, most of these companies operate in sectors that are important for Indonesia, such as machinery, electronics, chemicals and allied industries, processed food and drinks, and transportation. After the enlargement of the EU in 2004, the Central and Eastern European (CEE) countries inside the EU have started to form industrial agglomeration across the CEE with stronger links to Asia.

As a major trade player, the EU has been actively engaged in forming trade agreements with its partners (Woolcock, 2007). Some ASEAN countries including Thailand, Vietnam and Malaysia are negotiating CEPAs with the EU, and it is expected that these negotiations will be concluded in the near future.

2.2. Indonesia – EU Trade

Trade Importance

By 2012, total merchandise trade between Indonesia and the EU reached US\$ 34.06 billion, with the trade of non-fuel and non-gas products making up two-thirds of this. Indonesia has always enjoyed trade surplus with the EU. In 2012 this surplus reached around US\$ 9.5 billion and has been increasing steadily ever since.

The EU is one of the major destinations for Indonesia's exported products. However, Indonesia's total non-fuel and non-mineral exports to the EU have waned in recent years. While more than 22 per cent of Indonesia's export commodities in 2007 were sold to the EU, this number fell to 18.5 per cent by 2012. Meanwhile the share of EU non-fuel and non-mineral exports to Indonesia has consistently ranged between seven to eight per cent throughout 2008 to 2012. Although the market penetration of Indonesian goods in the import baskets of the EU remains at a low 0.45 per cent, it seems to be increasing. This suggests that there is a large untapped potential for Indonesian products in EU's market, even though previous exports figures also suggest that the importance of the EU market to Indonesia has slightly declined.

Further observations on trade statistics also show that Indonesia might not be as important to EU is to its other trading partners. Indonesia's average share in EU's total trade with ASEAN is lower than that of Singapore, Malaysia and Thailand. In fact, the EU's total trade with Singapore is twice as large as its total trade with Indonesia, and Indonesia occupies the fourth largest share in the EU's total trade with ASEAN (Table 1).

TABLE 1.
THE SHARE THE EU'S TRADE WITH THE ASEAN REGION
GOING TO EACH MEMBER

	AVERAGE SHARE IN EU'S TOTAL TRADE WITH ASEAN (%)		AVERAGE SHARE IN EU'S TOTAL EXPORTS TO ASEAN (%)		AVERAGE SHARE IN EU'S TOTAL IMPORTS FROM ASEAN (%)	
	2000	2012	2000	2012	2000	2012
SINGAPORE	26.87	28.60	35.63	38.81	21.50	21.01
MALAYSIA	22.82	20.31	21.20	17.79	23.80	22.16
THAILAND	17.80	18.12	17.03	17.63	18.26	18.45
INDONESIA	14.20	13.93	11.09	10.99	16.12	16.10
PHILIPPINES	11.29	6.02	10.01	5.90	12.08	6.10
BRUNEI DARUSSALAM	0.28	0.40	0.48	0.92	0.15	0.01
CAMBODIA	0.53	0.93	0.28	0.28	0.68	1.42
LAOS	0.17	0.23	0.09	0.25	0.21	0.22
MYANMAR	0.50	0.19	0.23	0.21	0.67	0.18
VIETNAM	5.54	11.24	3.96	7.22	6.51	14.35

Source: COMTRADE

While there has been no substantial change in the EU's imports from the region as a whole, several countries have experienced changes in their share of the EU's exports. For example, the share of exports to the Philippines and Malaysia decreased by 4 to 5 per cent between 2000 and 2012, while, during the same timeframe, the share of exports to both Singapore and Vietnam rose by 4 to 5 per cent. Notably, while most countries' share of European imports remains fairly constant, Vietnam's share rose considerably from 6.51 per cent to 14.35 per cent in the same period. Indonesia's average share in both EU's exports to and imports from ASEAN stayed at around 11 per cent across all years.

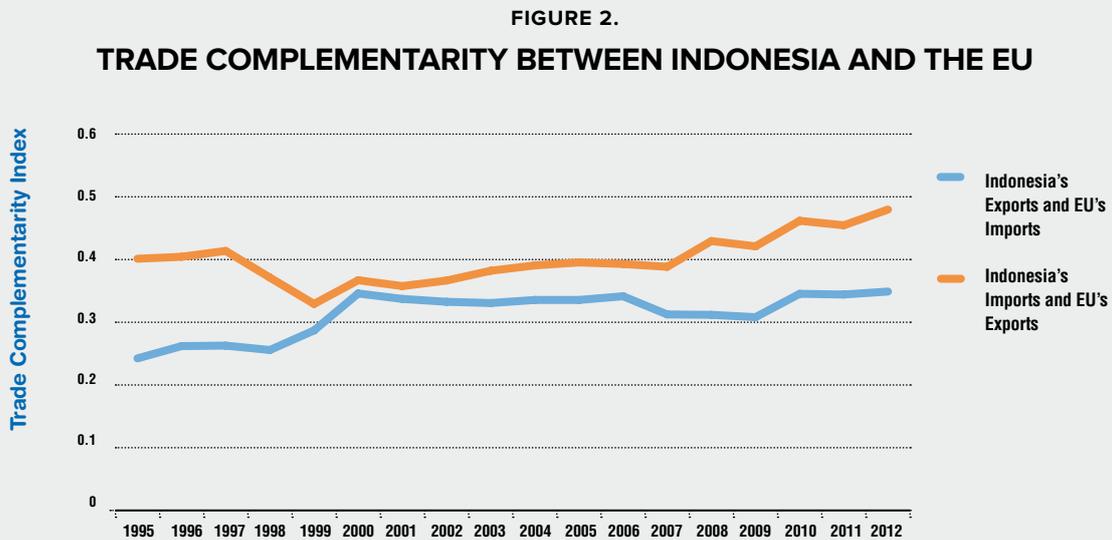
There are some possible explanations for the decline of EU's importance as a market destination for Indonesia's exported products, especially in more recent years. For one, many EU member states have been experiencing economic problems that led to a reduction of domestic demand. During the period of 2008 to 2010, the share of exports that other emerging countries were selling to EU countries also declined. It is also important to note that the decline in Indonesia's share of exports to the EU occurred at the same time as the share of Indonesian export to Japan and the US dropped.

Indonesia also trades more intensively with other emerging countries, and in particular with ASEAN countries, than with more developed regions such as the EU. Along with the emerging trend of production fragmentation and the emergence of regional value chains in East Asia, intra-ASEAN trade has risen sharply in recent years. This has led to a larger share of exports - around 25 per cent - directed to other ASEAN countries. The rise of China has also led to another market destination for Indonesian products. Furthermore, the EU has also expanded its manufacturing bases in the Central and Eastern European (CEE) countries since 2004, meaning that we should expect a shift in exports from Indonesia, specifically in machinery and electronics, away from the Western European countries and towards these CEE countries.

It is also possible that the decline in the competitiveness of Indonesian imports to the EU in the last decade was due to the decline of Indonesia's competitiveness more generally. Countries such as China, Vietnam, Thailand, Malaysia, India, and Turkey have become strong competitors to Indonesia in key manufacturing sectors, and are likely to secure an increasingly large share of European imports.

Trade Complementarity

The Indonesian and European Union economies belong to two different levels of economic and technological development. Consequently, trade between Indonesia and the EU should be complementary in nature. Indonesia's exports are complementary to the EU's demand, especially in woods and wood products, fisheries, textiles and vegetable products. The Indonesian culture is rich in arts and handicraft, and in consequence, Indonesia has the potential to develop value-added commodities in the furniture and wood carpentries sectors, for which the EU has a high consumer demand. Meanwhile, the EU holds an advantage in exporting high-technology transportation, machinery and electrical products to Indonesia.



Source: COMTRADE

In reality, complementarity between Indonesia's exports and EU's imports has been stagnant over the past years. This is evident from the relatively low complementarity index figures averaging at around 0.35 during 2000 to 2012 (Figure 2).³ Meanwhile, complementarity between Indonesia's imports and EU's exports is always higher (0.4 to 0.5) than the complementarity between Indonesia's exports and EU's imports throughout the years.

At Harmonized System (HS) 6 digits level, around 48 per cent of goods that are in the top one-thousand Indonesian exports to the EU are also in the top one-thousand EU's top imported products in 2012. The coverage rates in each HS 2 categories are presented in Table 2.⁴ The coverage rate was obtained by dividing the number of HS 6 commodities in each group that are in both Indonesia's top 1000 exports to the world and the EU's top 1000 imports from the world by the number of HS 6 commodities that are in Indonesia's top 1000 export commodities, but not included in EU's top 1000 imported commodities. For example, Table 2 shows that for HS 2 Transportation category, there are 30 products in the category that are in both Indonesia's top 1000 exports and EU's 1000 imports, which made up around 71 per cent of top commodities (that are included in Indonesia's top 1000 export commodities) in that category. This means that in the transportation category, 71.4 per cent of Indonesia's top export commodities are highly demanded by the EU.

The coverage rate in six out of fifteen sectors are higher than 50 per cent, indicating a relatively high compatibility between Indonesia's top export commodities and the EU's top imported commodities. This suggests that Indonesia is exporting the commodities that are most demanded by consumers and manufacturers in the EU. The sectors in which major compatibility is observed are transportation, machinery or electrical products, plastics or rubbers, foodstuffs,

³ Complementarity index indicates how export structure of one country fits into the import structure of its partners. It is calculated by looking at how the country's exports at disaggregated level can fulfill import demand of the partners. More technical explanation can be found in Appendix 1.

⁴ Coverage rate is equal to the percentage of Indonesia's top exported commodities in a sector that are also the EU's top imported commodities in that sector

metals, chemical and allied industries, miscellaneous, textiles, and woods and wood products. Indonesia's main exports to the EU are palm oils, fuel and mining products, as well as furniture and textile commodities.

TABLE 2.
COVERAGE RATE OF EACH HS 2 CATEGORY

SECTORS	NO. OF GOODS	COVERAGE RATE (%)
TRANSPORTATION	30	71.43
RAWHIDES, SKINS, LEATHERS AND FURS	7	70.00
MACHINERY OR ELECTRICAL	111	66.07
PLASTIC OR RUBBERS	45	63.38
FOODSTUFFS	28	60.87
METALS	45	54.22
MINERAL PRODUCTS	13	54.17
CHEMICAL AND ALLIED INDUSTRIES	53	53.54
FOOTWEAR AND HEADGEAR	9	50.00
MISCELLANEOUS	31	49.21
WOODS AND WOODS PRODUCTS	24	48.00
STONE OR GLASS	15	40.54
VEGETABLE PRODUCTS	13	25.00
TEXTILES	45	22.50
ANIMALS AND ANIMAL PRODUCTS	8	21.62

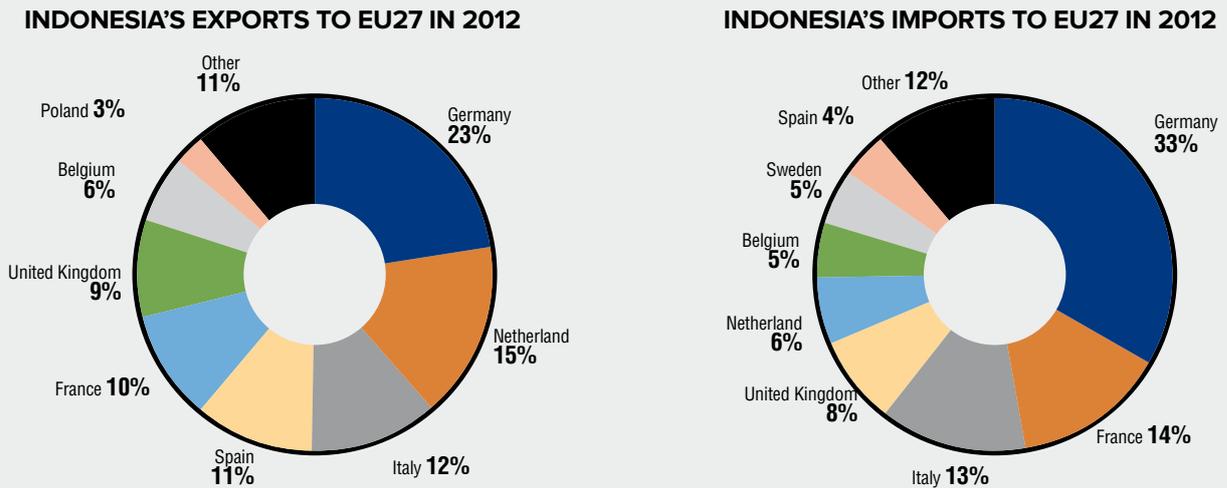
Source: COMTRADE

Despite the evidence of compatibility, complementarity between Indonesian exports and European imports has been stagnant over the years, while the complementarity between Indonesian imports and European exports has risen (Figure 2). Even though Indonesia's exports are relatively complementary to EU's imports of transportation, machinery or electrical products, plastics or rubbers, foodstuffs, metals, chemical and allied Industries, miscellaneous, textiles, as well as woods and wood products sectors, the share of Indonesia's exports that make up the EU's total imports has stagnated.

This study will look at the issue of trade complementarity between Indonesia and the EU in further detail in order to obtain better insights into the trade pattern between the two economies. In addition, the study will evaluate the performance of potential Indonesian exports to the fast-growing EU market.

2.3. Bilateral Trade Composition

FIGURE 3:
MAIN DESTINATIONS AND SOURCES OF TRADE



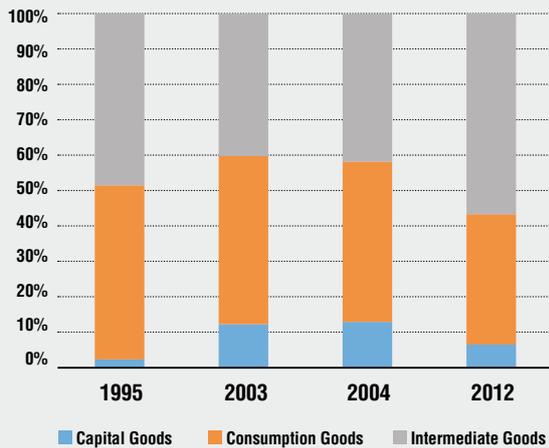
Source: COMTRADE

Despite the enlargement of the EU in 2004 and 2007, Indonesia's major trading partners in the EU throughout 1995 to 2012 continue to be Germany, the United Kingdom, Spain, the Netherlands, France, Italy and Belgium. Among this group of countries, Germany remained Indonesia's top export destination in 2012. That same year, Netherlands and Italy ranked as the second and the third most important markets for Indonesia's exports, while the United Kingdom fell from being the second most important market for Indonesia in Europe to being the seventh most important. Similarly, Germany remained Indonesia's top source of imports between 2003 and 2012, while the UK dropped from being Indonesia's second most important import source in the EU to the fourth most important import source.

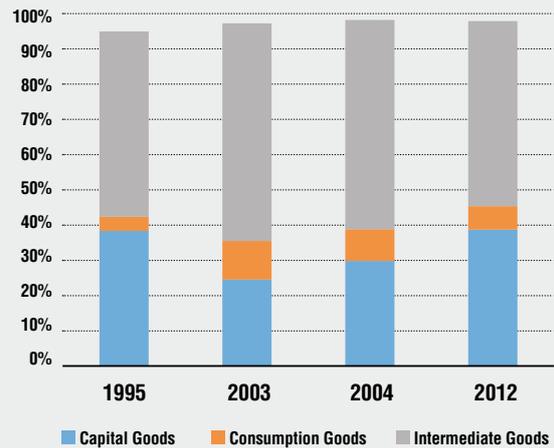
Trade statistics in Figure 4 reveal that from 1995 to 2012, Indonesia has been an importer of capital goods and intermediate goods from the EU, while also being an exporter of consumption goods and intermediate goods to the EU. Figure 4 shows that in 2012, fifty-five per cent of both Indonesia's exports and imports to and from the EU were intermediate goods. Furthermore, in 2012, around forty per cent of Indonesia's exports to the EU were consumption goods, whereas forty per cent of Indonesia's imports from the EU were capital.

**FIGURE 4:
TRADE COMPOSITION (NON-FUELS AND MINERALS)**

COMPOSITION OF INDONESIA'S EXPORT TO THE EU



COMPOSITION OF INDONESIA'S IMPORT FROM THE EU



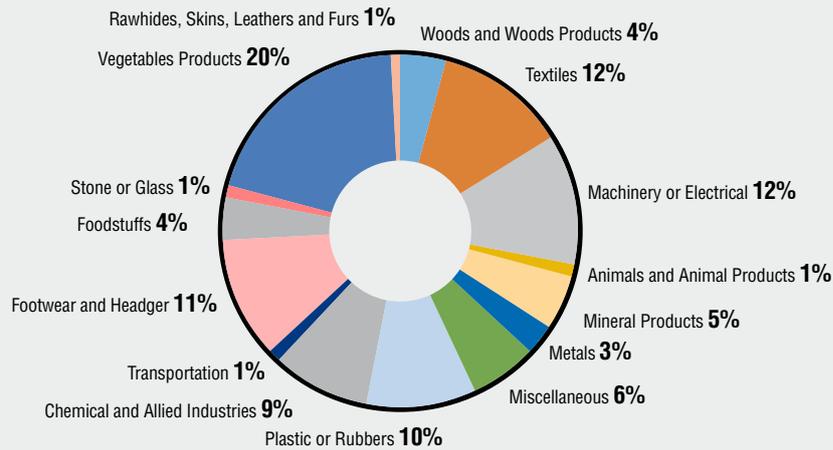
Source: COMTRADE

By 2012, around 66 per cent of Indonesia's imports of capital goods were found in all sectors excluding transportation and transportation equipment. Machinery or electrical sectors made up around 88 per cent of capital goods – 73 per cent in nuclear reactors, boilers, machinery and mechanical appliances and computers, 15 per cent in electrical machinery and equipment parts, telecommunication equipment, TV recorders and sound recorders, and 10 per cent in optical, photographic, cinematographic, measuring, checking, precision, medical or surgical instruments and accessories.

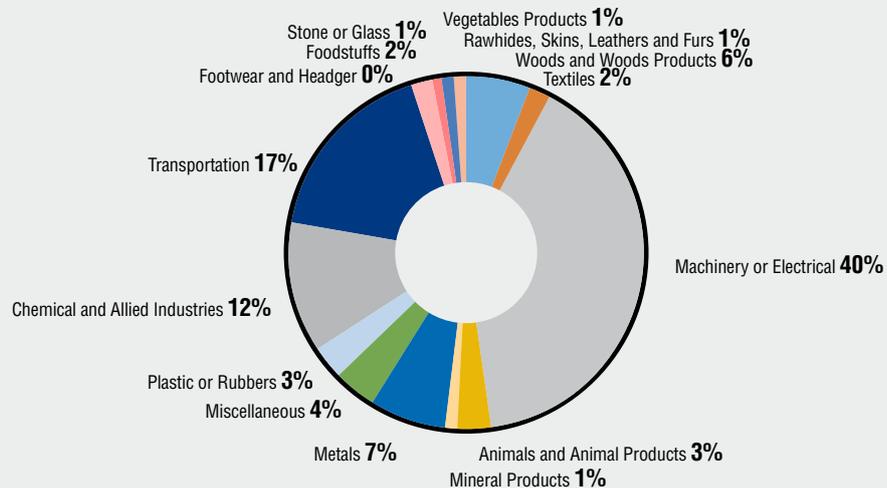
Throughout the years, Indonesia's exports of consumer goods to Europe have always been dominated by semi-durable products, which made up 65 per cent of Indonesia's exports in consumption goods in 2012. That same year, around 52 per cent of Indonesia's exports to the EU came from HS category 64 (footwear, gaiter and the likes), while around 32 per cent came from HS category 61 and 62 (art of apparel and clothing).

Further observation reveals little significant change in the composition of trade during the period of 1995 to 2012. A majority of Indonesia's top export commodities to the EU have been vegetable products, textiles, machinery or electrical products, footwear and headgear, and plastics or rubbers. By 2012, the vegetable sector accounted for 20 per cent of bilateral exports between Indonesia and EU27 (Figure 5). Meanwhile, textiles as well as machinery or electrical sectors respectively contributed to around 11.87 per cent and 12.47 per cent of Indonesia's exports to the EU. Plastic or rubbers, as well as footwear and headgear contributed around 10 per cent to Indonesia's exports to the EU, and around 46 per cent of exports from the vegetable products sector were crude palm oil exports, which accounted for 9.28 per cent of Indonesia's total exports to the EU.

**FIGURE 5:
TRADE COMPOSITION IN 2012 (ALL GOODS)
INDONESIA'S EXPORTS TO EU27 IN 2012**



INDONESIA'S IMPORTS FROM EU27 IN 2012



Source: COMTRADE

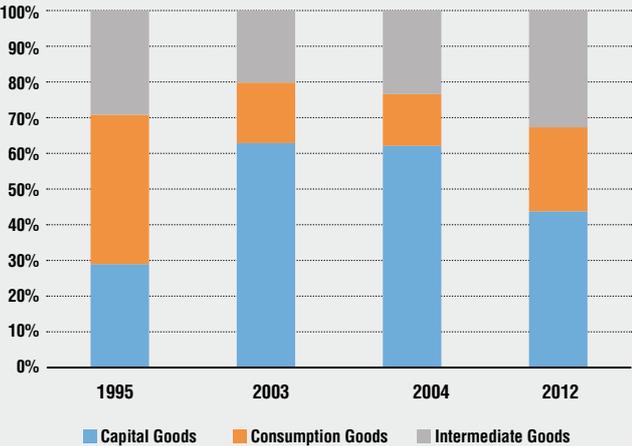
On the other hand, a majority of Indonesia's imports from the EU came from machinery or electrical products, transportation, and chemical and allied industries. As can be seen in Figure 5, 39.6 per cent of Indonesia's imports from the EU were machinery or electrical products by 2012. Meanwhile, around 17 and 9 per cent of Indonesia's imports from the EU respectively came from transportation as well as chemical and allied industries sectors. An 8.16 per cent of

Indonesia's imports from the EU were airplanes of an unladen weight of more than 15,000 kg, which in turn represented around 48 per cent of Indonesia's imports in the transportation sector.

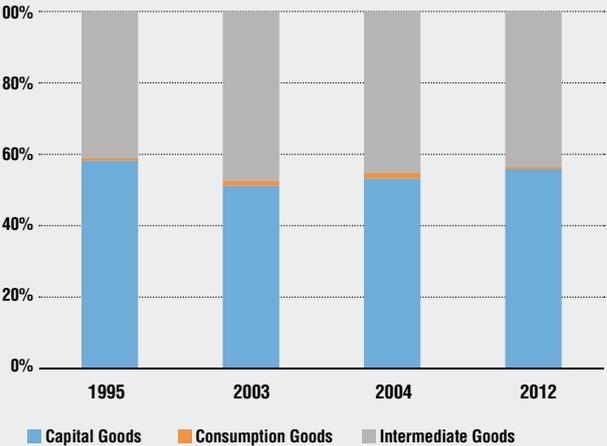
In general, the composition of traded goods in each sector did not change significantly until 2012. Exports from sectors such as footwear and headgear, plastic or rubbers, vegetable products, as well as machinery or electrical goods made up a large proportion of intermediate goods, while a large proportion of consumption goods in exports came from the textile sector. Imports from chemical and allied industries as well as machinery or electrical sectors were largely dominated by intermediate goods. In addition, imports from the transportation sector, as well as machinery or electrical products were largely capital goods.

FIGURE 6.
SECTORS WITH CHANGES IN THE COMPOSITION OF TRADED GOODS

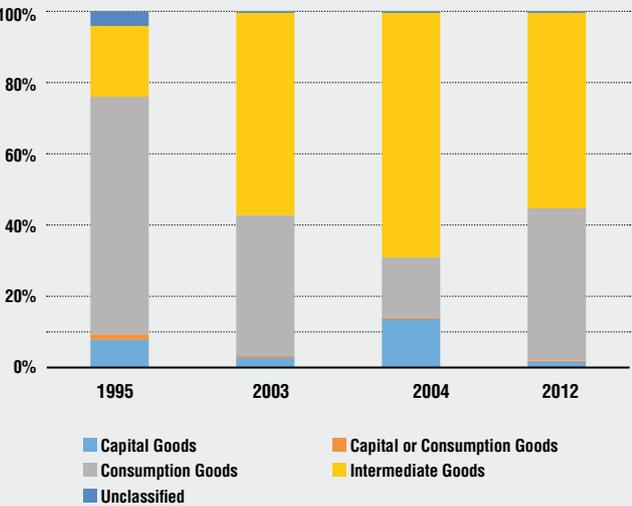
EXPORTS FROM MACHINERY OR ELECTRICAL SECTOR



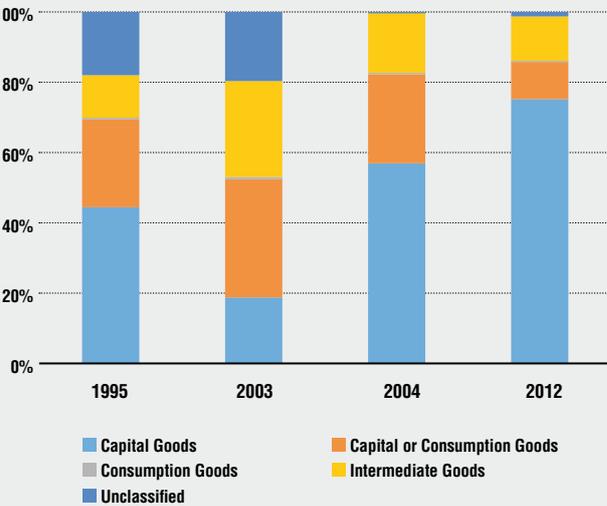
IMPORTS OF MACHINERY OR ELECTRICAL SECTOR



EXPORTS FROM TRANSPORTATION SECTOR



IMPORTS FROM TRANSPORTATION SECTOR



Source: COMTRADE

Nevertheless, some notable trends concerning the composition of traded goods in each product group should be taken into account (Figure 6). Imports of goods in machinery or electrical sectors have been relatively unchanged in composition, wherein capital and intermediate goods made up the entirety of imports from the EU. With regards to exports, there has been an increase in the proportion of final consumption and intermediate goods in the machinery or electrical exports to EU countries. The composition of transportation product exports has not changed drastically. Nevertheless, there has been an increase in the proportion of capital goods and a decrease in the proportion of intermediate goods making up transportation product imports.

Based on these trade statistics, three observations should be made concerning Indonesia's bilateral trade with the EU. First, excluding fuel and mineral products, Indonesia is an importer of capital goods and intermediate goods from the EU. Nevertheless, it is also an exporter of consumption goods and intermediate goods to the EU, with intermediate goods making up around 50 per cent of Indonesia's exports to the EU and 60 per cent of Indonesia's imports from the EU in 2012. Around 50 per cent of Indonesia's exports of intermediate goods to the EU came from HS 2 category 15, 44 and 50, while around 32 per cent of Indonesia's imports of intermediate goods from the EU were from HS 2 category 84 and 65 (machinery or electrical sector).

Second, the composition of Indonesia's exports to the EU is diverse while its composition of imports from the EU is much less so. Third, regardless of the degree of diversity of both exports and imports composition, Indonesia's trade with the EU seems to be largely concentrated in a few sub-categories. Nearly 20, 12.5, 12 and 11 per cent of Indonesia's exports to the EU respectively came from the categories of 15 (vegetable products), 84-85 (machinery or electrical), 50-63 (textiles) and 64-67 (footwear/headgear) in 2012. Meanwhile around 40, 17 and 12 per cent of Indonesia's imports from the EU came from the categories of 84-85 (machinery or electrical sector), 86-89 (transportation), and 28-38 (chemical and allied industries).

2.4. Indonesian Products in the EU Market

With the exception of a few products, the penetration rate of Indonesian products in the EU market remains relatively low, making it increasingly important to look at the reasoning behind the declining importance of the EU market to the Indonesian economy. Two questions can be raised to evaluate this situation. First, it is important to discuss whether Indonesia's exports to the EU are in line with its competitiveness. Second, we must look at whether Indonesia's exports are in line with the expansion of the EU's import market.

In order to answer the first question this study analyses the competitiveness of Indonesian products. This is done by calculating a trade indicator known as Revealed Comparative Advantage (RCA), which measures the importance of a product in Indonesia's exports basket in comparison to its importance in the global trade market.⁵ An RCA index larger than one indicates that the associated product has a high level of comparative advantage, which in turn can be interpreted broadly as greater competitiveness. The study compares products' RCA indexes with their importance in Indonesia's current export structure to the EU, while at the same time looking at their market penetration.

5 Detailed explanation is provided in Appendix 1.

TABLE 3.
STRUCTURE AND COMPETITIVENESS OF INDONESIA'S EXPORTS

SITC 3	PRODUCT DESCRIPTION	SHARE OUT OF INDONESIA'S TOTAL EXPORTS TO EU (%)		RCA		MARKET PENETRATION (%)	
		2000-2002	2010-2012	2000-2002	2010-2012	2000-2002	2010-2012
821	FURNITURE/STUFF FURNISHING	7.38	3.72	3.13	1.48	12.06	3.87
422	FIXED VEG OILS NOT SOFT	7.35	17.02	34.22	48.16	39.77	42.60
851	FOOTWEAR	7.09	8.18	4.5	3.46	8.57	6.89
845	ARTICLES OF APPAREL N.E.S	5.60	2.82	2.51	2.29	4.59	1.54
841	MEN'S/BOYS WEAR, WOVEN	5.21	2.79	4.08	3.2	4.06	2.27
763	SOUND/TV RECORDERS ETC.	5.03	2.90	4.92	3.1	5.39	4.33
842	WOMEN/GIRL CLOTHING WOVEN	3.54	1.89	3.84	2.65	3.77	1.79
635	WOOD MANUFACTURES N.E.S.	2.97	1.18	7.8	2.63	15.67	7.55
651	TEXTILE YARN	2.74	1.66	5.74	5.2	6.48	5.19
764	TELECOM EQUIPMENT N.E.S	1.95	1.18	0.97	0.43	0.48	0.29
231	NATURAL RUBBER/LATEX/ETC.	1.85	8.27	30.98	29.66	18.19	32.19

Source: COMTRADE, BPS⁶ and Eurostat Database

Table 3 illustrates the statistics concerning Indonesia's top products in the EU market during two observation periods – 2000 to 2002 and 2010 to 2012. Eleven product categories are included in the list of Indonesia's top 20 exports to the EU in both periods, including furniture, vegetable oils and footwear. Ultimately, three of the eleven categories – footwear (851), natural rubber (231), and fixed vegetable fats and oils (422) – exhibited an increasing share in Indonesia's total non-fuel and non-mineral exports to the EU during the period of 2000 and 2012, as indicated by the increase of RCA index. Meanwhile, the other eight categories made up a decreasing share of Indonesia's total trade with the EU with time, in addition to occupying a decreasing share of the EU's imports.

Based on the table, Indonesia's exports to the EU have followed a similar pattern as the country's more general competitiveness. This means that products with increasing competitiveness tend to occupy larger shares of Indonesia's total exports to the EU, and that these products have also gained greater market penetration in the EU's market. Vegetable oils' market share, for example, increased from only 39 per cent in the first period to 42 per cent in the second period. Other than the top twenty products, there are many other products with an increasing competitiveness and increasing share in both Indonesia's exports and the EU's market. Nevertheless, some products failed to increase their market share or their share in exports.

When looking at the second question, (concerning) whether Indonesia's exports are in line with the expansion of the EU's import market, Figure 7 shows the correlation between Indonesia's

6 BPS is an acronym for Badan Pusat Statistik (Indonesia's National Statistics Agency).

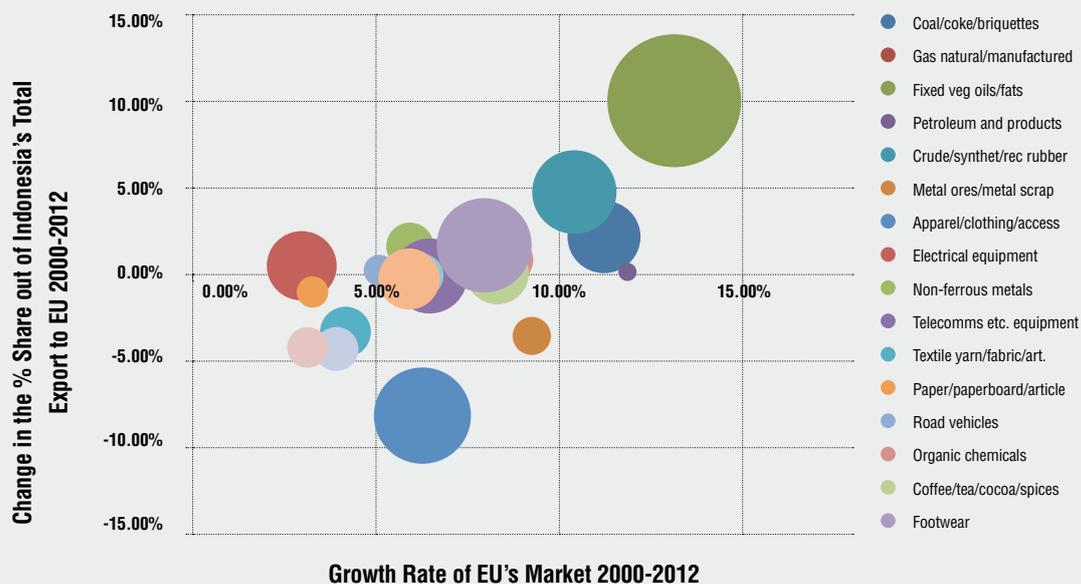
export structure and the expansion of the market of related products in EU countries. In Figure 8, the share of associated products in Indonesia's total exports (y-axis) is compared to the growth of import market in EU countries (x-axis) for Indonesia's top 20 exported products. Indonesian exports can ultimately face four different outcomes: (i) products can face positive change in export share during the observation period of 2000 to 2012, and be positioned in the expansive EU's market, (ii) products can face declining export shares, but be positioned in the expansive EU's market, (iii) products can face increasing export share, but happen to be in the declining EU market, and (iv) products can face declining export share, and also be in the declining market. The size of the bubbles in Figure 7 correlates with the value of the exported products to EU's market.

Indonesia's top products classified at Standard International Trade Classification (SITC) 2 digits can be classified as products with a growing share in the EU's market. For example, during the last twelve years, exports of vegetable oil products grew by 13 per cent per year, while rubber products grew by an average of around 10 per cent, and luckily, some of Indonesia's top exports managed to take advantage of these market expansions. Among the products that grew fastest and increased their share of Indonesia's export to the EU are vegetable oils, mostly palm oil products, rubber products and coal. Although some manufacturing products, such as footwear and electrical equipment also expanded their exports to EU member countries, their growth was below that of the three commodities mentioned earlier.

However, some other products failed to reap the benefits of the expanded market. Textiles and garment products respectively grew by 6 and 5 per cent, but no longer remained important components of Indonesia's exports. In 2000, garments contributed 17 per cent to Indonesia's exports, but by 2012 the share had dropped to 8 per cent. A similar situation happened to the textile and other manufacturing industries.

FIGURE 7.

INDONESIA'S EXPORT STRUCTURE AND MARKET GROWTH



Source: COMTRADE

In general, the analysis shows that Indonesia's exports to the EU were in line with Indonesia's competitiveness. Those products with higher competitiveness – as measured by the RCA – dominated Indonesia's export to the EU countries. Moreover, the export structure followed the expansion of the EU import market quite closely. Thus, the problem Indonesia's exporters to the EU currently face may not be due to the marketing strategy of selecting top potential products. The study will further look at issues related to market access and trade policy in the EU in order to gain an alternative explanation for the changing performance of Indonesian products in the EU.

2.5. Market Access and Trade Policy

Trade Policy in the European Union

Previous analyses of international trade activities of the two economies revealed that one of the reasons behind the weak performance of Indonesia's exports in the EU might be partly due to the diversion of trade away from extra-EU and towards intra-EU trade. The enlargement of the EU and its single market program to include several Eastern European Countries (EECs) whose economic characteristics complement the economic structure of the earlier members of the EU gave a larger advantage to European businesses compared to non-EU businesses, and thus has led to more intensive intra-EU trade. In addition, the EU has been very active in conducting preferential trade agreements with their major trading partners, and in particular with developing nations.

One serious problem faced by Indonesian exporters to the EU, however, is the erosion of preferential tariffs that are normally provided under the Generalized System of Preference (GSP), which is a program designed to promote trade relations between developed and developing countries by providing lower tariff rates comparable to those under the Most Favoured Nation (MFN) tariff rules of the WTO. The EU provides three types of GSP tariffs: general GSP, GSP plus – which enhances preferences for countries that ratify and implement international conventions related to human and labour rights, environment and good governance – and GSP for least developed countries, also known as “everything but arms”, or EBA, providing duty-free access for most products except arms.

Various exported products from Indonesia are eligible for a preferential tariff under the EU GSP, meaning that up to 45 per cent of the total value of EU's imported products from Indonesia entered the market using the GSP facilities.⁷ However, the EU set out its proposals on trade policy for the next decade by updating its GSP program in January 2012, in such a way as to reduce the number of beneficiary countries from 177 to 90. Countries that are excluded from the preferential treatment under the updated GSP are countries that have reached high and upper-middle income status, countries with existing trade agreements with equivalent measures, and all overseas and offshore territories.

While Indonesia is still included in the list of countries eligible to receive GSP facilities, several Indonesian products have been exempted, and have thus colloquially been named “graduate

⁷ The figure comes from Eurostat. A more detailed analysis on GSP and tariff structure is presented in the next chapter

sectors.” These include live animals and animal products excluding fish, animal or vegetable oils, fats and waxes, and chemicals (other than organic and inorganic chemicals). In total, those products contribute to around 24 per cent of total Indonesia’s exports to the EU. With the exception of vegetable oils, which have been “graduated” for a while, around 90 per cent of the exports received GSP status before the tariffs were updated. The declining trend of GSP coverage, coupled with concern over greater trade diversion, is likely to be more crucial in the future as Indonesia becomes more developed.

Even more serious concerns are related to non-tariff measures (NTMs) and have arisen in tandem with the reform of the GSP scheme. NTMs can reduce the competitiveness of products from developing economies and more specifically lead to market access problems for a range of Indonesian products.

The Trade Defence Instruments (TDI) can take on the form of anti-dumping actions, trade defence and safeguard measures, and ultimately place another hurdle in the path of efficient performance of Indonesia’s exports to the EU. While around 73 per cent of goods imported from Indonesia are duty free, some potential products have been subject to higher punitive tariff rates due to anti-dumping policies. Many of Indonesia’s top products, such as textiles, rubber products, furniture, and food products, are also subject to high tariffs.

Below are some examples of specific sector-based market access issues that are being faced by some of Indonesia’s products exported to the EU.

Fisheries

Two types of trade barriers have been imposed on the Indonesian fisheries’ exports to the EU market: import tariffs and food safety standards.

Tunas, shrimp, and seaweed are Indonesia’s top export commodities from fisheries. Yet, Indonesia faces higher import tariffs for tuna compared to other EU tuna suppliers, especially for canned tuna products, which face tariffs that are 20 to 25 per cent higher.⁸ These tariffs remove incentives for Indonesian producers to export their products to the EU, as well as for European buyers to purchase more Indonesian products. However, the lower tariff is based on EU trade agreements and/or preferential schemes with those respective countries, such as GSP+ and EBA (“Everything But Arms”).

EU food safety standards are among the highest in the world, and many Indonesian producers have been having a hard time to adapt to these standards. Their inability to do so has effectively become a barrier to efficient trade, and is pushing many of these producers to shift to other markets or sectors. The EU requires testing and labelling of products from every shrimp farm in order to guarantee full traceability and quality control. For instance, no forbidden medicines shall be used in the production process. Regulations in the EU also require fishermen to obtain catch certificates for fish imported to the EU as part of EU regulations concerning Illegal, Unreported and Unregulated (IUU) fishing. Unfortunately, in developing countries (including in Indonesia), the fisheries industry consist of small, unregistered vessels operated by uneducated fishermen. Although it has been reported that most of the main fisheries have now registered all vessels,

8 LEI Wageningen UR (2012)

and that new policies have been implemented to help fishermen and exporters provide the documents required for export to the EU market, the introduction of these particular requirements has become a barrier to trade.

Furniture and Wood Products

While Indonesia's furniture and wood products enjoy relatively low tariffs due to the EU's GSP, some issues, especially with regard to trade regulations and other NTMs remain. The first main barrier to trade comes from the rules of origin (ROO) of the GSP, which require, for example, that the value of all materials being used in furniture or wood products that comes from non-originating countries should not exceed 40 per cent of the ex-works price of the product. This stringent rule poses difficulties for producers to uphold the competitiveness of their products, while at the same time maintain high-quality and excellent designs.

A second barrier comes from the fact that the EU also requires that all furniture meets standard requirements related to dangerous substances and environmental issues. The regulations under the Forest Law Enforcement and the Governance and Trade (FLEGT), for example, forbid European operators from engaging in the illegal trade of timber. Although Indonesia has signed a Voluntary Partnership Agreement (VPA) with the EU with regards to FLEGT, the entry into force of the VPA has been viewed by Indonesian loggers as a potential threat to their exports to the EU, since they claim that they may not be in a position to provide all necessary documents.

Electronic Products

The Indonesian electronics sector has enormous potential as an export product, despite the fact that it currently contributes a relatively low market share of exports to the EU. However, some issues have raised concerns about Indonesia's ability to improve its export performance. To be eligible for GSP status, for instance, Indonesia's electronic products need to source more than 70 per cent of their value from domestic manufacturers. However, in the current international production network, where parts and components of electronics are sourced mostly from other countries, this strict ROO does not support the industrial development of the sector.

EU regulations also restrict the use of certain substances in the production of electrical and electronic equipment that are deemed to be hazardous. The EU further has a directive on waste electrical and electronic equipment (known as the WEEE Directive), which aims to reduce the amount of electrical and electronic equipment being produced and to encourage everyone to reuse, recycle and recover the used products. Although important, these regulations make it difficult for Indonesian electronic producers to promote exports abroad.

Palm Oil Products

In November 2013, the EU launched an anti-dumping investigation based on a complaint by the EU biofuels industry of unfair market practices by Indonesian exporters. In accordance with due WTO procedures and based on the results of the investigation, the EU decided to impose anti-dumping duties of 18.9 per cent on certain Indonesian biofuel exporters. This policy was implemented under the suspicion that Indonesian producers were dumping and receiving

discriminatory domestic price of crude palm oil (CPO) that was lower than the world price. In this scenario, lower domestic price would have been accomplished by charging taxes to the export of CPO. This policy, once again, has acted as a barrier to efficient trade in this sector.

In summary, market access remains one of the most important issues surrounding Indonesia's export performance to the EU. This highlights the importance for Indonesia to seek a formal and deeper trade agreement between the two economies in order to increase its export performance and reduce the risk of preferential tariff erosion and trade diversion.

Trade Policy in Indonesia

Indonesia recently launched several policies and regulations that are perceived to be trade-restrictive, thereby signalling the growing importance of protectionist tendencies in Indonesia. The new policies include various import and export restrictions, as well as restrictions on investment. The import restrictions could potentially affect the EU's major export products to Indonesia, particularly machinery and transport equipment (around 52% of EU's total export to Indonesia) and food and live animal (5% of EU total export to Indonesia and it is growing), while the export restriction would reduce the supply of Indonesia's mineral to the EU.

The Ban of Mineral Exports. The 2009 Mining Law (Undang Undang 2009) requires all owners of Mining Business Permits (Izin Usaha Pertambangan, IUP) and Contracts of Work (CoW) to add value to mining products through domestic refining and processing by January 2014. Three years after the enactment of the Mining Law, the Ministry of Energy and Mineral Resources (MEMR) created MEMR Regulation 7/2012 that obligated miners to formulate smelting plans, that defined minimum standards for domestic processing and refining, and that imposed a ban on the export of raw mineral ores within three months of the regulation. On 11 January 2014, the Indonesian Government announced a new regulation, named PP 1/2014, which bans unprocessed exports of nickel and bauxite, while permitting the export of semi-processed 'concentrates' for the other minerals, including copper until 2017. Because of these regulations, export tax rates making up close to 20 to 25 per cent of sales revenues in 2014, are set to increase to 60 per cent by 2016.

This ban on mineral exports will add to the existing fiscal strain on Indonesia's budget, since pressure is mounting for the government to issue subsidies if the construction for smelters is not a viable project in its own right. In its quarterly report, the World Bank estimated that, without any adjustment in fuel prices this year, state spending in Indonesia will swell by Rp 56 trillion, consequently pushing up the budget deficit to 2.6 per cent of GDP. The fiscal space problem will be an obstacle for budget allocation to other sectors such as health, education and more importantly, infrastructure, which will in turn slow down the development of Indonesia's manufacturing sector.

The New Food Law. On 18 October 2012, the Indonesian government issued its Food Law No.18/2012, which aims at implementing food sovereignty, food sufficiency and food security in Indonesia. Under the Food Law, food sovereignty is defined as the state's right to independently determine its food policies, while food security is defined as the fulfilment of the food needs of the state and each and every individual. This is to be reflected in the availability of sufficient food, both in quantity and quality, as well as in terms of food safety, diversity, and nutrition. Food should be widely available and affordable, and must not conflict with religious or cultural beliefs, and shall support a healthy, active, productive and sustainable life.

The new Food Law's goal is to rely primarily on domestic production for creating a supply of food, although it may lead to volatile domestic food prices that jeopardize food security for Indonesians. Food trade protection reduces the overall efficiency of national resource use in agriculture, as it helps some poor households at the expense of other households, while unnecessarily helping some non-poor groups.

The New Trade and Industry Laws. The Indonesian government issued its new Law No. 3/2014 on Industry in January 2014, and Law No. 7/2014 on Trade the following month. The new trade law is expected to further solidify Indonesia's stance on international trade schemes, in which it promotes managed trade rather than free trade. The new trade law will provide clear direction for investors by creating conducive investment climate and by protecting small and medium enterprises (SMEs). Meanwhile, these laws work to save domestic industry, especially SMEs, by extending the scope of industrial obligation to include export oriented and green businesses, as well as businesses that use products or parts made by SMEs. In essence, both laws intend to save domestic industry through a series of protectionist measures.

The new trade law is unattractive to foreign investors because of the ambiguity of statements inside the law, and because of the unfair and one-sided nature of the policy. Many of the clauses within the laws are ambiguous and broad, postpone the implementation of regulation, and are explained on the grounds of national interests. Moreover the trade law legalizes protectionist governmental actions, which further adds to criticism on Indonesia's recent protectionist trade measure in general.

2.6. European Union Products and Indonesian Industrial Development

This study will now look at Indonesia's imports from the EU in order to complete the analysis on the trade relations between the two economies. The analysis attempts to look at how imported products from the EU have shaped industrial development in Indonesia.

Table 4 shows the development of the Industrial Production Index for Indonesia. Sectors that recorded positive growth in 2011 and 2012 were food products and beverages, apparel, chemicals and chemical products, rubber and plastics products, non-metallic mineral products, fabricated metal products apart from machinery and equipment, computers, electronics and optical products, electrical equipment, motor vehicles, trailers and semi-trailers. Those sectors are also receiving imported products, mostly as intermediate inputs and capital good.

Recent developments and innovation in logistics, telecommunication and production management gave rise to a new production model where intermediate inputs such as parts and components are sourced from many different countries. Thus, production has become more efficient. In this international production network also known as Global Value Chain (GVC), imports can no longer be separated from exports. That is, in order to produce globally competitive products for exports, imports are necessary as components of this final product. Countries with higher import contents tend to produce more competitive products and improve their export performance. In China, for example, the import content of gross exports are around 30 per cent of overall exports, an indication of high participation in the international production network.

TABLE 4.
GROWTH OF INDUSTRIAL PRODUCTION INDEX, 2010-2013

YEAR	2010-2011	2011-2012
FOOD PRODUCTS	12.88	10.99
BEVERAGES	0.16	6.77
TOBACCO	14.87	-11.69
TEXTILES	-3.23	-12.5
WEARING APPAREL	4.6	7.45
LEATHER AND RELATED PRODUCTS AND FOOTWEAR	3.33	-3.56
WOOD AND PROD OF WOODS AND CORK EXCEPT FURNITURE	-17.63	3.72
PAPER AND PAPER PRODUCTS	3.54	-7.71
PRINTING AND REPRODUCTION OF REC MEDIA	-1.64	16.52
CHEMICALS AND CHEMICAL PRODUCTS	5.55	24.05
PHARMACEUTICALS, MEDICINAL CHEMICAL & BOTANICAL PRODUCTS	36.25	-6.31
RUBBER AND PLASTICS PRODUCTS	13.06	2.22
NON- METALLIC MINERAL PRODUCTS	4.67	12.67
BASIC METALS	21.32	-14.15
FABRICATED METAL PROD EXCEPT MACHINERY AND EQUIP	12.24	4.79
COMPUTERS, ELECTRONICS AND OPTICAL PRODUCTS	11.5	23.1
ELECTRICAL EQUIPMENT	37.81	10.86
MACHINERY AND EQUIPMENT	6.74	-10.87

Source: CEIC

To measure Indonesia's involvement in the GVC, the study looks at the GVC participation index (Koopman, 2010), which is an indicator of a country's participation in GVC. It is expressed as the sum of backward participation index (measuring the proportion of imported inputs, or foreign value added in the overall exports of a country) and forward participation index (measuring the proportion of domestic inputs, or domestic value added of a country in the overall exports of third countries). The backward and forward participation indices measure the participation of a country in GVC through upstream and downstream links respectively.

FIGURE 8.
KOOPMAN PARTICIPATION INDICES



Source: OECD-WTO TIVA Database

As seen in Figure 8, Indonesia has increasingly participated in the global value chain of goods and services in general. Nevertheless, in 2009, Indonesia's participation in the global value chain through the upstream link has decreased to its initial level of 1995, while its participation through downstream link has risen considerably from 18.81 per cent in 1995 to 29.31 per cent in 2009. This is typical to many countries at an earlier stage of industrial development. In contrast to Indonesia, the EU has a larger increase in participation through upstream links, compared to participation through downstream links.

TABLE 5.
IMPORT CONTENT OF INDONESIA'S GROSS EXPORTS BY INDUSTRY

INDUSTRY	1995	2000	2005	2008	2009
AGRICULTURE, HUNTING, FORESTRY AND FISHING	3.90	4.18	4.90	6.28	4.74
MINING AND QUARRYING	4.73	3.69	6.07	5.18	4.11
FOOD PRODUCTS, BEVERAGES AND TOBACCO	7.35	9.70	8.85	11.14	8.57
TEXTILES, TEXTILE PRODUCTS, LEATHER AND FOOTWEAR	22.99	25.39	22.29	29.46	24.35
WOOD, PAPER, PAPER PRODUCTS, PRINTING AND PUBLISHING	11.22	21.22	19.41	20.04	15.39
CHEMICALS AND NON-METALLIC MINERAL PRODUCTS	21.35	23.68	24.90	18.14	14.89
BASIC METALS AND FABRICATED METAL PRODUCTS	19.80	23.77	22.91	21.75	16.29
MACHINERY AND EQUIPMENT, NEC	40.11	49.42	50.97	40.60	38.71
ELECTRICAL AND OPTICAL EQUIPMENT	32.75	28.75	31.31	30.02	27.51
TRANSPORT EQUIPMENT	20.93	20.37	31.80	19.60	17.13
MANUFACTURING NEC; RECYCLING	27.26	19.24	18.88	17.39	13.93

Source: OECD-WTO TIVA Database

In Table 5, we can see that the highest import content in Indonesia's gross exports is found in machinery and equipment, as well as electrical and optical equipment. However, the proportion of import content has declined since 2005. By 2009, around 39 per cent and 27.5 per cent of the respective total value of exports in machinery and equipment and electrical and optical equipment originated abroad. This finding is consistent with the previous observation that Indonesia's participation in the GVC in these two sectors is completed through upstream links. More importantly, this finding highlights Indonesia's dependency on foreign inputs in these two sectors. In addition, machinery and equipment, as well as electrical and optical equipment, recorded the largest level of value added in Indonesia's imports from the EU, indicating the importance of imported goods from the EU in the industrial development of highly-skilled and high-technology sectors.

To put these observations into context, it is necessary to refer to the previous findings in Section 2.3 on trade composition. Indonesia mainly imports capital goods and intermediate goods from the EU. Around 40 to 45 per cent of imported intermediate goods from the EU are found in the machinery or electrical sector. At the same time, 34 per cent of imported capital goods from the EU are industrial transport equipment. Most of the remaining imports of capital goods from the EU are found in machinery, followed by electrical equipment and optical equipment. These observations show that Indonesia is strongly dependent on the EU for intermediate

inputs and capital inputs in transportation, machinery and the electrical sector. Since Indonesia's dependence on foreign inputs is the highest in these sectors, and since Indonesia needs imports of intermediate goods and capital goods from EU in order to be competitive in the GVC of these two sectors, trade with the EU in these sectors is complementary from Indonesia's point of view. Greater trade relations between the two economies – in particular Indonesia's trade of intermediate goods with the EU – could further boost Indonesia's participation in GVC. This will help to improve Indonesia's industrial performance and exports.

2.7. Lessons Learned from Trade Relations

Our analysis so far has uncovered several important concerns regarding the CEPA between Indonesia and the EU.

Indonesia and the EU member states are natural trading partners as the two economies are at different levels of economic development and different stages of technological acquisition. However, trade relations between the two have not yet met its full potential. Trade statistics show that although trade relations have been growing in terms of absolute value, the relative importance of both economies to each other has weakened.

Part of the problems faced by Indonesian products relate to the issues of market access. Most noticeably, problems are related to the implementation of various measures on exports to the EU, since many Indonesian producers find it difficult to fulfil various regulations, including sanitary measures, standards and technical requirements, especially with regards to NTMs. Nevertheless, the problem of market access will also emerge from the erosion of preferential tariffs due to Indonesia's graduation from the GSP scheme, as well as from trade diversion of the EU's imports to its FTA partners.

These problems highlight the significance of a new trade agreement between Indonesia and the EU. Such a CEPA will provide a medium for better information sharing and exchange in trade regulations and procedures, in addition to lower import tariffs for Indonesian products.

However, the advantage of having enhanced trade relations with European countries goes beyond simply creating greater market access for exports. The analysis of the composition of Indonesia's imports reveals that most of imported products are either intermediate or capital goods used for further production. With the rise of international production networks, imported intermediate inputs are necessary requirements for the creation of competitive industries for both domestic consumption and exports. The EU is known to have efficient producers of high quality parts and components, as well as capital goods. The proposed CEPA would open opportunities for Indonesian producers to increase their performance and enhance industrial development.

The next chapter will examine the potential impact of the CEPA on trade relations in a more detailed manner using economic modelling methods.

3. Potential Impact of EU-Indonesia CEPA on Trade

The analyses and discussions of the previous chapter highlight the importance of improving trade relations between Indonesia and the EU member states. One way to create better trade relation is by concluding a trade agreement that provides greater market access for the two economies. A potential trade agreement between Indonesia and the EU would be an important part of the Comprehensive Economic Partnership Agreement.

The proposed CEPA has nevertheless raised several concerns among Indonesian stakeholders⁹. First, the public in general is concerned that by giving preferential access to EU products, Indonesian producers across numerous sectors would risk losing their market share domestically as a result of increased competition. Second, while the CEPA would provide greater access to the European market for products from Indonesia, these producers continue to have a limited capacity to fully exploit this opportunity. Third, the coverage and the modalities of trade liberalization have not been defined appropriately, thereby raising questions about the scope and pace of liberalization, and about which products would be considered as sensitive for ACP regions and thus excluded from liberalization.

This chapter examines the impact of trade liberalization, and in particular tariff reduction initiatives, on trade relations between the Indonesian and European economies. A simple partial equilibrium modelling technique is used to provide direct and detailed measures of the impact of tariff elimination. In addition to the quantitative analysis on tariff elimination, this chapter will

⁹ See for example “CEPA Tidak Mengulangi Kesalahan ACFTA”, *Business News* 29 February 2012, or “Inilah Dampak Perdagangan Bebas RI-UniEropa”, *Republika* 26 Juni 2012.

discuss NTMs, along with other impacts of trade liberalization, which are not captured by the modelling exercise. Before examining the impact of tariff liberalization, the study will first look at the tariff structures of the two economies and at how they affect bilateral trade patterns.

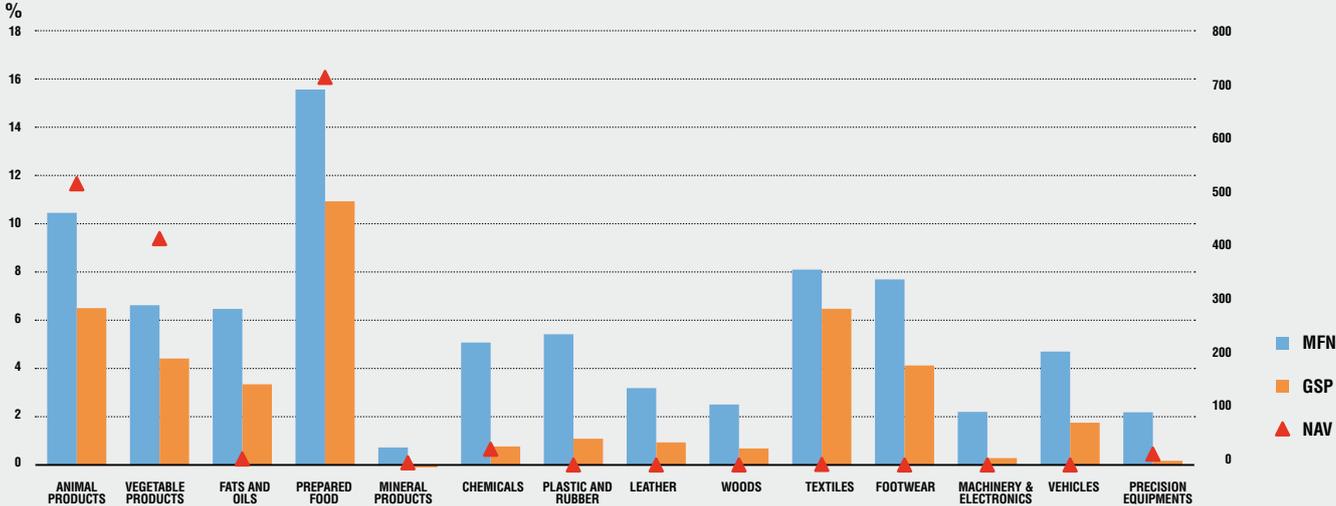
3.1. Trade Relations and Tariff Structures

European Union Tariff Structures for Indonesian Products

The EU generally applies three types of tariff structures: MFN tariff rates that are used for all WTO members, GSP for developing and least developed countries, and reciprocal preferential tariff rates based on external trade agreements. Indonesian products are currently eligible for either MFN tariff rates or the lower GSP rates, depending on the development of the sector from which they originate. Figure 9 shows the average 2012 MFN and GSP tariff rates in the EU for various product groups, as well as information on the number of tariff lines subject to non-ad valorem tariffs (NAV).

Based on this information, certain features can be observed concerning the EU’s tariff schedule. First, the EU’s MFN average rate seems to be quite high for various agriculture and food products, along with certain sectors outside of agriculture, such as textiles and footwear. It should be noted that some of these products are produced competitively and exported by Indonesia.

FIGURE 9.
EU'S TARIFF STRUCTURE



Note: Average rate are shown on the left axis, while the number of tariff lines subject to NAV are on the right.

Source: TARIC Database

Second, NAV tariffs are still quite prevalent in the EU’s tariff structure, with agricultural products being among those goods that are mostly subject to these higher rates. This type of tariff is relatively more restricted for lower quality and less costly goods, since it is applied based on various aspects of imported goods other than their prices and value, such as weight, length or number of unit.

Third, it is obvious that GSP rates are significantly lower than MFN rates. In agriculture-related goods, the average tariff rates that countries under GSP programs received were 40 per cent lower than those subject to MFN rates. GSP rates for many manufactured goods are also substantially lower. This gives significant advantages to Indonesian products that are receiving the preferential rates, and also implies that Indonesian products would lose most of these advantages when the country graduates from the GSP framework.

In order to get an insight into how the EU's tariff structure affects Indonesian exports to the EU, this study examines the information available in Table 6, in which we can see that Indonesia's exports to the EU are concentrated in mineral products, or primary or resource-intensive products such as fats and oils. We can also see that some of those products have high shares of the EU's market.

TABLE 6.
EU'S IMPORTS FROM INDONESIA (AVERAGE 2010-2012, € MILLION)

HS SECTION	DESCRIPTION	INDONESIA		WORLD	
		GSP (% OF TOTAL)	TOTAL IMPORT	GSP (% OF TOTAL)	TOTAL IMPORT
1	ANIMAL PRODUCTS	91.62	184.05	66.14	20,685.91
2	VEGETABLE PRODUCTS	2.29	453.53	31.29	42,189.38
3	FATS AND OILS	0.00	2,316.86	37.01	8,426.64
4	PREPARED FOODSTUFFS	57.72	621.90	39.40	38,032.42
5	MINERAL PRODUCTS	2.74	1,294.13	4.58	483,594.33
6	CHEMICAL PRODUCTS	89.21	1,449.76	19.37	136,965.18
7	PLASTIC AND RUBBER	27.78	1,566.34	37.95	46,317.96
8	LEATHER	89.73	87.44	32.51	12,748.95
9	WOOD PRODUCTS	26.70	499.48	15.28	10,362.76
10	PULP OF WOODS	0.00	205.67	0.00	15,944.71
11	TEXTILES AND TEXTILE ARTICLES	98.02	1,611.73	51.54	89,279.15
12	FOOTWEAR	98.80	1,102.58	31.40	17,524.57
13	ARTICLES OF STONE	74.22	100.62	27.68	10,859.81
14	PEARLS AND PRECIOUS STONE	80.89	47.02	3.22	72,761.63
15	ARTICLES OF BASE METAL	12.95	600.73	23.93	96,013.96
16	MACHINERY AND ELECTRICAL	59.72	1,838.44	12.81	351,533.04
17	VEHICLES	91.21	146.81	24.25	95,990.39
18	PRECISION EQUIPMENT	83.18	279.70	14.57	55,272.96
19	ARMS AND AMMUNITION	0.00	0.01	15.27	1,070.35
20	MISCELLANEOUS MANUFACTURES	32.31	678.77	10.31	37,078.79
21	WORKS OF ART, ANTIQUITIES...	0.00	3.00	0.00	3,012.32
TOTAL		46.77	15,088.60	16.84	1,645,665.22

Source: Calculated from Eurostat, Comext Database

Around 50 per cent of the EU's imports from Indonesia enter the market through the utilization of the GSP program, which is higher than the average utilization of the GSP for all extra-EU imports. Textile and footwear products, as well as machinery and electronics are among the products that depend most on GSP facilities. Around 98 per cent of these products coming from Indonesia receive lower tariff rates as a part of the program. However, the primary Indonesian exports to the EU, namely vegetable oils, are no longer eligible to receive GSP tariff rates since they have dominated the EU's market for some time. Nevertheless, for those products still under the GSP framework, the data indicates that lower tariff rates under the GSP program remain to be one of the most important aspects in determining Indonesia's export performance in the EU market and in ensuring greater market access.

To see how the tariff rates affect Indonesian exports to the EU, this study looks at how different tariff rates influenced imports from Indonesia. Table 7 compares trade volumes according to tariff rates in 2001 and 2012. Around 58 per cent of the EU's imports from Indonesia in 2012 fell in the category of duty-free imports (receiving no tariff), which was a significant increase from 45 per cent of products that were duty-free in 2001. It is also quite obvious that a smaller portion of the imports received higher tariff rates in 2012; in fact, only around 6 per cent of the imports from Indonesia were subject to tariffs higher than 10 per cent, whereas this figure was 20 per cent in 2001.

TABLE 7.
EU'S IMPORTS FROM INDONESIA BASED ON TARIFF RATE (€ MILLION)

	2001			2012		
	GSP (% OF TOTAL)	MFN (% OF TOTAL)	TOTAL	GSP (% OF TOTAL)	MFN (% OF TOTAL)	TOTAL
0	21.52	78.48	4,946.71	35.75	64.25	8,976.94
1 - 5	67.91	32.09	1,492.71	67.10	32.90	2,502.11
5 - 10	51.10	48.90	2,102.47	77.58	22.42	2,219.80
10 - 20	82.61	17.39	2,050.46	64.96	35.04	833.54
20 - 40	-	100.00	14.90	94.46	5.54	57.96
> 40	100.00	-	0.02	100.00	-	0.13
NAV TARIFF	81.03	18.97	90.34	91.22	8.78	101.21
TOTAL	45.99	54.01	10,697.60	49.68	50.32	14,691.71

Source: Calculated from Eurostat, Comext Database, and TARIC database

These changes are largely due to the more intensive use of GSP for lower tariff rates. In 2012 around 36 per cent of duty-free imports from Indonesia fell under GSP facility, compared to the 22 per cent in 2001. Most of the imports from Indonesia also get tariff rates lower than 10 per cent due to the GSP scheme.

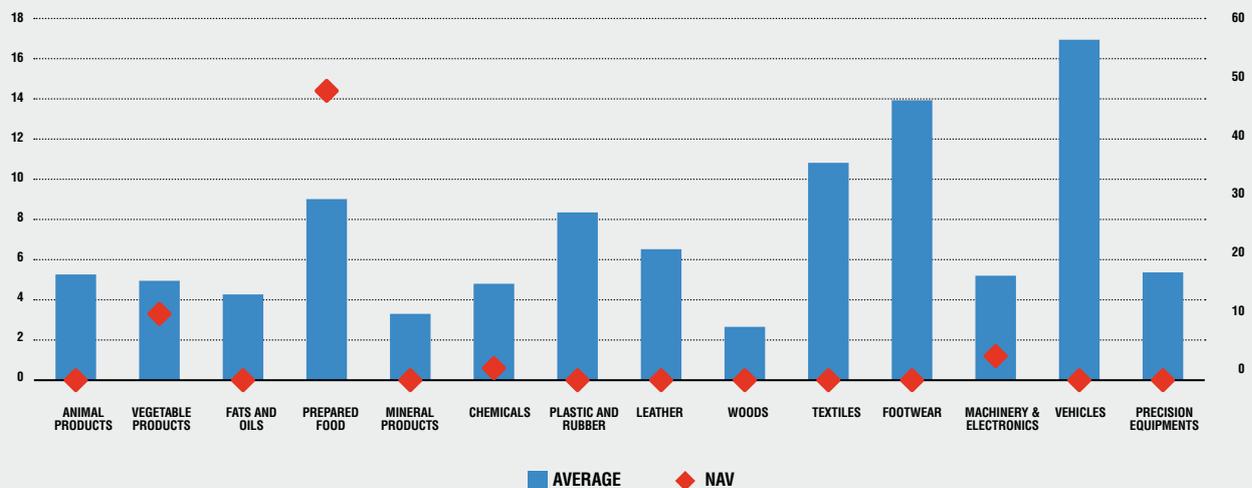
Another feature observed is that only a small share of imports from Indonesia could be associated with high tariff rates or NAV rates. While this indicates that high tariff rates do not significantly affect Indonesia's exported goods, this could also mean that the tariffs are too high to allow more

imported goods. Since most high and NAV tariffs affect agricultural and food products, which belong to Indonesia's sectors with the greatest export potential, the latter argument might have some ground.

Indonesian Tariff Structures for European Union Products

Indonesia's tariff structure is less complicated compared to that of the EU. Indonesia applies MFN tariff rates for non-FTA partners. In contrast to the European tariff schedule, higher tariff rates are applied to manufacturing products, rather than agriculture. Figure 10 illustrates Indonesia's simple average tariff rates for a variety of imported products. The highest rates can be observed for vehicle products, and especially for motor vehicle. The highest tariff for this product group can reach up to 40 per cent. Other manufacturing product groups with high tariff rates include textiles and footwear. While average tariffs on agricultural goods are reasonably low at around 5 per cent, some products are subject to NAV tariffs, such as in the vegetable products sector where 11 tariff lines are subject to NAV tariff rates. The largest number of these specific tariff rates is applied to prepared foodstuffs (48 tariff lines). In contrast to the EU, however, NAV tariffs are not generally a common feature of Indonesia's tariff structure.

FIGURE 10.
INDONESIA'S TARIFF STRUCTURE



Source: BTKI 2012

Table 8 provides information on Indonesia's imported products from the EU, and the tariff rates applied to them. The majority of Indonesia's imports from the EU were duty-free imports or were treated to tariffs of less than 5 per cent. As explained previously, machinery and electrical products occupy the largest share in Indonesia's imports from the EU, and of these products, around 4 per cent were subject to tariffs of greater than 10 per cent. This number is smaller than it has been in the past, implying a shift in the EU's exports and a downward trend in Indonesia's tariff rate. Since most of the NAV tariffs are applied on agriculture-related products that are not major exports of the EU, the portion of imports subject to this type of tariff remains very small.

TABLE 8.
INDONESIA'S IMPORTS FROM EU COUNTRIES
BASED ON APPLIED TARIFFS

TARIFF RATE	2001	2007	2012
0	49.24	56.55	34.75
1 - 5	33.71	30.35	51.83
5 - 10	7.22	7.19	9.01
10 - 20	3.77	5.36	2.79
20 - 40	0.06	0.09	1.56
> 40	0.01	0.44	0.00
NAV TARIFF	0.00	0.01	0.06
TOTAL	4,427.33	10,558.03	14,134.18

Source: BBMI, BTKI, BPS Trade Database

3.2. Modelling the Impact of Tariff Reductions on Trade

In this section, we look at the possible impact of an EU-Indonesia CEPA. More specifically, this analysis uses modelling to estimate the trade impact of tariff elimination. While we recognize that the impact of non-tariff measures might be quite significant, discussions about them must be qualitative given limitations in data and methodology. This study briefly discusses the model and alternative possible scenarios before discussing the result of the simulations.

A Brief Review on Modelling Methodology

Various modelling tools help to quantify the potential economic effects of different trade policy alternatives, and to answer “what if” types of questions. Using information on the current state of the Indonesian and European economies, this analysis asks how things could be different if specific policy instruments were altered. The analysis can be used to evaluate the likely impact of tariff elimination as part of a trade agreement, given certain conditions and assumptions behind the simulation modelling.

Simulation models can be structured using either a partial or a general equilibrium setting. A partial equilibrium model focuses on one part or one sector of an economy, and assumes that changes in that sector have zero or minimal impact on other sectors, taking into account neither the linkages between sectors, nor the link between income and expenditures. In contrast, a general equilibrium analysis explicitly accounts for all the links between the different elements of the considered economy, be they households, sectors of activity, factors of production or even different economies. For instance, as a result of tariff elimination, a contraction in a given sector could result in an expansion in another sector since the factors of production will shift to the expanding sector and shift away from the contracting one. Each approach offers advantages and shortcomings.

This study used a partial equilibrium model to evaluate the potential impact of tariff elimination under an EU-Indonesia CEPA. This approach offers several attractive features. The main advantage is its simplicity and its minimal data requirements. This makes the simulation easy to implement while at the same time easy to evaluate and understand. Since the data requirements are relatively minimal, the model can be done at highly disaggregated level, thus reducing the

aggregation bias and providing users with more accurate and detailed results. This is an important feature in trade negotiations, as they are usually conducted at much more disaggregated level. It should be noted that this approach loses the ability to capture linkages between elements compared to general equilibrium modelling. Nevertheless, the benefits surpass the weaknesses in regards to the main purpose of this policy exercise.

This simulation exercise follows a methodology designed in the partial equilibrium model by Laird and Yeats (1986). In this model, the trade effects of tariff elimination come from two sources. The first and most direct effect is the trade creation effect, in which an increase in demand results from the decreasing price caused by the change in tariff rate. The second is the trade diversion effect, in which the price of imported goods from Indonesia are relatively lower than the price of goods from other sources, prompting EU buyers to substitute goods from other countries to products from Indonesia. More detailed explanations of the model can be found in Appendix 2.

Simulation Exercises: Data and Scenarios of Tariff Reduction

To conduct the simulation exercise, three types of data and information are needed. First is data on imported goods of the partnering countries – Indonesia and the EU. The import data come at highly disaggregated level from the 8-digit EU CN classification, which was collected from the Eurostat Comext database, and 10-digit Indonesian classification, collected from Indonesia's Statistics Agency. This analysis uses an average of the data of three years, from 2010 to 2012. The use of this average reduces yearly fluctuation of the import data, which is quite important for highly disaggregated data.

The second type of data needed concerns the applied tariff rates for each product or tariff line. In the case of Indonesian imports, the tariff line is defined as 10-digit level tariff following HS classification, similar with the EU's use of a 10-digit tariff line based on HS. However, as explained above, EU's imports from Indonesia are subject to GSP in addition to MFN rates, while Indonesia only applies MFN rates to its imports from EU countries.

The third piece of data is price elasticity of imported goods, and more specifically, the import demand price elasticity and import substitution elasticity. Import demand elasticity tells us the per centage change in the import volume of a product given a one per centage change in the price that consumers of the product face. Import substitution elasticity tells us the change in the relative import volumes of a certain product from countries A and B given a 1 per centage change in the relative domestic prices of these imported products from countries A and B. The information on elasticity is available from the work of Kee, Hiau Looi, Alessandro Nicita, and Marcelo Olarreaga (2008).

In addition to all of this, we need to define the scenario of tariff reduction. Four possible scenarios are defined for EU's imports from Indonesia.

- i. The tariffs for all products are immediately reduced to zero,
- ii. Tariffs are eliminated sequentially over six years for non-agricultural products, and ten years for agricultural products,
- iii. All Indonesian imports to the EU are removed from the GSP program,
- iv. The EU established preferential trade agreements with other countries, and Indonesian exports to the EU suffer the effects of trade diversion.

The Potential Impact on European Union Imports from Indonesia

The study will examine the potential impact of the CEPA on EU imports from Indonesia (which can also be conceptualized as the impact on Indonesia's exports to the EU). The scenario used to simulate the potential impact, as previously explained, is relatively straightforward. However, the relatively complex tariff structure of the EU requires the analysis to include special tariff rates, for example GSP and other preferential facilities. A partial equilibrium analysis in this study is able to capture the effect of different rates for each tariff line.

Scenario 1: Immediately Reducing All Tariffs to Zero

The first scenario looks at the effect of immediate tariff elimination, in which both MFN and GSP tariff rates for all imported products from Indonesia are reduced to zero. The tariff cuts faced by Indonesian exporters depend on the current size of exports under MFN and GSP, and on the applied tariff rate. Products that are already receiving significant GSP facility tend to be affected less than those products with little or no preferential treatment. Table 9 summarizes the trade impact of tariff elimination, using the HS section categories.

TABLE 9.

SCENARIO 1: IMMEDIATE TARIFF ELIMINATION ON IMPORTS FROM INDONESIA

PRODUCTS	IMPORTS FROM INDONESIA (MILLION EURO)	CHANGE (% OF IMPORTS)	TRADE CREATION (% OF CHANGE)	TOP 10 (% OF CHANGE)
ANIMAL PRODUCTS	184.05	10.90	53.55	53.52
VEGETABLE PRODUCTS	453.53	0.16	56.19	-
FATS AND OILS	2,316.86	6.05	63.16	63.48
PREPARED FOODSTUFFS	621.90	10.19	43.12	43.70
MINERAL PRODUCTS	1,294.13	0.12	51.08	99.99
CHEMICAL PRODUCTS	1,449.76	1.76	53.08	40.68
PLASTIC AND RUBBER	1,566.34	0.38	39.94	19.70
LEATHER	87.44	13.81	90.32	77.35
WOOD PRODUCTS	499.48	0.87	55.31	59.32
PULP OF WOODS	205.67	-	-	-
TEXTILES AND TEXTILE ARTICLES	1,611.73	19.16	47.57	29.12
FOOTWEAR	1,102.58	9.61	49.58	45.01
ARTICLES OF STONE	100.62	9.05	48.01	69.47
PEARLS AND PRECIOUS STONE	47.02	0.00	59.26	100.00
ARTICLES OF BASE METAL	600.73	0.20	54.80	-
MACHINERY AND ELECTRICAL	1,838.44	4.32	52.09	94.14
TRANSPORT	146.81	15.80	69.31	98.67
PRECISION EQUIPMENTS	279.70	0.12	41.48	-
ARMS AND AMMUNITION	-	-	-	-
MISCELLANEOUS MANUFACTURED	678.77	0.16	48.05	62.51
WORKS OF ART, ANTIQUITIES...	3.00	-	-	-
TOTAL	15,088.58	802.77	52.26	49.17

Source: Authors' calculation

The first column of Table 9 presents the three-year average value of imports from Indonesia between 2010 and 2012; the second column presents the per centage change of the import value; the third column provides information on how much of these changes come from trade creation; the last column shows the size of increases in imports that originate from the top 10 Indonesian export products in each category.

This analysis shows that the elimination of tariffs for all goods causes the value of imports from Indonesia to increase by as much as €800 million (US\$ 1.083 billion), which is equivalent to around 5 per cent of the value of the EU's more recent imports from Indonesia.¹⁰ Textile and textile articles are among the products with the highest gains, equivalent to €300 million, or 19 per cent of the current import value. However, only less than a half of this increase is due to the trade creation effect. This means that the elimination of tariffs for textile products creates a value of less than €150 million in new trade, while the rest of the gains come from the diversion of imports currently being supplied by other countries. The impact of this trade diversion is also dependent on whether or not competing countries would also receive lower tariff rates in the future; if Indonesia's competitors, e.g. ASEAN countries, also obtain duty-free import facility, the estimated impact of trade diversion is likely to be much lower.

There are several other products that experience a significant increase in trade volume after tariffs are eliminated, namely footwear, animal and vegetable oils, machinery and electrical equipment, and foodstuffs. In these sectors the largest increase in value comes from the creation of new imports from Indonesia, rather than from substitution away from other supplying countries.

One of the advantages of partial equilibrium analysis is the ability to conduct simulation at highly disaggregated level, and in this case, at 10-digit tariff line level. In Table 9, the impact of tariff elimination on the exports of Indonesia's current top ten products to the EU for each category is shown. In some cases the increase in imports is concentrated in the top 10 products, as is the case for machinery and electrical equipment, mineral products, as well as transportation equipment. However, with the exception of machinery and electrical equipment, the gains from tariff elimination are not large. Meanwhile, product groups with higher gains tend to be less concentrated. Less than 30 per cent of the gains in textile articles come from the top 10 products, while less than a half of import increase in footwear category takes place in the top products. In general, Indonesia's major exported products contribute quite significantly to the potential increase of exports to the EU.

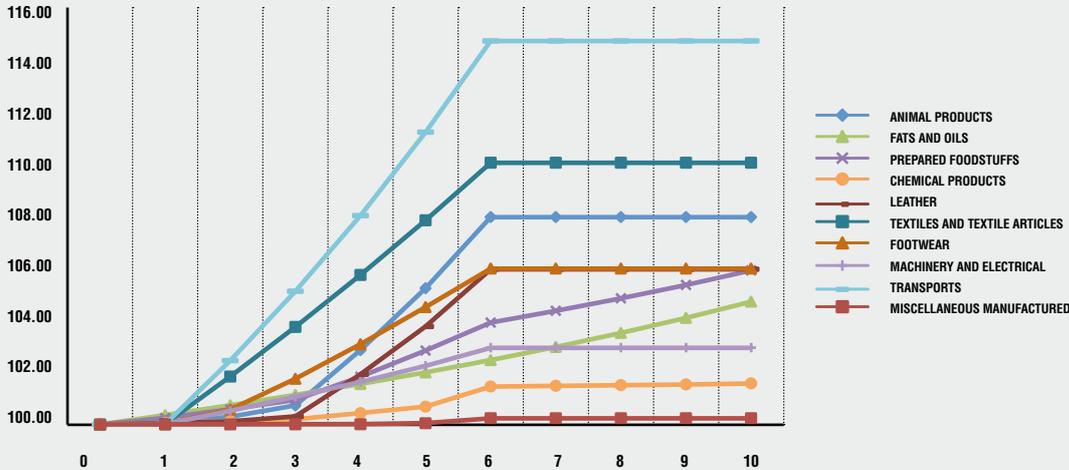
Scenario 2: Sequential Tariff Elimination

The second scenario takes into account the fact that in many trade agreements, tariffs are not eliminated immediately after the agreements are enacted. Moreover, the tariff elimination schedule for agricultural products differs from that of industrial products. To examine the time dimension of tariff reduction in the proposed CEPA, a simulation of tariff reduction was conducted following a scenario in which tariffs are sequentially reduced every year by the same amount over ten years for agricultural products and six years for non-agriculture ones. Agriculture and non-agriculture goods were selected based on the WTO classification of these associated categories.

¹⁰ Conversions between the Euro and US Dollar assume an exchange rate of 1.35.

Figure 11 presents the estimation of changes in EU's imports from Indonesia over the schedule of tariff elimination. It is likely that over this period of six to ten years, the EU will conclude other trade agreements that may erode the benefits of preferential tariff obtained for Indonesian products. Thus, this estimation focuses solely on the trade creation effect of tariff elimination, and assumes that other trade agreements would eventually eliminate the trade diversion effect of preferential tariff elimination.

FIGURE 11.
SCENARIO 2: IMPACT OF TARIFF ELIMINATION ON SELECTED PRODUCTS



Source: Authors' calculation

In terms of percentage changes, non-agriculture products are estimated to gain more than agriculture products from the reduction in tariffs. Exports of most non-agricultural products, such as transportation equipment, textiles, and footwear, would increase significantly during the second year of tariff elimination. Other products would experience significant changes during the third or fourth year, while imports of agricultural products, such as vegetable oils, would see gains increase steadily over ten years.

A Note on NAV Tariffs

One feature of the EU's tariff schedule is the high frequency of NAV or specific tariffs, which make up around 12 per cent of the 14,000 EU tariff lines. This type of tariff is more restrictive for cheaper products, since the rate is calculated based on various characteristics other than price such as size, weight, or number of units.¹¹ It is more difficult to estimate the impact of the elimination of these tariffs, since it requires the use of estimation on the effect of an NAV on price of goods, otherwise known as an ad-valorem equivalent (AVE). Several methods are available to estimate AVE, although each of them holds some drawbacks.

This study therefore estimated the impact of NAV tariff elimination using the AVE calculated by

¹¹ One example is imports of "Lactose in solid form and lactose syrup..." (1702190000), which is subject to a €14 tariff for each 100 kg imported from Indonesia. In 2012, the average value of the EU's import of this product from Indonesia was €277/100 kg, creating an effective ad-valorem tariff for Indonesia's imports of around 5 per cent, although the same product from Japan, whose average value of imports equalled €2392/100 kg, was only subjected to a 0.5 per cent.

UNCTAD, and made available through the TRAINS database WITS platform.¹² The latest available calculation of AVE of the EU is for the 2009 tariff schedule. Hence this data was used to estimate the impact of NAV tariff elimination on goods imported from Indonesia.

TABLE 10.
IMPACT OF NAV ELIMINATION ON IMPORTS FROM INDONESIA

PRODUCTS	IMPORTS SUBJECT TO NAV (THOUSAND EURO)	AVERAGE AD-VALOREM EQUIVALENT (%)	CHANGE (% OF IMPORTS)	TRADE CREATION (% OF CHANGE)	TOP 3 (% OF CHANGE)
ANIMAL PRODUCTS	5.20	50.21	194.31	82.61	90.23
VEGETABLE PRODUCTS	106.44	28.71	165.46	67.31	92.27
FATS AND OILS	0.25	86.95	414.23	85.69	100.00
PREPARED FOODSTUFFS	108,910.72	33.63	8.15	50.21	85.81
MINERAL PRODUCTS	9.00	6.32	13.52	25.99	100.00
CHEMICAL PRODUCTS	202.63	21.08	52.11	48.14	99.99
TEXTILES AND TEXTILE ARTICLES	26.82	6.70	5.71	100.00	100.00
TOTAL	109,261.06		9,167.38	50.56	86.11

Source: Authors calculation

Table 10 presents the result of our estimation on the impact of the elimination of NAV tariffs on several products imported from Indonesia. Since only a small fraction of Indonesia's imports are subject to NAV tariff rates, the largest group of imports from Indonesia that faced these tariffs were prepared foodstuffs, wherein around one-sixth of imports in this category was subject to NAVs. The average AVE for prepared foodstuffs is quite high, at around 33 per cent, with some foodstuffs products estimated to receive tariff rates higher than 50 per cent. Tariff elimination was estimated to increase imports from Indonesia by around 8 per cent.

In general, the estimation result does not conclude that the elimination of NAV tariffs would bring significant changes to European imports of Indonesian products. However, it is important to note that our estimation only takes into account the products currently traded between the EU and Indonesia. More than 92 per cent of the EU's NAV tariff lines recorded zero imports from Indonesia in the last three years. It is possible that the NAV tariffs are so high that imports from Indonesia are not competitive. Since the method used in this simulation is an extrapolation based on the current value of imports, it is possible that this study underestimates the potential impact of tariff elimination for products subject to NAV tariffs.

Scenario 3: All GSP Tariffs are removed

The third scenario looks at the effects of Indonesia's graduation from the GSP Program due to its categorization as an upper-middle income country. This is quite likely to happen relatively soon

¹² UNCTAD methodology of calculating AVE is based on the calculation of unit value as a proxy of price of imported goods. The unit value can come from specific import partners or from an average of all import partners. Once a unit value is estimated, it is then used to calculate the specific or NAV tariff.

given that the Indonesian economy is developing relatively well and may reach a higher level of economic development in the near future. When products from Indonesia are no longer eligible to receive GSP tariff, or graduated from GSP program, they will face higher MFN tariff rates.

TABLE 11.
GSP GRADUATION AND ITS IMPACT TO IMPORTS FROM INDONESIA

PRODUCTS	IMPORTS FROM INDONESIA (MILLION EURO)	GSP (% OF IMPORTS)	CHANGE IN IMPORTS (%)
ANIMAL PRODUCTS	184.05	91.62	-21.83
VEGETABLE PRODUCTS	453.53	2.29	-0.41
FATS AND OILS	2,316.86	0.00	0.00
PREPARED FOODSTUFFS	621.90	57.72	-17.33
MINERAL PRODUCTS	1,294.13	2.74	-0.12
CHEMICAL PRODUCTS	1,449.76	89.21	-45.02
PLASTIC AND RUBBER	1,566.34	27.78	-2.30
LEATHER	87.44	89.73	-17.55
WOOD PRODUCTS	499.48	26.70	-22.25
PULP OF WOODS	205.67	0.00	0.00
TEXTILES AND TEXTILE ARTICLES	1,611.73	98.02	-8.30
FOOTWEAR	1,102.58	98.80	-4.07
ARTICLES OF STONE	100.62	74.22	-16.22
PEARLS AND PRECIOUS STONE	47.02	80.89	-80.53
ARTICLES OF BASE METAL	600.73	12.95	-2.33
MACHINERY AND ELECTRICAL	1,838.44	59.72	-22.02
TRANSPORT EQUIPMENTS	146.81	91.21	-9.98
PRECISION EQUIPMENTS	279.70	83.18	-6.66
ARMS AND AMMUNITION	0.01	0.00	0.00
MISCELLANEOUS MANUFACTURES	678.77	32.31	-21.56
WORKS OF ART, ANTIQUITIES...	3.00	0.00	0.00
TOTAL	15,088.60	46.77	-11.91

Source: Authors' calculation

Table 11 looks at the estimated impact that Indonesia's graduation from the GSP Program will have on European imports from Indonesia. This impact is dependent on two factors: (1) the degree to which imports from Indonesia are dependent on the preferential tariff rates received under the GSP program, and (2) the difference between MFN and GSP tariff rates. Since GSP facilities are crucial for ensuring that Indonesian products have access to the European market, the impact of this graduation is likely to be significant. On average, European imports of Indonesian products would drop by about 12 per cent once tariffs were increased to the MFN tariff rate.

The products facing the greatest impact due to this change will be chemical products as well as machinery and electrical equipment, since a significant portion of these products still relies on GSP facilities. Other manufactured products, such as textiles and footwear, would also experience considerable reductions in trade, although these would not be as significant as those faced by the other two products.

Scenario 4: The EU Negotiates Trade Agreements with Other Countries

The fourth scenario looks at the negative impact on Indonesian exporters to the EU if the EU negotiates trade agreements with other countries, and thus grants them more competitive tariffs. Preferential tariffs often shift imports away from countries without the preferential tariffs to partners that receive the lower rate. Currently, the EU is in the process of negotiating trade agreements with several ASEAN countries and it is likely that when these agreements come into effect, imports from Indonesia will fall due to a diversion of trade towards other ASEAN countries. Table 12 presents an estimation of the trade agreements currently being negotiated between the EU and some ASEAN countries such as Malaysia, Thailand, and Vietnam.

These agreements are likely to have a significant impact on Indonesian exporters. On average, the total imports from Indonesia would decrease by around 8 per cent, with machinery and electrical equipment facing the largest loss in market share due to the fact that other ASEAN countries are also important suppliers of these products to the EU. Textiles, footwear, and prepared foodstuffs will also be among the categories that lose a significant amount of their market share as a result of those other trade agreements. Although the performance of Indonesian export products in the foodstuffs sector in the EU's market has never been substantial, agreements between the EU and other ASEAN countries could force this sector to lose almost 90 per cent of its current import level.

TABLE 12.

IMPACT OF ASEAN COUNTRIES AGREEMENTS TO IMPORTS FROM INDONESIA

PRODUCTS	IMPORTS FROM INDONESIA (MILLION EURO)	REDUCTION IN IMPORTS (% OF IMPORTS)	REDUCTION IN TOP 10 INDONESIA'S EXPORTS (% OF CHANGE)
ANIMAL PRODUCTS	184.05	1.71	27.78
VEGETABLE PRODUCTS	453.53	0.06	-
FATS AND OILS	2,316.86	4.39	86.17
PREPARED FOODSTUFFS	621.90	83.17	5.52
MINERAL PRODUCTS	1,294.13	0.00	8.23
CHEMICAL PRODUCTS	1,449.76	0.47	11.72
PLASTIC AND RUBBER	1,566.34	2.28	1.58
LEATHER	87.44	0.21	65.06
WOOD PRODUCTS	499.48	0.25	84.06
PULP OF WOODS	205.67	-	-
TEXTILES AND TEXTILE ARTICLES	1,611.73	1.61	26.64
FOOTWEAR	1,102.58	2.84	23.66
ARTICLES OF STONE	100.62	0.60	64.12
PEARLS AND PRECIOUS STONE	47.02	-	-
ARTICLES OF BASE METAL	600.73	0.31	-
MACHINERY AND ELECTRICAL	1,838.44	22.81	10.83
TRANSPORTS	146.81	5.41	29.88
PRECISION EQUIPMENTS	279.70	3.85	-
ARMS AND AMMUNITION	-	0.01	100.00
MISCELLANEOUS MANUFACTURED	678.77	0.22	14.41
WORKS OF ART, ANTIQUITIES...	3.00	-	-
TOTAL	15,088.58	1,165.84	533.39

Source: Authors' calculation

The Potential Impact on Indonesian Imports from the EU

After examining the impact of tariff elimination on European imports from Indonesia, this study also conducted a simulation to examine the impact on Indonesia's imports from the EU.

Table 13 illustrates the impact of immediate tariff elimination on Indonesia's imports from the EU, it shows that on average, the EU's exports to Indonesia might increase by around 14 per cent as a result of such tariff elimination. The largest gains come from the transportation equipment sector, which could increase its exports by US\$540 million, which is equivalent to 38 per cent of the current level of its exports to Indonesia. Machinery and electrical products, which dominate the EU's exports to Indonesia, would also receive a significant boost of more than US\$400 million. It can also be seen that the elimination of tariffs on the top ten products will lead to a substantial gain. Most of these gains would come from the trade creation effect, implying that the gains in consumer welfare would be more substantial than just the trade diversion effect.

TABLE 13.
IMPACT OF IMMEDIATE TARIFF ELIMINATION ON INDONESIA'S IMPORTS FROM THE EU

	PRODUCTS	IMPORTS FROM EU (MILLION US\$)	CHANGE (% OF IMPORTS)	TRADE CREATION (% OF CHANGE)	TOP 10 (% OF CHANGE)
1	ANIMAL PRODUCTS	266.43	8.98	51.59	85.09
2	VEGETABLE PRODUCTS	107.15	14.34	67.35	35.96
3	FATS AND OILS	16.21	29.98	90.80	81.44
4	PREPARED FOODSTUFFS	224.82	19.94	47.25	10.62
5	MINERAL PRODUCTS	148.78	5.00	51.99	40.98
6	CHEMICAL PRODUCTS	1,642.80	9.06	48.00	22.98
7	PLASTIC AND RUBBER	497.14	14.14	40.70	19.54
8	LEATHER	77.20	25.27	87.26	89.87
9	WOOD PRODUCTS	29.03	5.12	73.35	18.17
10	PULP OF WOODS	684.05	6.65	-	-
11	TEXTILES AND TEXTILE ARTICLES	211.25	58.49	87.49	61.35
12	FOOTWEAR	12.54	41.75	76.15	81.02
13	ARTICLES OF STONE	65.85	21.16	69.71	25.49
14	PEARLS AND PRECIOUS STONE	15.62	6.79	65.41	95.85
15	ARTICLES OF BASE METAL	843.25	11.44	47.28	16.44
16	MACHINERY AND ELECTRICAL	4,575.18	8.96	52.02	10.02
17	TRANSPORT	1,412.29	38.05	79.73	20.53
18	PRECISION EQUIPMENTS	260.36	8.54	41.84	33.68
19	ARMS AND AMMUNITION	-	-	-	-
20	MISCELLANEOUS MANUFACTURED	47.25	24.74	58.85	16.58
21	WORKS OF ART, ANTIQUITIES...	0.29	7.22	-	-
	TOTAL	11,137.50	1,603.47	62.13	22.74

Source: Authors' calculation

3.3. A Brief Discussion on Non-tariff Measures (NTMs) and Technical Regulations

Previously, this study focused on modelling the impact of tariff elimination on trade between Indonesia and the EU. Tariff elimination is a substantial part of the economic partnership agreement on trade in goods, although the agreement needs to also pay attention to other trade-related measures and technical regulations such as standards, technical barriers, and sanitary-phytosanitary measures. These NTMs are important instruments that national regulators, manufacturers and consumers can use to ensure product quality and to provide protection against threats to human and animal health and safety or to the environment. However, these regulations also influence the intensity of trade between economies.

Unfortunately, estimating the benefits of reducing the NTMs is much more difficult than estimating the benefits of tariff reduction. This is partly due to the lack of available valid information on NTMs, and partially due to the difficulty of estimating the impact of various measures as opposed to estimating the impact of tariff agreements. Since these measures are numerous, estimating their impact depends on such factors as the type of product, type of measure, and level of regulation.

However, the most challenging part is to quantify liberalization measures of NTMs and other technical regulations in a trade agreement. Unlike tariff reduction, which has a fairly straightforward direction, agreements on technical regulations can range from the total elimination or amending of procedures, to the simple facilitation of transparency. These aspects of trade agreements need to be quantified in order to model their impact, which puts this type of analysis beyond the scope of this study.

In general, the impact of non-tariff measures and regulations on trade comes from three sources. First is the availability of information about regulations, and the ease with which they can be understood. Exporters from both trading countries often find it difficult to find most recent regulations concerning their export products – an outcome that becomes even more problematic in cases where regulations change very frequently. Furthermore, since regulations are often written using pedantic language and include several legal clauses, it takes more effort for exporters to translate these regulations into relevant information. Mistakes caused from the misunderstanding of foreign legislation often leads to additional operational costs or in the worst case scenario to the rejection of exported goods trying to enter the market.

The second way in which NTMs impact trade is by creating the cost of compliance to relevant technical regulations. Firms react to domestic and foreign technical regulations in various manners. When exporters decide to comply with these requirements, they typically employ additional resources to make an improvement in product quality that requires additional investment and labour for production. This, in turn, requires additional operating and overhead costs, which contribute to the increase in product prices. The obligation to meet these requirements may discourage producers from exporting their products, since they may choose not to take on the additional costs of these technical regulations.

The third source of an impact on trade is the cost of testing goods before they are shipped abroad in order to conform to foreign technical regulations. Conformity assessment measures, including activities such as certification, testing, and inspection are an important way of ensuring that exported goods follow the prescribed regulations. However, with the increasing importance

of international trade, differences in conformity assessment requirements across global markets can serve as technical barriers to trade (TBTs), since they require producers to complete different tests depending on the market they wish to enter.

The greater the variation of technical regulations between different markets, the greater the cost of operation and trade will be. In fact, many initiatives on NTMs and technical regulations in trade agreements attempt to simplify procedures and to harmonize the regulations through measures such as mutual recognition agreements among trading partners, the unilateral adoption and recognition of another country's regulations and conformity assessment results, and increased acceptance of a supplier's declaration of conformity. Harmonization of internationally accepted standards would simplify the procedures and regulations, as well as reduce the cost of compliance and conformity tests.

Indonesia has recently enacted regulations concerning Indonesia's National Standard (SNI) stating that it would be mandatory to apply the SNI on 66 upgraded products, such as electronic products, furniture, metals, basic chemicals, and downstream products. The SNI includes technical regulations, as well as certification and lab testing that needs to be applied to imported and local products. While the objective of the SNI is to protect consumers and increase the quality of Indonesian products, there is also interest to use the SNI as a defence against imported products.¹³

This national standard system has increased the cost of compliance to new regulations, as well as the cost of obtaining evidence of conformity through testing and certification for both domestic producers and importers. However, this increase in expenditure is even more substantial for Indonesian producers, since producers of exported goods need to comply to the national standards in addition to international standards, even though both are often quite different.¹⁴ In cases where SNI requirements are in line with other standards, the costs of conformity assessments remains, since the national standard system requires additional tests to be performed. This increases the price of exported products and reduces the competitiveness of Indonesian products in international markets.

In order to increase the competitiveness of its exported products, it is important for Indonesia to ensure that its national technical regulations are in line with internationally accepted standards. Policymakers should avoid creating national standards that are too different from international standards, especially if they are only doing so in order to erect barriers on imported goods. A CEPA between Indonesia and the EU provides an opportunity for both economies to cooperate over technical regulations and other non-tariff measures. A Mutual Recognition Agreement (MRA) may not be the most suitable option given the current situation. However, the CEPA can start with other arrangements, such as third-party or first-party conformity assessments. More specifically, Indonesia could follow the EU standards and regulations that are normally accepted in many other market destinations.

¹³ Some comments from Indonesian business on the benefits of SNI demonstrate this tendency. See for example BSN (2014).

¹⁴ During an interview automotive producers commented on the national standards that frequently are less demanding than the international one, but which nevertheless need to be fulfilled. Several food producers of products such as palm oil also commented on how specifications under SNI are often different from internationally-accepted standards.

3.4. Lesson Learned from the Modelling Exercises

Three conclusions can be made based on the simulations and modelling exercises discussed in this chapter. First, both economies would gain from a more open trade regime and tariff elimination would benefit producers from both economies. This tariff elimination would increase all exports, although the gain would largely go to the manufacturing sector, and to the pre-existing top export producers. This indicates that tariff elimination in the CEPA should include substantial coverage, as the Vision Group maintained in their recommendation of 95 per cent coverage. However, since gains from a more open trade regime can be achieved with a less ambitious agenda too, both economies should be more open to discussion about the scope of coverage and should make sure that important products are included in the agreement.

Second, tariff elimination is more important to Indonesia than it is to the EU. Our simulation predicts that most of the gains would accrue on the European side of the trade agreement, since Indonesia's import from the EU would increase by 14 per cent (US\$ 1.6 billion), while the EU's import from Indonesia would rise by 5 per cent (US\$ 1.1 billion). However, Indonesia's current market access to the EU relies heavily upon GSP facilities, which will be withdrawn once the Indonesian economy progresses to upper-middle income status. Withdrawal of GSP tariffs would likely reduce Indonesia's exports by 12 per cent (US\$ 2.4 billion), since normal MFN tariff rates would be implemented in place of the lower GSP rates. Indonesia needs to find other options to maintain preferential access to the EU market after its graduation from the GSP program. In addition to the gains from increasing trade that Indonesia would receive under a CEPA, the agreement would allow the country to forgo the potential 12 per cent losses to exports that would come from the withdrawal of GSP status. Since the EU is in the process of negotiating trade agreements with other ASEAN countries – whose enactment could, according to our simulation, cause an 8 per cent drop in Indonesian exports to the EU – Indonesia should use the CEPA to compete with these countries that produce similar export products for the EU market.

Third, if tariff elimination is not done immediately, the gains from more open trade takes place in later period, when the reduction in tariffs is more substantial. This implies that a shorter tariff reduction schedule allows for more significant gains than a longer schedule would.

While the previous analysis was limited to a simulation of tariff reduction, this study recognizes the importance of non-tariff measures and technical regulations. Greater harmonization on technical regulations would facilitate trade between the two economies. The two partners should aim at cooperating on this issue, instead of abusing regulations to erect non-tariff barriers on imports.

The CEPA should thus be used to help promote this cooperation by focusing on several specific principles. First, a CEPA could promote transparency. Information on NTMs needs to be easily accessible and contain all necessary materials, be it in any related regulation or other practical information. Second, a CEPA should promote the principle of non-discrimination. All measures should be implemented across all products, regardless of their origins. More specifically, this means that domestic products cannot be exempted from necessary requirements, since this could put domestic consumers in jeopardy. Third, a CEPA should promote the principle of scientific-based evidence. Non-tariff measures and trade-related regulations need to be based on scientific evidence in order to avoid imposing unnecessary burdens on producers. WTO agreements have set guidelines concerning various NTMs, and the CEPA could emphasize the

importance of these principles by using them to develop a well-defined consultation mechanism for both parties

Additionally, the CEPA could be used as a framework within which the EU could provide technical assistance to Indonesia in order to promote a better understanding of the implementation of NTMs. Since Indonesian exporters often lack sufficient and reliable testing facilities required to meet international regulations, technical assistance provided through the CEPA could assist the development and improvement of those facilities needed to meet the EU and international applied standards. Specific and direct technical assistance towards the improvement of Indonesian product compliance with the EU's requirements is another option of tackling the issue of NTMs.

4. Trade in Services and EU-Indonesia CEPA

One of the important aspects in the EU-Indonesia CEPA is the agreement on trade in services. We look at the importance of services in economic relation of the two economies and discuss how the proposed CEPA can contribute to the development of the services sector in both economies. The analysis in this section is less formal without quantitative simulation on services liberalization due to some limitations on available data and methodology.

4.1. Cross-border Trade in Services

The services sector occupies an increasing share of Indonesia's GDP. Based on World Bank Development Indicators data, trade in services¹⁵ to GDP ratios were around 37.06 per cent and further increased to 38.61 per cent in 2012. More importantly, the growing needs for the Indonesian economy to import services is evident in the trend of rising cross-border trade in services and deficits in cross-border trade in services from 2004 to 2012¹⁶.

On the other hand, the EU is the largest exporter of services in the world and recorded the highest cross-border trade surplus in "other business services", followed by financial services, and transportation services. Nevertheless, while the proportion of external trade in services is slowly expanding, the proportion of internal trade in services is slowly shrinking in the EU. This increase in proportion of external trade in services is driven by the increasing proportion of both

¹⁵ Services, etc. value added as per cent of GDP from World Bank Development Indicator database.

¹⁶ Based on CIC data, total trade in services rose by 61.7 per cent from its value in 2005 to US\$56.5 billion in 2012, while trade deficits in services rose by 13.25 per cent from its value in 2005 to US\$10.3 billion in 2012. By 2013, Indonesia has recorded US\$11.4 billion of deficits in services.

exports to and imports from countries outside the EU, which indicates a growing demand of services within the EU.

The majority of trade in services in both economies has been concentrated on transportation, tourism and “other business services”, in which the EU and Indonesia complement each other. Occupying a large share in Indonesia’s services trade¹⁷, transportation services maintain the largest trade deficit ¹⁸ over the years, mainly due to the deficit in Freight (Table 14). Meanwhile, Indonesia’s travel services sector recorded a surplus throughout the years, and recorded US\$1.55 billion surplus in 2012, which was the highest surplus among all services sectors¹⁹. The EU, on the other hand, has recorded surpluses both in the transportation and business services sector, and continues to record deficits in travel services. Apart from the three key sectors, complementarity in trade is also found in financial services, computer and information services. These are Indonesia’s weakest sectors. Meanwhile, larger proportions of the EU’s total services exports come from these sectors.

TABLE 14.
TRADE IN SERVICES BY SECTOR

SERVICES SECTOR	TOTAL TRADE		NET EXPORT (BILLION USD)		
	% GROWTH 2005-2009	% GROWTH 2009-2012	2005	2009	2012
SERVICES	3.08	56.88	-9.12	-9.74	-10.33
TRANSPORTATION	-12.94	82.15	-4.61	-4.08	-8.68
PASSENGER	18.47	67.24	-0.59	-1.14	-1.15
FREIGHT	-20.44	86.25	-4.33	-3.21	-7.57
OTHERS	-7.29	89.32	0.31	0.26	0.03
TRAVELS	34.65	38.30	0.94	0.28	1.55
COMMUNICATIONS	-0.61	21.85	0.50	0.58	0.37
CONSTRUCTIONS	14.35	8.02	-0.24	-0.21	0.23
INSURANCE SERVICES	278.64	-16.31	-0.32	-1.30	-1.07
FINANCIAL SERVICES	-35.57	15.81	-0.17	-0.23	-0.30
COMPUTER & INFORMATION SERVICES	8.30	21.16	-0.41	-0.52	-0.52
ROYALTIES & LICENSES FEES	28.15	18.49	-0.70	-1.49	-1.74
OTHER BUSINESS SERVICES	-18.59	93.57	-4.14	-3.00	-0.11
PERSONAL, CULTURAL & RECREATIONAL SERVICES (PCRS)	-9.40	143.65	-0.11	-0.05	-0.07
GOVERNMENT SERVICES	40.65	47.45	0.14	0.28	0.01

Source: CEIC Database

The bilateral services trade pattern between Indonesia and the EU closely follows the individual services trade pattern of these two economies. Bilateral trade in services between Indonesia and the EU concentrates on three sectors, namely transportation, travel and other business services. Indonesia recorded its largest trade deficit in 2012 in the “other business services

17 Transportation services sector occupies significant space in Indonesia’s services trade - 16 per cent out of Indonesia’s total exports of services and 37 per cent out of Indonesia’s imports of services in 2013.

18 Trade deficit in transportation services finally amounted to US\$8.9 billion in 2013.

19 By 2013, surplus in travel services sector has increased by 30.5 per cent from 2012 and reached US\$20.3 billion.

sector”, amounting to € 0.9 billion. In addition, one of the largest trade deficit is also found in computer and information services (€ 0.3 billion), followed by transportation services (€ 0.24 billion). On the other hand, travel services sector recorded a surplus of € 0.63 billion with the EU in 2012 - an amount that is three times the sector’s surplus in 2005.

As shown in Table 15, total trade has a strong positive relationship with trade deficit in the case of bilateral services trade between Indonesia and EU. This positive relationship is even more pronounced in the case of bilateral trade between Indonesia and the EU than in the case of Indonesia’s services trade with the whole world.

TABLE 15.
INDONESIA’S TRADE IN SERVICES WITH EU (IN € BILLION)

SERVICES SECTOR	TOTAL TRADE BETWEEN INDONESIA AND EU					NET EXPORT WITH EU			MARKET PENETRATION OF INDONESIA’S PRODUCTS IN EU’S EXTERNAL MARKET OF SERVICES (%)		
	2005	2009	2012	%GROWTH 2005-2009	%GROWTH 2009-2012	2005	2009	2012	2005	2009	2012
TRANSPORTATION	0.76	0.79	1.22	4.01	55.23	0.03	-0.01	-0.24	0.44	0.43	0.42
TRAVEL	0.54	0.73	1.07	35.34	45.11	0.21	0.46	0.62	0.43	0.70	0.89
COMMUNICATIONS SERVICES	0.04	0.08	0.16	95.20	104.05	-0.00	-0.01	-0.08	0.28	0.28	0.24
CONSTRUCTION SERVICES	0.10	0.14	0.19	38.08	29.46	-0.05	-0.08	-0.02	0.43	0.30	1.04
INSURANCE SERVICES	0.05	0.12	0.16	132.51	35.99	-0.03	-0.08	-0.10	0.16	0.18	0.29
FINANCIAL SERVICES	0.05	0.13	0.17	138.58	34.82	-0.03	-0.09	-0.14	0.10	0.13	0.09
COMPUTER AND INFORMATION SERVICES	0.15	0.37	0.31	155.43	-17.95	-0.12	-0.32	-0.30	0.16	0.18	0.02
ROYALTIES AND LICENSE FEES	0.08	0.12	0.15	44.77	23.34	-0.08	-0.11	-0.13	0.01	0.01	0.02
OTHER BUSINESS SERVICES	0.48	1.09	1.58	125.97	45.41	-0.08	-0.67	-0.92	0.23	0.17	0.23
PCRS	0.01	0.01	0.02	50.52	90.73	-0.00	-0.01	-0.00	0.03	0.05	0.20
GOVERNMENT SERVICES, N.I.E.	0.07	0.13	0.09	75.51	-29.86	-0.02	-0.04	-0.03	0.44	0.59	0.43
SERVICES	2.34	3.71	5.13	58.92	38.09	-0.15	-0.96	-1.33	0.31	0.32	0.37

Source: Eurostat

Total trade of services between Indonesia and the EU exhibits an increasing trend and recorded 58.92 per cent growth from 2005 to 2009. Nevertheless, there has been a slowdown in trade activity between Indonesia and EU where total trade in services grew by only 38.09 per cent from 2009 to 2012. Sectors with increasing growth are transportation, travel, communication services, as well as personal, cultural and recreational services. Government services, as well as computer and information services recorded a negative growth rate by 2012.

In 2012, Indonesia’s trade in services deficit with the EU reached €1.33 billion, which equals nine times the amount of trade deficit between Indonesia and EU in 2005. It should be noted that sectors with trade deficit in 2005 continued to accumulate increasing trade deficit up until 2012. This trend is seen across all sectors of services except for travel, as there has been increasing surplus.

Despite the growing need for Indonesia to import services, growing demand of services from the EU, and the obvious complementarity between the two economies in the services sector, services trade to and from Indonesia has not been a large part of the EU's total trade with Asia. More than 55 per cent out of EU exports to ASEAN were sent to Singapore. On the other hand, while the trend of services exports from ASEAN to the EU is positive, the largest service supplier in ASEAN region has always been Singapore, followed by Thailand (Figure 15). Indonesia's share in ASEAN supply of services to the EU has stayed in the range of 7.4 to 7.5 per cent over the past years and accounted for 7.5 per cent in 2011²⁰. Meanwhile, Singapore and Thailand had a share of 48.8 per cent and 20.5 per cent respectively.

The penetration rate of Indonesia's services in the EU market is incredibly low in general. Indonesia's export of services accounted for around 0.3 per cent of EU's external import of services in 2005, 2009 and 2012. Nevertheless, services sectors such as travel, construction, business and insurances showed improvement in performance in 2012.

4.2. EU's Commercial Presence in Indonesia

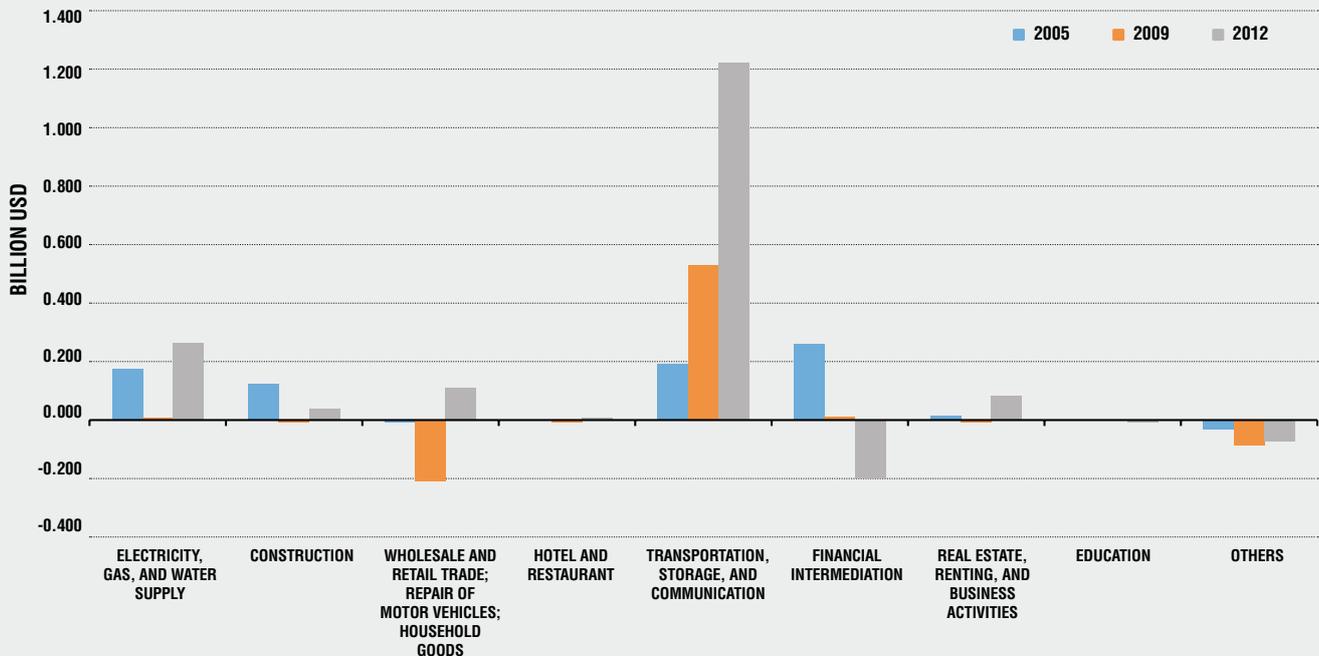
Another approach in measuring exports of services from the EU to Indonesia is to examine the commercial presence of EU companies in Indonesia. Services from the EU in the form of commercial presence (Mode 3 as per GATS agreement) are supplied to Indonesian consumers through the establishment of EU companies' local presence in Indonesia by means of representational office, franchise, registered subsidiary, or branch office.

In order to illustrate the commercial presence of the EU services in Indonesia, the study observed fifty-three member companies of the European Chamber of Commerce in Indonesia that had a significant relationship with EU companies in 2013. There are 16 companies affiliated with Germany, 11 companies affiliated with France and 10 companies affiliated with the UK. Companies that are affiliated with Germany and France provide a wide range of services operations in *transportation, storage and communication*, as well as in *consulting*. Meanwhile, companies affiliated with the UK provide services mostly in the sector of *financial intermediation*. Based on this snapshot, the presence of EU in the Indonesian services industry is largely found in the fields of *transportation, storage and communication* sector.

The above observation is consistent with the observations based on net FDI inflows from EU to Indonesia in 2005, 2009 and 2012 (Figure 12). Based on sectorial net FDI inflows, the EU's commercial presence in Indonesia in transportation, storage and communication sector has been largely expanding from 2005 to 2012. This sector recorded the highest net inflow of FDI in 2005, 2009 and 2012. While all other sectors experienced declining net FDI inflows in 2009, transportation, storage and communications experienced a steady increase of net FDI inflows in 2005, 2009 and 2012.

20 EBOPS 2002, OECD Stat (the latest data is for 2011)

FIGURE 12.
DIRECT INVESTMENT FLOWS TO INDONESIA FROM EU



Source: BI (SEKI)²¹

On the other hand, entry of commercial entities from EU in financial intermediation sector has been stagnant as evident from the significant decline of net FDI inflows from 2005 onwards. By 2012, the financial intermediation sector ceased to be one of the largest contributors of net FDI inflows. Even though EU's presence in this particular sector had been reasonably strong in 2005, there was a negative net inflow of FDI from this sector by 2012, which suggests that there is little or no expansion of the existing entities in this sector.

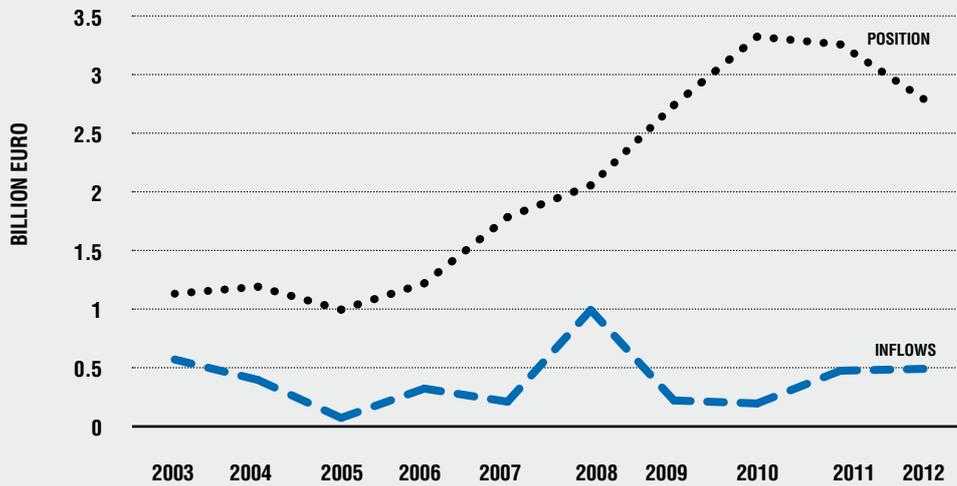
Meanwhile, recovery in net FDI inflows in 2012 is seen in other sectors such as (i) *electricity, gas and water supply*, (ii) *construction*, (iii) *trade and repair*, (iv) *hotel and restaurant*, and (v) *renting, real estate and business activities*. In particular, some sectors recorded significantly higher net inflows in 2012 compared to 2005, namely *renting, real estate and business* (6 times larger), as well as *trade and repair* (67 times larger).

Figure 13 shows historical trends of aggregated net FDI inflows and net FDI position²² in services of several EU countries with a large commercial presence in Indonesia, namely Germany, France, UK, Denmark, Sweden, Italy, Netherlands, Finland and Austria. In general, net FDI positions and net FDI inflows exhibit identical trends until 2008. Nevertheless, as the net stock of the EU's major investors in Indonesia rose, the net inflows of FDI to Indonesia from these major investors deteriorated from 2008 onwards.

21 Statistik Ekonomi Keuangan Indonesia from Bank Indonesia.

22 Net FDI Position of EU with respect to Indonesia = EU's Direct Investment in Indonesia – FDI Stock in EU

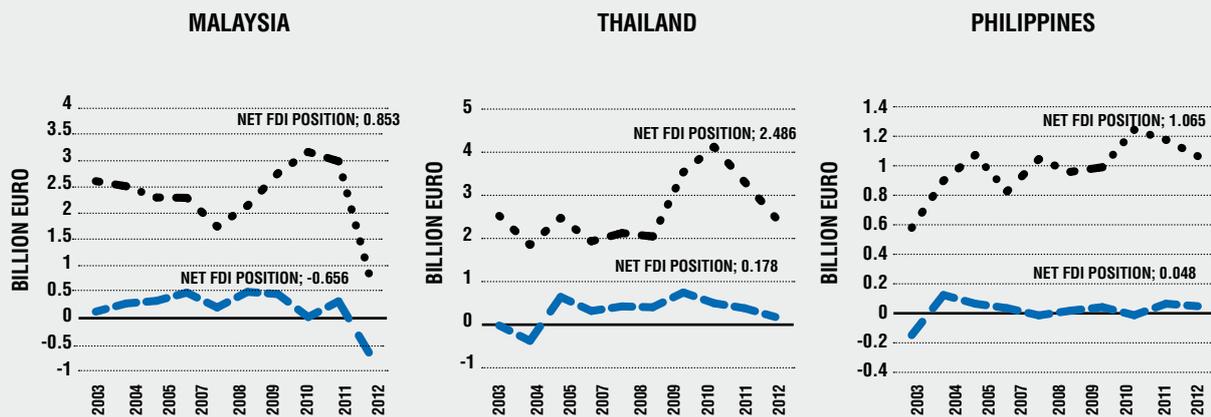
FIGURE 13.
EU'S FOREIGN DIRECT INVESTMENT OF SERVICES IN INDONESIA



Source: Eurostat

Meanwhile, a negative relationship between net FDI stocks and net FDI inflows of EU's major investors in Malaysia, Thailand and Philippines is observed from 2008 to 2010. After 2010, however, the relationship between net FDI stock and net FDI investment inflows was positive (Figure 14).

FIGURE 14.
EU'S FDI OF SERVICES IN MALAYSIA, THAILAND AND PHILIPPINES

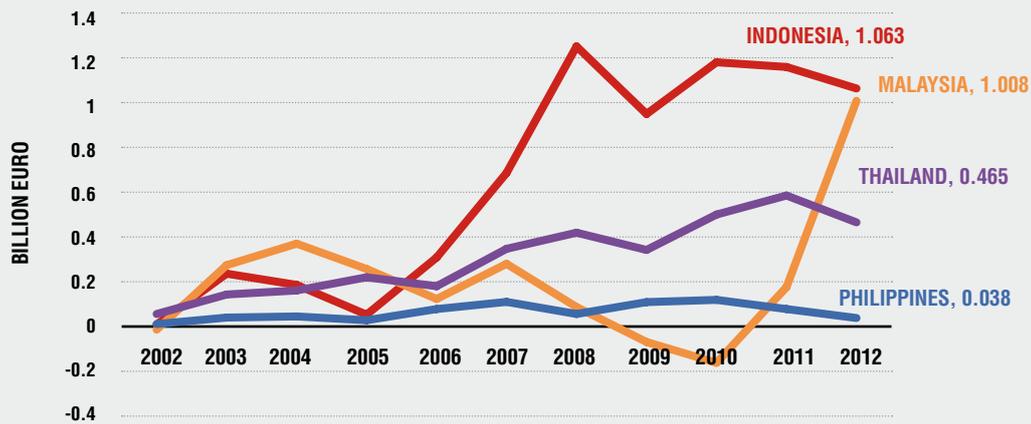


Source: Eurostat

Net investment income from Indonesia has been increasing throughout the years, and stayed far above the levels recorded by Thailand, Malaysia and Philippines (Figure 15). Nevertheless, net investment income in 2012 was slightly smaller than net investment income in 2008. Net investment income from Malaysia increased significantly and nearly caught up to Indonesia by

2012. Meanwhile, net investment income from Thailand has been growing, albeit at a smaller rate compared to Malaysia.

FIGURE 15.
NET INVESTMENT INCOME



Source: Eurostat

There are two explanations for these aforementioned observations. First, the developments in Indonesia might be due to the prolonged interest of EU's existing direct investment in Indonesia. The proportions of earnings of EU's entities in Indonesia that are allocated for reinvestment in these existing entities might be larger than the proportion of earnings that are sent back to EU, which may cause the increase of net FDI stock.

Second, there might be stagnancy of incoming investment in Indonesia after 2008. That is, existing EU entities in Indonesia prefer to reinvest their local earnings for further expansion, rather than relying on overseas investment. In addition, it is possible that new entities pulled their investments from Indonesia. This is plausible as the political situation in Indonesia became less attractive to EU investors. Inefficiency of Indonesia's bureaucracy and political uncertainty in Indonesia during SBY's second term was viewed as impediment to business growth. Nevertheless, Indonesia's large market and rising middle-class still provide above average net investment income, in comparison to other countries.

4.3. Recent Policy Developments in the Indonesian Services Sector

Restrictions on foreign participation in the services sector through trade or through FDI remain to be prevalent despite the broad-based liberalization efforts since 1997. According to the OECD 2014 Services Trade Restrictiveness Index (STRI)²³ database, Indonesia's trade restrictiveness surpassed that of China and India. The index is an aggregate measure over five forms of restrictions: restrictions on foreign ownership and other market entry condition (1), restriction

²³ The index is an aggregate measure over five forms of restrictions: restrictions on foreign ownership and other market entry condition (1), restriction on the movement of people (2), other discriminatory measures and international standards (3), barriers to competition and public ownership (4), and regulatory transparency and administrative (5). STRI values ranged from 0 to 1, where 0 indicates 100 per cent openness and 1 indicates complete barrier of trade in a particular sector.

on the movement of people (2), other discriminatory measures and international standards (3), barriers to competition and public ownership (4), and regulatory transparency and administrative (5). STRI values ranged from 0 to 1, where 0 indicates 100 per cent openness and 1 indicates complete barrier of trade in a particular sector.

The most significant restrictions on trade in services in Indonesia belong to types (1), (2) and (4). Significant restrictions of type (1) are found in fourteen out of eighteen services sectors²⁴. Meanwhile, restrictions of type (2) are found in eight sectors. There are significant restrictions on foreign ownership and other market entry condition on trade in telecommunication, air transport, legal services, and motion pictures.

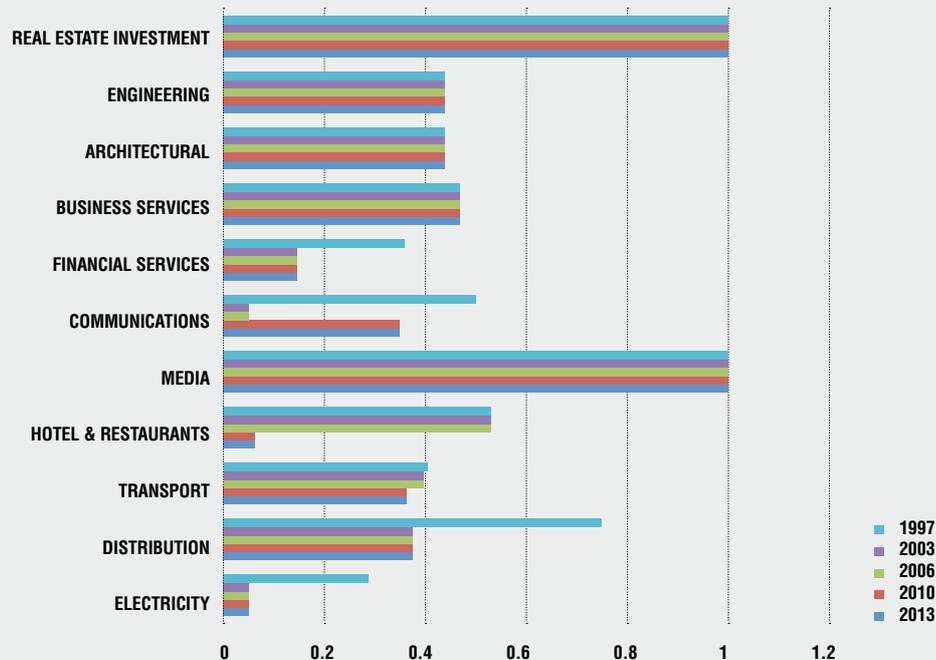
In addition, Indonesia is ranked among the top three countries with the highest level of restrictions on the movement of people in the OECD database in nine services sectors, namely accounting services, architecture services, computer services, construction, engineering services, legal services, maritime transport, motion pictures and sound recording. Based on the STRI, the highest restrictive measures of type (2) are found in legal services, followed by engineering services and architecture services. In terms of the movement of natural persons, EU member countries with large commercial presence in Indonesia's services industry²⁵ are much less restrictive compared to Indonesia in most sectors.

Meanwhile, most restrictions on FDI in the services sector come in the form of equity restriction. A significant increase of the equity restriction index from 2006 is seen in the telecommunications sector (Figure 17). This is due to further tightening of foreign equity limits in telecommunication sectors through the issuance of a negative investment list by the Indonesian government following the issuance of the landmark Telecommunication Act in 1999 that allows for the deregulation of the Indonesian telecommunications sector.

24 Accounting services, air transport services, architecture services, broadcasting, commercial banking, computer services, construction, courier services, distribution services, engineering services, insurance services, legal services, maritime transport, motion pictures, rail freight transport, road freight transport, sound recording and telecommunication.

25 Germany, France, UK, Denmark, Sweden, Italy, Finland, Australia and Netherlands

FIGURE 16.
**FDI REGULATORY RESTRICTIVENESS INDEX (STRI)
 MEASURED BY EQUITY RESTRICTION**



Source: OECD

The negative investment list that was issued through Presidential Decree No. 36/2007 was further revised in 2014 and issued through Presidential Decree No. 39/2014. In the new list, foreign ownership in telecommunication network providers is restricted to 65 per cent, while foreign ownership in telecommunication services is restricted to 49 per cent.

The benefit of further regulatory restriction in the transportation and communication sectors is arguable. As of now, most of Indonesia's exports and imports are carried out via sea (Patunru, Nurridzki and Rivayani, 2007), and shipping is highly regulated under the cabotage system. As a matter of fact, Law No 17 of 2008 dictates that maritime transportation services must be supplied by Indonesian companies (with majority domestic ownership), and in addition should operate with Indonesian-flagged vessels staffed by Indonesian crew. However, trade in transportation services is still dominated by foreign suppliers even though there was a dramatic increase in the share of domestic players in Indonesia's shipping industry for both domestic freight and international freight following the implementation of the cabotage principle in 2011 (Asrofi, 2011).

While the cabotage approach encourages the production of smaller capacity ships for inter-island trade, it has placed Indonesian ships at a comparative disadvantage in competing for maritime services trade. This in turn has increased Indonesia's dependence on foreign carriers for international trade which resulted in a growing gap between imports and exports of transport services.

Referring to the analysis in the previous section, the largest contributor to the trade deficit in transportation sector is *Freight*. The deficit in *Freight* has been more than twice the amount of deficits in non-freight categories combined (*Passenger* and *Other*). However, after the implementation of the cabotage principle in 2011, the deficit in Freight has more than doubled, reaching €7.27 billion on 2012 from the previous of €3.21 billion in 2009. This growing gap between the import and export of transport services is likely to continue as Indonesia's economy continues to grow.

Indonesia's performance in the ICT sector as measured by the World Economic Forum's Networked Readiness Index²⁶ is also still less than satisfactory, as it was ranked far below Singapore (2nd) and Malaysia (30th) at 64th out of 148 countries. Recently, there have also been some concerns with regards to the possible requirement for electronic service providers to establish data centres in Indonesia in compliance with Law 82/2012 on the Operation of Electronic Systems and Transactions. If the regulation is to be approved, it will increase the financial burden on electronic services providers, which will in turn limit technological innovation that is needed for further economic growth.

4.4. Trade in Services and Potential Contribution of EU-Indonesia CEPA

The importance of Trade in Services

Services contribute to Indonesia's economic development in at least three ways. First, it is one of the most important production sectors of an economy. It creates value added and products that are to be exported and consumed domestically. As mentioned previously, the commercial services sector in Indonesia is the largest services sector that contributes almost 40 per cent to the total value added.

Second, the services sector also employs most of the labour force in the Indonesian economy. By 2012, 43 per cent of Indonesia's labour force was employed in the services sector, 35 per cent employed in the agriculture sector and 22 per cent employed in the industrial sector (based on the World Bank Development Indicators database).

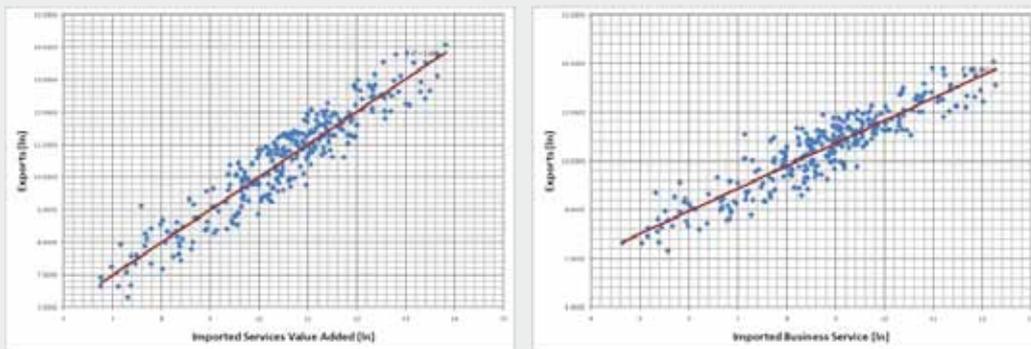
Third, services sector is also important in providing support and input to the economic activities. For example, it is difficult and costly to move raw materials and supporting inputs for production without having high-quality transportation services. Moreover, obstacles in the distribution of products will encourage economic inequality and inhibit poverty reduction efforts.

Experiences from other countries that allow greater penetration of producer services from abroad show that the availability of reliable services surpasses the concerns over the inability of domestic suppliers to compete. In fact, Chinese firms in mid 1990s relied on foreign business services providers (mostly from Hong Kong) to assist them in adopting international standards of business governance, including accounting and financial standards. The "imports" of business services has allowed them to have access to the international financial market, while at the same time enabled them to develop a more reliable domestic services sector.

²⁶ The index evaluates the environment for ICT development, the national stakeholders' readiness, and stakeholders' actual usage of ICT.

The aforementioned fact is further supported by trade statistics. Using trade statistics and trade in services value added statistics from fifty-six countries during five periods of time, we found that there is a strong correlation between import of services and export performance. As shown in Figure 17, countries with a high level of services import tend to have high export performance too²⁷. Similarly, positive correlation can also be observed between export performance and imports of producer services. These are the important inputs for production, namely telecommunication, transportation, and other business services.

FIGURE 17.
STRONG CORRELATION BETWEEN EXPORT PERFORMANCE AND SERVICES IMPORT



Source: OECD Trade in Value Added Database (2013) and UN COMTRADE Database²⁸

In the case of Indonesia, services imports could improve export performance due to two factors. Firstly, importing services will increase competition in the domestic market, which will ultimately improve the performance of the domestic services industry. For example, importing more cutting edge telecommunication services will improve the quality of communication services as well as the quality of the Indonesian labour force which will in turn boost international competitiveness and support long-term development. The utilization of suitable imported communication services could bring improvement in the quality of service provision, reducing the digital divide. In the era of digitalization, good-quality telecommunication is also needed to support better coordination and dissemination of information.

Secondly, the import of services will reduce the cost of inefficiencies. For example, trade in transportation services enables firms to use the most efficient providers available to support their international supply chain activities. For example, shipping liners from other countries can provide cheaper and timely transportation to ensure that production bases in a country operate competitively²⁹.

27 The data shown comes from UN-COMTRADE Trade Database and WTO-OECD Trade in Value Added (TIVA) Database. The period of observation is for the year 1995, 2000, 2005, 2008 and 2009.

28 The data comes from IO Table and trade statistics of 56 countries for five periods. Simple regressions yield strong correlation ($R^2 = 0.88$ and 0.84).

29 In fact, trade in transportation services has increased tremendously due to the nature of global value chain that requires intermediate goods being shipped across border several times in the process of production; during the last 15 years it grew by around 7 per cent each year.

Access to high-quality business services is also essential to boost a country's participation in the global value chain as well as to upgrade its industrial performance and exports. Business services such as accountancy, marketing services and financial services allow companies to produce and operate in more efficient ways. In short, services are important intermediaries in the production process.

Potential Contribution of CEPA to the Indonesian Services Sector

Despite of the importance of trade in services to the economy, Indonesia's trade in services still lag behind other countries in ASEAN region. In 2009, the services-contents of Indonesia's export were only less than 21 per cent. Of this small proportion, only a quarter comes from imports. Meanwhile, services constitute around 30 per cent of Thailand's exports, of which 50 per cent of them are imported.

In order to increase competitiveness, Indonesia needs to increase the services-contents of its exports, particularly high-quality services that may be sourced, at least for the time being, from imports. In this context, the development of Indonesia's services sector should be emphasized to fit its role in improving competitiveness of the economy and supporting more efficient production activities. At the same time, improving the performance and competitiveness of the Indonesian services sector is also of paramount importance to tap the potential of a growing world market.

The CEPA between Indonesia and the EU can serve as a catalyst for such development in at least four respects. First, the CEPA can facilitate sufficient supply of quality services to support economic development. As Indonesia aims at becoming one of the world's top economies, the need for quality services is eminent. Opening up the market to competitive and high-quality suppliers would satisfy the growing demand of services from economic activities. Moreover, the availability of quality services is necessary for Indonesia to increase its participation in the regional and global value chain as discussed in the previous section.

A study from Dugan, Rahardja and Varela (2013) suggests that the relaxation of restrictions on FDIs in the services sector is positively correlated to improvements in manufacturers' productivity. The authors find that the liberalization of FDI in the services sector contributed 8 per cent of the observed increase to manufacturers' total factor productivity during the period of 1997 to 2009.

At cross-country level, openness in a range of intermediate service sectors is also linked to increased export competitiveness for high-technology manufacturing sectors, in which services tend to be an important element of total cost (Fink, Mattoo and Neagu, 2005).

In 2012, EU member countries contributed 42 per cent and 52 per cent to the global value of services exports in transportation and communication services respectively. As more than a half of those exports go to countries outside of the region, the provision of greater market access for services from the EU member states under the proposed CEPA would benefit the EU. Nevertheless, it will also open up the possibility for Indonesian economy and industries to enjoy first class and high quality services. By allowing for more services from the EU member countries, Indonesian industries and consumers would have better options in transportation and communication in addition to the existing supply of services by domestic suppliers or service providers from neighbouring economies.

Second, the CEPA can improve the performance of Indonesia's services sector through increased competition, and through the transfer of know-how. Tougher competition may stimulate firms to upgrade the quality of services provided and to create more innovation. A study on the impact of policy reform in basic telecommunication sector performance found that more competition leads to significant improvements in the performance of the sector. Using a panel data set for 86 developing countries over the period of 1985 to 1999, the study found an 8 per cent increase in fixed line communication connections and a 21 per cent higher level of labour productivity compared to the periods in which there was partial and no reform (Fink, Mattoo and Rathindran, 2003).

Service providers from the EU member states can also become business partners to Indonesian service providers in order to develop the services sector. Since most of "imported" services need to be produced locally, foreign service providers are likely to bring performance-enhancing factors, namely technology and know-how, in addition to capital. This includes necessary methods, strategies and management to produce quality services in a more efficient way. Since services production is relatively more human-capital intensive than goods, those resources are needed to enhance domestic human capital.

Third, the CEPA might open up opportunity for Indonesian suppliers of Mode 4 services to EU member countries, especially for skilled workers. The EU is open for trade negotiation on mode 4 in most of its trade agreements. Indonesia can benefit from an agreement on labour movement by asking for greater entry permission of skilled and semi-skilled workers for temporary work in EU countries, especially when this is organized within training and development programs. The Indonesian economy would gain not only from the potential workers' remittances, but also from the development of human capital which could contribute further to the economy. At the same time, EU countries could benefit from the supply of skilled workers currently needed by their economies.

Lastly, one of the major problems related to the services sector in many developing countries is that the regulatory regime is cumbersome, intransparent and often contradictory. This is quite true in the case of Indonesia, where services sector authorities are organised under various technical ministries, and coordination remains scarce. An agreement in services will force the authorities to review all existing regulations, while at the same time increasing regulatory transparency. Even when there is no substantial liberalization³⁰, services agreements offer a reliable basis for services sector regulatory reform and the development of the sector.

4.5. By Way of Conclusion: Where Should the Services Agreement Go?

Improvement in the services sector is needed for Indonesia's long term economic growth and prosperity. While Indonesia's penetration to the EU services market has been less than stellar, recent developments in EU's trade in services show untapped opportunities for Indonesia. The EU's proportion of external trade shows an increasing trend, especially towards the regions of

30 Most agreements on services, including WTO-GATS, aim to introduce disciplines and rule-making on regulatory framework of services based on certain principles of most favoured nations (MFN) and national treatment (NT). They offer limited market access liberalization. Rather, the agreements only ensure that current market access situation would not be compromised too far by binding countries on the committed level of market access, which are normally below their actual regime (Borchert, Gootiz and Mattoo (2012).

Asia and ASEAN. Nevertheless, Indonesia is not among the largest suppliers of services to the EU in the ASEAN region, despite having the largest population in the productive age group.

Therefore, the pressing matter at the moment is not how to penetrate the EU market, but how to obtain competitive labour skills for the long term development of the Indonesian services sector. If a CEPA between Indonesia and the EU is to be negotiated further, it should aim at producing a suitable trade framework in which skill transfers from the EU are prioritized.

Skill transfers could be done through numerous channels, for example through commercial presence (Mode 3) and the movement of natural persons (Mode 4). At the moment, commercial presence of EU's companies is largely found in the transportation, storage and communication sector. Meanwhile, the EU's commercial presence in the financial intermediary sector has been stagnant in the past few years. Stronger commercial presence of EU companies in Indonesia could improve domestic labour skills as the result of skill transfers, or even increasing competition. Meanwhile, returning overseas workers could bring the much needed skills to the domestic industry, while expatriates working in Indonesia in either PMAs or domestic companies allow for skill transfers. Thus, it is important to pay special attention to trade barriers in Mode 4 of supply of services.

Liberalization in these two modes of supply of services is necessary for Indonesia's services sector to grow. As evident from the transportation sector, the cabotage principle implemented by the Indonesian government increased dependence on foreign liner carriers for international trade which led to a growing gap between imports and exports of Indonesia's transport services. This growing gap of transport services is likely to continue as Indonesia's economy continues to grow. Surely, this could become an impediment in reaching sustainable economic growth.

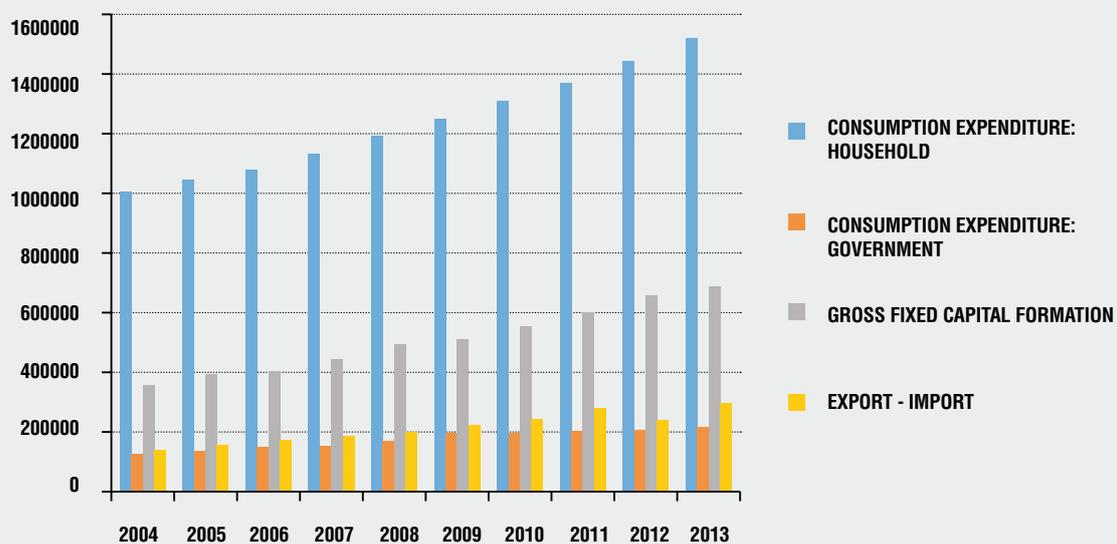
Lastly, domestic reforms are also needed to support the conclusion of an EU-Indonesia CEPA. Based on the previous analysis, Indonesia exhibits untapped potential to attract FDI in services sector. Despite the stagnation of incoming investment in Indonesia after 2008³¹, there is prolonged EU interest in direct investment in Indonesia. Indonesia is attractive for EU investors due to its large market and rising middle-class which provide above average net investment income. Therefore the Indonesian government should push the domestic reform agenda to tap the opportunities arising from a potential CEPA.

31 The stagnancy of incoming investment could be attributed to the political situation in Indonesia that has become less attractive to EU investors - inefficiency of Indonesia's bureaucracy and political uncertainty in Indonesia during President Yudhoyono's second term was viewed as impediment for business growth.

5. Foreign Direct Investment and EU-Indonesia CEPA

Foreign Direct Investment (FDI) is crucial in bolstering the quality of economic growth due to its dual roles as financing instrument and source of technology and knowledge transfer. In fact, FDI has been one of the main drivers of Indonesian economic development since the early 1970s and in supporting industrialization³². For the last decade, investment and household consumption have been the two major sources of economic growth in Indonesia (Figure 18).

FIGURE 18.
CONTRIBUTION TO GDP 2004-2013 (IN BILLION OF RUPIAH)



Source: BKPM

32 See for example Pangestu (1997) for the role of FDI in early stage of Indonesia's economic development.

Nevertheless, one could always find restrictions for foreign direct investment or FDI in one form or another in various sectors of the economy. Details of such restrictions are listed in the country's negative list of investment. It is, therefore, deemed important, that the (EU-Indonesia CEPA should include provisions on investment. The EU-Indonesia Partnership and Cooperation Agreement (PCA), which entered into force on May 1st 2014, states that the aim of a comprehensive partnership *“is developing trade and investment between the Parties to their mutual advantage”* and *“establishing cooperation in all trade and investment-related areas of mutual interest, in order to facilitate trade and investment flows and to prevent and remove obstacles to trade and investment, including where appropriate, ongoing and future regional EC-ASEAN initiatives”*. One would hope that an agreement could restore the EU position as the top source of FDI in Indonesia, a position it used to hold not long ago.

This section discusses issues regarding foreign direct investment in a possible EU-Indonesia CEPA. Indonesia has been one of the main destinations of investment from some EU countries. As noted, the level of EU investment in Indonesia could be increased further. However, for this to happen, Indonesia needs to address a number of issues that have been hindering investment - foreign investment in particular - in the country. Problems such as a non-conducive investment climate, lack of involvement in the global value chains and lack of enforcement of intellectual property rights (IPR) might have limited EU investment in Indonesia. The expectation is that the EU-Indonesia CEPA would be able to help rectify these and other problems that have been hampering FDI in Indonesia.

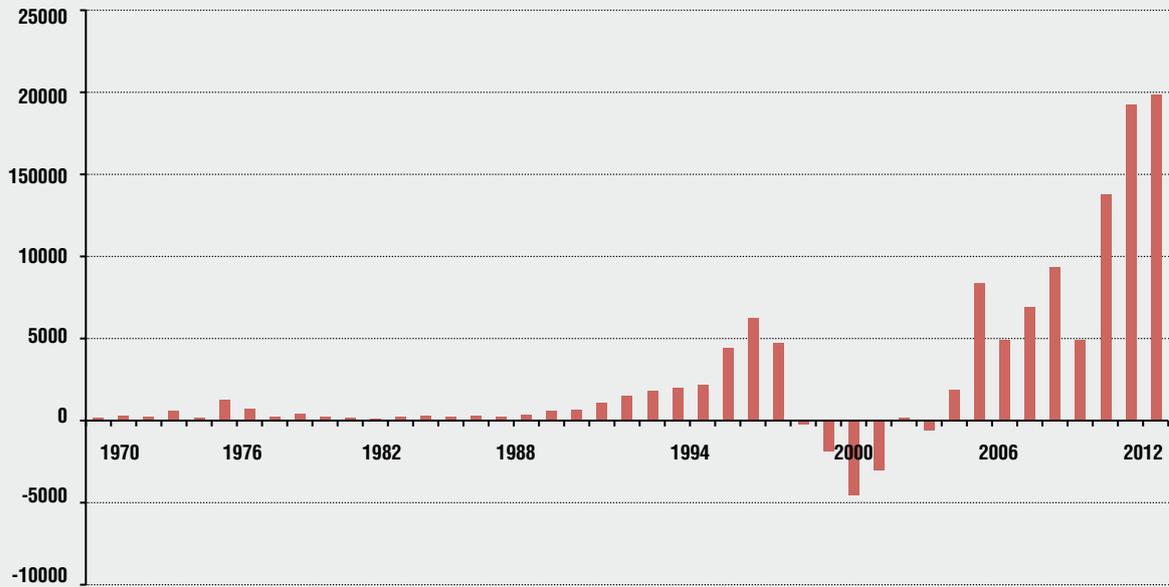
The first part of this Section discusses the trend of FDI inflow to Indonesia with a special emphasis on EU FDI in Indonesia. The review includes the country of origin, targeted sectors and relative importance of Indonesia from the EU perspective. The next part discusses the relationship between trade and investment using the EU-Indonesia case, followed by a discussion on Intellectual Property Rights (IPR) as one of the most important issues of a possible CEPA. Finally, the section also examines issues regarding recent developments in the investment regime and climate in Indonesia.

5.1. FDI flow to Indonesia

In general, Indonesia has experienced positive trends in terms of FDI inflows, which is evident from three facts. Firstly, based on Figure 19, the general upward trend of FDI inflows to Indonesia persisted until 2012, except for the brief periods following the Asian Financial Crisis (AFC)³³. Initially, substantial economic reform and deregulation that was initiated during the mid-1980s brought larger FDI inflows to Indonesia, which boosted steady growth of FDI inflows to Indonesia in the next decade from 1990 to 1999. Even though it took a number of years for Indonesia to regain foreign investors' confidence after the AFC, recovery from the crisis is evident in the healthy growth of FDI inflow from 2004 onwards (Figure 19)³³.

³³ In particular, there has been substantial increase in FDI inflows to Indonesia from 2010 to 2011. By 2012, Indonesia received US\$20 billion of FDI.

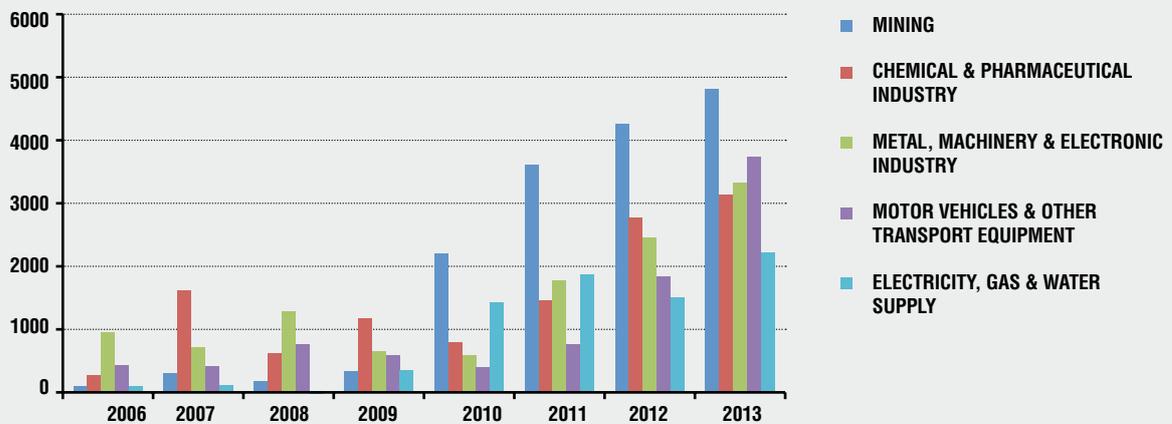
FIGURE 19.
FDI INFLOWS TO INDONESIA 1970-2012 (MILLION US\$)



Source: UNCTAD

As evident from Figure 20, the positive trend of FDI inflows to Indonesia is also seen in all major commodity and services sectors. The majority of FDI in the commodity sectors are found in mining, food crops and plantation sectors, metal, machinery and electronics industries, chemical and pharmaceuticals industries, as well as the food industry. Meanwhile, majority of FDI in the services sectors are found in transport, storage and communication, as well as electricity sectors.

FIGURE 20.
INVESTMENTS IN MAJOR SECTORS 2006-2013 (MILLION US\$)

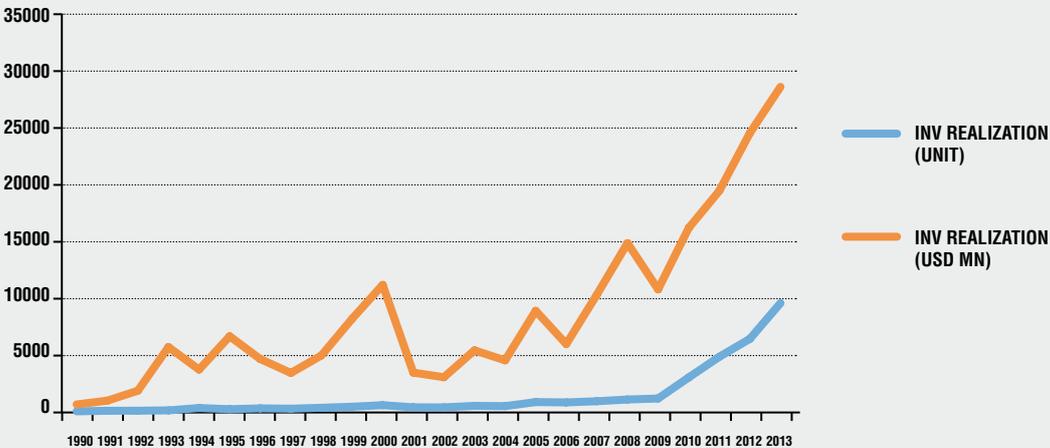


Source: Author's calculation based on BKPM data

Based on Figure 20, firstly, the highest rate of FDI increase is found in the motor vehicles and other transport equipment sector. Nevertheless, FDI inflows in transportation, storage and communication sectors reached the highest levels in 2008 and declined afterwards. Meanwhile, FDI inflows in the mining sector increased substantially in the last two years. However, this is not expected to be a long-term increase as the Indonesian government has recently introduced a new regulation restricting the export of 65 minerals. The new policy has generated confusion and angst among multinational mining companies, and thus might have an adverse impact on FDI in the mining sector. Meanwhile, investment in the electricity, gas and water supply has also increased substantially in the last two years. Lastly, investments in the metal, machinery and electronics industry almost tripled from 2010 to 2011. As for the chemical and pharmaceutical industry, FDI in 2011 doubled from 2010.

Secondly, there was an increase of around 14.6 per cent in terms of FDI realization in Q1-2014 compared to Q1-2013. In fact, the value of FDI realization in Indonesia exhibits a positive trend over the years (Figure 21). Thirdly, an increasing number of foreign establishments have been operating in Indonesia which might indicate confidence in Indonesia's prospect. The size of FDI realization in recent years in Figure 21 also supports this notion.

FIGURE 21.
INDONESIA FDI REALIZATION 1990-2013 (MILLION US\$)



Source: BKPM

It is important to note that despite the aforementioned positive developments in the FDI sector, Indonesia still lagged behind other countries in Asia. The fact that FDI to GDP ratio in Indonesia is lower compared to China, India, Malaysia and Thailand³⁴ implies that those countries might have been more successful in attracting FDI. This might be due to better investment facilitation schemes as well as better fiscal incentives in those countries, among others.

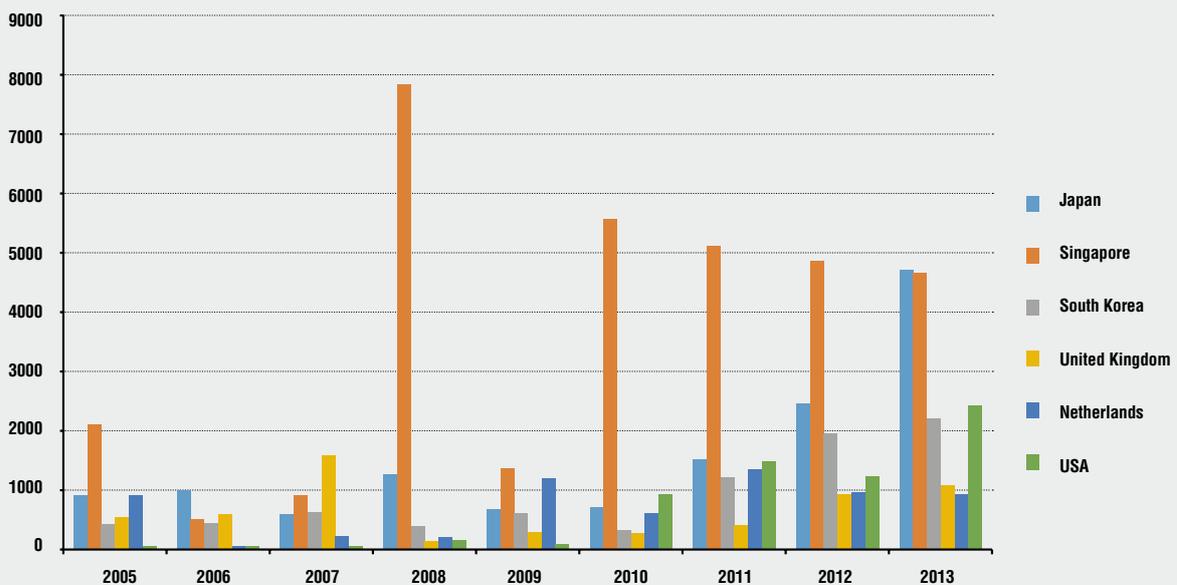
34 World Bank 2012 data

5.2. EU's FDI in Indonesia

The EU has historically been one of Indonesia's major investors³⁵. While the United States (US) was the largest source of FDI in Indonesia until the early 1990s, the EU replaced the US as the largest source of FDI between 1993 and 2003. In the last four years, Indonesia has received around US\$9 billion of FDI from the EU. By 2013, the EU was the third largest foreign investor in Indonesia after Singapore and Japan (Figure 22).

Nevertheless, while the level of FDI coming from the United States began to rise rapidly in recent years - especially since 2010³⁶, the level of FDI from the EU has dropped significantly (Figure 23). During the period of 1993-2003, FDI from the EU accounted for around 46 per cent of total FDI in Indonesia. However, it accounted for only around 16 per cent of the total FDI in Indonesia (Ernst & Young Indonesia, 2013) between 2004 and 2012.

FIGURE 22.
COUNTRY OF FDI ORIGIN 2005-2013 (MILLION US\$)



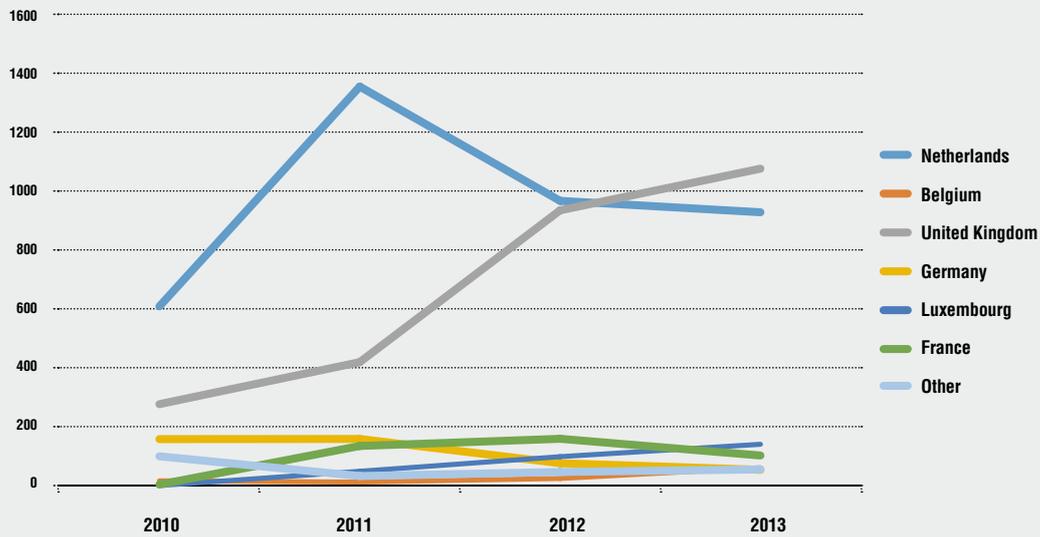
Source: Author's calculation based on BKPM data

The Netherlands and the UK have been the two major EU investors in Indonesia since 2010. Nevertheless, the levels of FDI from the UK and the Netherlands have been volatile in recent years. FDI inflow from the UK reached its peak in 2007 and declined dramatically in 2008 presumably due to the Global Financial Crisis (GFC), but recovered since then. In contrast, FDI from the Netherlands exhibits declining trend since 2011 (Figure 23).

³⁵ Japan, Singapore, South Korea, Malaysia and Taiwan are currently the other major investors in Indonesia.

³⁶ Prior to 2010, the amount of the US yearly investment was relatively low. In 2013 its investment has doubled relative to that in 2012.

FIGURE 23.
FDI EU COUNTRIES TO INDONESIA (MILLION US\$)

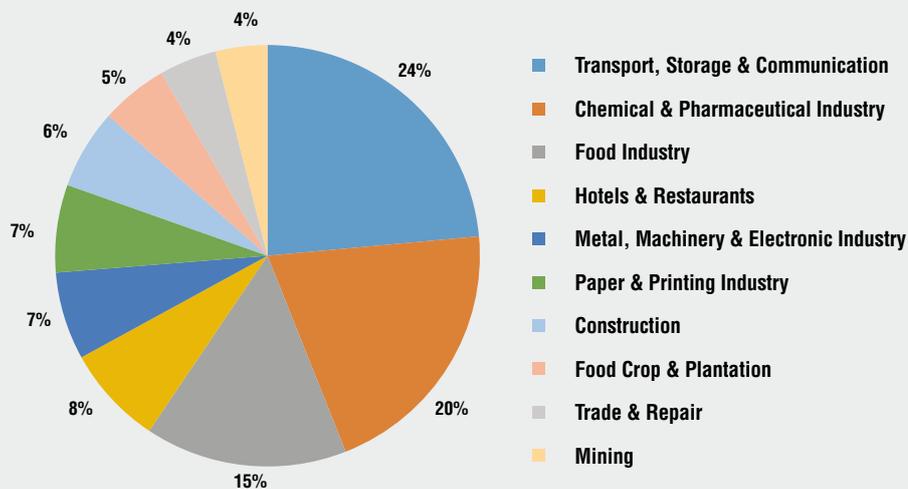


Source: BKPM

In 2013 the UK overtook the Netherlands as the largest EU investor in Indonesia with over US\$1 billion investment, while Luxembourg climbed to be the third largest EU investor in Indonesia. From 2010-2013, FDI inflows from the UK, Luxembourg and Belgium exhibited upward trends while FDI from the remaining EU member countries exhibited declining trends (Figure 23).

Judging from the trend of the FDI inflows from the EU, transportation, storage, and communication are the most attractive sectors for EU investors. During the period of 2004-2012, a majority of FDI from the EU was found in sectors such as transportation, storage and communication, mining and quarrying as well as chemical and pharmaceutical goods. Figure 24 illustrates the breakdown of FDI coming from the EU in 2011.

FIGURE 24.
FDI FROM EU IN INDONESIA BY SECTOR 2011

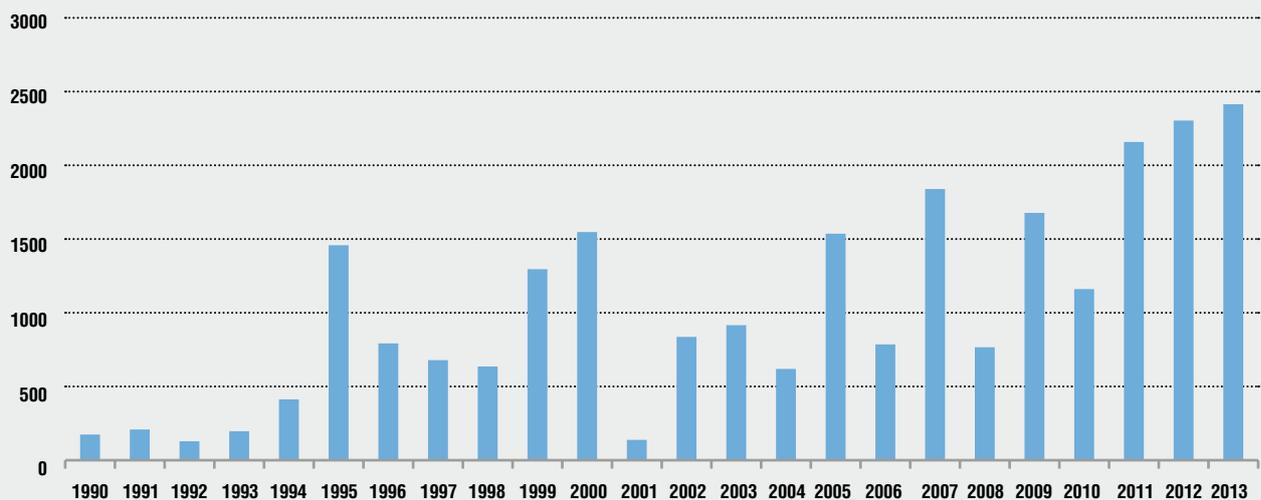


Source: Eurostat

In 2012, fishing, supplies and construction sectors received a majority of FDI from the EU. Meanwhile, the trade sector experienced a substantial recovery from the GFC during the period of 2011 to 2012. On the other hand, while the mining and quarrying sector is still one of the largest recipients of EU investment, the sector received significantly less FDI in 2011. In addition, FDI in the manufacturing sector began to shrink (recorded negative net inflows) after reaching its peak in 2007.

In general, there are two notable observations with regards to FDI inflows from the EU. Firstly, there is positive growth of FDI inflows from the EU to Indonesia in general despite some fluctuations (Figure 25). As shown in Figure 25, FDI inflows from the EU exceeded US\$1 billion in 1995, but declined sharply afterwards. From 2001 to 2010, FDI inflows from the EU exhibited a positive trend despite some minor fluctuations

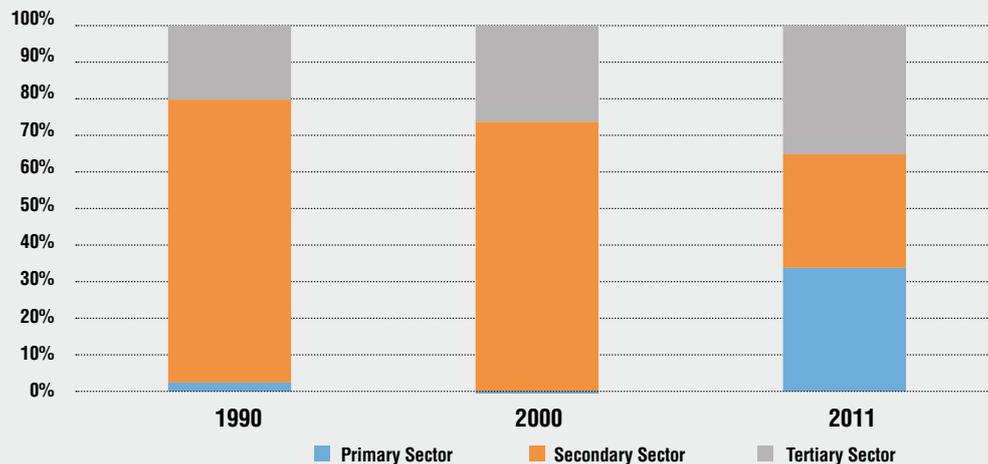
FIGURE 25.
FDI INFLOWS FROM EU TO INDONESIA (MILLION US\$)



Source: BKPM

Secondly, a shift in terms of the largest recipients of FDI from the EU took place after 2010 (Figure 26). Before 2010, the primary sector was not attractive for foreign investors and the tertiary sector was not yet well developed. Consequently, the secondary sector that consisted of food industry, textile, leather goods and footwear industry, chemical and pharmaceutical industry, motor vehicles and other transport equipment received most of the FDI from the EU before 2010. After 2010, both the primary and tertiary sectors alone received more FDI from the EU than the secondary sector. In general, sectors such as transport, storage and communication, food crops & plantation and mining are the main recipients of EU FDI.

FIGURE 26.
EU FDI BY SECTORS



Source: Eurostat

One possible explanation of the shift from the secondary to the primary and tertiary sectors is the intense competition from other countries such as China, Vietnam, India and Bangladesh for FDI in the manufacturing sectors. These countries are arguably more competitive in terms of labour-related costs. Consequently, Indonesia's labour-intensive sectors such as textile and footwear became less attractive to foreign investors.

5.3. "Investment Climate in Indonesia"

Indonesia introduced a negative list of investment in 2007, which described sectors that are closed or open to foreign and local investors under certain conditions. The list has been revised twice since then. A new version of the list, namely Presidential Regulation No. 39/2014 has replaced the old investment regulation (Presidential Regulation No. 36/2010). The regulation provides a list of business sectors that are closed or open to investment under certain conditions. Those conditions are:

- a. Reserved for Micro, Small, Medium Enterprises and Cooperatives
- b. Partnership
- c. Foreign Capital Ownership
- d. Certain location
- e. Special license
- f. 100 per cent local capital
- g. Foreign Capital and Location Ownership
- h. Special license and foreign capital ownership
- i. 100 per cent local capital and special license
- j. Foreign capital ownership requirement and/or location for capital investment from ASEAN countries

There are some notable changes in the new regulation. On the one hand, there are a number of business sectors that experienced increasing foreign capital ownership such as transportation, health, tourism, the creative economy and finance.

On the other hand, there are also sectors or subsectors which apply more restrictive conditions for investors, such as energy and mineral resources, as well as communication and information. A significant revision refers to drilling services and supporting oil and gas services (design and maintenance). In these services foreign investors used to hold up to 95 per cent the ownership. Now they are reserved for local investors only. In other subsectors, such as communication and information foreign equity ownership has been lowered up to 49 per cent in content services (ringtone, premium, SMS, etc.), call centre and other services, data communication system services and NAP.

In addition to policies like the Negative Investment List, investments in Indonesia face problems related to the unfavorable business and investment climate. In the newest Doing Business Report by the World Bank, Indonesia climbed up to the 114th position out of 189 countries, while occupying the 117th position in the previous report. The most significant improvement is seen in terms of access to electricity, but Indonesia got lower scores in some indicators related to starting up business, e.g. increasing number of procedures and forms.

Indonesia still lags behind other countries in the region such as Thailand, Philippines and Vietnam, which all receive higher rankings than Indonesia. In Indonesia's case, immediate improvement is needed in registering property, getting credit and resolving insolvency. This shows that there is room for improvement of Indonesia's investment situation in attracting FDIs, including from the EU countries. The CEPA has potential to contribute to this process.

5.4. Will EU-Indonesia CEPA raise FDI from the EU?

Based on the aforementioned facts, the EU is a major source of FDI for Indonesia. Nevertheless, the FDI coming from EU member states to Asia is less than 10 per cent of its total FDI in 2010. Of the 10 per cent, the largest parts went to Singapore and China. This suggests that Indonesia is not an important destination for EU investors.

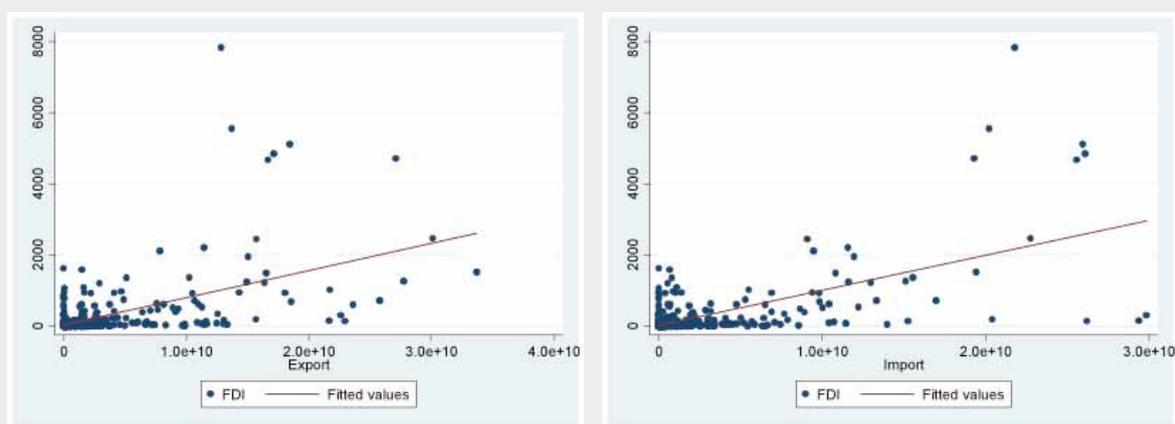
Although Indonesia has strong economic growth and market potential, some other factors such as transparency and uncertainty of government policies, as well as the lack of infrastructure and technological capabilities are regarded as the main constraints for investment in Indonesia. As such, EU companies consider Indonesia as risky. In this context, Singapore, Malaysia, Thailand and Vietnam pose more attractive options for them. It remains to be seen whether the EU-Indonesia CEPA will be of assistance in boosting investment from EU to Indonesia.

There are two possible channels through which the EU-Indonesia CEPA may lead to a higher level of FDI coming from the EU to Indonesia. Firstly, since the EU is Indonesia's major trading partner³⁷ and the findings in the previous section show that an EU-Indonesia CEPA is likely to increase the trade volume between the two parties, greater trade between the two parties may promote greater flows of investment between them. Therefore, this study will look at the degree

37 By 2013, the total trade between the two economies was around US\$30.1 billion. Animal products, vegetable fats and oils; electrical and electronic equipment; mineral oil, fuel, and distillation products; ores, slag and ash; footwear; apparel; rubber; furniture; and machinery are among Indonesia's top ten export commodities to the EU. Meanwhile, machinery; electrical and electronic equipment; aircraft, spacecraft; organic chemicals; wood pulp, fibrous cellulose material, vehicles other than railcars; plastics; iron and steel; and pharmaceutical products are among the EU's top ten exports to Indonesia.

of correlation between FDI and exports, and the degree of correlation between FDI and import in order to analyze the possible impact of an increase in trade on investment flows. Correlation between trade and investment volumes will be calculated using trade and investment data during the period between 2005 and 2013. The data were obtained from from BKPM and UN-COMTRADE and cover all of the Indonesian trading and investment partners.

FIGURE 27.
INDONESIA-WORLD FDI & TRADE RELATION

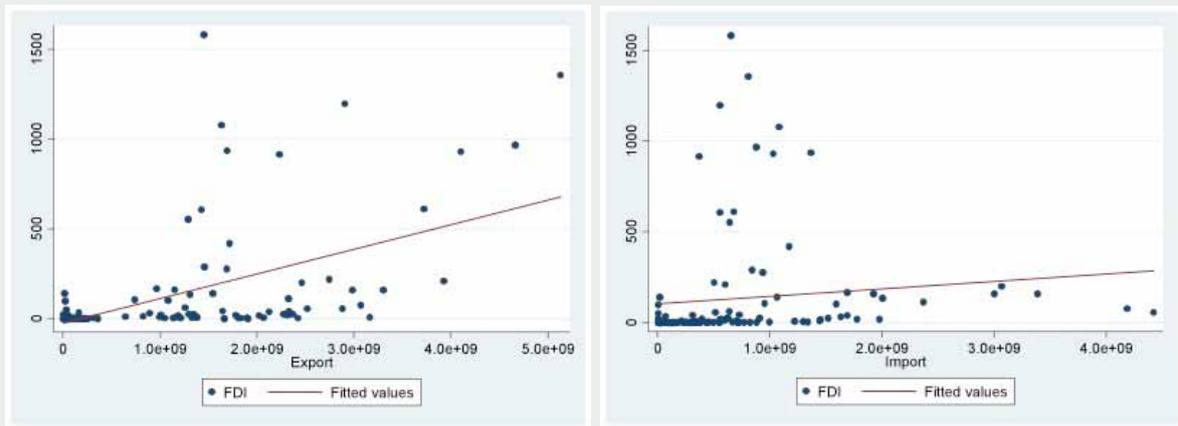


Source: Author's calculation

The relationship between FDI and exports is positive (Figure 27, left side), while positive correlation between FDI and imports is also observed (Figure 27, right side). However, it should be noted that the correlation does not necessarily explain a causal relationship between the two variables. In other words it is rather ambiguous as to which way the causal effect takes place: Will an increase in trade volume lead to an increase in investment? Or the other way around? The positive correlation between FDI and export might imply that FDI increases Indonesia's export performance with the trading partners, while a positive correlation between FDI and import indicates that increasing imports will lead to an increase in FDI.

A similar exercise is done for nineteen EU member countries for which data are available. While the positive correlation between FDI and export is stonger at 0.52, the positive correlation between FDI and import is weaker at 0.11 (Figure 29). This result implies that the positive relationship between FDI and Indonesia's export to the EU is much stronger compared to the positive relationship between FDI and Indonesia's import from the EU. In other words, there is a fair likelihood that one would observe large exports from Indonesia to the EU when Indonesia receives a high level of FDI from the EU and vice versa. A possible explanation for this is that EU investors tend to invest in sectors with significant exports to the EU.

FIGURE 28.
EU-INDONESIA FDI & TRADE RELATION



Source: Author's calculation

An EU-Indonesia CEPA will include a chapter on investment provisions that aims at boosting investment flows between the parties. It has been argued that an inclusion of investment issues in a CEPA is likely to promote more investment flows between countries that are parties to the agreement. Empirical evidence on this claim, however, is inconclusive. On the one hand, a study by Neumayer and Spess (2005) shows that a higher number of bilateral investment treaties (BITs) involving a developing country raise the FDI that flows into that country. The study also argues that, to some extent, BITs might function as substitutes for good domestic institutional quality. The BITs guarantee certain standards of treatment to foreign investors that are enforceable through a dispute settlement mechanism outside the domestic judicial system.

On the other hand, Hallward-Driemeier (2003) examines investment flows between OECD countries and developing countries and argues that the increase of FDI to countries covered by BITs was coming from additional country pairs entering into bilateral investment agreements rather than an improvement in FDI flows between each pair. The study also claims that BITs act more as complements rather than substitutes for adequate institutional quality and local property rights.

Implicitly, the two studies cited above recognize the importance of solid institutions to promote investment. Features such as the protection of property right, including intellectual property rights, the rule of law, competition, among other things constitute incentive for investors to invest. Investment provisions in a possible CEPA between Indonesia and the EU should aim at providing promotion, facilitation and protection in FDI in order to promote the growth of investment in Indonesia.

5.5. FDI and Intellectual Property Right

The majority of literatures on IPRs highlight the importance of IPRs in fostering both knowledge creation and investment in research and development (R&D). In this context, IPRs also act as incentive for companies to produce innovative and high quality products. In the absence of

IPRs, companies will be hesitant to invest in R&D for fear of piracy by other companies. On the other hand, Arrow (1962) argues that IPRs can also create a distortion by constraining the current consumption of knowledge through enhancement of the market power, or monopolistic practices of title holders.

Intellectual property rights (IPRs) are an important feature in many of the EU's trade agreements. However, according to a recent survey (Chandra, A. C. et al., 2010), the Indonesian respondents consider the importance of IPR issues at a lesser degree than their EU counterparts. In this context, the issue of IPRs could pose a hindrance in EU-Indonesia CEPA negotiations due to the differing perceptions between the Indonesian and the EU businesses.

In addition, the UNDP highlights some potential problems concerning IPRs in the case of a mishandling of the issue. According to the UNDP report, there were cases of pharmaceutical and agro-industrial companies that have accrued benefits from IPR protection at the expense of the poor people in Indonesia. An estimated yearly profit of US\$32 billion have been generated from drugs 'developed' by these companies based on existing indigenous medicine. Local farmers also potentially suffered from the loss of access and control over seeds. Bina Desa, a local NGO, describes how Indonesian farmers who have been using and producing agricultural products for generations are now categorized as thieves and IPR violators as the result of the menace of bio piracy.

From the aforementioned evidence, it is crucial for the EU-Indonesia CEPA to take into consideration the development needs of Indonesia. The treaty should recognize that Indonesia is rich in biodiversity and traditional knowledge, and therefore should be protected accordingly from a violation of IPRs. Apart from the issue of IPRs, the treaty should ensure farmers' access to seeds that originate from local varieties, in addition to their access to medicine.

6. Political Economy Considerations and Policy Recommendations

Although considered as “the logical sequel of the steady stream of Indonesia’s political, institutional and economic reforms” (EU-Indonesia Vision Group 2011), the EU-Indonesia CEPA discussions have not progressed much in the past three years. If realised, the CEPA between the EU and Indonesia will be a trade agreement that could have an impressive scale, creating a market of more than 750 million consumers. However, some obstacles and political economy considerations have proven to be larger obstacles than expected.

This last section will discuss briefly the various aspects of negotiations that could hinder the process of forming a deeper economic partnership. The discussion is based on several interviews we conducted with various stakeholders both from Indonesia and the EU, and from various other information sources³⁸. We begin with a summary of our analysis of the potential benefits of a CEPA before looking at some critical issues.

6.1. EU-Indonesia CEPA: Benefits at Stake

The economies of EU and Indonesia are rather complementary as they are vastly different to each other. The current average GDP per capita in EU is around US\$33,000, which is more than nine times of Indonesia’s average per capita GDP of around US\$3,500. In addition, the Indonesian economy relies heavily on abundant labour and raw materials, while most countries in the EU are already founded on human capital and technology.

³⁸ The interviews were held with a range of stakeholders in government and private sector, including representatives from Directorate General for International Industrial Cooperation (Ministry of Industry), Directorate General of International Trade Cooperation (Ministry of Trade), Directorate of Bilateral Cooperation (Ministry of Trade), Directorate General of American and European Affairs (Ministry of Foreign Affairs), Investment Coordinating Board, Indonesian Chamber of Commerce and European Business Chamber of Commerce. Other sources are available as references.

Despite being vastly different economies to each other, the trade relations between Indonesia and the EU have not reached their full potential. Based on the observations on trade statistics discussed in Section 2, the relative importance of the two economies to each other has declined even though bilateral trade relations between the two economies have been growing in terms of absolute value. Complementarity between Indonesia's exports and EU's imports has been stagnant over the years as indicated by relatively low complementarity index averaging around 0.35 during the period of 2000 to 2012. Correspondingly, market penetration of the top Indonesian products in the EU market has been stagnant.

The EU-Indonesia CEPA would help to promote trade between the two economies through the improvement of market access. Today, market access to the EU is one of the key obstacles for Indonesian products in the EU market. The root of this problem mainly lies in the difficulty to fulfil various requirements issued by the EU, especially the Non-Tariff Measures (NTM) such as sanitary measures, as well as standards and technical requirements. Erosion of preferential tariff due to Indonesia's graduation from the GSP scheme, as well as trade diversion of EU's imports to its FTA's partners could also hinder market access for Indonesia's exports to the EU in the future.

The graduation from the GSP scheme will potentially impact Indonesia and the EU in the following ways. Firstly, it has the potential to reduce Indonesia's exports to the EU. Based on our analysis, Indonesia's exports to the EU would suffer up to 12 per cent loss due to a shift of tariff scheme from GSP tariff rate to MFN tariff rate at Indonesia's graduation from the GSP scheme. Since Indonesia's top export commodities to the EU such as textiles and garments or footwear are among the recipients of GSP facilities, the change in tariff schemes will have a significant adverse impact on Indonesia's exports to the EU.

Secondly, there is the possibility of trade diversion to the EU's other trading partners that are currently negotiating trade agreements. If the agreements between the EU and other ASEAN countries, such as Malaysia, Thailand, and Vietnam came into effect, Indonesia might lose up to 8 per cent of its current export level.

Thirdly, a CEPA could potentially increase Indonesia's and EU's exports to each other. Indonesia could potentially increase its exports to the EU by around 5 per cent, while the EU could potentially increase its exports to Indonesia by 14 per cent. Based on our analysis, the EU seems to reap more benefits from Indonesia's graduation from the GSP due to relatively higher ad valorem tariff rates of Indonesia. On the other hand, the EU uses specific or non-ad valorem (NAV) tariff rate more intensively, which cannot be captured properly in our analysis³⁹. By including a reduction of NAV tariff in tariff elimination scheme under CEPA, market access for Indonesian products in the EU could be elevated further.

A similar situation can also be observed in the services sector. While Indonesia's penetration to EU's services market has been less than stellar, recent developments in EU's trade in services point to untapped opportunities for Indonesia. By allowing greater market access for both parties, the CEPA could facilitate the development of a services sector in Indonesia. The possibility of

39 Many of EU's specific tariff rates are quite high than it raises the barriers that does not only reduce imports from Indonesia, but totally wipe-out the imports. Our analysis on AVE tariff will miss the potential of those AVE reductions, simply because we cannot calculate the potential of zero imports.

having a more flexible arrangement on labour movement will also benefit Indonesia's service providers as it will assist them in expanding their operations.

Greater investment from the EU member states to Indonesia is one of the key potential benefits of the proposed EU-Indonesia CEPA. There are two possible channels through which the EU-Indonesia CEPA may lead to a higher level of investment from the EU coming to Indonesia. Firstly, greater trade between the two parties might promote greater flows of investment between them. Secondly, the EU-Indonesia CEPA includes investment provisions to boost investment flows between the parties to the treaty. These investment provisions cover investment facilitation, promotion and protection. The EU - Indonesia Vision Group 2011 has argued that an inclusion of investment issues in a CEPA is likely to promote more investment flows between countries that are parties to the agreement as the agreement increases confidence of foreign investors to put their capital in the host country.

The agreement is also crucial for improving communication between Indonesia and the EU. The challenge in communication exists because the EU has a tendency to manage its economic relation issues through formal mechanisms. In contrast, informal dialogue between government officials is used to solve economic relation issues between Indonesia and many of its trading partners, such as countries in Southeast Asia and East Asia. In this context, a CEPA between Indonesia and the EU will bring more weight to successful economic relations compared to Indonesia's current agreements with its trading partners.

More importantly, the agreement should aim at ultimately building confidence and trust between Indonesia and EU member states. A CEPA between Indonesia and the EU will provide a formal and well-defined mechanism to protect investors' assets in Indonesia as it will increase the confidence of EU investors. Consequently, producers and traders from Indonesia and EU member countries will have a more positive attitude towards greater trade relations, knowing that greater market access is described appropriately under the trade agreement and trade issues would be settled properly.

Such confidence could boost the economic relations between the two economies even further beyond what is currently predicted. In short, the proposed EU-Indonesia CEPA could potentially bring significant benefits to the two economies. It is therefore necessary for both parties to put special attention on the completion of the negotiation.

6.2. Critical and Contentious Issues with regards to CEPA Negotiations

The main challenge in the negotiation of an EU-Indonesia CEPA is the different perceptions both parties hold on several issues. These issues can be categorized into issues concerning the modalities of negotiation, and issues that are more substantial with regard to the contents of the agreement.

Issues Related to Negotiation Process

The most widely mentioned concern related to the process of negotiations is the boundary of negotiations as defined in the proposed scoping paper from the EU. In this draft scoping paper, the EU lays out its expectations and the level of ambition for the proposed agreement.

For example, the draft paper defines that the CEPA should aim at covering at least 95 per cent of trade in goods and tariff lines in both economies, which shall further be eliminated within a period of seven years. The draft scoping paper also defines a minimum level of commitment expected to be achieved in the CEPA on IPRs, competition policy and government procurement.

Due to its extensive coverage of many important aspects of the agreement, the draft scoping paper is perceived by some parties involved as an obstacle for further negotiation as it limits the scope of future negotiation process. This has been seen to put Indonesia in a difficult position as Indonesia is still uncertain on its position towards many areas of the agreement. Moreover, the EU is perceived as taking a uniform approach towards different partners based on a certain template, and thus limiting the flexibility of the partners in conducting negotiations conditional to their position⁴⁰.

Another issue that may hold back negotiations is the implementation of Indonesia's new Trade Law. The Law is expected to improve Indonesia's stance in the international trade scheme by arranging various aspects of international trade. One part of the new Law mentions that the Government of Indonesia needs to seek consultation with the parliament after an international trade agreement is signed. In the consultation, it shall be decided whether the new agreement needs to be ratified as a Law, which requires an approval of the parliament, or can be implemented directly by the government. In the case that an approval is needed, there is a possibility that the parliament does not give its approval and the agreement is annulled⁴¹. Given that the next elected parliament would be politically more fragmented than the current one⁴², it is likely that the Indonesian government will find more difficulties in formulating policies, including getting approval for international trade agreements.

This brings several consequences to the future international trade negotiation. While the implementation regulation of the Law is yet to be formulated, the Government of Indonesia is likely to be more cautious in conducting trade negotiations, not to mention initiating any new ones⁴³. Therefore, the new Trade Law would increase uncertainty surrounding Indonesia's position on various areas of international commitments and cooperation.

The new Law does not define the process of consultation outside the Parliament. However, the government will be likely to increase transparency and allow for more consultation, especially with non-corporate stakeholders and civil society organizations, since a lack of transparency and stakeholders' participation will increase distrust that such negotiations cater mostly for few economic actors. In the case of negotiations with the EU, this concern is amplified by the fact that various non-economic issues are heavily featured in the EU's FTAs. In light of this, the consultation process and transparency issues could lengthen the process of negotiations. A right balance between transparency and confidentiality – as often required in international negotiations – should be maintained throughout the negotiation process.

40 Based on interviews with several stakeholders on the CEPA negotiation.

41 Law No. 7/2014 on Trade, Article 83-84

42 The result of parliamentary election in 9 April 2014 revealed that no political party won majority of the parliamentary seat. Coalitions would likely to be formed among parties supporting the new administration and those taking opposition stances.

43 A negotiation with countries of European Free Trade Area (EFTA), which has been conducted for around three years in nine negotiation rounds, was suspended until undetermined time. The last round of negotiation only agreed to consolidate the progress for the benefits of Indonesia's new administration. While there is no mention about the reason, it coincidence with the launch of new Trade Law, raised the suspicion that the Gol would like to wait until the new regulatory framework is in place appropriately.

Negotiations on investment provisions might also be delayed due to Indonesia's current move to not automatically continue Bilateral Investment Treaties (BITs) that have been due for review, and to postpone all negotiation for new BITs⁴⁴. The Government of Indonesia is preparing a guideline and template for future investment agreements as it deems the current investment situation requires better formulation of Indonesia's position. While the government is expecting to complete the process by the end of this year, there is possibility that it would hold back all trade negotiations with investment provisions in it, including the proposed CEPA.

Intellectual Property Protection

Provisions on intellectual property rights (IPRs) are an integral part of many modern trade agreements, especially those between developed and developing countries. Provisions on IPRs seek to ensure returns on IP by promoting international standards, and to ultimately prevent or dissuade counterfeiting and piracy. There are varieties of such provision in regional trade agreements which may include cooperation for better IP creation, cooperation for better commercialization of intellectual property, or provisions to create better regulation and enforcement of IP protection.

The EU normally puts some emphasis on the provision related to IPRs in its free trade agreements. In its older trade agreements, the EU preferred to seek compliance with the Trade-Related Aspects of Intellectual Property Rights (TRIPS) agreement and other intellectual property conventions rather than press for deeper commitments in its FTA negotiations. The commitments in these agreements are relatively simple and did not incorporate substantive provisions⁴⁵. However, there has been a change in recent trade agreements. For example, disciplines for IPR protection went beyond commitments under WTO TRIPS in the FTA with South Korea and Colombia. In some other cases, the EU even pursued sector-specific commitments for protection of its IPRs in various industries, such as pharmaceutical products in its FTA negotiations with India⁴⁶.

The EU discusses IP protection in its scoping paper of the EU-Indonesia CEPA. It also highlights the importance of geographical indication as one of the main areas of IP protection that would be enhanced within the CEPA. The notion that the protection of IPRs would become the focus of attention in the negotiations of the CEPA might interrupt the process. Although various studies show that IPRs may contribute positively to economic development, many developing countries are still hesitant to internationally commit to greater protection of intellectual property, partly due to difficulties in enforcement while at the same time that may subject the countries to international trade disputes.

As of now, discussions on IP are covered in several of Indonesia's trade agreements, including the ASEAN agreements. Provisions of IPs in those agreements are mostly limited to the promotion of IP creation and cooperation, as well as adoption of some basic principles in regulatory frameworks, such as transparency and exchange of information between the parties involved.

44 There have been a lot of misunderstandings among foreign investors and media that Indonesia has terminated the BITs. In fact Indonesia simply does not automatically continue current BITs that have been subject for review, mostly for old BITs from earlier period, while maintains the implementation of more recent ones.

45 See for example S. Woolcock (2007), or ICTSD (2007)

46 Prakash (2010, July)

One agreement where Indonesia provides greater commitments on IPRs is the Indonesia-Japan Economic Partnership Agreement (IJEPA). Under this agreement, the two countries committed to provide adequate efforts for the enforcement of IP protection related to relevant trade activities. At the same time, the agreement also ensures that available penalties will be enforced accordingly. While the IJEPA takes enforcement of IP protection to the attention of both Indonesia and Japan, the agreement does not specify measures that may require both parties to changes their regulatory framework. A similar approach towards IP protection may be of assistance to Indonesia and EU in the negotiation on IPRs in the CEPA.

Government Procurement

Provisions related to government procurement (GP) are quite widely observed in many recent FTAs, including trade agreements between the EU and its trading partners. The provisions can cover various aspects from the disciplines in procedural rules to market access for international suppliers. According to the WTO database on regional integration, around two-thirds of trade agreements contain provisions on GP. However, more than half of these only mention single provision, which normally cover soft commitments, such as transparency and provision on integrity, or recognition of the importance of GP and possibility for future negotiation.

In several of the recent agreements between the EU and its trading partners, provisions of GP are covered quite extensively. The agreements normally emphasize greater market access for supplying goods and services and push for binding rules on adequate transparency to create so-called “effective” procurement systems. In the proposed EU-India agreement, for example, the European Union is demanding access to India’s government procurement market for contracts above a certain cut-off value.

Indonesia has included provisions on GP in several of its trade agreements. However, the scope of these commitments is limited to create better procurement procedures and to provide disciplines for the government procurement regulatory environment. The agreements include neither liberalization nor non-discriminatory principles such as most favoured nation or national treatment.

On the other hand, the scoping paper of EU-Indonesia CEPA talks about the intention to improve market access on the basis of the principles of non-discrimination and national treatment. In light of this, GP is another possibly contentious area in the negotiation of EU-Indonesia CEPA. The EU suggestion inside the scoping paper would likely be opposed by the Indonesian side since the Government of Indonesia still utilises public procurement as one of the instruments to promote domestic producers and suppliers.

Government Regulation No. 54/2010 grants special preferences to encourage domestic sourcing and to maximize the use of local content in government procurement. It specifies that foreign providers are allowed to participate in public bids greater than 10 billion Rupiah (around US\$900 thousand) for consultancy work, and greater than 100 billion Rupiah for construction work. In addition, foreign providers need to work together and form partnerships with local companies. Other regulations stipulate that all state administrations should optimize the use of domestic

goods and services and give price preferences for domestic goods and providers, along with initiatives to provide privileges to small and medium sized enterprises.

Therefore, Indonesia might find it difficult to come up with significant commitments on GP. One solution is to allow the current agreement to focus on creating better procurement disciplines while at the same time opening up the possibility for market access discussion in the future.

Other Areas of Partnership Agreement

There are several other areas of the proposed CEPA that are likely to be sources of disagreement and thus will hold back the negotiation process. These are civil protection, human rights, and social issues (Horn, et. a. 2009). Concerns for these issues come from the shared value upheld by many members of the EU, in addition to the fact that many of these member states adopted soft power models to influence foreign diplomacy. The EU also seems keen to use trade as a tool to disseminate and promote these values, as evident from the European Parliament's call to include those other issues in trade agreements⁴⁷.

Indonesia has not yet endorsed the inclusion of various non-economic issues, such as human rights conditions as well as environmental standards or non-proliferation clauses in its trade agreements. The refusal may not come from substantive and unbridgeable concerns, but rather from doubts that these issues should be included in trade negotiations. However, Indonesia has improved its stance in many areas, such as human rights and civil protection. Indonesia should use the progress made as a means of improving its international profile by implementing the international conventions it has signed, while at the same time using them to leverage its position in trade negotiation process like CEPA with the EU.

Another issue that may become a stumbling block in the negotiation is market access for agricultural products. Our simulation shows that both economies may increase their exports if agricultural products were included in the liberalization process. However, this would be difficult since both economies view agriculture as a sensitive sector: The EU applies many of its NAV tariffs on agriculture imports, while Indonesia applies some restrictive measures on the products. Considering that the EU provides heavy subsidy on agricultural production, liberalization of Indonesian market of agricultural products would not be received positively. The right scheduling of liberalization in both economies, including modification of NAV tariffs into clear-cut ad valorem tariffs is necessary to facilitate greater market access for agricultural products in both economies.

Indonesia may request the inclusion of temporary skilled and perhaps semi-skilled worker movement to EU countries, especially under the Mode 4 agreement on services liberalization. Nevertheless, while the CEPA could offer possibility for greater access for Indonesia's workers to many of the EU member economies, agreement on this issue may be difficult to find. Although foreign workers contribute significantly to the workforce of the EU countries, a majority of the member states has maintained a restrictive stance with respect to labour movement.

In many trade agreements, the EU has offered to take commitments under all four categories of service suppliers - including Mode 4 - although with limitations. Under the WTO, the EU has

47 See for example European Parliament resolution of 25 November 2010 on Human Rights and Social and Environmental Standards in International Trade Agreements

offered to make commitments for graduate trainees but has not offered market access for executives. Under its bilateral trade agreements, the EU has rarely made commitments beyond its offers in the WTO, although there are several cases where it provides greater market access to trading partners. The EU-CARIFORUM, for example, has made commitments on a range of different categories of workers, including independent professionals and contractual service suppliers, although limited to a short period of stay. As mentioned earlier, Indonesia could take advantage of this opportunity, although the negotiations may not be easy as the country needs to convince the EU member states of the benefits of greater labour movement.

6.3. Policy Recommendations

The negotiations for an EU-Indonesia CEPA should not be delayed for too long. As mentioned in the previous sections, there are various difficulties in negotiating the EU-Indonesia CEPA. Nevertheless, the benefits of the CEPA for the two economies are undeniable. The need for a CEPA is imperative to Indonesia as greater market access to the EU member states may improve the country's export performance in the EU market. Moreover, as the two economies are complementary to each other, greater market access for EU products would also increase Indonesian industrial competitiveness.

In the negotiation, Indonesia needs to focus on products that are currently receiving GSP facility in addition to other top export products. Based on previous simulation in Chapter 3, the gains from tariff elimination are greater for the EU (14 per cent increase, or around US\$1.6 billion) than for Indonesia (5 per cent increase or around US\$1.1 billion) due to the relatively low tariff Indonesian products currently receive under the GSP program. However, Indonesia will soon graduate from the GSP program and consequently Indonesian products will no longer be eligible for lower tariff facility under GSP. Without any further measure, this may reduce the country's export performance by up to 12 per cent (or around US\$2.4 billion) according to the simulation. Taking into account this possible loss, the CEPA offers trade gains of around US\$3.5 billion (or 17 per cent of total trade).

While the CEPA should aim for substantial coverage of tariff elimination, it can be done sequentially starting from less sensitive products to both parties. However, those other products, including agricultural goods, need to be opened up further as they potentially increase the benefits of greater market access. Specifically for Indonesia, the reduction and transformation of NAV tariffs to ad-valorem tariffs might enhance the performance of the country's export products. Our analysis shows that the gains from tariff elimination are concentrated mostly on the top export products. This signifies that the agreement would deliver significant benefits even if it only partially liberalises the markets of the two economies.

It is necessary for the CEPA to alter the current regulatory regime in the services sector and offer significant improvement in terms of market access. Increasing needs for high quality services in Indonesia can be fulfilled by granting greater access to EU providers. In addition, the EU should open up greater access for workers from Indonesia for training and professional jobs.

As investment has become an integral part of trade agreements like the CEPA, the negotiations should aim for various aspects related to investment, including facilitation, promotion and protection of FDI. The negotiation of the EU-Indonesia CEPA should start by

listing the basic principles that the two economies need to agree upon, regardless of the current initiative of the Indonesian government to review Indonesia's position on investment agreements.

More flexibility on the position of each party is needed on the previously discussed issues such as protection of IPRs, government procurement, labour movement, as well as non-economic issues such as labour standards, environment, and animal welfare. At the same time, the negotiations should also accommodate the possibility of deeper commitments in the future.

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Appendix

Appendix 1

RCA Index and Trade Complementarity Index

In the list of equations below, the under scripts w denotes the world, k denotes partner-country k , i denotes Indonesia and j denotes good j . Thus, x_{ij} denotes exports of Indonesia to the world of good j and w_j denotes the world's total exports of good j . Since the value of world's total exports and imports in COMTRADE database are not always equal, the world's total exports is used all throughout the study for consistency.

Additionally, some notations used in the index equations are:

$$X_{ij} = \frac{x_{ij}}{\sum_j x_{ij}}$$

$$W = \frac{w_j}{\sum_j w_j}$$

$$M_{kwj} = \frac{m_{kwj}}{\sum_j m_{kwj}}$$

Revealed Comparative Advantage Index

Liesner was the first person who introduced the measurement of revealed comparative advantage in Liesner (1958), which was later developed by Balassa in Balassa (1965). In Balassa (1965), revealed comparative advantage is quantified as a ratio of a country's share of the commodity in the country's total exports to the share of world exports of the commodity in total world exports. Balassa (1965), Balassa (1977), Balassa (1989) studied revealed comparative advantage measure in manufacturing across industries.

The original Balassa equation that is used in this study is depicted below, where RCA_{iw} is the revealed comparative advantage of Indonesia. The value of index exceeding 1 suggests a comparative advantage, while the value of the index less than 1 suggests comparative disadvantage.

$$RCA_{iw} = \frac{X_{iw}}{W}$$

The Balassa index RCA_{iw} could be a useful indicator of Indonesia's competitiveness in the world market. However, it fails to measure the competitiveness of Indonesia's exports in partner-country/area's market. Thus, in order to see the competitiveness of Indonesia's exports in partner-country's market, an alternative index based on the original Balassa index was used in this study.

Trade Complementarity Index

The trade complementarity index shows how well the structures of the exports and imports of two countries matched with each other. The value of the index is zero when no goods are exported by one country or imported by the other and one and vice versa when the export and import shares exactly match.

$TC(x)_{ik}$ denotes the trade complementarity index between Indonesia's exports and partner-country k 's imports. $TC(m)_{ik}$ denotes the trade complementarity index between Indonesia's imports and partner-country k 's exports.

$$TC(x)_{ik} = 1 - \frac{1}{2} \sum_j (X_{iwj} - M_{kwj})$$

$$TC(m)_{ik} = 1 - \frac{1}{2} \sum_j (X_{kwj} - M_{iwj})$$

Appendix 2

Modeling the Impact of Tariff Reduction on Trade

In (Laird and Yeats, 1986), the trade effect of tariff elimination comes from two sources: *trade creation and trade diversion*. Trade creation: Increased demand for commodity i in country j produced in country k as the result of the decrease in price when tariff or non-tariff distortions are reduced or eliminated. Trade diversion: measure of tendency of importers to substitute goods from one source to another in response to a change in the import price of supplies from one source but not from the alternative source.

Equation (1) and (2) are used in the partial equilibrium modeling in the study to evaluate the potential impact of tariff elimination under EU-Indonesia CEPA, namely trade creation (TC_{ijk}) and trade diversion (TD_{ijk}) respectively. For trade diversion, the values of elasticity of substitution (E_s) with respect to relative prices of the same product from different sources of supply is obtained from (Kee, HiauLooi, Alessandro Nicita, and Marcelo Olarreaga, 2008). For trade creation, E_m denotes elasticity of import demand with respect to domestic price and also obtained from (Kee, HiauLooi, Alessandro Nicita, and Marcelo Olarreaga, 2008).

$$TC_{ijk} = \frac{M_{ijk} \cdot E_m \cdot dt_{ijk}}{(1 + t_{ijk}) \cdot \frac{E_m}{E_x}} \quad (1)$$

$$TD_{ijk} = \frac{M_{ijk}}{\sum M_{ijk}} \cdot \frac{\sum M_{ijk} \cdot \sum M_{ijK} \cdot E_s \cdot \frac{d\left(\frac{P_{ijk}}{P_{ijK}}\right)}{\frac{P_{ijk}}{P_{ijK}}}}{\sum M_{ijK} + \sum M_{ijk} + \sum M_{ijk} \cdot E_s \cdot \frac{d\left(\frac{P_{ijk}}{P_{ijK}}\right)}{\frac{P_{ijk}}{P_{ijK}}}} \quad (2)$$

In equation (1) and (2), $M_{ijk} = F(Y_j, P_{ij}, P_{ik})$ denotes the import demand function of country j for commodity i produced in country k . It follows that $X_{ijk} = F(P_{ikj})$ denotes export supply function of country k for commodity i . The parameter of the functions are national income (Y) and price (P)⁴⁸. The notations k and K are two different groups of foreign suppliers.

48 P_{ijk} is the price of commodity i in country j from country k .

