

Report No. 6356-IND

Indonesia

Policies and Prospects for Non-Oil Exports

Annex II: Policies Influencing Non-Oil Export Performance

December 31, 1986

Country Programs Department
East Asia and Pacific Regional Office

FOR OFFICIAL USE ONLY



Document of the World Bank

This report has a restricted distribution and may be used by recipients only in the performance of their official duties. Its contents may not otherwise be disclosed without World Bank authorization.

CURRENCY EQUIVALENTS

Before November 15, 1978

US\$1.00 = Rp 415

Annual Averages 1979-85

1979	US\$1.00 = Rp 623
1980	US\$1.00 = Rp 627
1981	US\$1.00 = Rp 632
1982	US\$1.00 = Rp 661
1983	US\$1.00 = Rp 909 ^{1/}
1984	US\$1.00 = Rp 1,026
1985	US\$1.00 = Rp 1,111
December 30, 1986	US\$1.00 = Rp 1,654 ^{2/}

FISCAL YEAR

Government	-	April 1 to March 31
Bank Indonesia	-	April 1 to March 31
State Banks	-	January 1 to December 31

^{1/} On March 30, 1983 the Rupiah was devalued from US\$1.00 = Rp 703 to US\$1.00 = Rp 970.

^{2/} On September 12, 1986 the Rupiah was devalued from US\$1.00 = Rp 1,134 to US\$1.00 = Rp 1,644.

ANNEX IIPOLICIES INFLUENCING NON-OIL EXPORT PERFORMANCETable of Contents

	<u>Page No.</u>
A. <u>External Barriers to Non-oil Exports</u>	1
The Extent of Barriers Facing Indonesia Exports.....	1
Tariffs.....	1
Nontariff Barriers.....	3
NTB's Facing Individual Product Groups.....	19
Fish.....	19
Coffee, Tea and Spices.....	20
Vegetables and Products Thereof.....	21
Wood and Wood Products.....	23
Textiles and Clothing.....	23
Administration of Textile Quotas in Indonesia.....	26
B. <u>Institutional Arrangements for Stimulating Non-oil Exports</u>	31
Introduction.....	31
Duty Drawbacks and Exemptions.....	32
Financing Production.....	40
Producing and Selling the Goods.....	48
Shipping the Goods to the Overseas Market.....	53
References.....	59
Appendix 1 The Experiences of Korea and Taiwan in Providing Duty-Free Imported Inputs for Exporters.....	60
Appendix 2 Indonesia's New Inspection System for Traded Goods...	63
Appendix 3 Mexico's In-Bond Assembly Program.....	67
Appendix 4 Key Changes Resulting from INPRES 4 on Ports and Shipping.....	70

POLICIES INFLUENCING NON-OIL EXPORT PERFORMANCE

A. External Barriers to Non-oil Exports

1. In this section an attempt is made to identify barriers facing Indonesian products of actual and potential export interest and to discuss some of the problems associated with them. While the literature on the theoretical aspects of access to import markets is abundant, empirical studies are infrequent particularly those that deal with nontariff barriers.

2. Information contained here was drawn primarily from the UNCTAD Data Base on Trade Measures. Inquiries in Indonesia revealed little concern by exporters with barriers to export with the exception of those facing textile and plywood. In other product groups, Indonesian exports are too small or too stagnant to suffer from import controls.^{1/} However, as the experience of textile exports to the USA shows, once the imports of "sensitive" products reach significant level or display dynamic growth, restrictions are imposed.^{2/} Since the Indonesian comparative advantage seems to be exactly in those products considered as sensitive (i.e. the labor intensive manufacturers), trade restrictions in industrial countries should be of major concern when studying potential exports.

3. The discussion is divided into three parts. In the first, the extent of tariff and nontariff barriers (NTBs) affecting current exports is estimated. In the second, NTBs facing individual product groups of export interest to Indonesia are discussed. In Part 3, the system for allocation of export licenses for textiles (i.e. the institution that it has been necessary for Indonesia to develop in order to administer trade restrictions imposed on it by industrial countries) is examined and its efficiency discussed.

The Extent of Barriers Facing Indonesian Exports

4. Tariffs. Table 1 shows that, in the aggregate, the tariff rates on Indonesian exports to major industrial markets currently stand at relatively low levels. The average for total exports do not exceed 2.5% and is lower than the average facing world exports. Only agricultural exports to Japan and industrial exports to Australia appear to be subject to significant charges.

While it may be tempting to dismiss the current importance of tariffs based on the data in Table 1, it should be recognized that these overall statistics may conceal very different tariff profiles which may exist on a sectoral basis and that for some specific goods tariffs can still constitute a very important trade barrier. In addition, particularly from the view point of a developing

^{1/} Dynamic growth of imports is currently one of the most "popular" reasons behind import restrictions)

^{2/} The number of Indonesian textile products subject to specific limits in the USA escalated from 9 in 1983 to 18 in 1984 and 34 in 1985.

country, the tariff structure can be equally important as the tariff level; specifically, numerous empirical studies have demonstrated that raw materials imported into industrial country markets typically face zero or very low import duties while tariffs increase as these goods experience further processing. It is held that the effects of such "escalating" tariff structures are to produce an important bias against exports of processed or fabricated goods.

Table 1: AVERAGE POST-TOKYO ROUND TARIFFS FACING
INDONESIA IN MAJOR INDUSTRIAL MARKETS /a

Products	Importers			
	Australia	EEC (9)	Japan	USA
All	2.4	1.6	2.1	0.7
All excluding fuels	2.8	1.7	1.6	0.1
Agricultural	0.1	3.3	7.3	0.3
Industrial	9.6	0.0	0.1	0.1
<u>Memo item: Total (World) Exports</u>				
All	n.a.	2.4	5.8	2.9

/a Weighted averages of the post-Tokyo Round MFN and preferential nominal tariff rates. To arrive at them, first, a tariff average for each tariff position was calculated using actual import values and the import duties facing them (i.e. MFN, GSP or special preferences); and second, the average rates for tariff positions were aggregated to the product group level, using shares of tariff position in total imports of this product group.

Source: UNCTAD Data Base on Trade Measures

5. As an illustration of the nature of the problem, Table 2 (adapted from UNCTAD, p. 44) examines the structure of nominal tariffs in ten industrial country markets before and after the Tokyo Round for selected

processing chains, many of which are of primary importance to Indonesia.^{3/} Shown here are the average pre- and post-Tokyo Round tariffs applied to each stage of fabrication as well as two statistical indices which measure whether the degree of escalation increased or decreased due to the Multilateral Trade Negotiations. For example in the case of coffee the rate facing primary products was reduced from 10.0% to 6.8% (i.e. by 32%) while the rate facing fabricated products (i.e. processed coffee) decreased from 13.3% to 9.4% (i.e. by 29.3%). Consequently, the overall level of tariff protection, as well as, the absolute difference between rates on primary and processed coffee, were reduced, but the relative (percentage) difference was in fact increased.

6. The two major points that emerge from Table 2 are that, in cases like fish, coffee, hard fibres and wood, the degree of escalation in tariffs actually increased due to disproportionately large tariff reductions for primary and intermediate stage items which were made in the Tokyo Round. In these instances it is clear that the changing structure of tariffs (i.e. the increased degree of escalation) will have a negative influence on Indonesia's (and other developing countries') efforts to expand exports of fabricated goods. Second, the table also indicates that the degree of escalation for many of the chains remains very high after the Tokyo Round. For example, the average post-Tokyo tariff for processed fruit (16.6 percent) is almost four-times that for fresh fruit (the primary stage product) while a similar degree of escalation is also evidenced in the wood processing chain (tariffs rise from 1.8-6.6% over the different stages). Similarly, in the case of leather, raw hides are subject to a zero average import duty in the ten industrial markets with the average for leather manufactures standing at more than eight percent. All in all, the evidence presented in Table 2 indicates that tariff escalation continues to be a problem for Indonesia (and other developing countries) and, in some cases, the magnitude of the problem has increased as a result of the Tokyo Round results.

7. Nontariff Barriers. Since the protective effect of tariffs is frequently seen by importing countries as inadequate, and since tariffs are in any case difficult to manipulate in a quick and efficient manner owing to legal constraints, governments often rely on various nontariff measures.

^{3/} The analysis in Table 2 follows the standard GATT approach of calculating the levels of tariffs at each processing stage and determining how these average tariffs behave over the chain. If tariffs are found to escalate with fabrication this is taken to indicate a bias against processed good exports from developing countries. However, a recent analysis shows that even when tariffs do not escalate over a processing chain there may still be an important bias against processed goods due to the relatively greater demand elasticities for these products. See Yeats.

	ATA	AIA	BLX	DEN	FR	GER	GRE	IRL	ITA	NET	UK	FIN	JAP	NR	SWZ	
9703		L														
0706			VL				L									
1605					S					L			L			
2205			L,R					Q								
2302			VL,L	L,VL	L				Q							
3808			TQ													
4415			TQ													
5505												L				
0901	L			Q												AL
0602					S										L	L
1703		L	VL,L	L				Q								
2006			L	L	S,L	L	L	L	L	L	L	L				
4405					IS											
4413					S											
6103										S		S			L	AL
7302			S	S	S	S	S	S	S	S	S					
8515			L		Q		Q			L						
8521					Q											
8706					S											
0603			TS	L			L	Q								

	ATA	ALA	BLX	DEN	FR	GER	GRE	IRL	ITA	NET	UK	FIN	JAP	NOR	SWZ
1006			VL				L								
2002			Q	Q	Q	Q	Q	Q	Q	Q	Q	L			AL,Q
6202						Q						L			
8702		L	Q				Q	Q		Q					
0701			L	Q	S		Q	Q		L		L		L	Q
0802			R	R	R	R	R	R	R	R	R	L			
1104			VL	L			AL								
1702			L	L	L	L	L	L	L	L	L	L		L	AL
1704		L	VL												
2107			L,VL	VL	VL	VL	VL	VL	VL	L,VL	VL		Q		VL
0407		L										L	L		
0508													L		
0509													Q		
0512													L		
1005			L	L	L	L	L	L	L	L	L	VL	TQ		L
1108			L,VL	Q	Q										
1208													Q		
1302													Q		L
1303		L			S								Q		
1405		L											L		

ATA	ALA	BLX	DEN	FR	GER	GRE	IRL	ITA	NET	UK	FIN	JAP	NOR	SWZ
-----	-----	-----	-----	----	-----	-----	-----	-----	-----	----	-----	-----	-----	-----

9028 L

Explanation of Symbols

Nontariff Barriers

- L - licensing
- Q - quota
- AL - automatic licensing
- VL - variable levy
- S - surveillance
- TQ - tariff quota
- R - reference import price

Importing Countries

- ATA - Austria
- ALA - Australia
- BLX - Belgium-Luxembourg
- DEN - Denmark
- FR - France
- GER - Germany, Fed. Rep.
- GRE - Greece
- IRL - Ireland
- ITA - Italy
- NET - Netherlands
- UK - United Kingdom
- FIN - Finland
- JAP - Japan
- NOR - Norway
- SWZ - Switzerland

Notes

/a Symbol in normal print indicate measures actually imposed on imports from Indonesia, bold symbols indicate measures which would face Indonesian product should it be exported to a given country.

/b Measures taken under the Multifibre Arrangement (MFA) are not included.

8. Especially striking about the current array of nontariff measures is its wide variety: some studies suggest that over 200 different types of these measures exist. Here four groups of major NTBs are investigated.

(a) Quantitative restrictions and "voluntary" export restraints:

Prohibitions: embargoes on the importation of a product. A prohibition may be total, may admit exceptions or may operate only under certain conditions.

Quotas: ceilings (specified in value or quantitative terms) imposed for a given period of time.

Discretionary import authorizations: permission to import granted at the discretion of the competent authorities.

Conditional import authorizations: permission to import granted subject to the importer undertaking commitments in areas other than importation, or to specified overall economic conditions.

"Voluntary" export restraints (VERs): Agreements between an exporting country and an importing country as to the maximum amount of exports to be effected within a given period of time.^{4/}

(b) Price controls

Variable levies: variable charges serving to equalize the c.i.f. import price with a decreed price.

Minimum price systems: the setting of a minimum import price by the importing country. Actual prices below the decreed minimum may trigger the imposition of additional duty or a price investigation.

"Voluntary" export price restraints: agreement between the exporter and the importer on the minimum price to be observed by the exporter.

^{4/} While voluntary export restrictions are administered by exporting countries, their imposition is the result of successful protectionist requests in importing countries.

(c) Monitoring measures

Anti-dumping and countervailing duties: duties levied on a product that is sold in the importing country at a lower price than in the exporting country (dumping), or to offset rebates or subsidies provided for the production or export of a good (countervailing). Although the GATT permits the use of these duties under certain circumstances, there is evidence that they are frequently applied in lieu of safeguards with both the intent and effect of protecting domestic industry, see Finger, Hall and Nelson.

Price investigations: Formal investigations of charges by domestic producers about unfair trading practices of an exporting country. While an investigation is obviously necessary to determine the facts of dumping or subsidies, there is evidence that the inquiry process itself has a protective effect, independent of the eventual findings, see Finger. Also, in some cases, price investigations were a prelude to the negotiation of "voluntary" export restraints.

Monitoring: formal close surveillance of imports of sensitive products, primarily by the means of automatic and liberal licensing. Surveillance may be the precursor to restriction ^{5/} or may inhibit trade in its own rights.

(d) Measures increasing the landed price of imports

Tariff quotas: the application of two tariff rates, the higher rate coming into operation when the quantity of imported goods exceeds a specified level.^{6/}

Seasonal tariffs: different tariff rates are applied to the same (agricultural) product according to the time of year.

9. All these types of measures are binding nontariff barriers since they control or restrict either the price or the quantity of imports. In some cases the mechanism is direct -- e.g. for quotas, minimum price agreements, and "voluntary" export restraints -- while in others, it is more subtle. For example, price investigations and surveillance measures are necessary precursors to control and thus create uncertainty and encourage "self-restraint" among exporters irrespective of whether explicit protective action is subsequently taken.

^{5/} Indeed European Economic Community regulations [e.g., Council regulation (EEC) 288/82] explicitly refer to surveillance for this purpose. (See the Official Journal of the European Communities, 1982.)

^{6/} Note that tariff quotas may also provide for preferences if the lower rate is set below the applied MFN rate.

10. Table 3 presents estimates of the extent of the above listed NTBs on Indonesian exports of non-oil products in 17 major industrial markets, and compares them with similar estimates for exports of developing countries. Information on NTBs is for 1983 and that on trade for 1981.^{7/} The statistical indicators employed to measure the extent of NTBs are the coverage and frequency ratios. For any importer, i , and type of NTB, let $N_{qx} = 1$ if there is a nontariff barrier on (tariff-line) imports of q from exporter x , and let $N_{qx} = 0$ otherwise. For sets of commodities, Q , and exporters, X , both indices take the form:

$$I = \frac{\sum_{q \in Q} \sum_{x \in X} W_{qx} N_{qx}}{\sum_{q \in Q} \sum_{x \in X} W_{qx}}$$

The import coverage ratio defines W_{qx} as the value of i 's actual imports of q from x . The frequency ratio defines W_{qx} as the presence or absence of a flow of q from x to i : thus $W_{qx} = 1$ if (tariff-line) imports of q from x are nonzero and $W_{qx} = 0$ otherwise.

11. Note that the purpose of the coverage and frequency ratios is to measure the extent to which imports are covered by NTBs and not the degree to which they are restricted. Thus, it is a more elementary concept than a tariff average. An appropriate parallel is the ratio of dutiable to total (dutiable plus duty free) imports. A tariff rate is, by its very nature, a measure of the "intensity" of restriction, whereas nontariff measures, unfortunately, provide us with no such "natural" indication of intensity: all we have is a "Yes or No" indicator -- strictly qualitative information on whether or not governmental considerations influence trade.

12. Both indices have strength and weaknesses. The coverage ratio is possibly more natural in that the extent of NTBs is represented by the size of the particular trade flow it affects. Its drawback is that it understates the restrictiveness of barriers because the tighter an NTB the lower is the relevant import. The frequency ratio avoids some of the downward bias. The extent of NTB is measured by the number of trade flows that are subject to them so that every barrier or every observed trade flow receives equal weight. On the other hand, however, the frequency ratio ignores the perfectly natural differences in the sizes of different trade flows, and it is also sensitive to the tendency of trade classifications to be more fragmented the more monitored and restricted is a category of imports.

13. Returning to Table 3 we note that over 15% of the value of Indonesian exports to (major) industrial markets are subject to nontariff barriers. Comparison with the coverage ratio for all developing countries (22.5%) seems to indicate that while significantly impeded by NTBs, Indonesian exports suffer less from these barriers than exports of other developing nations. That observation however, is contradicted by the frequency ratio

^{7/} More recent data on NTBs facing all developing countries were not available for this tabulation. However, Chapter 2 provides up-to-date information on NTBs facing Indonesian exports.

which points to Indonesian products as a more frequent subject of NTBs than the products of other developing countries.

**Table 3: THE EXTENT OF NONTARIFF BARRIERS FACING IMPORTS
OF NON-OIL PRODUCTS FROM INDONESIA AND ALL DEVELOPING COUNTRIES
BY SELECTED MAJOR INDUSTRIAL MARKETS**

Importer	Value of Imports (1981, US\$ mill.)		NTB Coverage Ratio		NTB Frequency Ratio	
	Indonesia	LDCs	Indonesia	LDCs	Indonesia	LDCs
United Kingdom	177	1,1854	20.9	27.4	31.1	19.8
Netherlands	185	5,851	24.0	32.3	29.2	21.1
Italy	206	9,128	2.5	16.2	28.6	15.0
Ireland	3	357	39.8	19.9	40.9	22.1
Germany	260	17,800	11.5	23.9	26.3	18.5
Greece	6	739	0.4	12.9	9.4	17.1
France	150	10,606	32.8	28.6	36.1	30.0
Denmark	36	1,140	47.8	35.8	41.0	24.6
Belgium-Lux	66	5,606	45.5	45.1	29.2	19.9
<u>TOTAL EEC</u>	<u>1,089</u>	<u>63,089</u>	<u>19.7</u>	<u>26.9</u>	<u>29.9</u>	<u>20.9</u>
USA	908	55,384	4.2	18.9	21.5	10.3
Switzerland	33	2,111	37.0	34.5	33.6	24.7
Norway	7	917	0.6	18.2	6.5	18.6
Japan	1,437	24,358	15.7	17.5	14.4	11.3
Finland	2	812	16.3	26.9	14.3	21.0
Austria	13	1050	34.6	19.2	2.5	6.3
Australia	80	2,904	11.9	27.9	25.6	19.5
<u>All Above</u>	<u>3,569</u>	<u>150,625</u>	<u>14.1</u>	<u>22.5</u>	<u>25.3</u>	<u>18.5</u>

Source: World Bank estimates.

14. Does this contradiction suggest that Indonesian exports are particularly adversely affected by NTBs since only small values manage to overcome numerous obstacles? This in fact is the case of exports to some markets. For example, as it will be documented in detail in Chapter 2, textile and clothing exports to the USA are kept by the means of NTBs at a very low level. On the other hand, however, very often Indonesia exports only very small quantities of particular products which are covered by NTBs in importing countries, but which due to their marginal size are not affected by these restrictions. For example in exports to Japan, values of 136 products (i.e. of 37% of all non-oil products) do not exceed US\$10,000. While 13 of these products fall into tariff lines which are subject to NTBs their size is too small to trigger restriction. However, as was already noted once these products display a sharp increase or it reaches an "undesirable" level they would most probably be regulated.

15. Thus the conclusion to be drawn from Table 3 is that the structure of Indonesian exports is such that a relatively large proportion of products fall into categories subject to nontariff barriers. While the current effects of NTBs on export value cannot be unambiguously evaluated, the above finding indicates that the growth of a large part of Indonesian exports is not only dependent on market conditions but also on the decisions of importing countries' governments as to the desirable levels of imports from Indonesia.

16. Tables 4-6 provide more detailed estimates -- by large product categories -- of the extent of NTBs. As is revealed by Table 4, with the exception of a few markets, Indonesian agricultural products face very high nontariff obstacles. Only in the US, Australia, (which however maintains very stringent health and sanitary requirements equivalent, in many cases to a prohibition), and some smaller markets, the extent of NTBs is small. In other countries -- including Japan, i.e. the largest market for Indonesian products -- NTBs cover from 11% to as much as 67% (Japan) of agricultural exports.

17. Indonesia is a signatory of the Multifibre Arrangement (MFA), an umbrella type agreement between exporters and importers which regulates international trade in textiles and clothing. Based on provisions of the MFA Indonesia has concluded four bilateral agreements -- with the USA, EEC, Canada and Sweden -- involving quantitative limits to its exports, and one agreement -- with Norway -- providing for the monitoring (the so-called "double checking"). An agreement with Finland is currently being negotiated.

18. In addition, Indonesian exports are subject to unilateral measures in countries which did not sign or do not apply the MFA. Thus, in Switzerland textile imports require (automatically issued) licenses; in Japan quota limits imports of silk; Finland monitors imports of all textiles of the type exported by Indonesia and Australia operates a system of tariff quotas which provides for relatively low duties for specified (yearly) amounts of textiles and clothing and very high, penalty, duties for imports in excess of these limits.

19. Table 5 shows that as the result of the above restrictions, the coverage and frequency NTB indices for textiles and clothing are particularly

TABLE 4

NON-TARIFF BARRIERS OF INDUSTRIAL COUNTRIES APPLIED(*) TO IMPORTS FROM
INDONESIA

1. AGRICULTURE (CCCN 0101-2402; TSUSA 10001-19324)

IMPORTER	1981 VALUE OF IMPORTS FROM INDONESIA					NUMBER OF PRODUCTS (TARIFF POSITIONS) FROM INDONESIA				
	TOTAL	PERCENT OF IMPORTS COVERED BY NTBS				TOTAL	PERCENT OF PRODUCTS SUBJECT TO NTBS			
	(US \$,000,000)	QR + VER	PRICE CONTR.	MONITORING	ALL(1)	(NUMBER)	QR + VER	PRICE CONTR.	MONITORING	ALL(1)
UNTD. KINGDOM	52	8.9	7.9	0.0	9.1	58	5.1	8.6	0.0	10.3
NETHERLANDS	137	22.2	13.5	0.0	27.6	110	15.4	14.5	0.0	26.3
ITALY	75	0.0	0.9	0.0	0.9	35	0.0	11.4	0.0	14.2
IRELAND	2	28.9	0.0	0.0	28.9	8	12.6	0.0	0.0	12.6
GREECE	3	0.0	0.0	0.0	0.0	16	0.0	0.0	0.0	0.0
GERMANY	127	2.0	8.8	0.0	10.9	81	4.9	4.9	0.0	9.8
FRANCE	87	0.4	41.7	0.1	41.9	43	2.3	6.9	4.6	11.6
DENMARK	32	45.3	0.0	0.0	45.3	31	3.2	0.0	0.0	3.2
BELGIUM+LUX	51	20.9	48.8	0.0	51.8	45	11.1	8.8	0.0	15.5
EEC (TOTAL)	546	11.7	16.1	0.0	23.2	427	7.4	8.4	0.4	14.5
U.S.A.	257	0.1	0.0	0.0	0.1	88	1.4	0.0	0.0	1.4
SWITZERLAND	20	0.2	0.0	58.0	58.2	30	16.6	3.3	20.0	40.0
NORWAY	4	0.0	0.0	0.0	0.0	15	0.0	0.0	0.0	0.0
JAPAN	331	67.2	0.0	0.0	67.3	98	39.8	0.0	0.0	40.8
FINLAND	1	0.0	0.0	0.0	0.0	17	0.0	0.0	0.0	0.0
AUSTRIA	8	57.5	0.0	0.0	57.5	33	3.0	3.0	0.0	6.0
AUSTRALIA	39	1.3	0.0	0.0	1.3	34	17.6	0.0	0.0	17.6
ALL ABOVE	1,206	24.1	7.2	0.9	30.4	722	11.8	5.2	1.1	17.0

(*) SITUATION AS OF 30 JUNE 1984

(1) INCLUDES ALSO TARIFF TYPE MEASURES (I.E TARIFF QUOTAS AND SEASONAL TARIFFS).

Source: World Bank and UNCTAD.

TABLE 5: Textiles

(CCCN 8001-8302; TSUSA 30010-39080)

IMPORTER	1981 VALUE OF IMPORTS FROM INDONESIA					NUMBER OF PRODUCTS (TARIFF POSITIONS) FROM INDONESIA				
	TOTAL	PERCENT OF IMPORTS COVERED BY NTBS				TOTAL	PERCENT OF PRODUCTS SUBJECT TO NTBS			
	(US \$,000,000)	QR + VER	PRICE CONTR.	MONITORING	ALL(1)	(NUMBER)	QR + VER	PRICE CONTR.	MONITORING	ALL(1)
UNTO. KINGDOM	8	98.2	0.0	71.4	98.9	77	80.5	0.0	64.9	97.4
NETHERLANDS	6	98.6	0.0	51.3	98.6	76	90.7	0.0	11.8	90.7
ITALY	4	98.6	0.0	0.0	98.7	81	79.0	0.0	0.0	80.2
IRELAND	0	97.1	0.0	92.4	97.1	7	85.7	0.0	71.4	85.7
GREECE	0	5.2	0.0	0.0	5.2	5	80.0	0.0	0.0	80.0
GERMANY	14	98.3	0.0	0.0	98.3	102	83.3	0.0	0.0	83.3
FRANCE	7	99.9	0.0	81.6	99.9	57	98.4	0.0	24.5	96.4
DENMARK	2	99.6	0.0	0.0	99.6	48	85.4	0.0	0.0	85.4
BELGIUM+LUX	1	99.3	0.0	58.7	99.3	30	93.3	0.0	16.6	93.3
EEC (TOTAL)	40	97.5	0.0	35.0	97.5	483	85.7	0.0	17.1	88.8
U.S.A.	38	99.7	0.0	0.0	99.7	72	88.8	0.0	0.0	88.8
SWITZERLAND	0	0.0	0.0	76.5	76.5	31	0.0	0.0	61.2	61.2
NORWAY	0	86.9	0.0	0.0	86.9	4	75.0	0.0	0.0	75.0
JAPAN	4	80.1	0.0	0.0	80.1	65	4.8	0.0	0.0	4.8
FINLAND	0	0.0	0.0	100.0	100.0	4	0.0	0.0	100.0	100.0
AUSTRIA	0	0.0	0.0	0.0	0.0	18	0.0	0.0	0.0	0.0
AUSTRALIA	15	0.6	0.0	0.1	40.0	78	5.1	0.0	1.2	34.6
ALL ABOVE	97	82.4	0.0	14.4	88.6	755	64.6	0.0	14.1	72.5

(1) INCLUDES ALSO TARIFF TYPE MEASURES (I.E TARIFF QUOTAS AND SEASONAL TARIFFS).

Source: World Bank and UNCTAD.

(* * * IN CCCN/TSUSA * * *)

TABLE 6: Other Manufactures

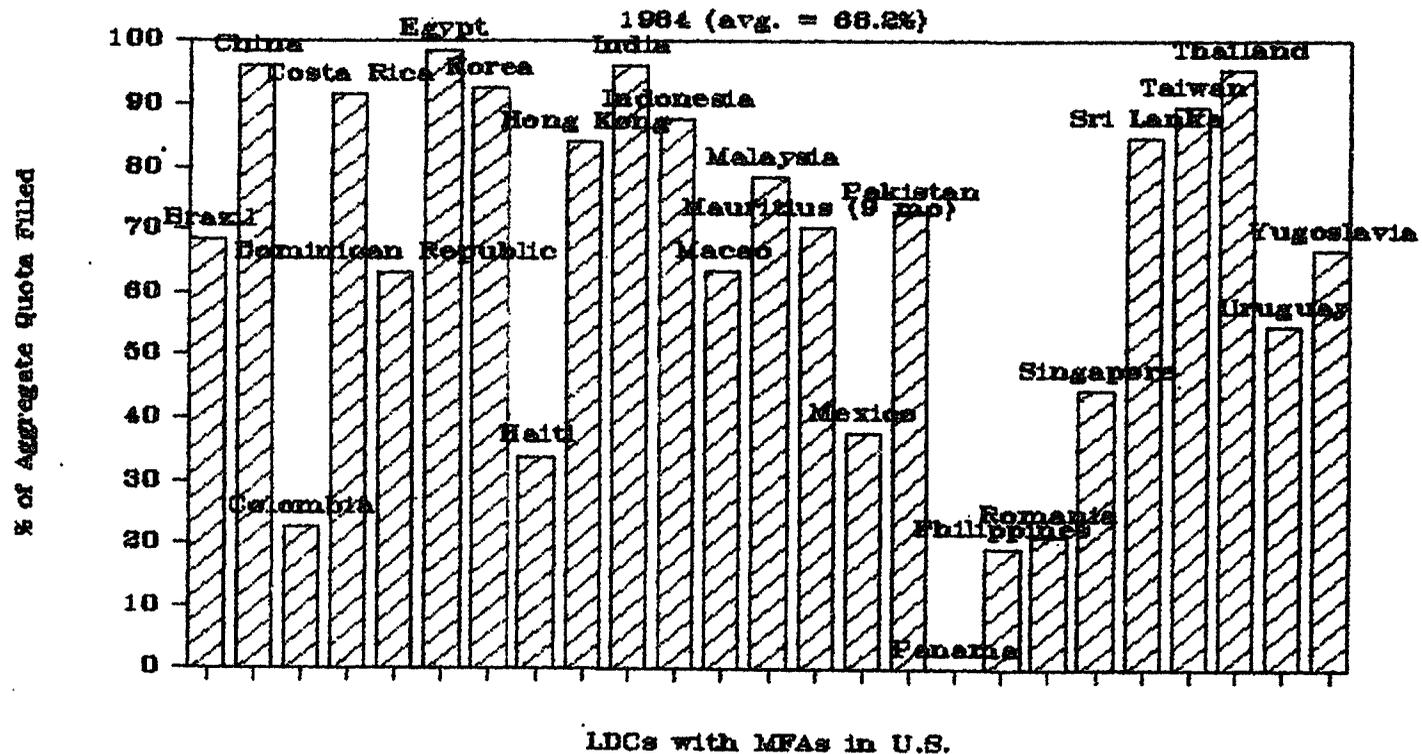
IMPORTER	1981 VALUE OF IMPORTS FROM INDONESIA					NUMBER OF PRODUCTS (TARIFF POSITIONS) FROM INDONESIA				
	TOTAL	PERCENT OF IMPORTS COVERED BY NTBS				TOTAL	PERCENT OF PRODUCTS SUBJECT TO NTBS			
	(US \$,000,000)	QR + VER	PRICE CONTR.	MONITORING	ALL(1)	(NUMBER)	QR + VER	PRICE CONTR.	MONITORING	ALL(1)
UNTD. KINGDOM	117	0.0	0.0	0.0	22.3	129	0.0	0.0	0.0	1.5
NETHERLANDS	42	0.0	0.0	0.0	1.5	154	0.0	0.0	0.0	1.3
ITALY	127	0.0	0.0	0.0	0.3	141	0.0	0.0	0.7	2.8
IRELAND	1	0.0	0.0	0.0	59.0	7	0.0	0.0	0.0	28.5
GREECE	3	0.5	0.0	0.0	0.5	32	3.1	0.0	0.0	3.1
GERMANY	104	0.0	0.0	0.0	2.3	176	0.0	0.0	0.0	1.1
FRANCE	78	4.6	0.0	11.8	18.6	102	6.8	0.0	4.9	12.7
DENMARK	2	0.0	0.0	0.0	32.7	26	0.0	0.0	0.0	3.6
BELGIUM+LUX	14	0.0	0.0	0.0	18.3	55	0.0	0.0	0.0	5.4
EEC (TOTAL)	486	0.8	0.0	1.8	9.6	322	0.9	0.0	0.7	3.6
U.S.A.	613	0.0	0.0	0.0	0.0	198	3.5	0.0	1.5	4.8
SWITZERLAND	12	0.1	0.0	0.0	0.1	44	6.8	0.0	4.5	11.3
NORWAY	3	0.0	0.0	0.0	0.0	27	0.0	0.0	0.0	0.0
JAPAN	938	0.0	0.0	0.0	0.0	194	4.6	0.0	0.0	4.6
FINLAND	1	0.0	0.0	0.0	0.0	7	0.0	0.0	0.0	0.0
AUSTRIA	5	0.0	0.0	0.0	0.0	30	0.0	0.0	0.0	0.0
AUSTRALIA	28	4.7	0.0	0.0	11.5	101	21.7	0.0	0.0	24.7
ALL ABOVE	2,084	0.2	0.0	0.4	2.4	1,423	3.4	0.0	0.7	5.4

(1) INCLUDES ALSO TARIFF TYPE MEASURES (I.E TARIFF QUOTAS AND SEASONAL TARIFFS).

Source: World Bank and UNCTAD.

FIGURE 1

**The Utilization of the MFA
Specific Quotas in the USA (1984)**



high. Overall, 88.6% of total value of exports of these products are subject to nontariff obstacles, especially to quotas and "voluntary" export restraints.

20. Finally, as indicated by Table 6, the extent of NTBs facing other manufactures is relatively small. Overall only 5.4% of these products accounting for about 2.4% of their total value are facing nontariff obstacles.

NTBs Facing Individual Product Groups

21. This section discusses nontariff obstacles to product groups of export interest to Indonesia. Extensive information is presented in the Annex which lists the NTBs facing the 4-digit CCCN categories of products which are exported by Indonesia and which meet NTBs in at least one of the 16 industrial country markets (the USA is not included since her trade classification -- SUSA -- is not compatible with the CCCN). For each of these products both the NTBs actually imposed on them as well as those which would be encountered in other markets should a product be exported there (those symbols in bold print) are shown.

22. The text below provides additional details on NTBs affecting selected products of particular interest to Indonesia. Note that two major export groups, ores and metals and rubber, accounting for 17.2% and 15.5% of non-oil exports respectively, face very few nontariff obstacles. Only the unhardened vulcanized rubber (tariff item 4014200) is subject to global quota in Japan and ferro-nickel (position 730257) to automatic licensing in France. Both rubber and tin (the major commodity in metals group) are covered by international commodity agreements.

Fish

23. In 1982 Indonesia exported US\$231.4 million worth of fish and fish preparations accounting for about 6% of total non-oil exports. Table 7 shows fish products of the kind exported by Indonesia listed by importer, tariff position, and type of nontariff barrier encountered.

Table 7: FISH: NON-TARIFF BARRIERS

Australia

0301000	Fish, fresh	L
0302000	Fish, dried, salted, in brine	L
0303000	Crustaceans and molluses	L

EEC

030122	Whole yellow-finned tuny (over 10 kg each)	MP
030126	Grilled and gutted yellow-finned tuny (over 10 kg)	MP
030128	Grilled and gutted tuny (other than yellow)	MP
030175	Saltwater fish, fresh	MP
160530	Prepared crustaceans other than crab	L

Japan

0301190	Aquarium or ornamental fish	L
0301262	Skip-jack and other Bonito, frozen	L
0301264	Yellowfin tuna, frozen	L
0301265	Bluefin tuna, frozen	L
0301266	Big-eye tuna, frozen	L
0301268	Swordfish, frozen	L
0301273	Hairtails, frozen	L
0301276	Shark, frozen	L
0301279	Other fish, frozen	L
0301282	Fillets of tuna and swordfish, frozen	L
0301289	Fish fillets, frozen	L
0302190	Hard roes	L
0302219	Fish, salted, in brine and dried n.e.s.	L
0303112	Ise-ebi, fresh	L
0303119	Shrimps, prawns, lobster - fresh	L
0303120	Shrimps, prawns, lobster - preserved	L
0303212	Cuttle fish and squid, fresh	GQ,L
1604241	Bonito and the like, boiled, dried	L
1605219	Shrimps, prawns, lobster - prepared	L

Note: L stands for import licensing, MP for minimum import price, and GQ for global quota

Coffee, Tea and Spices

24. These products traditionally account for a large proportion of Indonesian exports: 13.9% of non-oil exports in 1982. The single largest item in this group is coffee, which is subject to the discipline of the International Coffee Agreement. The current export quota provides for 150,000 tons annually (until 1980-2000). Given the production of about 360,000 tons and domestic consumption of 80,000, the remainder (i.e. 130,000 tons) is

exported outside the agreement, to nonmember countries at heavily discounted prices.^{8/} Indonesian trade and foreign affairs officials are attempting to negotiate an increase of allocation from the current 4.5% of the total quota, to 7%. While at present, quotas are not in effect due to the drought in Brazil, it is unclear whether Indonesia will succeed in its application for an increased share of the quota. However, due to the large difference between prices for quota and nonquota exports it would not be in the Indonesian interest to withdraw from the ICA, nor does this option seem to be seriously considered by authorities.

25. Export licenses for coffee (90% of which is grown by small farmers) are allocated among registered traders according to their past performance (see the section on administration of textile exports).

26. Other products in the group do not face border barriers with the exception of coffee extracts in Australia (tariff position 2102110) which are subject to licensing and tea in Switzerland (09021000) subject to automatic licensing. Note however, that in many markets (particularly in Australia and Japan) food is subject to (sometimes very stringent) health and sanitary controls and in Australia marking and packaging standards apply to spices. Indonesian exporters very often find these requirements cost increasing.

Vegetables and Products Thereof

27. This group accounts for about 8.8% of non-oil exports (about US\$340 million in 1982) and consists of vegetables and fruits (0.8%), feeding stuff for animals (1.9%), tobacco (1.1%), crude vegetable materials (2.4%) and fixed vegetable oils (2.6%). Table 8 shows nontariff barriers facing major items included in this group.

^{8/} About 50% of "quota" price. For example a current contract with Algeria provides for annual shipments of 20,000 tons for US\$35,635 thousand; that is about 81 cents per pound.

Table 8: VEGETABLES AND THEIR PRODUCTS: NON-TARIFF BARRIERS

<u>Australia</u>		
1201900	Oil seeds, other than ground-nuts	L
<u>Austria</u>		
1904	Tapioca	VL
<u>EEC</u>		
070199	Other vegetables, n.e.s.	L
070630	Manioc	VL,VER
170249	Other sugars and syrups	L
170300	Molasses	VL,L
2302	Residues of cereals	L
<u>Germany</u>		
200298	Vegetable and mixtures	Q
<u>Japan</u>		
1108310	Manioc starch	GQ
1405111	Seaweeds of genus gelidiaceae	L
1405119	Seaweeds, other	L
<u>Switzerland</u>		
15073000	Other edible fixed vegetable oils, crude	AL
<u>USA</u>		
14548	Peanuts, prepared or preserved	Q

Note: L indicates import licensing, GQ indicates a global quota, VL is variable levy, q is quota, AL is automatic licensing, and VER is voluntary export restraint.

28. Note that manioc (tapioca) is on the list. The "Voluntary" Export Restraint regulating access to the EEC market, where manioc competes with domestic cereal-based animal feeds, is important. The arrangement with the EEC makes imports over the quota subject to a tariff of about 18% plus the variable levy, rather than a tariff of 6% for imports under the quota. This penalty rate makes manioc uncompetitive. In contrast to Thailand, another VER exporter, Indonesia is not utilizing fully its quota due to the low level of production. Price appears to be a problem, since the Indonesian manioc is of a high quality.

Wood and Wood Products

29. Wood is the single most important category of non-oil Indonesian exports. In 1982 it accounted for about US\$879 million, 22.4% of non-oil exports. Plywood is the most important item in the group, accounting for over US\$300 million in 1982.

30. Wood faces relatively few NTBs in industrial markets. Plywood (NIMEX item 441520), blockboard, laminboard and battenboard (NIMEX 441531) and laminated wood products (NIMEX 441539) are subject to tariff quotas in the EEC with the penalty rate of 15%, and in France, nonconiferous wood, planed, tongued, etc (NIMEX 441350) requires import licenses. Other countries do not apply border restrictions. In this situation tariffs appear to be of greater concern. In particular, the 17.5% tariff on plywood in Japan, scheduled to be phased down to 10% and 15% depending on thickness, is considered by Indonesian exporters as a major obstacle to further growth of shipments to that market.

Textiles and Clothing

31. As noted earlier, textiles and clothing are particularly tightly regulated by means of nontariff barriers. While this group of products still has a relatively small share of non-oil exports (4.1% in 1982), in recent years it displayed impressive growth (see below).

32. Two most important markets for Indonesian textiles are the EEC and the USA: in 1981 they accounted for about 60% of total shipments and for 80% of exports to (17) major industrial countries.

33. The current bilateral agreement between Indonesia and the USA was signed for the period July 1, 1985 to June 30, 1988. It differs from the preceding agreement in three major respects:

- (a) it covers all MFA textile categories and not only selected items as the preceding;
- (b) it also covers ramie which is not a MFA product;^{9/}
- (c) it establishes specific limits for 34 product categories (only 18 in 1984 and 9 in 1983); and,
- (d) it establishes an aggregate limit for the group of remaining categories (no such provisions in earlier agreements).

34. In quantitative terms, the agreement imposes for (quota year) 1985 a quota of 235.2 million square yards equivalent (SYE) for categories subject to specific (individual) limits and of 49.8 million SYE for all other categories

^{9/} Specifically, the agreement provides for an application of the MFA type mechanism (i.e. bilateral consultations, specific limits, etc.) in case of market disruption or the threat thereof.

as a group with a specific quota for wool items of 3 million SYE. In sum, Indonesian exports to the USA are not to exceed in the period July 1, 1985 to June 30, 1986 a level of 285 million SYE. Since in 1984 they amounted to about 268 million SYE this limit implies a growth rate of about 6% which is also the rate provided for in the agreement for the period of its duration.^{10/}

35. These very restrictive provisions (a demonstration of an increase in protectionism in the USA) seriously affect prospects for Indonesian textile exports, which in recent years displayed remarkable growth. Two statistics will illustrate this point. First, the volume of shipments to the US increased from 84.2 million SYE in 1983 to 268.0 million in 1984: an increase of over 218%. Secondly, as Figure 1 shows, Indonesia was in 1984 among the MFA countries which have utilized their quotas to the highest degree. While the average rate of utilization was 68.2%, the rate for Indonesia was 88%.^{11/}

36. As is well known, the current restrictions are not considered by the US textile industry as sufficient. Thus, the traditionally powerful pressure group, continues to lobby for more restrictive legislation. Recently the US President vetoed the Jenkins Bill which provided for substantial cuts in textile imports from developing countries. According to a recent estimate, due to their particular product composition (mostly cotton and man-made fibre wearing apparel) under this legislation, Indonesian exports would have been dramatically reduced by 85%.^{12/} However, the large support that the sponsors of the Jenkins Bill managed to organize in the US Congress indicates that there is a continuous danger of further tightening of import restrictions.

37. The current agreement with the EEC was signed for the period of January 1, 1983 to December 31, 1986. It provides for three specific quotas for a total quantity of 492,000 metric tons. Imports of other items are subject to the so-called "basket extractor". This mechanism provides that when imports in a product category not subject to specific limits, reach a certain designated percentage of the preceding years' total imports into the EEC of products in that category, the EEC may request the opening of consultations "with a view to reaching agreement on an appropriate restraint level for the products in such a category". The percentage applicable differs according to product groups (based on "sensitivity").

^{10/} With an exception of wool items which are not to grow more than 1% a year.

^{11/} It needs to be added, however, that despite this performance Indonesia remains a marginal supplier to the US market: in 1983 it accounted only for 1.1%, and in 1984 for 2.6% of total US imports from the MFA suppliers.

^{12/} Compared with, for example, 66% reduction in imports from Brazil, 55% in the case of Thailand, 47% from Taiwan, etc. See, International Business and Economic Research Corporation.

38. What renders the EEC mechanism particularly restrictive is:
- (a) the Community is broken down by "regions" (i.e. individual member countries) and quotas for one "region" cannot be shifted to another. Also, consultations can be initiated when any of the regional (basket extractor) limits is met;
 - (b) the exporting countries are required to provisionally limit their exports from the date of notification of the request for consultations;
 - (c) if the consultations do not result in a satisfactory solution within two months of the notification, the EEC can impose unilateral restrictions.

39. The recent performance of Indonesian textile and clothing exporters to the EEC was quite impressive. Total exports to this market increased from 7,000 tons in 1983 to 12,000 tons in 1984 (an increase of 58%); value increase was 51% in US dollar terms and 70% in ECU terms. Nevertheless, the utilization of quotas was not as good as in the USA. Thus, for category 6 (outer garments), the quota was filled to 67.2%, for category 7 (knitted or crocheted garments), to 46.3% and for category 8 (men's and boy's under garments) to 92.9%.

40. There seems to be two reasons for the under utilization of quotas. The first, is the fragmentation of the EEC limits. For example in category 6, the quota for Germany was used to 96% while those for France and Italy to less than 1%. Also, there were no exports of these products to Greece. Similarly, the utilization of quotas for category 8 in Germany and Ireland was over 100% while in Belgium and Luxembourg only 2.5% and in Italy 19.9%. In general, quotas are best utilized in Germany, Ireland and the United Kingdom, while only small shares are used up in Greece, Belgium and Luxembourg and Italy.

41. Secondly, it is argued that due to the strong appreciation of the US dollar the profitability of the EEC market was in recent years seriously eroded. Thus the Indonesian exporters seemed to concentrate their marketing efforts on the US rather than European markets. This contention is indeed supported by the drop in the unit value of Indonesian exports in US dollar terms from 6.33 dollars per kilogram in 1983 to 6.05 in 1984 (the unit value in ECU increased from 7.11 to 7.67 respectively). The drop in price seems to be a longer term phenomenon associated also with reasons other than changes in the US dollar exchange rate. For example in the period 1981-1983 the average unit value in US dollars decreased from 10.5 to 6.05 and in ECU from 9.40 to 7.67. At the same time the unit value of total EEC imports from the MFA suppliers decreased from 6.33 to 5.10 in dollar terms and increased from 5.67 to 6.47 in ECU terms. Therefore, there seems to be a problem of a substitution of the higher unit value goods by the lower price products, which perhaps should be linked to the Indonesian system of allocation of export

licenses which (as is discussed in Part III) supports inefficient producers of textiles and clothing.^{13/}

42. The MFA is scheduled to expire in July 1986 and the developing countries are arguing that it should not be extended. On the other hand, domestic textile interests in industrial countries press for even more restrictive measures. Given the strength of these pressures as well as a generally protectionist mood in the United States expiration of the MFA seems unlikely. Certain relaxation of textile restrictions can perhaps be expected in Europe, for example, in a form of overall (and not regional) quotas in the EEC and liberalization of access for certain suppliers. Indonesia, however, as a very dynamic exporter should not expect to be among those suppliers.

43. In the USA, the tendency is rather to tighten textile restriction. Firstly, the bilateral agreements are extended to other (including nonMFA) products and aggregate limits are introduced. Secondly, the criteria for the imposition of specific limits are less difficult to meet than before. For example since 1983, the US legislation provides, in summary, that if a total growth in imports in a given textile product or category is more than 30% in the most recent year, or if the ratio of total imports to domestic production in that product or category is 20% or more and imports from the individual supplier equal at least one percent of total US production of that product or category, then there is a presumption of market disruption. The new criteria resulted in 1984 in the requests ("calls") for consultations with Indonesia concerning imports in 8 categories.^{14/}

44. In another legislative action related to textiles, the US published (on August 3, 1984) new "Customs Regulating Amendments Relating to Textiles and Textile Products" which impose more stringent requirements concerning transformation of products in a third country (when a product is exported from a country other than the country of origin).

Administration of textile exports in Indonesia

45. A feature distinguishing voluntary export restraints (VER, that is the measures employed to regulate international trade in textiles) from other types of import restrictions is that the administration of VERs rests with the exporting country. This creates two types of problems. Firstly, an administrative procedure has to be established to control exports. Typically countries employ export licenses issued by the Ministry of Trade. Secondly, and more importantly so, criteria for allocation of the scarce licenses have to be devised.

^{13/} Also the so-called export certificates which contain an element of subsidy could be contributing to the phenomenon.

^{14/} In a subsequent decision (November, 1984) the GATT Textile Surveillance Body ruled that two of these calls should be withdrawn, one is justified and five required further consultation.

46. In a situation when exports are restricted, the right to export carries a value. This is illustrated by Figure 2. As exporting country restricts (under the VER) its exports by $q_1 q_0$ the export supply schedule changes from SS^1 into SaS^{11} and the price increases to p_s . However, the lower cost producers are willing to supply the restricted volume $0q_1$ at a price of at least p_2 per unit. Any price above this level will give them an additional income (rent) the maximum amount of which would be equal to $p_2 acp_1$.

47. The government in dealing with this situation has three basic options: (a) it may levy an export tax of $p_1 p_2$ per unit; (b) it may auction export licenses (producers would be willing to pay at least $p_1 p_2$ per unit) or, (c) it may distribute licenses as gifts. In all three cases the export volume will be $0q_1$. In the first two cases, the highest cost producers will be driven out of business and the government will collect (tax or export license) revenue of $p_2 acp_1$. In the last case, the high cost producers could stay in business and the rent income will be captured by exporters.

48. The Indonesian system for allocation of export licenses (like those of other ASEAN countries) is of the third type. Specifically, until 1984, licenses were allocated in the following fashion:

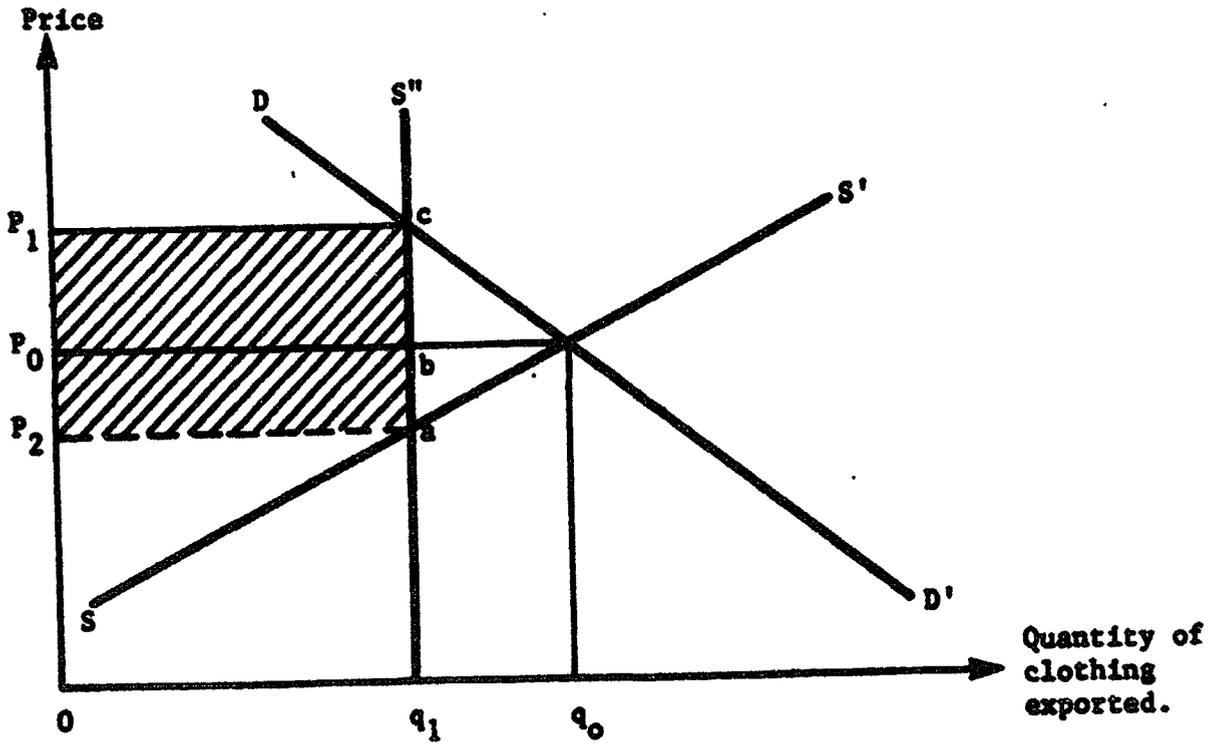
- (a) 85 percent of export volume was allocated to established producers: 26% as minimum quota, 20% according to production, 26% according to past performance, 9% for export oriented producers and 4% for small factories;
- (b) 15 percent was reserved for newcomers;
- (c) licenses not used by April 30 had to be surrendered for redistribution; and
- (d) no transfer of licenses between producers was allowed.

49. Since 1984, i.e. after the reform of the system the basic provisions of the system are as follows:

- (a) 90% of licenses are allocated to established producers according to their past performance (in 12 months preceeding 2 months before quota period). No other criteria for allocation are applied;
- (b) 10% of export volume is reserved for newcomers. Priority is given to (a) Indonesian owned, (b) export oriented producers;
- (c) licenses which are not used must be returned for redistribution; and
- (d) transfer of licenses is allowed between quota holders. Approval of each transfer is necessary. No payments are permitted.

50. While the system appears to be effective in terms of utilization of quotas available in the USA, it has a negative impact on the efficiency of the Indonesian textile sector. Firstly, it promotes inefficiency by passing the quota rent to producers and thus allowing high cost producers to remain in

Figure 2: Voluntary Export Restraint:
The Exporting Country Perspective (one commodity Market)



business. Secondly, it stifles structural change in the textile sector by freezing existing structure (past performance) and imposing obstacles to new entrants. This problem is aggravated by the recent changes both in the system itself and in the provisions of the arrangement with the USA. The share of quota available to newcomers was lowered from 15% to 10%, while the number of product categories subject to specific limits increased from 8 in 1983 to 34 in 1985 and the share of "free" items in total volume of exports to the USA decreased drastically.

51. Thirdly, the system implies illegal transactions and encourages corruption. It does so by not allowing for payments for quota rights. Since -- as it was shown -- they carry a value, payments in fact may occur. It appears, for example, that the current price of a license to export jackets to the USA (US textile category 357) is about US\$7 per dozen. The magnitude of a trade in quota rights is difficult to estimate, as (i) although transfers of licenses are allowed payments for them are not, and (ii) transfers are discouraged by the fact that they negatively affect performance which, in turn, is the basis for future quota allocation. In consequence, undisclosed subcontracting is widespread.

52. The Government of Indonesia should be strongly encouraged to abandon the existing system and replace it by the auctioning of quotas. The auctioning could cover all or some part of the quota. For example, following the Australian system in respect to (import) quota for textiles a share of quotas (e.g. initially 30%) could be put up for bidding while the remaining amount would be distributed according to some other criteria. Such a practice would reveal prices of licenses and exercise additional pressure on government to auction the entire amount of quotas. The Australian Industries Assistance Commission could be requested to provide technical assistance in introducing and organizing the auctions. Due to an apparent strong involvement of foreign textile traders in the Indonesian textile sector, participation in auctions should perhaps be restricted to domestic producers and utilization of quotas should be monitored with the possibility of a penalty for not returning unutilized licenses on time. No other restrictions, however, should be permitted.

53. Given that auctioning of export quotas would cause the quota rent to shift from producers to the government, and that this rent is of significant size,^{15/} the Government of Indonesia could perhaps continue to "give away" licenses for exports to markets where quota utilization is low. This would provide an incentive for the producers to increase their exports in these directions. Since the quotas are underutilized, licenses should be issued to all requesting them; once the rate of utilization reached 80%-90%, the auctioning should be introduced.

^{15/} As mentioned, the current price of a license for exports of jackets to the USA is US\$7 per dozen. That is from 4% to 7% of the export price depending on the quality of the jackets.

54. If the Government of Indonesia was unwilling to go along with the proposed change, it should in any case modify the system of quota allocation with an aim to improve efficiency of textile production. In particular, the share of quota available to newcomers has to be increased and the currently used criteria to distribute licenses among established producers changed. For example, past performance in terms of unit values rather than volume could be used so as to give preferences to producers of higher quality products.

B. Institutional Arrangements for Stimulating Non-oil Exports

Introduction

55. At Indonesia's stage of development, export promotion should chiefly consist of the removal of disincentives to export, rather than the provision of positive incentives, since the latter can be costly and raise objections abroad by going against international codes of trade behavior. Indonesia's producers do not export as much as they might because they do not expect that orienting production towards foreign markets and increasing sales abroad will be as profitable as producing for the domestic market. This perception is usually twofold: producers do not expect to be able to compete on the international market, either due to known cost factors, or to the unknown risks of seeking customers and selling abroad; and domestically oriented production may be very profitable due to the protection of the market from foreign competition.

56. In a country with active policies of protecting the home market, as Indonesia has, specific export promotion measures initiated by the government do not attempt to change the exceptionally profitable nature of domestically oriented production, but instead try to overcome some of the disadvantages a potential exporter faces by removing some of the obstacles inhibiting export flows. Occasionally the problem is just informational, and can be solved by improving the data available within the country on foreign prices, product specifications, paperwork, marketing systems, shipment, insurance and so on, thus enabling the producer to more clearly evaluate his potential earnings from exporting. More frequently, and more importantly, the local producer would not be able to compete on the world market because his costs are too high in comparison to those of foreign producers. Where this is a result of the nation's resource endowment, it cannot be remedied, but too often it is the result of cost factors such as policies, procedures and institutional arrangements that are effective disincentives to export, and could be removed or counterbalanced.

57. This section studies existing Indonesian export-promotion policies and the institutional arrangements designed to implement them, in order to assess their impact on non-oil exports and identify areas where modifications could result in additional exports. The following sections are organized according to the stages of exporting, from the import of inputs, through production finance, acquisition of technology, training, and marketing, to final shipment to the foreign client. For each stage in this process, some export-promotion policies have already been initiated in Indonesia, but some modifications are required to remove bottlenecks or improve the efficiency of the implementing institutions.

58. The experience of other exporting nations has shown that the design of export-promotion policies is not a static, once-and-for-all activity, but instead an ongoing process that must continuously adapt to new market conditions and techniques of production, both within the country and internationally. Once Indonesia adjusts its current policies to suit present requirements, attention will have to be turned to establishing systems and institutions for

periodically revising export-promotion methods in response to new opportunities and obstacles. The achievement of a desirable policy goal may be impeded or its outcome distorted if, at the implementation stage, attention is not paid to practical issues such as the availability of qualified administrative staff, training facilities for them and their support personnel, the access to information on foreign markets and procedures, possible infrastructural bottlenecks and the clarity of documents and forms. Consideration of possible complications in these areas at the planning stage, and their periodic evaluation afterwards, will contribute to the success of Indonesia's export-promotion drive.

Making Imported Inputs Available at a Competitive Price: Duty Drawbacks and Exemptions ^{16/}

59. As Indonesia begins to develop her manufactured exports, it is essential for producers to have access to imported inputs at internationally competitive prices. If Indonesian firms cannot obtain inputs at the same prices as their competitors abroad, they will be handicapped from the outset in their efforts to increase overseas sales. Only with import prices at international levels can the nation's industry be expected to discover its areas of comparative advantage based on domestic resource endowments and relative factor costs.

60. A key element in making imported inputs available to domestic producers at internationally prevailing prices is the removal of any duties on them when they are purchased by exporters. Provision of duty-free status for inputs to the manufacture of exports is a common and acceptable international practice for industrializing countries, and has in the past been a central element of export-development policies in nations now noted for their industrial and trade-based prosperity. Especially when a nation has a somewhat restricted trade regime, intended to protect new domestic industries during their early stages of learning and efficiency improvement, it is necessary to establish policies that will approximate a free-trade regime for exports. The more restricted the regime, the more important such policies become for export promotion.

61. A practical scheme to provide duty-free status to export production has to be designed to cope with a wide range of goods, production methods, firm sizes, ratios of domestic to imported content, number of middlemen, and production schedules. Yet this flexibility has to be provided at reasonable cost in time, personnel and funds for both the government and the producers. Furthermore, flexibility must not be achieved through excessive detail or loss of clarity in the scheme: if businesses are to be encouraged to produce for the purpose of exporting rather than just exporting surpluses during spells of weak domestic demand, they must face an understandable, automatic and perma-

^{16/} This section summarizes the main findings of the study entitled A Proposal to Strengthen Indonesia's Duty Exemption/Drawback Scheme, by Eul Y. Park, a consultant to the World Bank, which was submitted to the Indonesian Ministry of Trade in November 1985.

ment system. Transparency and consistency are essential for firms to estimate costs, plan production and reliably supply foreign buyers.

62. Usually, no one scheme is suitable for all the exporting industries in a country, and even within subsectors, a single scheme may provide very different exemptions for various firms, if their techniques and productivity are not the same (for example, in the case of standardized wastage allowances in calculating requirements of imported inputs). Nevertheless, for administrative feasibility, product-by-product or firm-by-firm schemes are not desirable, and most successful exporter nations have started with uncomplicated systems that paralleled the small range of export products and the simplicity of production methods at the outset, and later adopted more sophisticated systems in line with manufacturing techniques and the ability of government administrators to assess them.

63. In general there are two types of schemes that may be used to meet the policy goal of providing exporters with access to imported inputs at international prices. Duty exemptions may be allowed at point of entry for imports that are demonstrably to be used for export production. Under this scheme, the importer does not pay import duties if he is an exporter, and an official input-output coefficient schedule verifies that his requested exemption is for the amount of inputs he will need to satisfy his export contract or export plan. Subsequent checking will verify the passage of the imported inputs into an exported good. This checking is easiest when separate inventories of imported and domestic inputs are kept, and production is a one-stage process, all handled within the same firm. It becomes very difficult to verify when subcontractors are involved or the same goods are sold both domestically and abroad. Wide deviations in production methods could mean that the single exemption rate has different accuracy for different firms. At an early stage of exporting, though, these complications are not typical of most companies, and the exemption system can be efficiently and effectively used.

64. The second sort of scheme is the duty-drawback system, under which normally applicable duties are paid on all imports as they enter the country, and that portion of the duty that was levied on inputs incorporated into an export good is refunded to the exporter once his shipment has gone abroad. The benefit of this scheme is that in economies where multistage processing, involving significant transformation of the inputs and several domestic transactions before a product is exported, tracing the inputs through production is not needed. Instead, once it is verified that an export has been made, the input-output coefficient schedule is checked to see the amount of imported inputs per unit of exported output needed for that category of goods. One of the major difficulties with this scheme is the financial burden it imposes on exporters, who must wait until they ship to have their duty payment refunded. In more advanced exporting nations, this is less of a problem than in those just setting out on an export drive, both because the financial health of the exporting firms allows them to bear this delay and because the domestic financial system may be flexible enough to grant some sort of credit to worthy exporters against the future receipt of their rebate.

65. For both the exemption and the drawback schemes the input-output coefficient schedule (ICS) should play a vital role since it serves as the

handbook for customs or trade officials when determining the amount of intermediate inputs that should be imported on a duty-free basis. There is a difficult trade-off inherent in the construction of an ICS. On one hand, a fine definition of export categories, each with an accurately and frequently revised estimate of import requirements, would be costly in terms of technical staff, time and funds. On the other hand, a more roughly approximated set of coefficients would be less expensive to derive and use, but would frequently over or undercompensate exporters whose use of imports differed from the average.

66. A third system, sometimes viewed as the logical extreme of the exemption scheme, is the creation of geographically defined export processing zones (EPZs) in which firms import physical inputs for assembly without significant transformation nor combination with domestic materials, and export the entire output. As long as the zone is clearly delineated, so that imported goods cannot move beyond it into domestic use or sale, and domestic inputs cannot enter, there is no reason to levy and rebate duties. This is especially suitable for firms who export all of their outputs, and use almost all imported inputs. (Table 9 summarizes the main features of the two schemes, and the export processing zone.)

**Table 9: MAIN FEATURES OF DIFFERENT TYPES OF
DUTY-FREE SCHEMES FOR EXPORTERS**

Features	Exemption	Drawback	Bonded export processing zone
1. Financial burden for exporters	Moderate (collateral)	Substantial	Limited or none
2. Administrative burden for exporters	Moderate	Substantial	Limited
3. Administrative requirements for government	Moderate for exports with simple fabrication. Substantial for exports with multistage processing	Substantial for all exports	Limited
4. Importance of accurate price information	Moderate	Substantial	Not required
5. Inventory control requirement	Substantial	Not required	Mandatory
6. Scope of local transaction with imported inputs	Limited	Unlimited	Not allowed
7. Coverage for indirect exporters	Limited (one stage)	Unlimited	Not applicable (no indirect exporters in zone)
8. Technical calculations requirement (ICS* and rebates)	ICS*-required Other-minimal	ICS*-required Other-substantial	Not required

* Input-output coefficient schedule.

67. Since these schemes in theory provide the same benefit -- duty-free imported inputs for export production -- but in practice may have very different effects, the experiences of successful exporting nations in their implementation is significant. Korea and Taiwan have used some or all of these schemes at various stages in their export drives, in recognition that their manufacturers needed a large proportion of imported inputs to produce for export, and that protection of the domestic market to promote import substitution had established high duty rates for many of these goods. For the first decade of her export drive, Korea relied mainly upon an exemption scheme, which granted automatic exemptions to exporters who had obtained an import

license by providing evidence of an export order. The ICS was used to determine the amount of imported inputs to be used by the exporter. This scheme proved the most suitable while export production was largely a one-stage simple process. In Taiwan, where a drawback scheme was started in the early 1950s, to ensure that users of the exemption scheme had these characteristics, only exporters who did their own processing in plants of significant size were eligible for it. This way verification was simplified. At a later stage of development, both Korea and Taiwan shifted their emphasis to duty-drawback schemes, as multistage processing became more common. With elaborate production methods it became impossible to physically trace the imported inputs through to export, so that duties were not paid in cases where they should have been. To avoid these problems, the drawback scheme was brought in, although in both countries, the exemption scheme remains useful for simple processes. Modifications were made in Korea to ease the financial burden for companies awaiting rebates, and in Taiwan to eliminate the tariffs and need for any scheme wherever possible. (For more detail on these cases see Appendix 1).

68. Indonesia has had both duty-drawback and exemption schemes in use since 1978, when they were established as part of an overall export-promotion package (Decree 434). However, neither scheme has operated effectively to ensure that exporters get duty-free access to imported inputs. By far the most widely used of the schemes is a fixed-rate duty-drawback system, known as the export certificate scheme (Sertificat Ekspor, or SE). Due to the substantial shortcomings experienced in operating this scheme, it has been phased out, and a new system to replace it is being implemented.

69. Indonesia's new system to provide duty-free imports for export production will need to satisfy three goals:

- (a) consistency with the GATT code and other trade agreements between Indonesia and her export-client countries;
- (b) timely provision of complete duty-free status for the imported inputs used for any export production, including that of indirect exporters; and
- (c) minimal financial and administrative costs for both the government and exporters.

70. Under the GATT code, duty drawback and exemption schemes are permissible as long as they do not allow rebates in excess of duty paid; such overrebating would constitute a subsidy and be liable to countervailing duties under the subsidy code to which Indonesia is a signatory. In addition, each importing country has its own rule as to whether the drawback or exemption scheme may be applied to imported factors of production, such as machinery and fuel, that are not physically incorporated in the exported product. The US, for example, only permits inclusion of physically incorporated inputs. Other international rules cover substitution of imported inputs with domestic ones, which is theoretically allowed under a duty-free scheme only if the goods are identical, and it can be proven that the import took place. The maximum time allowed between importing and exporting is usually two years under international rules.

71. Within these external constraints, the challenge is to find the least-cost combination of duty drawback and exemption schemes to achieve approximate free-trade status for exporters in Indonesia. This must take into account the structure of Indonesia's manufactured exports, as well as the technical and administrative capacity of both government and firms.

72. Approximately two-thirds of Indonesia's manufactured exports fall within a few categories: plywood and veneer; aluminum, tin and nickel products; and textile yarn and fabric. In each product line, a few large firms have a large share of total exports. For example, plywood and veneer are dominated by less than a dozen firms, textiles and garments by about 40 firms, and semiconductors by two firms. In general, local fabrication of export products with imported inputs is relatively simple, and the import, production and export are done by the same firm. Usually, production for export is quite separate from that intended for the domestic market. (These are not the characteristics one would want Indonesian export production to have in the long run, so the duty-free scheme for imported inputs should not be so rigidly established as to prevent the development of more sophisticated exports.)

73. As can be seen on Table 10, these characteristics make Indonesia suitable for a duty-exemption scheme as the centerpiece of her system for assuring duty-free status for the imported inputs used for export manufacture. A major advantage of this type of scheme for Indonesia is that it places no direct financial burden on exporters, in terms of advance payment of duties later to be refunded. This is very important for new exporters who do not have substantial cash reserves or quick access to interim credit. The changes made in the May 6 package include provisions to allow duty-exemption and direct importation by exporters of their inputs. Only firms who export 85% of their output are eligible for this scheme although exporters who fall below this ratio have a revamped duty-drawback scheme. The May 6 package will need to be monitored and fine-tuned over time to assure that the results desired of it are actually achieved.

**Table 10: THE STRUCTURE OF TRADE AND TYPES OF DUTY DRAWBACK SCHEME:
GENERAL GUIDELINE**

	Phase I	Phase II	Phase III *
Stage of Industry and Export Development	Initial stage of manufactured exports	Intermediate stage of manufactured exports	Advanced stage
Typical Trade Structure	Simple fabrication and assembly-type export industry with high value-added imported inputs High level of import duties and nontariff barriers	Intermediate to high value-added export industry Moderate linkages between export and local market producers Medium to high level of duties on imports	High value-added export industry Close linkage between export and domestic producers Low level of duties
Types of Schemes	<u>Primary:</u> Exemption <u>Secondary:</u> Drawback/bonded scheme	<u>Primary:</u> Drawback <u>Secondary:</u> Exemption and bonded scheme	Selected use of drawback and bonded scheme

* Note that it is also possible to define a fourth phase, in which the distinction between export and domestic producers disappears, duties are very low, and no special scheme is needed.

74. Indonesia currently has a small EPZ, known as a bonded-warehouse zone, where duty-free imports are assembled for export. Two foreign-owned semiconductor assembly plants are located in the zone, along with a few smaller operations. The Government is currently considering expanding such zones, and has commissioned studies of their usefulness. It would seem suitable to expand the use of bonded zones for assembly operations or simple fabrication with very high import content and almost all the output exported.

75. The use of bonded zones should not be viewed merely as an extreme version of a duty-exemption scheme, though. In countries where they have been successfully employed, they have been a means of contributing to the international chain of production by which many products are manufactured in several different countries, taking advantage of the lower cost of some factor of production, resource, input or transport facility in each location. Typically, the developing country's initial participation involves the contribution of cheap labor in return for foreign exchange earnings. The bonded zone is ideal for assembly and other straightforward tasks, since materials, managerial and design skills, and equipment may be brought in from abroad,

while labor, land, and some services (utilities, plant maintenance, etc.) are used in the developing country. The assembled product is exported so that the next stage of processing, packaging or marketing may take place elsewhere. The bonded zone may be defined to allow other comparative advantages of the developing country to be exploited, such as abundant power, or locally made inputs, but these generally require a more complicated set of regulations and inspection arrangements than can initially be handled with ease.

76. Even without backward linkages to local production, though, bonded zones have proven to be significant generators of foreign exchange during the early stages of export development. In Malaysia, for instance, although very few intermediate inputs are locally made, the zones have generated high economic returns to the country. Mexico also has a successful EPZ scheme. It started in the early 1960s as a means of employing unskilled laborers and generating foreign exchange. US firms found the schemes advantageous due to the cost savings realized by having assembly operations performed by workers who were paid far less than their US counterparts. As the Mexican government, industrial park developers, and manufacturers, as well as US businessmen, gained experience in the "in-bond" assembly, the scheme was expanded. Some Mexican inputs are now used, technically sophisticated manufacture takes place, and plants may locate anywhere in the country. Customs officials at all Mexican shipment points are now able to handle the checking required, although the vast majority of in-bond plants are located either in industrial parks with on-site customs offices or near the two border points with the most experienced and specialized inspection operations. Foreign businesses look upon the scheme as an easy means of investing in Mexico, often with an eye to getting used to the country before setting up joint ventures for local-market production. (It is worth noting that in Mexico, as in Malaysia, liberal foreign ownership regulations have helped attract firms from abroad to the EPZs.) Mexican firms have acquired technical skills when they have become involved in subcontracted assembly work, and currently are learning to produce some inputs to in-bond production. As the assembly and manufacturing techniques used have advanced, the firms have demanded greater numbers of skilled workers, and in many cases undertaken training programs for them. This sector is now the second largest foreign-exchange generator in Mexico (after petroleum, and close to tourism), and employs roughly a quarter of a million workers. (See Appendix 3 for a full description of Mexico's "in-bond assembly program.")

77. Indonesia clearly could benefit from the employment and foreign-exchange generation a bonded zone would provide. Careful study of the international competition to induce firms to set up in the different developing-country bonded zones should be undertaken, to see how to set up the facilities to attract foreign investment (and if it would be beneficial to do so, given the likelihood of attracting sufficient business),^{17/} what standards the labor

^{17/} A master plan on export zone and estate development was recently prepared for the Ministry of Trade by Shannon Free Airport Development Co. This study indicated Indonesia's substantial potential for increasing exports through an EPZ.

force must meet, and how to secure the scheme against abuse. Such a zone would need to provide facilities that would compare favorably to those offered to foreign firms by other zones in the region. These would probably include: an adequate supply of labor; good infrastructure and facilities; simple regulatory and licensing procedures; liberal foreign ownership conditions; and good port access. The exact combination of these and other factors needed to attract investment would depend on the relative wages, rents and other costs, and the total cost of production in Indonesia with respect to nearby nations.

Financing Production

78. When a developing country begins a drive to increase export earnings and stimulate the production of exportable goods, there is normally a need to establish new firms in addition to expanding or modifying existing plants to cope with a different line of business. These new activities, whose success may depend on unfamiliar techniques and markets, and which frequently start on a small scale, fall in an unappealing risk category from the point of view of an incompletely developed domestic financial system with limited flexibility in its lending practices. Under such circumstances, it is typically quite difficult for potential exporters to receive working capital for export production, and this inadequate access to credit is often a barrier to the expansion of foreign sales. It is therefore necessary as part of an export-promotion policy package to establish credit facilities specifically designed for exporters.

79. Of course the fact that most foreign competitors in international markets do have good access to pre-shipment finance means that the lack of this service, its slowness and its costliness put the exporters in many developing countries at a disadvantage. It is worth noting, though, that the interest rate itself is rarely the largest or the prohibitive cost; the costs related to inadequate or nonexistent financing, administrative delays, and lack of access for upstream producers have been far more significant in many cases. Concessionary interest rates have been used by some nations as an export incentive, usually to compensate for effective disincentives, such as an over-valued exchange rate. At present, the question of the international acceptability of such subsidized rates, whether they are in compensation for other factors or not, has made it inadvisable to use such a policy, since it may result in countervailing duties. In any case, improving the availability of export credit removes a far more significant constraint to exporting than does subsidizing financing costs.^{18/}

80. In developed countries, and some export-oriented developing economies (most notably Hong Kong), the financial markets are sufficiently large and competitive, and offer a wide enough range of instruments, that exporters do not require any special treatment in comparison to other businesses. These markets are capable of properly assessing the earnings potential and risk inherent in export endeavors, and of quickly providing funds in a convenient

^{18/} See para. 47 below for a discussion of Indonesia's interest rates.

form for appropriate fees and interest rates in response to the producers' needs. By contrast, in a thin market with few instruments, banks and similar institutions prefer to lend their limited funds to the most secure companies, which tend to be the largest and longest established ones, rather than small, new ventures. (Often, collateral requirements are the means of effectively discriminating against new entrants.) Intercompany credit, such as delayed payment terms for input purchase, also tends to be rare in developing countries. To overcome this problem, in many developing nations the provision of credit to exporters has been greatly improved by the introduction of a formal export finance scheme with government sponsorship.

81. Typically such an export-credit system has initially consisted of short-term working-capital loans for the preshipment expenses of export production, requiring little or no fixed asset collateral, which are rediscounted by the central bank. Often these are supplemented by government guarantees of repayment to the creditor institutions. As needed, and if manageable and affordable, attention has also been turned to investment financing, post-shipment credit, government insurance against foreign country risks that might prevent payment for an export, and special payments-handling mechanisms. Working capital or preshipment financing is usually the most pressing need at the outset, though, because all exporters require working capital in order to produce, while usually only a relatively small number need post-shipment funding, given the typical payment terms attached to developing countries' exports.

82. Until 1982, Indonesia's financial mechanisms could not respond adequately to the special needs of new exporters, but in that year, in recognition that the lack of such facilities was hindering export development, the government included a comprehensive and ambitious export-credit system in the provisions of its Export Decree. Among other things, this seminal document and the implementing legislation promulgated shortly thereafter, established, in principal, preshipment and post-shipment export credit facilities including coverage for indirect exporters, credit guarantees, and export insurance. Some of these mechanisms have now been successfully set up, but much remains to be done on others, especially in terms of institutional arrangements.

83. As set out in the 1982 Export Decree, and more recently specified in the Bank Indonesia Circular Letter of September 9, 1985 on the subject of export credit, the salient features of the current export-credit system are as follows:

- (a) A working capital credit may be granted to any exporter with proof of a purchase order from abroad for his output. This preshipment credit is available to all exporters, whether temporarily or permanently in the export business, and whether their firms are domestically owned or joint ventures with some or all ownership in foreign hands.

- (b) Credit is made available for 85% of working-capital or preshipment needs in the case of fully Indonesian-owned companies, and for 70% of the total where partly or wholly foreign ventures are concerned.
- (c) This credit is to be available for all activities that generate value-added for export, which means that not only production of a final export good may be financed, but also the gathering, storing or packaging the products (the work of trading companies, for example), as well as the upstream preparation of materials, and subcontracted assembly or completion tasks are included.
- (d) The interest rate charged is ultimately 9% p.a. A higher rate, in the 20% range applicable to most domestic business loans, is charged for the duration of the credit until proof of export shipment is provided. At that time, a rebate is granted, to bring the effective rate paid down to 9%.
- (e) No collateral may be demanded by the banks granting export credits, other than the security provided by the export goods or expected payment for them.
- (f) A small commission (0.5% of the credit ceiling) is charged at the time the loan agreement is signed.
- (g) When the exporter receives payment for his products he has five working days to sell the amount of foreign exchange required to pay back his loan.^{19/} During that time he may seek the best rate of exchange available, anywhere he chooses. He is not obliged to sell any more foreign exchange than that demanded by his debt commitment.
- (h) Bank Indonesia, the central bank, provides "liquidity credit" to banks making export-credit loans. This "liquidity" covers 70% of planned export-credit loans and has an annual interest rate of

19/ The fact that the loan normally does not have to be repaid until the exporter receives payment means that the credit is not necessarily exclusively for preshipment financing, but may involve a post-shipment period also. This would only be the case for usance letters of credit, where drafts drawn on the account that the foreign client has set up in his bank in favor of the exporter have a delayed payment specification. In this case the drafts may be sold by the exporter to his bank in Indonesia, which in turn will discount them to Bank Indonesia. A maximum of 180 days after shipment is allowed for the payment dates on such usance drafts.

3%.^{20/} Each bank may draw down its liquidity credit once a month to the extent indicated by the exports realized with credits from that bank in the previous month.

- (i) Each export credit must be completely covered by an export guarantee. On a provisional basis, P.T. Askrindo, the public-sector company responsible for guarantees and insurance on financial transactions, has been providing these guarantees. Half of the premiums are paid by the lending bank, and half by Bank Indonesia. The premium rate is 0.5% for credit outstanding up to six months, 0.75% for six to nine months, and 1.0% for nine months to one year. P.T. Askrindo will compensate the lending bank for 85% of an export-credit loss, while Bank Indonesia and the bank will each bear 7.5% of the loss.
- (j) Credit insurance, against commercial and political risk of nonpayment, may be purchased by exporters from P.T. Askrindo. It varies in price according to the perceived riskiness of dealing with the client's country.

84. As of September, 1985, approximately 900 billion rupiah in 90- to 180-day export credits was outstanding. Approximately 1,200 export-credit loans are made annually. Non-oil exports in 1985 are estimated to have been 6,274 billion rupiah, which would mean that between one third and two thirds of these exports were covered by export credits, depending on the average duration of the credits.

85. For the exporters with access to preshipment credit,^{21/} this system has been providing an inexpensive source of funds. This has raised concern among some trading partners about subsidization; in that regard, Indonesia recently announced that after April 1987, the interest rate on export credits will gradually be increased so that by 1990 it will be the same as for similar domestic working-capital credits. The domestic commercial interest rates are currently high in real terms: nominal lending rates are 18% for term loans, and range from 21% to 24% for working capital in the case of state banks, and as much as four percentage points higher at private banks, while inflation is running near 5% p.a. Currently an average of seven to eight percentage points

^{20/} The intention of the government guarantee scheme for export credit is to reduce some of the write-off costs borne by banks. Currently the banks have a gross spread of about 4.8% between the rate they charge and their cost of funds. This is the difference between the interest rate (9.0%) plus commissions (0.5%) and the weighted cost of funds of the banks, consisting of 70% at 3.0% interest and the remaining 30% at their marginal cost of funds of about 12% interest. Since the Bank's risk is only on 7.5% of the loan amount, this spread should safely compensate for any write-offs arising from lending to exporters.

^{21/} See paras. 49-52 below for a discussion of access for indirect exporters.

of the interest rate charged are destined to cover intermediation costs.^{22/} It is to be hoped that efforts to diminish administrative overheads and large write-offs will have resulted in some reduction of domestic real interest rates by 1990. Nevertheless, it is impossible at this point to predict the direction in which rates will be pulled by the international conditions and expectations that affect speculative and official exchange rate movements. (Indonesia has an open capital account.) On balance, the shift to domestic market interest rates for exporters is bound to result in a considerable increment to their real financing costs, which will be only partially mitigated by bank efficiency gains, but this is not likely to be a binding constraint on export activity. Availability of credit continues to be crucial to exporters, as explained above.

86. Export value-added is generated in many stages of production. Often only the final stage before shipment is thought of as exporting, but the creation of anything of worth that is to be sold abroad is an export activity, so subcontractors, packagers and designers, for example, may contribute value-added for export. When these activities are not carried out by the last-stage export producer, they are often referred to as indirect exporting. The availability of credit for indirect exporters is as vital to nation's competitive position in international markets as is that for final or direct exporters. When access is not equal for the two groups, comparison of their costs is distorted, inducing investment and production decisions that do not fairly reflect other more fundamental differences in the economic cost of earning a unit of foreign exchange through various export activities. Where it is essential that more than one firm be involved in producing an export (for example, due to the need to use outside specialists for small amounts of work that cannot be economically done by the final exporter), the entire export process can be made so costly as to lose a competitive advantage, if the costs of one stage are too high.

87. While the 1982 Export Decree includes provisions to cover indirect exporters, in practice Indonesia's current export-credit mechanisms do not provide equal access, or indeed much access at all, for them. This problem endures, despite an apparent public sector recognition of it, because the procedures needed to process credit applications from indirect exporters have not been designed or implemented. Currently, in order to apply for an export credit, a producer or handler of export goods must be able to provide evidence that the goods in question will be sold abroad. Acceptable evidence is usually on Irrevocable Banker's Letter of Credit from the foreign buyer's bank, or a sales contract that cannot be unilaterally canceled. Allowance is made in the Bank Indonesia circular letter for proof in the form of "a supply of

^{22/} See Indonesia: Policies and Prospects for Long-Term Financial Development, World Bank Report No. 5501-IND, July 10, 1985 for a full discussion of these rates and the reasons for their high levels. There is some indication that not all of this spread is used to cover banking costs, but that side payments to smooth procedures and other such "leakages" may be occurring. These outflows, nevertheless, represent intermediation costs for the borrower.

goods to be exported" or "a plan to produce export goods for consignment", but without an established verification procedure, these provisions are virtually impossible to apply. As a result, upstream indirect exporters are effectively excluded from the export-credit scheme. Trading companies and other final-stage handlers would appear to have access to credit, though, under current provisions.^{23/}

88. One effective method utilized in some countries to include all indirect exporters in an export-credit scheme is the establishment of a back-to-back or domestic letter of credit mechanism. When this is operative, an exporter with an irrevocable international letter of credit (IL/C) from his client's bank presents it to his own bank, which in turn establishes a similar credit account and document (a domestic letter of credit, or DL/C) on behalf of the exporter, with the indirect exporter as beneficiary. Using the DL/C document, the indirect exporter may then apply for a working-capital export credit on the same basis as a final-stage exporter. The indirect exporter repays his working-capital loan by drawing a draft on the bank that issued the DL/C; this draft will not be honored without a receipt showing that the commodities have been delivered (or returned in processed or assembled form, in the case of the subcontracted work) to the final exporter.

89. The DL/C mechanism has the virtue of being a rapid, standardized process with little room for misuse once it is operating smoothly. Setting up the requisite administrative arrangements, however, involves significant effort and learning within the financial system, and this appears to be the reason that Indonesia has not yet implemented a DL/C scheme, despite the government having expressed interest in it for several years now. The most challenging setup tasks will be designing the necessary documents and forms, organizing their flow through the stages of creating a DL/C, granting a credit and repaying a loan, as well as training the staff of Indonesian banks and educating exporters in the use of the scheme. It appears that the difficulties could be somewhat reduced by taking advantage of the fact that a DL/C system is already in use for interisland trade, so that some related expertise does exist and could be exploited, but the training needs at the outset will still be considerable.

90. In recognition of the overall administrative and technical requirements involved, Bank Indonesia has recently recruited a technical expert to help put in place an effective system to reach indirect exporters as well as to strengthen the overall export-credit system. These are high priority tasks

^{23/} A related issue is the availability of credit for the purchase of certain imported inputs. One Indonesian exporter was unable to use bank working-capital credit to finance the purchase of imported inputs from a government-appointed sole importer; these importers demand cash payments rather than offering 30 or more day payment terms. Again, the extent of this problem is difficult to gauge, but should be examined to see if it is preventing some production for export from occurring. The exporter who expressed this concern did not seem to find it a binding constraint, but smaller firms with less liquidity might.

that will require strong support from Bank Indonesia, cooperation on the part of the commercial banks and close coordination with the guarantee and insurance institution. A central element of this effort will be the training of key staff in the financial sector as well as the informing of exporters. A substantial export-related training program is being put into place by the Ministry of Trade under the World Bank's proposed Export Development Loan and the facilities and resources available under this program should be fully exploited to meet the training needs of the export-finance system. Bank Indonesia is the institution that must take the lead in ensuring that this program effectively meets the needs in this area.

91. The Government has also made progress in establishing export guarantee and insurance facilities. The 1982 Decree set forth innovative and ambitious objectives for this support system by providing for an automatic guarantee of preshipment credit as well as optional export insurance. However, the institutional basis to provide such support did not exist at that time, and P.T. Askrindo, which handles the guarantee of domestic loans on behalf of the Government, was charged with providing export insurance and guarantee facilities on a provisional basis until a separate specialized institution could be established. Under the circumstances, P.T. Askrindo has done a reasonable job initiating the system. However, given the innovative and demanding nature of the tasks, which are new to Indonesia, it is essential that much stronger institutional support be provided. In recognition of this need, the Government established P.T. Asuranni Ekspor Indonesia (P.T. ASEI) in December 1985 to take over all export guarantee and insurance facilities from P.T. Askrindo.

92. One important issue that has arisen and will need to be dealt with by P.T. ASEI is the high rejection rate (up to 70%) of guarantee claims by Askrindo. Some rejections are always to be expected, if proper vigilance for cases of misuse and erroneous claims is being exercised, but it is difficult to believe that these problems exist in the majority of the claims. If a large proportion of legitimate claims is being rejected, then the scheme is not fulfilling its purpose of reducing the risk to the banks granting export credit. In turn, if this risk is not reduced, banks will allocate credit only to well established exporters with minimal credit risk. Closer coordination between the banks and the guarantee agency is needed to reduce the current claims rejection rate.

93. The cause of this problem seems to lie chiefly in the implementational aspects of the guarantee scheme. P.T. Askrindo was not established to deal with export-related guarantees and insurance, and it was required to fill an institutional gap on a temporary basis so that the scheme could be started. With the establishment of P.T. ASEI a specialized institution for the administration of the scheme, it should be possible to systematically address the problems. Having such an institution will allow a concerted effort to build up a specialized staff with expertise in export-related risks. Another institution that may be established is an arbitration board intended to solve disputes between P.T. ASEI and the banks. This board is intended to have Bank Indonesia and Ministry of Finance representatives on it, and to oversee the verification procedures used by P.T. ASEI and ensure that eligible banks receive funds when they make legitimate claims against the guarantee scheme.

94. Apparently one of the impediments to the functioning of an effective guarantee scheme is the Indonesian bank secrecy legislation, which prevents the banks from sharing enough of their records with the guarantee institution for the validity of claims to be substantiated. If this is actually an obstacle, then no amount of adjustment to other aspects of the export credit guarantee scheme will be sufficient to make the claim compensation mechanism function. This possibility needs to be examined and dealt with.

95. Of secondary importance to the guarantee scheme is the provision of export insurance. Export credit insurance is principally used to protect exporters who are extending credit to foreign buyers and therefore face a risk of nonpayment. Currently, the insurance scheme is used for fewer than 100 export transactions a year. This apparently small number is due to the lack of demand stemming from the prevalence of immediate payment transactions, as well as the lack of knowledge of the existence and purposes of an export-insurance facility. This experience is similar to that of other East Asian countries where these insurance schemes have been used by a very small percentage of exporters (in 1981, 4.8% of Singapore's manufactured exporters and 3.6% of Korea's were insured),^{24/} making it unlikely that they have been a major factor in increasing the exports of these countries. While of secondary importance, it is nonetheless appropriate to begin now to build the institutional basis for such a scheme so that Indonesia will not be penalized later when developing export products typically sold on credit terms.

96. The challenge to making the guarantee and insurance schemes effective, and thereby reducing the intermediation costs of export credit, lies in institution-building and the related learning of technical skills in risk evaluation with respect to exports. In this regard, the Government has recently established P.T. ASEI and is recruiting technical experts to help operate it. Crucial tasks for this new institution will be the establishment of a sound financial basis for the long-run operation of a guarantee and insurance scheme, the identification and solution (together with Bank Indonesia and the affected banks) of the problem of claim rejection, and the incorporation of mechanisms to reduce the risk of default. The institution will also need to improve the technical definition and application of criteria for providing conventional export insurance. Through these tasks the institution will fulfill the basic objectives of reducing export-credit risk, so that Banks are willing to give exporters the funding they need and to which their domestic market and foreign counterparts have access, and reducing the commercial and political risks of doing business abroad for Indonesian exporters. At the same time, the institution needs to be financially viable so that it does not become a drain on scarce government resources.

24/ See Yung Whee Rhee, Instruments for Export Policy and Administration: Lessons from the East Asian Experience, World Bank Staff Working Paper Number 725.

Producing and Selling the Goods

97. Once a developing country's government has put in place a regulatory and institutional environment that does not discourage exporting (see paras. 4 and 5 above), it may still not witness an export boom. Although imported inputs and shipping services may be obtained at competitive international prices, and working-capital credit is readily available at interest rates no higher than those charged to domestic-market producers, entrepreneurs may not start or expand production for export. They may not know how to do so, or they may not have access to the necessary factors of production (specialized labor and equipment). A developing country usually suffers from a shortage of designers, trained technicians, experienced managers and other skilled people. The machines and equipment being used by established exporters abroad may not be available domestically, affordable as imports, or useful once obtained, and yet it is difficult to devise alternatives or adapt what is available to the local conditions and materials without innovative personnel. Left to their own devices, the developing nation's entrepreneurs will teach themselves some of the needed skills, and foster the training of other workers, as well as the adaptation and acquisition of equipment, but this can be a slow uneven process.

98. As a consequence, there are strong arguments to be made for other means of obtaining skills in product design, processing methods, marketing, and the selection and adaptation of equipment. The investment in training required to develop these talents may be too large, and the payback period too long, for a company, especially one venturing into a new line of business, to bear. Instead, publicly sponsored training programs make sense for the skills which will be used by many exporting companies. Technical knowledge and costly capital goods may also be brought into the country by foreign companies, through direct foreign investment, licensing, turnkey projects and other such arrangements. Taking advantage of foreign experience can speed learning in setting up production processes, operating equipment obtained abroad, and marketing the output. This can be a far more efficient process than learning through experiment.

99. Nevertheless, foreign direct investment, and arrangements for paying foreigners to bring their skills from abroad, are usually viewed with great wariness by developing countries who fear that the companies will take advantage of domestic inexperience and remit excessive profits to their home countries without imparting knowledge or skills in return. One consequence of these concerns is that the developing country may make little effort to figure out which national purposes might usefully be served by foreign investment, and how arrangements with foreign firms might best be regulated to keep them beneficial without discouraging potential investors.

100. The current Indonesian conditions for foreign investment are not on the whole encouraging, although in some categories, regulations are far more favorable than those in other developing nations. The effective constraints have often been the restricted list of industrial subsectors open to foreign investment (a list that usually includes heavy industries and leaves out the light industries which arguably are the most likely to export) and the high cost of operating in Indonesia relative to other Asian countries. Due to

these high costs, foreign investors usually do not want to use the country as a base for exporting either to other Asian countries or elsewhere. Once that possibility is eliminated from consideration, the decision to set up production in Indonesia is based on local sales prospects. As Indonesian economic growth has slowed since 1982, so has foreign investment, presumably in response to poorer domestic market prospects.

101. As they now stood prior to May 6, 1986, the main provisions of Indonesian foreign-investment law are as follows:-

- (a) In principle, all foreign investment except that in the export-processing zones (see paras. 36-37 above) must take place through joint ventures with Indonesian partners, and the foreign ownership share must be reduced to 49% within ten years of establishment. In practice, this ten-year period can be extended if the local partner is in favor of prolonging the arrangement, and the investment contributes to recognized national development objectives such as employment, foreign exchange earnings or savings, geographical decentralization, or provision of a good that otherwise would not be available locally. There are no hard-and-fast rules for taking these factors into account, though, and the consent of the Indonesian partner remains the single most important element in determining the percentage of foreign ownership. A rough rule of thumb mentioned by one foreign investor was that an upper limit of 80% foreign ownership was allowable at the outset in cases where almost all of the output was to be exported. A plan for the percentage of production to be sold abroad must be submitted to the government with the joint venture agreement and deviations from it must be formally explained.
- (b) Employment of foreigners by the joint venture is strictly limited, and although the top few management posts may without question be held by expatriots, all other positions are classified either as off-limits to foreigners, open to foreigners only until a qualified Indonesian can be found, or those for which an Indonesian must be trained by a set date. Some firms have found this to be a constraint for positions such as foreman of a production line or unit, and state that the scarcity of qualified supervisory and management staff makes such people the most expensive in East Asia and is one of the reasons Indonesia is labelled a "high-cost economy".
- (c) The Capital Investment Coordinating Board (BKMP), whose role is to formulate investment policies and plans for Indonesia and submit them for presidential approval, issues an annual list of investment priorities (DSP), along with the incentives available for each area of investment, and which areas are open to foreign investment. The subsectors open to foreigners have been reduced in number over time; activities are closed off once it is judged that existing investors have the capacity to meet domestic demand. Areas completely closed to foreign investment, in the national interest, are shipping and ports, telecommunications, mass media, aviation, public railways, atomic energy, and defense. Automobile assembly and some other

manufacturing activities have been closed by regulations whose main intent is to promote domestic content. The "open" list excludes such obvious export sectors as textiles, garments, electronics, food processing and wood processing -- in fact, most light, labor-intensive industries.

- (d) For partly foreign joint ventures, the debt-equity ratio must be approved by BKPM, and some portion of the loan capital should be foreign. This external borrowing should cover overseas purchases. Short-term working capital may be obtained domestically. Bank Indonesia must be informed of foreign debt and has the right of approval of foreign loan agreements.
- (e) Capital and profits may be repatriated at the current rate of exchange without prior permits. Funds may be transferred abroad for the following purposes: the foreign owners' share of net operating profits; capital asset depreciation allowance; proceeds from the sale of shares by foreigners to Indonesians; employee expenses while travelling abroad; principal and interest on foreign loans; and compensation in the case of nationalization.
- (f) Investment guarantee agreements have been signed with Belgium, Canada, Denmark, the Federal Republic of Germany, France, the Netherlands, Norway, the Republic of Korea, Switzerland, the United Kingdom and the U.S.A (OPIC). By the 1967 law on Foreign Capital Investment, the Indonesian Government shall not nationalize foreign investments except by law and when necessary in the interest of the State. Full compensation will be given.
- (g) Special rules apply to certain sectors. For hard minerals (including coal, radioactive minerals, nickel, cobalt and tin) production sharing and work contracts with the Government are permitted. After 10 years, Indonesians must have 51% ownership, and a 60% excess profits tax must be paid. For coal, there are stipulations on the reduction of the contract area over a fixed period, on minimum exploration spending and on royalties in kind (an 86.5%/13.5% split of output between the contractor and the state coal mining board). Similar arrangements apply to oil and gas, and in all such cases the foreign contractor is obliged to finance exploration, production and development costs, which he may recover out of production before the split is applied. In forestry, only minority foreign ownership is allowed from the outset. Land for any use, including agriculture, may not be owned by foreigners, nor can it be used as collateral for loans to a company operating or building on it. Many foreign firms have considered this an effective barrier to agricultural endeavors, even though 30-year contracts enabling them to use the land may be made.
- (h) Tax incentives, especially tax holidays of up to six years, are no longer available for foreign investors in Indonesia. They were eliminated by the 1984 income tax law, although accelerated depreciation for some sorts of machinery and tax waivers for some

capital imports by new investors have been announced recently. The 1984 tax law also reduced the maximum corporate income tax rate to 35%, which offset the removal of incentives.

- (i) Foreign investors may not market their products domestically, but instead must channel them through an Indonesian national trade enterprise. A license for direct import of inputs may be obtained in some cases.
- (j) Foreign joint ventures must use Indonesian inputs and equipment whenever they are available.

102. Foreign firms are particularly discouraged from investing in Indonesia by the restricted list of subsectors open to them. Other areas where foreign investors have found difficulties are in the necessity of employing Indonesians in certain supervisory and management posts for which qualified people cannot be found or are very expensive, and in the firms' prohibition from marketing their own products in Indonesia, which prevents them from using their expertise in this area. The current lack of tax holidays and other such special incentives is only a problem for drawing foreign funds to Indonesia insofar as neighboring countries with similar costs of production and market potential are offering such benefits. Counterbalancing this is the great weight foreign firms put on freedom to remit profits and dividends abroad, and on the guarantee agreements reducing the risks from possible nationalizations. These provisions are not available in all other countries. Changes introduced on May liberalized foreign investment by allowing smaller national participation in the initial years of certain investments, a smaller restricted list of subsectors, longer terms that licenses are valid, provisions for reinvestment of profits, and assistance in divesting foreign ownership over time.

103. Interviews with foreign investors in the fall of 1985 revealed that for the most part what determined an investment decision in Indonesia was size of the local market and the share of it that was available for a new investor. Much foreign investment has been in import-substitution activities, and has thus far been able to bear high local costs of production due to the sharing of the same protectionist measures applied to Indonesian firms. Usually Indonesia will be used as an export base by a multinational company only for markets it cannot otherwise serve from a production facility located elsewhere, and for the few export products permitted for foreign-owned producers.

104. The benefits Indonesia is currently receiving from foreign joint ventures are inflows of scarce foreign capital, employment, and technology, but in most cases this is restricted to what the local market will bear, rather than being on a scale or at a level of efficiency that will permit exports. This situation will not change fundamentally as a result of slight modifications in the legal frameworks, but will improve as the costs of producing for export are reduced for all firms, whether local or foreign joint ventures, in Indonesia.

105. Two areas where gains specific to foreign ventures might be made, though, are in the employment regulations and marketing restrictions. Foreign investors will not be encouraged to bring in their best technology and internationally competitive product designs if they are not able to hire locally or allowed to bring in essential operators, foremen, maintenance staff and other technically or managerially skilled people. Since several firms mentioned this as a restrictive factor for their business planning, it would seem worthwhile to examine some of the guidelines on the eligibility of certain positions for foreign employees, and the duration of that eligibility. It is clearly in Indonesia's interests to encourage the use and the training of local employees, but restrictions should not be so severe that foreign firms simply avoid bringing in equipment and production methods for which staff is not immediately available or for which the training period exceeds the limit set by Indonesian law.

106. Indonesia appears to have a shortage of marketing skills, as is often the case for a country embarking on an export drive. While experienced in the international sale of certain relatively homogeneous commodities for which there are established markets, Indonesia, nevertheless, lacks practice and channels for launching products previously not exported. Since new exports often start on a small scale, a producer with little international experience is faced with a risky, confusing or costly undertaking compared to his expected initial revenues, if he is to begin making foreign sales. Simple techniques such as the writing of letters and mailing of brochures to the known foreign users of a product (when addresses can be obtained) pay off in some cases. Occasional trade missions, such as the August 1985 exchange of visits with China organized by the Indonesian Chamber of Commerce (KADIN), also yield results in some cases,^{25/} and it is expected that these will soon be stepped up and handled with better planning. However, a foreign company already has trading networks and knows the market for its goods. Allowing use of these skills may speed up and improve the marketing process, and leave Indonesian marketers with more time and resources to handle local firms' products.

107. One type of foreign investment that is all but banned is trading companies. Under current regulations foreign trading companies may set up representative offices in Indonesia, but may not directly trade themselves. It appears that Japanese trading companies with offices in Indonesia in fact promote the nation's trade by identifying exportable goods (including those made by their own subsidiaries' joint ventures) and informing their overseas branches of the availability of such products. Trade then occurs through an Indonesian intermediary.

^{25/} This particular mission resulted in agreements on the admittance of flag vessels from each country into the others' ports, a mechanism for granting business visas through diplomatic representatives in Singapore and Hong Kong, and allowable financial transactions through designated banks. Few concrete sales of Indonesian products resulted since in many cases the Chinese were trying to sell the same products or found Indonesian goods (especially steel, cement and textiles) too expensive.

108. Indonesia only allows 100% foreign investment in one limited free-trade zone on Batam Island in the northwest of the country. The purpose of this zone does not seem to have been clearly defined, and its use has not been actively promoted. The Government has been reluctant to allow 100% foreign ownership in the bonded-warehouse, or export processing zones, even though such zones currently operating in other countries have proven to be an effective means of bringing in scarce foreign capital and expertise, generating employment and earning foreign exchange. If properly managed, over the medium run, the industrial activities undertaken in such zones may become more advanced, and a sizeable group of local employees will be trained to international standards in some tasks and may then transfer their skills to domestic endeavours. There is intense international competition among nations providing such zones, so they do not succeed when undertaken half-heartedly. Proper facilities, including access to ports, reliable power supplies, and straightforward customs operations must be made available, and a vigorous promotion effort abroad undertaken. In Indonesia's case, although nearby Singapore has considerable experience and success with bonded zones, competition may still be possible for less complex assembly operations requiring unskilled labor. Singapore, Korea and Hong Kong now have sizeable skilled labor forces, and there is some evidence that labor costs in Singapore are less attractive for assembly operations requiring little skills than they once were. Indonesia needs to learn about the costs of production and the quality of facilities provided in competitor nations, then see whether there exists a niche in the market that could be gainfully filled.

109. In summary, Indonesian policies have generally not been very encouraging towards foreign investment, despite some incentives, such as allowance of majority foreign ownership and repatriation of earnings. Development priorities such as employment creation, foreign exchange earnings (or savings), and fostering of domestic skills have been seen as reasons to control foreign investment through some of the regulations. In a few cases, especially employment of expatriots and limitations on direct marketing by producers, it would be valuable to know whether the restrictions are in fact proving counterproductive. The extent to which production techniques that limit international competitiveness are chosen because skilled operators for other techniques cannot be found should be examined. Possible lost sales resulting from inadequate marketing skills, and the costs and potential gains of taking advantage of foreign expertise, should also be estimated. Nevertheless, the overriding limitations to foreign investment are the costliness of producing in Indonesia in comparison to other countries in the region, a small domestic market (which in turn may contribute to costliness due to production scale limitations), and the exemption of foreign investment in many likely export subsectors. The "high cost economy" may be remedied by the many other policies discussed in this paper, not just by alterations to foreign investment laws. Some expansion of the "priority list" of activities open to foreign firms to include potential exports is needed if Indonesia is to take advantage of capital and expertise from abroad in her export drive.

Shipping the Goods to the Overseas Market

110. Indonesia is an island nation whose only land boundaries with other nations are insignificant as trading points. To export from Indonesia there-

fore requires ships, and problems with shipping and ports have in the past proved a considerable hindrance to the nation's foreign trade.

111. In fact, in April 1985, the government instituted sweeping reforms of ports, shipping and customs procedures, in recognition of the extent to which over-regulation, excessive bureaucracy and entrenched protection of economically undesirable interests had become barriers to efficient trade. The reforms, issued in Presidential Instruction Number Four (INPRES IV) on ports and shipping, and an array of subsequent implementing regulations, were intended to deregulate much of Indonesia's sea transport industry and streamline port and customs procedures. Already it is clear that these measures have reduced the direct financial cost as well as the time and paperwork involved in shipping overseas from most points in Indonesia.

112. Before INPRES IV, even if an Indonesian firm were able to produce a competitively priced good for which foreign demand existed, it might have been unable to make an export sale due to the inefficiency, inconvenience or high price of shipping and related services compared to those available to producers in nearby nations. Indonesian shippers had a near monopoly over shipping to and from the nation, due to the requirements that foreign shippers get a separate permit for each visit to an Indonesian port and pay higher port fees than national ships. This effectively kept Indonesian shipping rates above those charged in other countries.

113. In addition to the direct cost of shipping, many indirect costs stemmed from time-consuming inefficiencies. Loading and unloading were performed by stevedores working for Indonesian shipping companies, with the result that ships were given priority according to company relations and considerations other than order of arrival; there were line-ups at some docks while others stood idle. Customs inspection of imports required upwards of 40 checks and signatures, and exports had to be examined also. The handling of goods and documents was the sole prerogative of appointed freight forwarding agents. At each stage in the process of receiving imports or sending exports, an Indonesian company was faced with paperwork, requirements for signatures and inspection, and unclear procedures and priorities. As was to be expected, this resulted in the creation of a great many niches for middlemen, handlers and government officials who could market the service of speeding up or circumventing one or more of these steps. Even with such services, though, the flow of goods was in most cases unacceptably slow and costly, and both the time and expense involved were difficult to predict, especially for new exporters and those with small or infrequent shipments. Business planning, where trade was involved, was severely hampered by these circumstances.

114. INPRES IV addressed each of these problems to some extent. Customs procedures were reduced to a bare minimum; a contract for almost all inspection responsibility was given to a foreign survey and inspection firm; and it was established that all payments of tariffs and taxes would be made to banks instead of customs. (See Annex 1 for a detailed description of the new inspection system.) The main beneficiaries of the customs reform have been importers, but, as pointed out in Section II above, imported inputs are essential to the production of many exports, with the consequence that exporters have benefitted both on this end as well as through the elimination of pre-

shipment export checking. (The question of point-of-arrival inspection for goods eligible for export certificates, and the scheme to replace them, is discussed in Section II above.) Some importers were reportedly unhappy with the clarification of the tariff class of their goods, which resulted in greater payments than before, but it would seem that overall, there are benefits for business planning and government revenue from the clarity and predictability of tariffs incurred. The disappearance of pre-shipment export inspection requirements is also apparently saving time, although there is no doubt that getting imports through customs was the most arduous task under the old system.

115. By the fall of 1985, just six months after the implementation of the new inspection system, businessmen, freight handlers and shippers interviewed were unanimously able to express satisfaction with the reduction of time spent on customs procedures for imports (average time savings seem to be a few weeks), although it appeared that some freight forwarders might lose business volume because importers and exporters could handle some tasks directly. The cost of freight forwarding has declined enormously (up to 80% according to one shipper), and this is largely attributable to savings in payments to intermediaries and reduced paperwork. In Tanjung Priok, the port management now boasts "one-stop service", a fifteen-minute process to arrange berthing permits, tugs, pilotage, water supply and stevedoring, which replaces the one-day struggle with paperwork that used to require visits to several different offices.

116. For exporters, the most important and direct gains from INPRES IV have been the reduction in shipping costs resulting largely from the entry of foreign competitors into Indonesia's international ports on the same port-fee basis as the domestic shippers. The world shipping industry has been suffering from excess capacity for almost seven years now, which has brought rates down to about 35% of their 1978 level in real terms. Efficiency gains from containerization have also contributed to this drop. As long as Indonesia kept her shippers insulated from foreign competition, costly inefficiencies in container handling, repairs and maintenance could be passed on to the consumer through high rates.

117. With the entry of foreign ships, price cutting, often in the form of rebates on officially published rates,^{26/} has become the norm, and this, in combination with the elimination of some port and dock charges and the reduction of others, has brought the cost of shipping from Indonesia down by 20% to 40%, according to those involved with the business. The exact price drop is difficult to determine, because it varies with the type of goods being shipped and the destination. One exporter said his shipping costs to Europe had

^{26/} At about the same time as INPRES IV, a shipping conference of 19 carriers set up the Asia-North American Rate Agreement (ANARA), which includes routes between Indonesia and North America. Under this arrangement, carriers can set new rates every 10 days. This is formal recognition of the pace at which rate-cutting, usually through rebates, has been occurring. Some major lines have even gone so far as to set rates daily.

dropped from 600 Rp to 200 Rp per dozen pairs of trousers between the period before INPRES IV was promulgated and mid-October. This producer had a fully containerized shipment method (his goods leave his factory near Tanjung Priok port in containers), so he was in an especially good position to benefit from less expensive foreign ships with modern equipment. A shipper said that, over the same period, the rate for shipping a container of garments to the US had declined from a range of US\$5,000-8,000 to US\$2,000-3,000. The cost of transporting tea from Indonesia to the US dropped by 50% in six months.

118. Another of the reasons that shipping costs have declined is the entry of non-liner vessels into Indonesian ports. For instance, there are a number of ships travelling from Japan to the Middle East fully loaded, but coming back virtually empty. These cross traders now call at Indonesian ports and offer very low rates to take cargoes to Japan. It is unclear at this point whether the higher port fees charged to trampers (ships without fixed routes and schedules) offset the discounts they are willing to offer because taking on an extra load is virtually cost-free to them.

119. This sort of price cutting has been going on for years internationally; through INPRES IV, Indonesia has gained access to its cost-saving implications for exporters. The effects of the new competition on Indonesia's own shipping industry may be quite severe, though, and efforts should be made to ensure that Indonesia's international shippers are not unduly handicapped in efforts to compete against foreign lines.^{27/} However, the factors making

27/ At least six factors currently make Indonesia's shippers more costly than their foreign competitors. (i) Working capital credit for Indonesian shippers is less available and more expensive than for competitors. (It is reported that in Singapore, payment terms of up to six months may be obtained for repairs, whereas in Indonesia, only bank credit, at 22% interest, may be used.) (ii) Bunker fuel prices are higher in Indonesia than in Singapore and purchases from Pertamina must be made on a cash basis. (iii) Indonesia-flag ships are required to use Indonesian repair and maintenance facilities (other than for emergency repairs, and normal refueling). The repair facilities are reported to be considerably more expensive and less efficient than those overseas. (iv) Indonesian crewing regulations set obligatory crew sizes in excess of those needed for efficient operation. For example, it is reported that a 1,000-ton Singapore-flag ship will normally function with 13 or 14 crew members, while a comparable Indonesian vessel must carry 22. (v) Many foreign shippers receive subsidies from their home governments (for example, the U.S.) which is not currently the practice in Indonesia. (vi) The regulations of INPRES IV, allowing foreign-flag ships into the 41 Indonesian ports open to international trade, permit competition with Indonesian domestic carriers to the extent that they used to handle short runs to the few larger ports for transshipment to international vessels (either Indonesian or foreign flag). The regulatory framework for Indonesian inter-island traffic has not been directly altered by INPRES IV, and still imposes many costly and inefficient arrangements upon domestic shippers. Routes, types of ships, when to buy and when to scrap vessels, are all to some extent constrained by regulations. See H.W. Dick, "Interisland Shipping: Progress, Problems and Prospects", Bulletin of Indonesian Economic Studies, Vol. XXI, No. 2, August 1985).

Indonesian shipping services expensive no longer affect the cost of shipping abroad, since exporters are free to choose the lowest price available from either a foreign or domestic shipper.^{28/} The Indonesian government is addressing some of the cost issues facing the domestic shipping industry through expenditure or infrastructure improvement, especially for the modernization of the largest ports and expansion of container-handling facilities. Some other cost factors, such as interest rates and fuel prices, as well as the absence of subsidies to the Indonesian shipping industry, respond to macroeconomic policy priorities and should not be altered for the sake of promoting or supporting the domestic industry. Considerable inroads could be made in the regulatory morass, though. The government seems to be studying this possibility.

120. Where improvements that will affect both international trade and transshipment from domestic routes can be made is in containerization. Indonesia currently lags far behind her neighboring countries in container handling; currently between 200,000 and 220,000 containers are moved in and out of Indonesia each year, compared to 700,000 and 800,000 in Thailand and the Philippines, a difference which is clearly out of proportion with the relative trade volumes. In 1983, Indonesia's four principal ports (Tanjung Priok, Surabaya, Belawan and Ujung Pandang) handled 17 million tons of international cargo, a figure which had been growing at more than 10% per year, on average, since 1977. In comparison, though, Singapore currently handles about 160 million tons and Manila about 140.

121. Most of the ports in Indonesia (there are more than 300, and about 45 of them have annual volumes in excess of 200,000 tons) have not been significantly modernized since before Indonesia's independence. Only Tanjung Priok and Surabaya (in western and eastern Java, respectively) and Belawan (in northern Sumatra) have been altered substantially in layout and facilities during the last 25 years. In most other ports, maintenance has been poor, so that cargo handling is slow and occasionally results in damaged goods, and infrastructure is run down. Dredging facilities, road and rail connections, quays and so on require attention, and whole layouts will have to be changed where cargo unitization and container handling capability is to be introduced.

122. Cargo containerization is used throughout the world; its cost savings result from lower damage and pilferage and faster handling than traditional methods. As Indonesia endeavors to compete in export markets, it is important that the country's exporters have access to these savings also. Currently, only Tanjung Priok has complete container handling facilities. Inland rail facilities cannot transport standard 20-foot containers more than 30 kilometers inland or 320 kilometers down the coast from Tanjung Priok port.

^{28/} Regulations require that all government imports and exports be shipped by Indonesian carriers, although it appears that in practice the requirement is that at least 50% of public-sector cargoes be transported in Indonesian vessels, and cargoes from some countries (for example, France) seem to be exempt. This guarantees considerable business for domestic shippers, but nowhere near capacity volumes.

123. The requirements set by foreign clients for some Indonesian commodities such as rubber, coffee, tea and tobacco necessitate container shipments from other ports, though. This is accomplished by the use of foreign vessels with their own containers, and loading and unloading gear. Instead of ships arriving and being loaded with filled containers lifted by cranes on the quays, which is a rapid process, the ships come with empty containers, await their filling, and load them with on-board lifting equipment. This latter process may take up to four days, and the cost incurred (between US\$15,000 and US\$50,000, depending on ship size) is passed on to the purchaser of the goods shipped.

124. The Indonesian government is aware of these and other problems with port facilities, and is addressing them through World Bank and Asian Development Bank projects which should satisfy all requirements for the medium run. The efficiency gains resulting from INPRES IV, which had quite low direct costs, should continue to be supplemented by infrastructural improvements in port facilities to bring the cost of exporting from Indonesia down to the level faced by her competitors (with allowance for different distances).

References

- UNCTAD (1984) Protectionism and Structural Adjustment in the World Economy, Part I: Analysis of Major Issues and Policy Requirements, TD/B/981 (Part I), Geneva.
- Yeats, A., "The Influence of Trade and Commercial Barriers on the Industrial Processing of Natural Resources," World Development, No. 9, pp. 485-94.
- Finger, J. M., H. K. Hall and D. R. Nelson, "The Political Economy of Administrative Protection," The American Economic Review, Vol. 72, pp. 452-66.
- Finger, J. M., "The Industry-Country Incidence of 'Less Than Fair Value' Cases in U.S. Import Trade," Quarterly Review of Economics and Business, Summer 1981, pp. 260-79.
- International Business and Economic Research Corporation, Executive Summary - Analysis of the Cost of the Textile and Apparel Trade Enforcement Act of 1985, Washington, D. C., June 1985.

The Experiences of Korea and Taiwan in
Providing Duty-Free Imported Inputs for Exporters

1. Korea and Taiwan are two of the developing countries that recognized from the start of their export drive the importance of providing free-trade status to their exporters. Their export-led growth strategy, adopted in the early 1960s, the high import content of their manufactured exports, as well as their relatively high nominal tariff rates, made the provision of duty-free inputs particularly important for their exporters. The overall systems of the two countries are similar; the few variations are related to differences in their industrial structures as well as the style and priorities of government decision making.

The Korean Experience

2. From the early 1960s, when Korea began its outward-looking growth strategy based on exports of manufactured goods, until 1975, the main mechanism used to provide Korean exporters with free-trade status was a duty-exemption scheme. This scheme exempted imported materials from all duties and related indirect taxes of any kind as they entered Korean ports, on condition that they were processed and exported within 12 months. In 1975, however, Korea switched to a duty-drawback scheme, which refunds the duties and other taxes that the importers have already paid. The refund is made when the goods produced with the imported inputs are exported.

3. Under the duty-exemption scheme (1962-75), imported inputs intended for export production were treated distinctly from those destined for local use. When a firm received an export order, it filed an application for a special import license with customs. This application was supported by a certification of the import requirements, based on the input/output coefficient schedule and the amount of export goods ordered. Once the licence was issued, duty exemption was automatic when the imports arrived, although some type of collateral normally had to be provided by the importer as a guarantee against non-fulfillment of export within a specified period (generally twelve months). If the export was not made in time, the responsibility for paying the duty was transferred to the local buyer of the material. The customs office played a very significant role in this exemption scheme, since it issued the import licence, checked the imports upon arrival, and traced them until they were exported. The Office of Input-Output Coefficient Determination was also of central importance.

4. During the 1960s, the Korean duty-exemption scheme was well suited to the country's stage of export production. Most exporters imported intermediate inputs and materials for simple, one or two-stage fabrication of export products. There were few significant linkages between manufacturing operations for export and those for the local market. The duty-exemption scheme was appropriate for that kind of operation because the tracing of the imported inputs to exported output was relatively simple.

5. As the Korean economy grew rapidly during the 1960s and 1970s, the duty-exemption system became increasingly inadequate to serve the exporters.

Multi-stage processing became more common, and imported inputs frequently changed hands as subcontractors and specialized manufacturers contributed to the value-added. Physical tracing of imported inputs became difficult and costly as a result. Also, the Korean export industry became more integrated with the domestic market as local substitutes for many imports were developed, and this complicated the maintenance of separate inventories of goods destined for local and foreign markets. The administrative expense of the scheme grew as the number of exported products increased, because each product was handled individually. In addition, the cost of collecting the duty owed when expected exports were not made on time became significant.

6. In 1975, the Korean Government introduced a duty-drawback scheme. This obviated the need of tracing each import through to an export, and the related maintenance of separate inventories. By using a fixed-rate drawback scheme, the Government was able to reduce administrative costs considerably. The difficulties with uncollectable duties were eliminated since the drawback scheme required normal payment of duty at the time of import, and allowed refunds once the export has occurred. Once this scheme was implemented, though, other difficulties presented themselves. The financial burden on exporters who had to wait considerable time for their rebates proved to be quite high. The simplification of rates to reduce administrative costs tended to result in underrebating to such an extent that many firms were allowed to file for individual drawbacks, a process which proved just as time consuming as the exemption scheme. Several subsequent modifications reduced the financial strain on exporters by postponing duty payments and allowing advance refunds. A limited exemption scheme was recently brought back to supplement the drawback scheme.

The Taiwanese Experience

7. Taiwan has had both drawback and exemption schemes in operation since 1958, when a temporary admission scheme was introduced to complement a duty-refund system implemented a few years earlier. Although Taiwan adopted both systems, initially exporters used the exemption scheme more than the drawback scheme for the same reason that Korea used the exemption system extensively prior to 1975. However, the use of the drawback system in Taiwan increased gradually during the late 1970s and early 1980s, and currently the drawback is more actively used than the exemption scheme, due to the increase in multistage local processing, and the Government's adoption of many simplification measures for the drawback scheme. Both schemes were established and maintained in parallel in order to utilize the strong points of each.

8. A special feature of Taiwan's exemption scheme is that it is restricted to those firms that have their own processing plants, are established exporters and have assets higher than NT\$1 million. These restrictions are intended to prevent abuses of the scheme and make the tracing of imports through to export easier.

9. Taiwan also has a bonded warehouse scheme involving over 300 plants. These operations contributed 15% of the nation's total exports in 1982. One feature that allows this scheme to function so smoothly is the use by about two-thirds of the firms of their own specially trained employees to handle most customs functions.

10. The Taiwanese system has been characterized by flexibility and simplifying measures to keep administrative costs reasonable. For example, a fixed-rate drawback is used for mass-produced standardized products for which both export and local demand are important. However, for products with limited domestic demand, relative to their exports, the duty rates on imported inputs have been reduced considerably so that there is no longer any need for a drawback or exemption in such cases.

Indonesia's New Inspection System for Traded Goods

1. In April 1985, the Indonesian government enacted a sweeping reform of its customs service, having recognized that the inefficiencies of the old system were resulting in unnecessarily high costs to domestic industry. As a result of the reform, most of the inspection of goods formerly handled by customs is now performed by a Swiss-based international inspection company, Société Générale de Surveillance S.A. Geneva (SGS).
2. SGS is the world's largest control and inspection company, and has been in this business for over a century. About 20 years ago, it pioneered the design and provision of specialized import inspection services to national governments and since then has been virtually the only company involved in this aspect of the international inspection business. (Since the Nigerian government decided a little over a year ago that it would prefer to have competition among suppliers of these services and terminated its previous arrangements with SGS, there have been some small companies attempting to do similar work for Nigeria. It is not clear that these new firms will be able to provide the same range of services, though, because the international inspection services industry would seem to require a very large minimum scale of operations.) SGS is able to undertake the task of inspecting some part of the traded goods of 22 nations because it has an extensive network of offices (290), laboratories (100), and affiliates (123) spread among 140 countries. SGS has approximately 18,000 employees, 2,000 of which operate in the USA.
3. In the case of the Indonesian work, the contract was awarded by the Ministry of Trade to P.T. Superintending Company of Indonesia, known as SUCOFINDO, a public sector inspection services company in which SGS has long had minority ownership and which had already functioned as SGS's affiliate in Indonesia for some years. SUCOFINDO in turn has assigned its rights and obligations outside Indonesian territory to SGS. SUCOFINDO currently has 800 employees in its many offices spread throughout Indonesia. The Jakarta offices employ 60 Indonesians and 20 expatriots. The expatriots for the most part came in to help set up the new system, and about eight members of the SUCOFINDO staff are soon to be sent abroad for training, so it is likely that the expatriots will be phased out over the next few years.
4. The main service that SGS provides for Indonesia is that of point-of-supply inspection of imports. In all the other countries where SGS provides this service to governments the principal purpose of inspection is to eliminate overinvoicing by importers who wish to overstate their needs for foreign exchange in order to circumvent exchange controls. In Indonesia, where there is an open capital account, the problem was typically under-invoicing to avoid full payment of tariffs, so SGS was asked to design a system to verify the tariff category of the goods being imported so that the correct tariff might be levied. Under the system implemented in May 1985, SGS must verify that the quality and quantity of goods being shipped to Indonesia are as specified in the purchase contract, and indicate the prevailing market price for such merchandise.

5. Once SUCOFINDO/SGS is alerted that an Indonesian purchase has been arranged, the nearest affiliate to the point of shipment is notified, and in turn telexes the seller, asking when and where inspection may take place. If there are any problems setting this up, SUCOFINDO refers back to the importer before proceeding any further. Once inspection has taken place, SGS or the appropriate affiliate issues a clean report of findings, referred to as an LKP, in the country of shipment. The LKP is then faxed to Indonesia, where it is used by the importer to calculate and pay the appropriate import tariff and taxes, where applicable. (Value-added, luxury, and one category of income taxes are included under this provision.) The tariff and taxes are paid on the basis of SGS's identification of the tariff category into which the goods in question fall, and the higher of the SGS and purchaser calculations of the total price of the goods. When SGS calculates a higher market price for the merchandise than that stated in the documentation submitted by the purchaser, it does not have a direct effect on the sum actually paid. The purchaser may pay a tariff on a higher price than he actually pays to his supplier. The exact procedures differ slightly between transactions using letters of credit (L/Cs) and those arranged on another basis; in the former case, the original LKP is sent directly to the Indonesian foreign exchange bank that issued the L/C, while in the latter, it is delivered to the bank via SUCOFINDO.

6. After the tariff and taxes have been paid, and the importer's bank has certified this with appropriate receipts, the importer may pick up his goods at the port of entry without further inspection by customs. The customs service has only to check the bank certification and some minimal identification to show that the shipment pertains to the importer in question.

7. Customs also retains the responsibility for inspecting some of those goods exempt from SGS inspection, which include personal effects (included in household moves), shipments whose f.o.b. value is less than US\$5,000, and weapons.

8. There is no doubt that the time savings resulting from the use of this system of import inspection have been enormous. Six months after the implementation of the new scheme, importers seemed unanimously able to report savings of time spent getting their goods out of the port area, as well as the improved simplicity and predictability of the new scheme. For example, in October 1985, representatives of one electronics firm were able to estimate the time savings on import procedures resulting from INPRES IV at 30%. (Not all of this saving is from customs procedures, though. See paras. 78-81 in text.) Others are pleased with the reduced need for intermediaries since the number of stages of inspection and related paperwork has been reduced from about 50 to fewer than 10 (and possibly as few as five in some cases).

9. Since June 1, 1985, SGS has also provided point-of-arrival inspection of some Indonesian exports, a service known as the Complementary Export Supervision Scheme, or CESS, to verify that goods eligible for export certificates have in fact been exported. The export certificate scheme, which is shortly to be phased out, provides a fixed percentage payment to Indonesian exporters of certain sorts of goods - principally textiles, plywood and glassware. The certificate can be worth as much as 20% of the value of the product exported, and normally credit can be obtained against it before it is

redeemed. Evidence of the quantity and category of merchandise exported is needed before the Treasury will pay the exporter. In this case, SGS does not inspect for quality, but only for certificate category and quantity. The exporter must provide SGS with a completed export announcement form or PEB,^{29/} a copy of the relevant sections of the export certificate decree defining the goods and percentage drawback applicable (SK), a copy of the bill of lading, and a supplementary data sheet detailing such things as the ultimate receiver (if a trading company is used). SGS does not provide any check of quality against the contract between seller and buyer, but only against the SK.

10. During the early stages of implementation of the CESS, problems occurred when exporters had not informed their clients of the need to accommodate SGS inspection, but it has since been made a legal requirement, to be specified in the contract or purchase agreement between the exporter and his client, that goods covered by an SK be submitted to inspection before final receipt by the purchaser. It is not clear how smoothly this is working, or how it will be adapted to any future duty-drawback system that might replace the export-certificate scheme.

11. SGS prides itself on the speed with which it can complete both import and export inspection requirements, on the rapid installation and programming of computers in the SUCOFINDO offices (since the government allowed only about three weeks to get the import-inspection system going), and on their use of faxes, telaxes and even phone calls (in the case of air freight) to keep all parties quickly informed. The SGS representatives with whom I met in Jakarta also made a point of their policy of keeping as much of the documentation of their work as possible out of Indonesia, both to lower the paperwork at that end, and to maintain greater security.

12. This system seems to be running fairly smoothly, and to have been understood and used by habitual importers and exporters with relative ease. Problems have arisen when the full documentation has not been available, and when overseas suppliers or clients have not been properly informed of the need to allow SGS access to products for examination or sampling. Several officials and businessmen interviewed in Jakarta also complained that SGS was not able to act rapidly when the foreign point of shipment or receipt was not in a major commercial center, but it was difficult to establish whether the complaint was hypothetical or real, since it is not clear how many small transactions involving shipment to or from out-of-the way villages abroad actually occur. Another complaint has been that SGS gives no documents to the buyer, so that he has no way of justifying any delays due to inspection time. One Indonesian garment exporter said his European clients complained of a lack of trust by the Indonesian government since the receipt of the importer was not deemed adequate evidence of the export having been made. A further problem seems to be the difficulty of tracking down references if the buyer is

^{29/} The PEB is a straightforward form requiring company identification, a description of the goods, their price and weight, shipment costs and arrangements, details of payment method, and the category and percentage of the applicable export certificate.

waiting to pick up his goods since neither the exporter nor the client has the SGS file number.

13. The Indonesian government pays SUCOFINDO/SGS a percentage of the value of goods handled.

MEXICO'S IN-BOND ASSEMBLY PROGRAM

1. In Mexico, a special version of an export processing zone (EPZ), known as the in-bond assembly program, vies with tourism for the position of second-largest foreign exchange earner after the petroleum sector. The program's success, and its evolution, have resulted from Mexico's proximity to the U.S. and the convenience of sharing production processes between the two neighbors.
2. The program was initiated in the mid-1960s, as one of many efforts to stem the flow of Mexican workers into the U.S. where their illegal presence has long been a contentious issue, although their low wage requirements maintained their attractiveness to many U.S. employers. Both the U.S. and Mexican governments provided legal frameworks that permitted the program to function, and interests on both sides of the border are satisfied by it.
3. In its current state, the in-bond program allows a U.S. company to ship materials and semi-finished goods to Mexico for assembly or completion. These tasks may take place in Mexican or foreign-owned plants, although the overwhelming majority are U.S. operations. (The number of Japanese, European and Canadian firms has increased in recent years, but is still quite small.) One-hundred percent foreign ownership is allowed for this type of firm, and legal establishment requirements can be completed in just one to three months (for other industrial activities, majority foreign ownership is usually difficult to obtain, and the processing of establishment permits even for a minority foreign interest can take up to a year). The in-bond plant may bring in all its capital equipment from abroad, and may rent or purchase a building in Mexico. Land may not be owned by foreigners in border and coastal zones, but a Mexican bank may hold it in trust for the U.S. firm. Foreign managers may be employed, and special visas are issued to them.
4. As the materials leave the U.S., they are checked by U.S. customs, and upon their arrival in Mexico, a Mexican customs inspection takes place. One completed form explaining the use of the goods is submitted by the firm and a bond for a small percentage of the value of the goods is posted as a guarantee that the goods will be exported later. When the materials are returned to the U.S., customs inspection takes place on both sides of the border again. The funds posted in Mexico are returned to the firm once the exit of the original imports is confirmed. U.S. Customs charges tariffs only upon the Mexican value-added, which is calculated by summing all expenditures made in Mexico, including wages, rental of premises and equipment, services such as electricity and so on. On the U.S. side, this arrangement is permitted by tariff codes 806.3 and 807.0, which are applied to similar assembly and subcontracting programs in other countries, especially in Asia.
5. When it started, this program was fairly restricted in nature, both due to Mexican regulations and to the inexperience of the firms and officials involved. Originally, the in-bond operations were legally limited to a narrow border zone in northern Mexico. No Mexican physical inputs could be used, and no output could be sold within Mexico. The majority of the early establishments were garment factories; fabrics were cut in the U.S. and sewn in Mexico. In other plants, simple toys were pieced together and other

straightforward assembly tasks were carried out. Co-ordination between the Mexican and U.S. operations was tightly maintained, typically by U.S. managers who crossed the border daily between plants separated by a distance as short as a kilometer. The labor used in Mexico was usually unskilled and readily available.

6. The in-bond program has matured, though. Mexican recognition of its benefits has led to changes in the laws affecting the sector and an increasingly active drive to attract more investors. Now, in-bond plants may be located anywhere in Mexico (although in practice Mexico City and Guadalajara are off limits due to urban congestion). Most firms still prefer to set up near the border, in order to keep transport costs down and make use of the efficient and experienced customs offices at the main border points (at several points, U.S. and Mexican inspection take place simultaneously), but companies with lightweight products, or the need for specially trained labor are now choosing other locations. Often state governments provide incentives to these companies, usually in the form of industrial park facilities, with Mexican customs officials on site, and occasionally through state fiscal incentives. Private industrial parks have also been founded in several areas. By the end of 1984, 50 plants were located away from the border zones, and this number is expected to increase rapidly.

7. During the last two years, provisions have been made in the Mexican laws to allow in-bond companies to purchase a small portion of their inputs and sell a similar share of their output in Mexico. These arrangements must be made on a case-by-case basis, and so far it seems that government criteria include assurances that no equivalent good is made by a local firm, and that the trade balance will not be negatively affected. This latter factor seems in practice to require that the sale of output in Mexico not exceed the value of inputs purchased there. It is hoped that these measures will improve the integration of the in-bond companies into the Mexican market; specifically, local suppliers may learn international standards and methods that they could later apply to direct export activities. Federal, state and local governments, in cooperation with industry and trade associations, have recently held several large exhibits in which in-bond firms have displayed inputs they currently import and local companies have studied the specifications and shown some of their own products.

8. In fact, one of the benefits of the in-bond program in Mexico has been the passing of skills to Mexican workers and the additional demand for skilled technicians such as electricians, machine maintenance staff and specialized builders. Increasingly, Mexican foremen and plant managers are used, and a growing number of plants employ almost no unskilled labor, now that electronics assembly has become the largest single category of plants, and a wide range of autopart assembly, as well as more unusual activities have been incorporated.^{30/}

^{30/} For example, tennis rackets are strung; athletic shoes, musical instruments and dental braces are put together.

9. The in-bond assembly industry currently employs almost 240,000 people, in approximately 800 plants. In 1985, it is expected that US\$1.3 billion in value-added will be earned. Value-added increased by almost 40% in 1984, and by between 10% and 15% in 1985.
10. The major attraction to U.S. firms continues to be the low wage rates in Mexico, but with the shift to more skilled labor, only a minor portion of the employees are paid minimum wage. At the two border towns with the biggest concentrations of in-bond firms, the wages and benefits have been pushed up by the demand for workers; large firms there frequently provide subsidized cafeterias and transit, educational benefits and sports facilities.
11. The in-bond program has been criticized on both sides of the border. U.S. labor unions complain that it takes jobs away from the States, and this complaint is the explanation for garments assembled in Mexico by U.S. firms being counted against the Mexican garment quota, a fact which has halted (and probably reversed) expansion of that subsector. On the Mexican side, concerns have included the originally temporary nature of the U.S. plants and the apparent accrual of all the benefits other than employment and wage payments to foreigners. These concerns have diminished as technological advancement has required far more heavy (and consequently more permanent) equipment, and the size of the sector has made secondary effects such as demand for support services by firms and local goods by employees more obvious. Several major firms, most notably consumer electrical and electronics goods makers, have now set up chains of production in Mexico involving up to 16 plants, many of which are highly capital intensive, and as advanced as their U.S. operations. Most of these companies also have joint ventures which manufacture for the Mexican market, and in fact one of the benefits of the program has been that U.S. businesses, once familiar with Mexico, have become increasingly imaginative in their investments. If Mexico's approval system for other types of foreign investment were less complex, there is no doubt that the inflows of foreign capital would be greater.
12. Even so, it must be emphasized that the major benefit to the U.S. firms is still access to inexpensive labor and proximity to home offices. For Mexico, foreign exchange and employment are the two biggest gains. The industry has expanded rapidly since 1982 in response to the devaluation of Mexico's currency, which greatly reduced the cost of operating in Mexico, but the efficiency improvements in customs handling, and the incentives offered by state governments (especially industrial park facilities) have helped also.

Key Changes Resulting from Presidential Instruction No. 4
on Ports and Shipping

A. Customs Inspection of Seaborne Cargoes

1. Cargoes with domestic origins and destinations (inter-island shipments) will no longer be subject to customs inspection.
2. Export cargoes are no longer subject to customs inspection within Indonesia. Port-of-destination inspection by the government appointed international surveyors is required only if an export certificate is applicable for that category of goods.
3. Taxes, tariffs and other due payments on imports shall be assessed at point of origin by the international surveyors and payment is to be made at foreign-exchange banks in Indonesia. The importer may remove his goods from the port area upon presentation of the surveyors' report, a bank receipt of duty payment and a bill of lading.

B. International Shipping

4. Foreign-flag ships where liners, conference members or trampers, are free to call at any Indonesian port open to international trade, and permits previously required for these vessels to enter a port have been abolished.
5. Foreign shipping companies are free to choose any local agent to act on their behalf and this choice need only be reported to the government by the Indonesian firm involved.

C. Terminal Operations

6. Within a period of one year after the issuance of the Instruction (April 4, 1985), loading and unloading of ship cargoes shall no longer be carried out by domestic shipping companies but will be performed by specialized firms established for that purpose. They will have to compete for terminal operations licenses in each port and provide contractually agreed services. Stevedoring is thus to be made independent of national shipping companies.
7. Compulsorily, cargo loading and unloading will be a 24-hour service, carried out in three shifts. Port labor pools will be reorganized, their management streamlined, and the fees paid to them reduced. The wages paid to the laborers will be increased.

D. Freight Forwarding

8. Handling of goods and documentation will no longer be the exclusive prerogative of appointed freight-forwarding agents, but can be performed

directly by any party, including brokers, freight forwarders, shipping companies, traders and individuals.

9. The compulsory routing of import cargoes from Asian ports through the warehouse complex in Cakung (Jakarta) is abolished. Cargoes can be directly released from their port of arrival.

E. Port Charges

10. The previous multitude of port charges has been simplified and related directly to services provided.

11. Dues for berthing, piloting, towing and mooring payable by foreign flag vessels, conference ships, and liners have been reduced to the same level as those applicable to Indonesian ocean-going ships. (Previously they were almost twice as much.) An exception to this is made for trampers (ships not belonging to conferences or having regular liner routes), which may be charged higher port fees.

12. Cargo loading and unloading charges have been reduced.

F. Inter-island Sea Transport Tariffs

13. Only one tariff shall be applicable to all types of cargo. The government will fix a ceiling rate and actual charges will be negotiated between shippers and shipping companies.

G. Port Administration

14. Port administrators, reporting directly to the Minister of Communications, will be appointed, and will be responsible for ensuring efficient and coordinated provision of both public and private services in each major port.