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Indonesia
Policies and Prospects for Non-Oil Exports

Main Report

December 31, 1986

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East Asia and Pacific Regional Office

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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.

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ABSTRACT : This report examines present policies in Indonesia towards non-oil exports and the prospects for expansion of non-oil exports over the medium term. The report is divided into four chapters and two annexes. The first chapter summarizes the report. Chapter II reviews the recent performance of Indonesia's non-oil exports, while Chapter III presents the prospects for Indonesia's major non-oil exports. Finally, Chapter IV discusses the feasibility of reaching these projections. Constraints imposed by Indonesia's commercial policies and by its trading partners' commercial policies are presented, followed by a discussion of institutional arrangements required to promote non-oil exports.

INDONESIA

POLICIES AND PROSPECTS FOR NON-OIL EXPORTS

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I. SUMMARY AND CONCLUSIONS

1.01 Over the last twenty years the Indonesian Government has placed a high priority on stimulating the development of Indonesia by utilizing the countries' natural resources -- a large workforce, its oil and gas reserves, the mineral deposits, and its tree-crop production. More recently industrialization and self sufficiency have been goals that the government has sought in order to stimulate development and promote employment. These latter goals have been fostered by the direct government involvement in a number of industrial projects and indirectly through regulation of commerce. Now the government is seeking to increase non-oil exports, particularly of manufactured goods. Various incentives and reforms have been put in place as initial steps toward achieving this end. In addition to generating foreign exchange the emphasis on non-oil exports is seen as providing a source of growth in the economy and creating skilled and semi-skilled employment opportunities for Indonesia's young and growing workforce.

1.02 Since the first world oil shock in 1973, exports of oil and LNG have been the dominant source of Indonesia's export earnings. Oil/LNG export earnings accounted for 69% of the total value of exports in 1974/75, peaked at 82% in 1981/82, and are now (1985/86) estimated to be 68% of export receipts. The recent declines in world prices of oil and LNG, together with the knowledge that oil and LNG are depletable resources, has served to remind Indonesia of its vulnerability and dependence on exports from this source and to stir renewed interest in the expansion of non-oil exports. With the significant risk of continuing diminution and volatility of oil revenues, Indonesia faces a major and immediate challenge of generating a pattern and pace of economic growth which will provide the employment and foreign exchange earnings required to sustain a healthy economy. Recognizing this, and the contribution that exports make to growth, the Government currently places high priority on the development and promotion of non-oil exports. It also recognizes that many obstacles (institutional and economic) lie in the way of a successful export-push. The importance and timeliness of this task is recognized in Repelita IV. The phrase "the high-cost economy" is frequently used by Indonesian officials and indicates the new sense of urgency that action must be taken to remove the obstacles that raise the cost of production and every aspect of doing business in Indonesia.

1.03 Recent World Bank reports on Indonesia have noted the need for careful strengthening of the production base of the economy indicating that a vital task is to foster the development of a broad-based and internationally competitive industrial sector leading to a sustained and rapid growth of non-oil exports.[1/] The existence of high and uneven levels of protection for domestic manufacturing is identified as a particular problem for non-oil exports in that it is a major contributing factor to the "high cost economy". The general conclusion of these reports, therefore, is that substantial

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1/ Most recently, Indonesia: Adjusting to Lower Oil Revenues, World Bank, Report No. 6201-IND, May 20, 1986.

changes in commercial policy should be made. The only challenge has been to define the appropriate type, size, and timing of such changes.

1.04 This report, rather than directly examining issues of industrialization and manufacturing, looks at the export prospects for a number of non-oil products -- both manufactured and raw products -- and notes the problems, from the point of view of domestic regulations and foreign access, to achieving the export goals. The report is necessarily selective in terms of issues addressed. Trade policy and a conducive environment to stimulate exports, are complex and often contentious topics that cannot be covered in their entirety in one report. As a consequence this report lays out specific issues and policies that assist or inhibit the development of a vigorous export sector and what must be done now in order to achieve this goal. Broader issues of commercial policy and the overall incentive structure are necessarily broached in this context because they strongly influence the performance of exports. Issues are identified and solutions are proposed. While the issues are ones that face the export sector today the solutions are not short-run palliatives but provide a basis for a medium and long run structure of the trade sector that will serve Indonesia now and in the future. In some cases, recommendations are product-specific but in most cases they are more general to the trade sector, being designed to improve investment in non-oil export activities and consequently the performance of non-oil exports.[2/]

1.05 The report is divided into four chapters. The remainder of this chapter summarizes the findings of the report. Chapter 2 reviews the historical performance of Indonesia's non-oil exports, summarizes the current state of the incentive structure in Indonesia, and outlines measures that have been taken in other East Asian countries to expand their exports. In Chapter 3 prospects for Indonesia's major non-oil exports are given in some detail. This leads to Chapter 4 where the feasibility of reaching these projections is discussed. First, the constraints imposed by Indonesia through its commercial policies are discussed. Second, a section describing the institutional arrangements required to stimulate non-oil exports is presented, followed by an examination of the constraints imposed by trading countries on Indonesia's products.

2/ Since this report was prepared two fundamental policy changes have been undertaken by the Government. These changes, the September 12 devaluation of the rupiah and the switch from non-tariff barriers to tariffs on many traded industrial items on October 25, are entirely consistent with the spirit and direction of the suggestions made here. Following a switch from non-tariff barriers to tariffs, it is desirable that tariffs be rationalized and progressively lowered. In addition, the report devotes some effort to discussing selected microeconomic and promotions issues of trade--issues that have not been addressed in the recent changes.

1.06 The body of this report is deliberately brief in order to appeal to the widest-possible audience. Often detailed justifications for positions taken are not given, technical discussion is kept to a minimum, and much documentation is suppressed. Those interested in pursuing any issue in greater detail are referred to the annexes and references which contain the information drawn on to compile the main report.

A. Present Exports and Export Prospects

1.07 Even though non-oil exports account for a relatively modest proportion of export receipts (around 30%) their contribution in terms of diversity and employment is significant. Agriculture and manufacturing account for 15% and 11% respectively of total exports leaving only 4% for all other non-oil sectors, most of which are metals (tin and nickel). Within agriculture rubber, coffee, tea, palm oil, and spices are the dominant products although many other minor products are exported. Despite the recent surge in manufactured exports, they still account for a small proportion of total exports and most is accounted for by two sectors -- garments/textiles and plywood. Thus many important activities where Indonesia may enjoy a comparative advantage still have an insignificant export orientation. For example, only 2% of footwear produced in Indonesia is exported even though Indonesia produces leather and even though footwear is a major manufactured export item for most East Asian countries. Accordingly a priority for government must be to structure the economy so that it is more export oriented. Developing an export mentality among businessmen by making exporting equally profitable as producing for the domestic market should be a goal. Many exportable industries are established and have excess capacity but presently supply only the local market. Orienting part of their output to the export market would be a relatively easy and quick process if conditions were conducive for doing so.

1.08 In terms of the markets for Indonesian non-oil exports Japan ranks first, accounting for 31% of the total, and the U.S. is second with 25%. The EEC is the third largest market with a share of 24%. Thus the three major industrial regions account for 80% of Indonesian exports. Until recently Indonesia has not actively attempted to diversify its exports. With the easing of regulations on trade with China and the production of exportable goods in demand by neighboring countries (e.g. fertilizer and cement) some market diversification is occurring. The heavy concentration on three markets suggests that trade potential with others has not been realized.

1.09 Indonesia's growth of non-oil exports has not been as vigorous as its neighbors' in the region and the value of non-oil exports has fluctuated quite widely. The decline in non-oil export growth in the early 1980s may be attributed to several causes including declining prices of commodities, the oil price boom, and the lack of export-orientation of Indonesian firms. The fact that its neighbors, whose resource endowments are quite similar to Indonesia's increased exports over the same period merely indicate that Indonesia suffered classic symptoms of "dutch disease" to a greater extent than its neighbors due to its larger share of oil revenues.

1.10 In terms of future prospects for non-oil export, prospects are mixed. For forest products, Indonesia has large reserves of hardwood and excess capacity in processing. It is therefore well positioned to take advantage of the increasing demand for wood products expected later this decade. In agriculture, despite depressed prices, Indonesia produces many products at competitive prices and is likely to capture a larger market share in the future as tree-crop expansion comes on stream. Likewise the outlook for fisheries (shrimp and tuna) is good. Indonesia is taking steps to stimulate shrimp production and is removing many of the obstacles that have inhibited tuna fishing and canning. For mining, substantial restructuring of mine operations, including the closing of some mines, appears to be inevitable in light of current and prospective world market conditions for minerals and metals. Export receipts from this sector will remain depressed in the foreseeable future. Similarly for manufactured products, much remains to be done to generate a strong response from the private sector. Garments and textiles have done well but may have reached their zenith (in terms of quantity). Diversification of manufactured export goods, which will come only if policy changes make manufactured exports more profitable, needs to be accelerated if Indonesia is to generate the foreign exchange and employment that it hopes from this sector.

1.11 However, regardless of the policy changes and promotion policies followed by Indonesia for manufactures, primary-based exports will remain by far the dominant source of non-oil foreign revenues in the immediate future. Thus while policymakers concentrate their efforts on stimulating manufactured exports they should not do so to the exclusion of primary products. Rather, more general policies that benefit all exports should be implemented. Examples of this are a reduction in regulations for importing and exporting, and more active exchange rate management.

B. Trade Policy and Export Promotion

1.12 Trade policy and government actions intended to foster trade and industrial development in Indonesia have been based on, or have resulted in, widespread state intervention and regulation of many industries that have strongly favored import-substitution over export promotion. While these policies resulted in a rapid growth of manufacturing capability and industrial deepening, the initial dynamic growth has now stagnated as domestic demands are satisfied and exports are not remunerative under the existing structure. The export promotion measures that have been introduced have, almost exclusively, been aimed at offsetting specific "high costs" to selected export industries rather than addressing the structure of incentives/disincentives. Thus the incentive structure remains strongly biased against export-oriented industries.

1.13 Recently Indonesia has moved aggressively to put many precursors to a successful non-oil export effort in place. Thus to some extent the process of equalizing incentives between the export sector and the import-replacement sector is already underway. Indonesia has made great strides in streamlining its financial, tax and tariff incentives in the last several years. The

relaxation in 1983 of financial controls removed some barriers to investment. The value added tax of 1985 has made rates of tax in all areas of manufacture and across firms more uniform and speeded the flow of goods through Indonesia's ports. The tariff and customs reforms of 1985 has made tariff rates and their administration more uniform. Finally, the steps taken in 1986 to allow duty free access to imported inputs to certain export oriented firms, a revamped duty-drawback system for other exporters, somewhat relaxed foreign investment/joint venture regulations, and the export promotion activities being developed under the Export Development Project, will assist the flow of manufactured exports. The dual-track approach to pricing of inputs (lower prices of inputs used in export products and higher prices for inputs used in domestic products) will make apparent the large price discrepancies between Indonesian and world prices and will create pressures in Indonesia to equalize prices.[3/] While there are still a number of perverse incentives that could be eliminated and other positive incentives that could be provided, Indonesia has made changes that will encourage non-oil exports. Further, the order seems correct. It is sensible to put in place all the preconditions for active export growth and attempt to stimulate non-oil exports prior to making broader changes that might initially put added demands on foreign exchange. The expected slower growth in the coming years will make such policies easier to implement since demand for imports will likely contract in any case.

1.14 Yet protection offered to import-competing industries in Indonesia remains too high and too dispersed. Not only are tariffs quite high but the numerous non-tariff barriers more seriously distort economic activity and resource allocation. If protection is to be maintained, it is least destructive when it takes the form of import tariffs levied at a relatively uniform low maximum rate for all goods. Thus moving from quantitative restrictions to tariffs, and lowering and unifying the tariff schedule is one priority goal. Likewise, the deletion programs need to be modified so that the worst inefficiencies embodied in the present structure are removed. The linkage between protected import-replacement industries and the performance of exports is not always appreciated. When import-replacement industries are made more profitable than export industries then exporters must pay more for their inputs than they would under alternative policies thus making exports less competitive on world markets. They pay more for their inputs produced by protected domestic industries and they pay more for other inputs such as capital and managerial skills that are bidded away from them by the artificially profitable import-replacement industries.

1.15 The export assistance measures that Indonesia has put in place, and is developing, to assist non-oil exports are helpful but not sufficient actions. Along with a change in trade policy, future export assistance measures should focus on developing more sophisticated financial/banking services for exporters, relaxing visa requirements for technical expatriate workers, and refining trade promotion/information activities in Indonesia and

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3/ The large September 12 devaluation, which was adopted after the completion of this report, will also strengthen export incentives and provide an important boost to the competiveness of Indonesia's non-oil exports.

abroad. In all cases ex-ante and ex-post analysis of the cost-effectiveness of the program should be made in order to eliminate unproductive ones.

1.16 There are no major surprises in this report. The conclusions reached are time-honored and well tested, and Indonesia is not unique either with its problems or their solutions. Indonesia is at a crossroads where it has, within its grasp, the ability to continue the process of opening and deregulating its economy, and allowing restructuring and reallocation of economic activity to occur. If the government decides that the long run economic benefits of such changes are worth the short-term political and economic costs, then details of the type and scheduling of changes need to be formulated.

C. External Trading Conditions

1.17 The recent external trading environment has been difficult for Indonesia due to low commodity prices and trade barriers on the two major manufactured exports (garments/textiles and plywood). Yet because many manufactured exports from Indonesia are so small and because raw product exports are usually admitted duty-free into industrial countries, trade barriers have not seriously impaired Indonesia's access to markets. Also, evidence indicates that while tariffs on raw products are not a problem, tariff levels increase markedly as the product moves along the processing chain. Thus one reason why Indonesia is an exporter of raw products rather than their finished derivatives is that tariffs on final goods by potential trading partners inhibit the development of further processing and fabrication.

1.18 There is not a great deal that Indonesia can do to change the external environment. Certainly having a diverse basket of exports to a diverse set of destinations would minimize the impact of any given trade barrier in a single nation but at the cost of losing the benefits of specialization. Looking for market niches (as it has done for coffee, for example) and avoiding "import surges" that invite reactions from importing countries are also useful actions. Indonesia should also bring its case for freer market access to every bilateral and multilateral forum that is appropriate.

D. An Agenda of Recommendations

1.19 The following list of specifics should be considered in order to provide a stimulus (and a less biased incentive structure) for non-oil exports. They are grouped into four themes -- the openness of the economy, regulations and controls, efficiency saving actions, and specific commodity suggestions -- and are ranked according to priority.

The Openness of the Economy

(a) the high and uneven level of protection of domestic industries in Indonesia urgently requires addressing. Indonesia should consider shifting the major instrument of import policy from quantitative restrictions to tariffs, and reducing the level and range of tariffs over time (paras. 4.06 to 4.08).

(b) in order to maintain its competitiveness vis-a-vis its neighbors and to rapidly adjust its productive structure to the new oil-price regime, Indonesia should continue to carefully monitor and manage its exchange rate (paras. 4.46 to 4.50);

(c) the deletion programs need to be modified to remove at least the most deleterious aspects of their operation. Existing lists of specific deletion items should be phased out, no further deletion programs should be initiated, and the structure of protection should be realigned to conform with changes in the general system of protection (paras. 4.16 to 4.20);

(d) the new duty-free scheme for exporters and the duty drawback scheme should be monitored carefully to ascertain that they are working as intended. For example, the definition of a producer-exporter as one who exports 85% of output could be lowered and regulations on whether export subsidiaries should be considered exporters could be clarified. In brief, the operating premise should be to make the regulations as non-restrictive as possible for all legitimate exporters (paras. 4.64 to 4.68);

(e) trade promotion efforts initially largely financed by Government such as providing a clearinghouse of trade information and a trade resources library should be carefully evaluated to determine whether they are cost effective methods of increasing exports (para. 4.77, 4.80 and para. 4.129);

Regulations and Controls

(a) the new regulations on foreign investment should be carefully watched and further liberalized if the desired response from foreign firms does not materialize (paras. 4.81 to 4.89);

(b) investment licensing policies should be reviewed to reduce the present restrictions on domestic competition and to avoid promoting industries which require protection. In many cases, investment licensing could be largely automatic (para. 4.88);

(c) policies to force development of downstream processing in industries such as leather, rattan, rubber, etc. should be avoided (paras. 4.21 to 4.40);

(d) Indonesia could take the lead in negotiating a set of common regulations for foreign investment with its neighbors (possibly within the context of ASEAN) (para. 4.89);

(e) restrictions on issuance of visas for foreign businessmen and foreign technicians should be eased (para. 4.85);

Efficiency-Saving Actions

(a) development of more sophisticated bank instruments to deal with exports is required. This could be accomplished by easing the

restrictions on the number and location of foreign bank subsidiaries in Indonesia (para. 4.70 to 4.71);

(b) the countertrade program should be made voluntary (paras. 4.112 to 4.113);

(c) ownership of land by joint domestic/foreign firms could be considered (para. 4.89);

Specific Commodity Suggestions

(a) the ban on log exports has helped to develop Indonesia's plywood industry, but the analysis presented in this report suggests that it has had large short-term costs in terms of lost export earnings and overcapitalization of the industry. The Government should carefully weigh these costs and benefits before extending the use of export bans to promote downstream processing of other products such as rattan and leather. A preferable policy is a severance tax and/or an export tax on the raw product (para. 3.13).

(b) a program to accelerate the replacement of traditional rubber tree varieties with modern high yielding clones could be undertaken (para. 3.38);

(c) limited quality upgrading for rubber to penetrate the EEC tire market and the global medical rubber market should be initiated, if economically justified (para. 3.38);

(d) processing capacity for palm oil could be expanded by relaxing licensing regulations and by allowing freer entry of processing equipment (para. 3.40);

(e) tin production needs to be concentrated at the most efficient mine while other mines should be idled (para. 3.42);

(f) a rehabilitation and maintenance plan for the remaining mine of P.T. Timah (at Bangka) could be developed and implemented (para. 3.42), while programs of early retirement and voluntary redundancy could be developed to deal with the surplus labor in the tin sector (para. 3.42);

(g) the role of the private sector in mining should be expanded given its record of success (para. 3.42);

(h) the Government could modify its formula of awarding garment quotas by auctioning-off a part (perhaps 50-75%) of the quota rights (para. 3.44);

(i) the plans to expand fertilizer production for export appear well-founded, but it is necessary that an evaluation of the pricing and end-use of natural gas be undertaken to ensure the success of those projects (para. 3.43).

II. RECENT PERFORMANCE AND SITUATION

A. Non-Oil Export Performance

2.01 At the beginning of the 1970s, non-oil exports were the primary source of Indonesia's foreign revenues, accounting for four-fifths of Indonesia's export earnings. But by 1975, as Table 2.1 shows, the export picture had changed dramatically. Although non-oil exports more than doubled in value between 1971 and 1975, their share in total exports slipped to barely more than a quarter. This change was due to the first oil-price boom of 1974, when prices of Indonesia's oil more than quadrupled, and a surge in Indonesia's oil export capacity. From that time, Indonesia's economic situation and prospects have been closely tied to developments in the oil market. Nevertheless, non-oil exports have continued to make a steady contribution to export earnings and employment. Indeed, non-oil export earnings expanded rapidly during the rest of the 1970s, increasing by almost 200% between 1975 and 1980. A significant portion of Indonesia's increased oil revenues was invested directly in the rehabilitation and expansion of non-oil export activities such as tree crops and minerals, as well as improved infrastructure in the transport and communications sectors, which was of direct benefit to exporters. Non-oil export earnings were also propelled higher by the general surge in world commodity prices.

2.02 Since 1982 the pendulum has swung in favor of non-oil exports, as oil prices and production volumes slipped from the peak levels. By 1985 non-oil exports rose to over 31% of total merchandise export earnings. In dollar terms export earnings are little changed from their levels of 1980 but oil prices have fallen sharply, so that in terms of their share, non-oil exports have risen substantially. And perhaps most importantly from the point of view of structural change, manufactured exports have become the most important source of export growth. Since 1980, manufactured exports have almost quadrupled in value and their share in total exports has leapt from 2% to 11%. Most of this growth is accounted for by a jump in plywood and textile exports, but over the past two years Indonesia's export base has broadened considerably as a variety of products including tires, cement, fertilizer, batteries and chemical products have entered the export market in significant quantities. While plywood and textiles are likely to remain the core of Indonesia's manufactured exports in the near future, the recent diversification is encouraging for it holds the promise that Indonesia can tap a rich range of latent sources for export growth if it improves the incentive structure for exports through appropriate policies.

Table 2.1: THE DISTRIBUTION OF EXPORTS BY DIFFERENT ECONOMIC SECTORS, 1971-85

Sector	1971	1975	1980	1985
Agriculture	45.9	13.0	11.4	14.6
Forestry	17.2	7.2	7.3	1.4
Nonfuel minerals and metals	8.3	3.5	3.4	4.4
Manufacturing	5.7	2.0	2.4	10.9
Oil and LNG	20.6	74.2	75.5	68.6
Others	2.3	0.1	0.0	0.1
Total	100.0	100.0	100.0	100.0
Memo items:				
Non-oil exports (US$ mln)	784	1,873	5,587	5,818
Oil LNG exports (US$ mln)	204/a	6,350	17,298	12,731
Non-oil exports/total exports (%)	79.4	25.7	24.1	31.4

/a Net oil exports.

Source: Bank Indonesia, BPS and World Bank staff estimates.

2.03 Even though the total value of non-oil exports in relation to the overall size of the economy is modest, non-oil exports nevertheless play a significant role in the economic life of many subsectors of the economy. In addition to its contribution to GDP, non-oil exports also contribute to the balance of payments and to employment. The contribution to sectoral GDP is shown in Table 2.2. While these figures must be treated with some degree of caution they are indicative of the importance of non-oil export activities for those sectors of the economy involved in producing tradeables.[4/] In 1984 non-oil exports were equivalent to almost 9% of the value added in those sectors generating non-oil exports directly. The most export-intensive sector is non-fuel minerals, where exports were equivalent to almost 90% of value added. The main items accounting for this are tin production and nickel matte, where virtually all of Indonesia's output is destined for export. Second in importance was the estate crops sector, where exports were equivalent to two-thirds of value added. Even in the manufacturing sector exports were equivalent to 29% of sectoral value added. Most of this was accounted for by plywood and textiles. Many important manufacturing activities still have only an insignificant export orientation. For instance only 2% of footwear produced in Indonesia is exported, even though footwear constitutes a major manufactured export item for most East Asian exporters. Similarly, only 0.6% of the

4/ The figures must be treated with caution since final exports from any given sector embody value added from other sectors and inputs. For example, plywood exports embody value added in the forestry sector.

country's agricultural equipment production and 0.1% of metal fasteners are sold abroad.

Table 2.2: THE ROLE OF EXPORTS IN THE ECONOMY, 1984

Sector	Value of exports (US$ million)	Exports (% of sectoral GDP)
Agriculture and forestry	3,058	14.6
(Estate crops)	2,112	66.0
(Fisheries)	227	16.5
(Forestry	366	39.4
Nonfuel minerals	782	88.4
Oil and LNG	14,426	84.2
Manufacturing (excluding LNG)	2,020	29.0
Non-oil exports	5,843	8.8
Total exports	20,269	24.2
Memo item:		
Non-oil exports as % of total GDP		6.9

Source: Bank Indonesia

2.04 The slowdown in the international economy in 1985 affected Indonesia's non-oil exports through lower prices of major primary commodities, metals and manufactured goods. On average, non-oil export prices weakened during the year. However, Indonesia was able to protect her non-oil export earnings by significantly boosting the volume of several primary commodities (vegetable oils, rice, tea, aluminum) and a wide range of manufactures (Table 2.3). Thus, the overall value of non-oil exports rose by over 4% in 1985, and non-oil export earnings, in current dollars, remained close to their 1984 levels.

2.05 The decline in current prices was particularly severe in the case of major primary products, such as rubber (-23%) and tea (-29%); (as also with machine parts (-94%) and transistor and semi-conductor parts (-36%)). Export volume and earnings also fell in the case of logs where Indonesia continued to restrict exports in order to encourage the development of the domestic sawn-wood and plywood industries. However, a significant expansion in the volume of exports of vegetable oils, rice, and most lines of manufactures helped to offset these losses. In the case of vegetable oils, the Government relaxed the prevailing bans on the export of coconut and palm oil in view of improved

Table 2.3: NON-OIL EXPORT PERFORMANCE, 1983-1985

	Export Revenue ($ million at current price			% change current prices		% change in constant 1983 prices	
	1983	1984	1985	1984	1985	1984	1985
Primary commodities /a	2,641	3,110	2.964	17.8	-4.7	3.5	5.8
Wood, lumber	348	368	244	5.8	-33.7	-15.4	-46.1
Rubber	848	937	718	10.4	-23.3	6.1	-0.5
Coffee	430	606	562	41.0	-7.3	31.3	-9.9
Tea	120	229	149	90.6	-34.8	25.5	4.6
Fish, fish products	234	230	233	-1.9	1.4	-14.6	6.5
Vegetable oils	116	129	353	11.4	173.1	-51.4	271.5
Rice	-	-	69	-	-	-	-
Spices, tobacco	132	152	174	14.8	15.0	-15.0	-4.0
Other	413	460	462	11.3	0.4	10.4	5.2
Minerals and metal /b	741	747	790	0.8	5.9	05.3	17.9
Tin	310	238	241	-23.3	1.1	-19.9	6.0
Aluminum	132	197	261	49.2	32.2	38.4	86.6
Other	299	312	289	4.3	-7.2	-9.4	-0.2
Manufactures /c	1,373	1,825	2,044	32.9	12.0	28.4	17.4
Plywood, veneers	745	795	941	6.8	18.3	-1.0	19.3
Textiles, clothing	278	462	536	66.3	15.9	66.9	-2.8
Fertilizer	47	37	80	-20.5	115.1	-23.3	160.2
Cement	7	12	22	75.7	80.5	86.5	135.9
Iron and steel	8	10	27	43.8	193.9	-7.2	82.5
Floor coverings	14	27	43	89.3	63.4	185.5	91.3
Nonelectrical machine parts	8	77	17	867.5	-77.9	212.0	73.8
TV, transitor, semi-conductor, apparatus	117	134	81	14.9	-39.8	60.1	-12.0
Other	149	268	289	79.5	8.1	81.0	8.2
Other /d	238	166	31	-30.4	-81.3	-71.4	-81.1
Total	4,993	5,847	5,829	17.1	-0.3	5.5	6.6

/a SITC sections 0, 1, 2 and 4 (food and live animals, beverages and tobacco, inedible crude materials, oils, fats and waxes) excluding 2.7 and 2.8.

/b SITC 2.7 (crude fertilizers and minerals), 28 (metalliferrous ores) and 6.8 (nonferrous metals).

/c SITC 5 to 8 less 6.5, 6.8, and 8.4.

/d SITC 9 - "special transactions consisting of unclassified parcel post, returned goods and goods in transit."

Source: Biro Pusat Statistik.

domestic availability, and in the case of rice, BULOG undertook exports of 410,000 tons, its first exports of rice.

2.06 The dynamic nature of manufactured exports, in value terms, is shown in Table 2.3 where exports increased by over 17% during the year. All categories of manufactured exports with the notable exception of TV, transistor and semi-conductor parts, and textiles and clothing, increased substantially; particularly fertilizer, cement, and floor coverings.

2.07 The growth of manufactured exports during 1985 was facilitated by a number of factors:

(a) Substantial excess capacity in the manufacturing sector and weak domestic demand encouraged producers to turn to export markets.

(b) The Government's exchange rate policy partially offset the adverse impact of falling external prices on rupiah profitability of exports.[5/]

(c) The resumption of trade relations with China helped exports of such items as plywood, cement and fertilizer. In the case of plywood, reduced production by traditional manufacturers (Japan, Korea and Taiwan) as a result of declining world prices and Indonesia's policy of banning log exports increased market penetration.

(d) The simplification of customs and port procedures announced in April 1985 has expedited movement of exports and imports thus lowering carrying costs.

(e) Government actions to stimulate non-oil exports such as improving export financing facilities by allowing foreign banks operating in Indonesia to provide export credit to companies located in Indonesia, and establishing an export insurance company (PT. Asuransi Ekspor Indonesia) to insure exporters from nonpayment due to commercial/noncommercial reasons.

2.08 In brief, recent non-oil export performance (1978-85) has been quite erratic depending on the commodity. For raw products and primary commodities such as tin and rubber, performance (and investment for future production) is largely determined by international prices which fluctuate widely with different levels of economic activity in industrial countries. When international prices fall, production of estate crops is adversely affected as rubber tapping or palm-harvesting is reduced. Accordingly export receipts fall by a

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5/ The rupiah depreciated by approximately 5% in nominal terms vis-a-vis the US dollar between end-December 1984 and end-December 1985, by 8% against the Singapore dollar, and much more sharply against the British Pound (28%), Japanese Yen (31%), Deutsch Mark (34%) and the Netherlands Guilder (34%) over the same period. In contrast, the domestic inflation rate was less than 4% during 1985.

larger proportion than the price since both price and production decline. For metals and minerals, when world prices decline production tends to be maintained since Indonesia is typically a low cost producer and also since employment levels in mining are maintained as a matter of policy. Thus export receipts from metals and minerals tend to fluctuate almost proportionally with international prices. Other primary commodities such as coffee and cocoa are bound by international agreements on prices and quantities. This provides Indonesia with very little flexibility.[6/]

2.09 For manufactured exports the consistent growth has been led by plywood and veneer. Exports of plywood and veneer have accounted for up to 50% of the value of manufactured exports. Their volume has increased steadily over the 1980s as the ban on exports of logs was phased in. The growth in these exports is largely offset by a parallel decline in receipts from log exports.[7/] But exports of other manufactured goods has also grown significantly. Textiles and garments have performed well but growth is limited by the multi-fiber agreement and several bilateral agreements. The remainder of manufactured exports cover a broad range of products. But exports of these products is small and is largely a residual of the domestic market. The improvement in manufactured exports over the 1980s can be attributed to a saturation (or downturn) in the domestic market in the presence of excess capacity. Thus manufacturers have been forced to look abroad as a survival mechanism where they are selling below domestic cost (but still probably covering variable costs). In some cases such as cement, iron and steel, and rice, exports have taken place only by virtue of export subsidies. Accordingly the basis for exports of several products is very shaky and depends on Government assistance and the state of the domestic economy.

2.10 In brief, recent export performance indicates that the commodities which did well in the 1978-83 period, most notably plywood and veneers, textiles and aluminum continued to grow rapidly in 1984 and 1985. The rebound in coffee and rubber exports in 1984 declined in 1985 although it appears likely that Indonesia has continued to increase its world market share in all of these categories during past two years, especially with coffee in 1986. The most striking aspect of Indonesia's recent performance was the rapid growth in exports of manufactures, which has been boosted by switching from log exports to plywood and veneers. But there was encouraging growth in a range of small miscellaneous items. Increased exports of certain basic industrial goods including cement, and iron and steel products cannot be considered a success since they were achieved by subsidies and resulted in a net loss of resources to the country.

6/ As of June 1986 the International Cocoa Agreement appears to be disintegrating and the quotas of the International Coffee Agreement have been lifted.

7/ It is shown in Chapter 4 that this policy has been very costly to Indonesia.

B. Non-oil Export Trading Patterns

2.11 The US is the largest single market for Indonesia's non-oil exports followed closely by Singapore and Japan. These three countries account for two-thirds of Indonesia's exports (Table 2.4). However, these figures are somewhat misleading, since a high proportion of Indonesia's exports to Singapore are re-exported to third countries. Two factors account for this phenomenon. First, Singapore, despite its small size, has a much more active and developed foreign trade sector than Indonesia because of its historical role as an entrepot center. Singapore businesses have been able to capitalize on these strengths to develop a considerable re-export trade based on goods imported from Indonesia.[8/] Second, because of Indonesian regulations requiring the use of Indonesian ships to carry Indonesian exports, exports have often been initially routed to Singapore before being transfered to other lower cost carriers.[9/] Since Singapore does not publish details of its trade with Indonesia, it is not possible to obtain direct information about the extent or destination of these re-exports.

8/ The role of Singapore as a middleman or as a "trading company" for Indonesian export products is not unlike a situation that prevailed in Japan during the late 19th century. During the Meiji period (1868-1912) when the Japanese government decided to industrialize and modernize its economy, and open it to trade with the West, Japan had no institutions or expertise in international trade. Rather, they relied on the services of Western traders who opened merchant houses (shokan) in major port cities. Japanese trading companies, some of them very large but without international experience, would contact merchant houses to sell their products or to purchase foreign goods. Rather quickly Japanese trading companies acquired the skills to displace foreign merchant houses which had allegedly taken advantage of the naivete of Japanese traders (see K. Kojima and T. Ozawa, Japan's General Trading Companies, Development Center Study, OECD, Paris, 1984). The analogy with Indonesia and Singapore is clear. Indonesia by and large has a recent history of inward-looking policies where emphasis was placed on self-sufficiency and on producing for the domestic market. With the exception of oil/LNG and some primary products, exports have been accorded a low priority and exports that have been made are residual to the domestic market. There has been no incentive to develop domestic expertise in foreign trade and the small scale of manufactured exports has not justified domestic firm's acquiring such expertise. Accordingly Singaporean traders have played the role of shokan. Over time, as the scale of Indonesian exports increases, domestic companies will acquire international trading skills and contacts. Accordingly, the amount of trade passing through Singapore from Indonesia will diminish.

9/ Although this requirement has since been abolished under INPRES IV, 1985, the structure of freight rates still favors trans-shipment through Singapore.

Table 2.4: NON-OIL EXPORTS TO MAJOR MARKETS, 1984
(US$ million)

Country	Value	Share
USA	1,213.8	20.7
Singapore	1,146.2	19.5
Japan	1,102.7	18.7
Netherlands	307.8	5.2
FR Germany	246.3	4.2
UK	142.9	2.4
South Korea	86.4	1.5
Australia	75.3	1.3
Others	1,584.3	26.5
Total	5,869.7	100.0

Source: BPS.

2.12 It is possible to infer the final destination of Indonesia's exports by examining import data from third countries which record imports on the basis of origin. This suggests that, once re-exports from Singapore are taken into account, Japan was the major market for Indonesia's non-oil exports in 1983 accounting for 31% of the total. The US is the second largest market accounting for 25% of the total. As a group, the 10 members of the EEC constitute Indonesia's third largest market with a combined share of 24% (Table 2.5). Thus three major industrial regions account for 80% of Indonesian exports. With the easing of regulations on trade with China, the production of goods in demand by neighboring countries (such as fertilizer and cement), and the trend toward greater production of tradeables as oil prices decline, the importance of these three regions should diminish.

Table 2.5: WORLD NON-OIL IMPORTS FROM INDONESIA BY MAJOR MARKETS, 1984/a

	Value ($ million)	Distribution (%)	Annual Growth (%, 1978-84)
Japan	1,377.0	27.4	-3.3
US	1,513.0	30.4	7.3
EEC 10	1,076.6	21.4	-1.5
Industrial countries	4,197.5	83.4	-0.6
World	5,003.8	100.0	2.0

/a Excluding Singapore. Since these data are based on reports by importer countries they differ significantly from Indonesia's official export data.

Source: UNCTAD trade Data System.

2.13 The data also indicate that the importance of the Japanese market has weakened relative to the US and the EEC. Exports to the US grew at an annual rate of 25% during 1973-78 while those to the EEC rose by 17%, compared with 8% for Japan. In the period 1978-83, non-oil export growth to all three of these markets slowed but the trend away from Japan continued; export growth decelerated slightly in the US and in the EEC but fell by a larger amount in Japan. Most of this decline was associated with a general slowdown in the growth of imports by these countries, but a decline in Indonesia's relative market share was also an important contributing factor.

2.14 Indonesia's export growth was not as vigorous as other countries in the region, but was, nonetheless, positive. In the period 1978-84, Indonesia's relative performance slipped compared to 1973-78 (Table 2.6). Other countries in the region all succeeded in increasing their exports at a faster rate than Indonesia and gained market share. While Indonesia gained market share, its gain was less than its Asian neighbors (with the exception of the Philippines) but was far better than that of all other developing countries. Even so, the growth of Indonesia's non-oil exports was superior to the average performance of developing countries as a group, whose exports scarcely increased in value and whose market share fell quite sharply. Another feature, not apparent here, is the annual fluctuations of export earnings. This is a result of the importance of agriculture in the trade basket and the historical fluctuations of commodity prices on world markets.

Table 2.6: NON-OIL EXPORT GROWTH 1974-84, INTERNATIONAL COMPARISONS

	Value ($ million, 1984)	Growth in value 1973-78	Growth in value 1978-84	Market share 1973	Market share 1978	Market share 1984
		-- (%, annual) --				
Indonesia	5,066	18.8	2.9	0.27	0.30	0.38
China	18,968	10.7	13.7	0.94	0.31	1.34
Hong Kong	27,315	18.6	13.5	1.01	1.09	2.07
Korea	27,961	32.2	13.4	0.67	1.25	2.12
Malaysia	8,567	16.8	6.5	0.48	0.53	0.65
Philippines	4,752	10.8	66.2	0.37	0.33	0.36
Singapore	17,895	18.8	13.3	0.61	0.73	1.35
Thailand	6,741	19.9	8.2	0.30	0.37	0.51
All developing countries	159,414	15.0	0.1	15.53	15.53	12.07

Notes: (a) Exports refers to exports and re-exports where available.
(b) 1983 is the latest year availabe for Malaysia, and the Philippines.
(c) Growth rates for China are calculated to 1983.

Source: UNCTAD Trade Data System.

2.15 While Indonesia benefitted from the commodity price boom in the seventies its continued specialization in these commodities led to a slowdown in exports in the 1980s. Most of the slowdown was due to the poor performance of the metals and minerals group and the other primary commodities group because of a deterioration in world commodity prices but more generally the sluggish output growth in a number of subsectors was probably a result of dutch disease where adjustment to the oil boom implies a contraction of the traditional export sector.

2.16 In terms of structure, the fastest growing component of world imports from Indonesia has been manufactures. The value of these exports grew at an annual rate of 33% during 1973-78, and by 29% during 1978-84 (Table 2.7). However, this was from a very small base. Even after the very rapid growth rates recorded during 1973-84, Indonesia's manufactured exports accounted for only 0.1% of total world manufactured imports. Thus, in relation to Indonesia's current and potential export capacity, Indonesia will not be limited by external market size but rather by its own ability to exploit export opportunities.

Table 2.7: WORLD NON-OIL IMPORTS FROM INDONESIA, 1973-83 /a

	1973		1978		1984		Growth rates (% annual)	
	Value ($ mln)	Share (%)	Value ($ mln)	Share (%)	Value ($ mln)	Share (%)	1973-78	1978-84
Metals and minerals	178	0.5	485	0.9	650	1.2	15.6	3.1
Other primary	1,788	1.5	3,510	1.7	2,608	1.3	15.0	-4.7
Manufactures	58	0.02	256	0.04	1,705	0.1	33.2	29.3
Total	2,024	0.4	4,251	0.4	5,004	0.4	15.7	2.9
Manufactured Exports								
China	2.191	0.68	4,500	0.63	9,938	1.2	14.2	17.3
Malaysia	254	0.08	1,819	0.25	4,005	0.48	47.6	16.2
Philippines	303	0.09	1,204	0.17	2,488	0.3	31.9	14.8

/a Excluding Singapore.

Source: UNCTAD Trade Data System.

2.17 In 1983, 10 commodities accounted for 72% of Indonesia's exports. Indonesia's share of world imports of these 10 commodities was 7.6%. In that year it supplied 18% of world imports of tin, 10% of rubber and 7% of plywood (Table 2.8). Since then its share of world plywood imports has at least doubled. For these products Indonesia appears to have a sufficient share of the world market so that its output and export decisions have some influence on world market prices. For the remainder of its major exports, world market prices are not likely to be influenced by Indonesia's export levels.[10/] The corollary of this observation is that the level of Indonesian non-oil exports is not dependent on market demand limitations although there may be some trade-off facing Indonesia between the unit value of its tin, coffee and plywood exports and total revenues.[11/] Rather it is Indonesia's own efforts in organizing efficient production and effective marketing and the Government's willingness to provide appropriate incentives to exporters which determine the value of Indonesian exports. At some point Indonesia could run into market limitations if its exports become large enough for trading

10/ An important exception to this observation is textile and clothing exports which are subject to severe trade restrictions under the multi-fiber agreement.

11 Some exports from Indonesia that do not rank in the top 10 in terms of value are of a sufficiently large world share to influence world prices. Examples include pepper and certain spices.

countries to impose trade restrictions but that is not now foreseeable. Indonesia has already experienced this in the case of garments and textiles and could also have problems with steel products in the future. Some of these barriers are in retaliation for unfair trade practices (subsidies) rather than as a result of the absolute volume of exports. Since they result from domestic political pressures they have little practical consequence for Indonesia when considering problems of market access.

Table 2.8: INDONESIA'S TOP 10 NON-OIL EXPORTS, 1983 /a

	SITC Category	Value ($ million)	Share of world imports (%)	Share of Indonesia's exports (%)
031	Fish fresh, simply preserved	272.4	2.3	6.1
071	Coffee	414.1	3.9	9.3
231	Rubber	624.3	10.4	14.0
242	Rough wood	393.7	6.5	8.8
243	Shaped wood	286.6	2.8	6.4
283	Nonferrous base metal	302.6	3.9	6.8
631	Plywood and veneers	341.2	7.3	7.6
684	Aluminum	146.6	1.2	3.3
687	Tin	306.5	17.9	6.9
841	Clothing	135.4	0.4	3.0
	Total	3,223.6	7.6	72.2

/a This data is reported by importing countries, excluding Singapore (a non-reporter). Therefore the data is somewhat different than that reported by Indonesia as an exporter.

Source: UNCTAD Trade Data System.

C. Current Trade Policy

2.18 In order to understand current trade policy in Indonesia it is necessary to appreciate the historical background from which it has evolved and to gauge it against national objectives to which it was to contribute. At the time of independence Indonesia possessed an undeveloped and rudimentary trade sector. Products from tree-crop estates, spices and minerals were the major exports. The industrial sector produced simple products for local consumption. Over the last two decades a high priority has been assigned to development of the industrial sector and to the creation of additional employment opportunities, using the country's natural resource base. Other

priority aspects of the country's development effort were regional dispersion of economic activity, prevention of over capacity, utilization of indigenous materials and resources, "orderly" industrialization, and the development of a cadre of indigenous entrepreneurs. In order to meet these goals the government created a series of industry-specific incentives to the private sector and placed regulations (especially on investment) on private business activity. Over the years, as the development objectives evolved and were refined, the number and specificity of incentives and regulations increased. Now, twenty years later, a very complex and sometimes confusing set of public measures has accumulated. Sometimes the measures conflict with each other or with some of the objectives, unintended side effects arise that are contrary to the objectives, or the behavior of private agents is distorted away from productive and desirable economic activities. Thus the initial and modified objectives, while well-based, have been met only partially because well intentioned policies either passed the stage of being useful or have never been as effective as originally envisaged. The cost of the accumulated regulations and incentives on resource use and allocation has become burdensome, and government is undertaking steps to reduce or offset it.

2.19 Indonesia does not have a recent record of being an outward-looking, free trade-oriented economy.[12/] After experimenting with more liberal policies in the mid-1960s the Government decided, by the end of that decade, to provide more formal government guidance to trade and industrial policy. There were two related reasons. First, for a relatively young nation still establishing its place in the world and with the need to develop a national identity, importing certain goods that could be produced domestically (albeit at a higher cost) was (and still is) interpreted as a shortcoming that required government actions to rectify. Second, in 1969 the Government began its system of 5 year plans (Repelitas). These plans in effect defined trade policy by specifying selected sectors and industries for particular support.[13/] During successive Repelita's different orderings of priorities have occurred and trade policy at times appears to be more inward-looking and at

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12/ A complete documentation of trade policy in Indonesia is given in The Timing and Sequencing of a Trade Liberalization Policy: Country Study of Indonesia, Mark M. Pitt. Conference on the Timing and Sequencing of a Trade Liberalization Policy, Lisbon, Portugal, June 15-21, 1986. (Mimeo, Country Policy Department, World Bank.)

13/ The general acceptance of active government participation in trade and commerce is illustrated in the following quotation:

> "...The borderline between the two categories of regulations (those necessary for economic and political development and those that impose a negative social gain on the economy) is nebulous, the more so in a country like Indonesia where the strong hands of the Government in economic management has never been seriously put into question."

Simandjuntak, The Indonesian Quarterly 13 (Oct. 85):423.

times to be more open. Now, during Repelita IV, while the goal of stimulating non-oil exports is recognized, the inconsistency between that goal and the goal of fostering many domestic industries through protection, is not explicitly recognized in many official documents.

2.20 Many devices have been used to implement the Government's trade policies. Tariffs were initially the most important trade policy instrument providing protection to the industries identified in early Repelita's as high priority. Surcharges also applied to certain imports (mainly luxuries). In 1985 Indonesia cut and simplified its tariffs. Except for the list of prohibited items there are eleven levels of tariffs (down from 25) with the maximum rate being 60% (down from 100%). Duties are typically ad valorem with considerable escalation based on the degree of processing or inversely on the degree of essentiality.

2.21 To offset tariffs or other protective measures there have been export subsidies, duty drawbacks, an export certificate scheme, export sales below cost (in the case of government owned enterprises) and export bans of upstream products when it is desired to promote the exports of certain industries.

2.22 But despite the breadth of coverage of tariffs, this device is now less restrictive to trade than the many other non-tariff barriers and restricting regulations placed on everyday commerce. Thus the reduction in the posted tariff rates have had only a marginal effect on the overall structure of protection.

2.23 Quantitative restrictions take many forms, but the most common are quotas (including zero quotas or import bans), import licensing, investment controls, counterpurchase requirements, local content legislation (the deletion programs) and restrictive importer arrangements. As of September 1985, 576 products were under quantitative restrictions and the list has since expanded. Many are operated through importer licensing where often a few firms will be the sole authorized importers of the good. The use of quantitative restrictions in Indonesia has been primarily to protect domestic industries against foreign competition particularly when tariffs are considered inadequate or ineffective and when it is judged desirable to establish domestic production of certain products.

2.24 Over the last two years the Government has taken some significant steps to open trade. The deregulation of foreign trade procedures by simplifying port procedures, deregulating shipping and freight forwarding activities, and totally reforming customs clearance procedures by having a private surveyor verify imports at the point of origin, are constructive steps. Also, accession to the GATT code on subsidies which requires the institution of a legitimate duty drawback scheme to replace the export certificate scheme and the phasing out of export-credit subsidies are steps in the right direction.

Further, the important package of policies announced on May 6, 1986, increasing the access of producers of export goods to imported inputs and improving the climate for foreign investment, is indicative of the Government's resolve to enhance the competitiveness of Indonesia's non-oil exports.[14/] Yet more remains to be done and for each of these steps others that go in the opposite direction, such as additional quotas and appointment of sole-importers or sole-exporter associations, can be cited.

2.25 Table 2.9 presents a summary of the policy instruments in common use in Indonesia and the administering agency for them. Further details on the various trade restructuring/promotion devices are given later in this report. However, the picture that emerges is that the Indonesian Government closely monitors and controls both export and import industries and closely orchestrates the direction and type of industrial development that takes place.

14/ The May 6 changes mainly concern getting inputs to exporters at world prices and easing foreign investment requirements. They are examined in more detail in Chapter 4, Part A.

Table 2.9: POLICY INSTRUMENTS AFFECTING MANUFACTURING INDUSTRIES

Policy Instruments	Principal decision makers/administrators
Investment Licensing	BKPM (Investment Coordinating Board) and Ministry of Industry.
Import-Related	
Tariffs	Ministry of Finance
Exemption from tariff (investment related)	BKPM
MPO (prepayment) tax	Ministry of Finance
Value Added Tax	Ministry of Finance
Quantitative Restrictions (bans, partial quotas, approved importers)	Ministry of Trade on recommendation of Ministry of Industry or other concerned ministries
Negative list	BKPM
Deletion programs	Ministry of Industry
Government purchasing	Cabinet/Minister for the Promotion and Use of Domestically Produced Goods
Price controls	Ministry of Trade
Subsidies	Ministry of Finance
Export-Related	
Export taxes	Ministry of Finance
Export certificate scheme	Ministries of Finance and Trade
Counter trade	Ministry of Trade
Exchange rate	Cabinet
Subsidized credit	Bank Indonesia and Ministry of Finance
Duty Drawback	Ministry of Finance

Source: Discussions with government officials and various decrees.

D. The Experience of Other East Asian Countries

2.26 It is now useful to compare export performance and policies in Indonesia with those of its neighbors and closest competitors - Thailand, Malaysia and the Philippines.

2.27 One of the favorable economic effects of exports is the role they play in boosting the import capacity of an economy. The import capacity or "the purchasing power of exports" depends on the level of export volume, export price and import price. Figure 2.1 shows the trends of purchasing power of exports since 1960 for the four countries. Purchasing power of exports for Indonesia, after stagnating during the 1960s, grew at a remarkably rapid pace in the 1970s, exceeding the growth in purchasing power of exports for Thailand, Malaysia and the Philippines throughout the entire period. In fact, the growth of purchasing power of exports for Thailand and Malaysia was below the average of non-oil developing countries. The strong performance of

Indonesia is attributable to oil revenues (both prices and volumes) which increased sharply as oil prices jumped in 1973 and 1979. This is shown in Figure 2.2 where the terms of trade of Indonesia are shown as strongly improving over the period (and showing a quantum jump in 1973 and 1979) while the terms of trade of her neighbors languished.

2.28 Yet, as Table 2.6 showed, the growth rate of Indonesia's non-oil exports over the 1978-84 period was worse than that of other countries in the region. The main reason for this was depressed primary product prices in the 1980s, the inability of nontraditional exports to offset the poor export performance of the other sectors, and the presence of oil revenues which tended to remove the urgency of developing non-oil exports. The presence of oil windfall gains allowed the economy to shift its resources to the nontraded sector since those revenues flowed into the economy. Consequently, unlike its neighbors, Indonesia has not developed a manufactured exports sector. In terms of the share of manufactured exports in total merchandise exports, Indonesia remains dramatically less developed than other countries in the region (Table 2.10). Other countries such as Malaysia, Philippines and Thailand that began from a similar level of 4 or 5% of total exports as Indonesia in 1965 had, by 1982 moved to 23-49% share of manufactured exports while Indonesia remained at 4%. Much of this is explained by the growth ir oil export revenues, but part of it is a result of incentives that encourage production of manufactured goods for the domestic market.

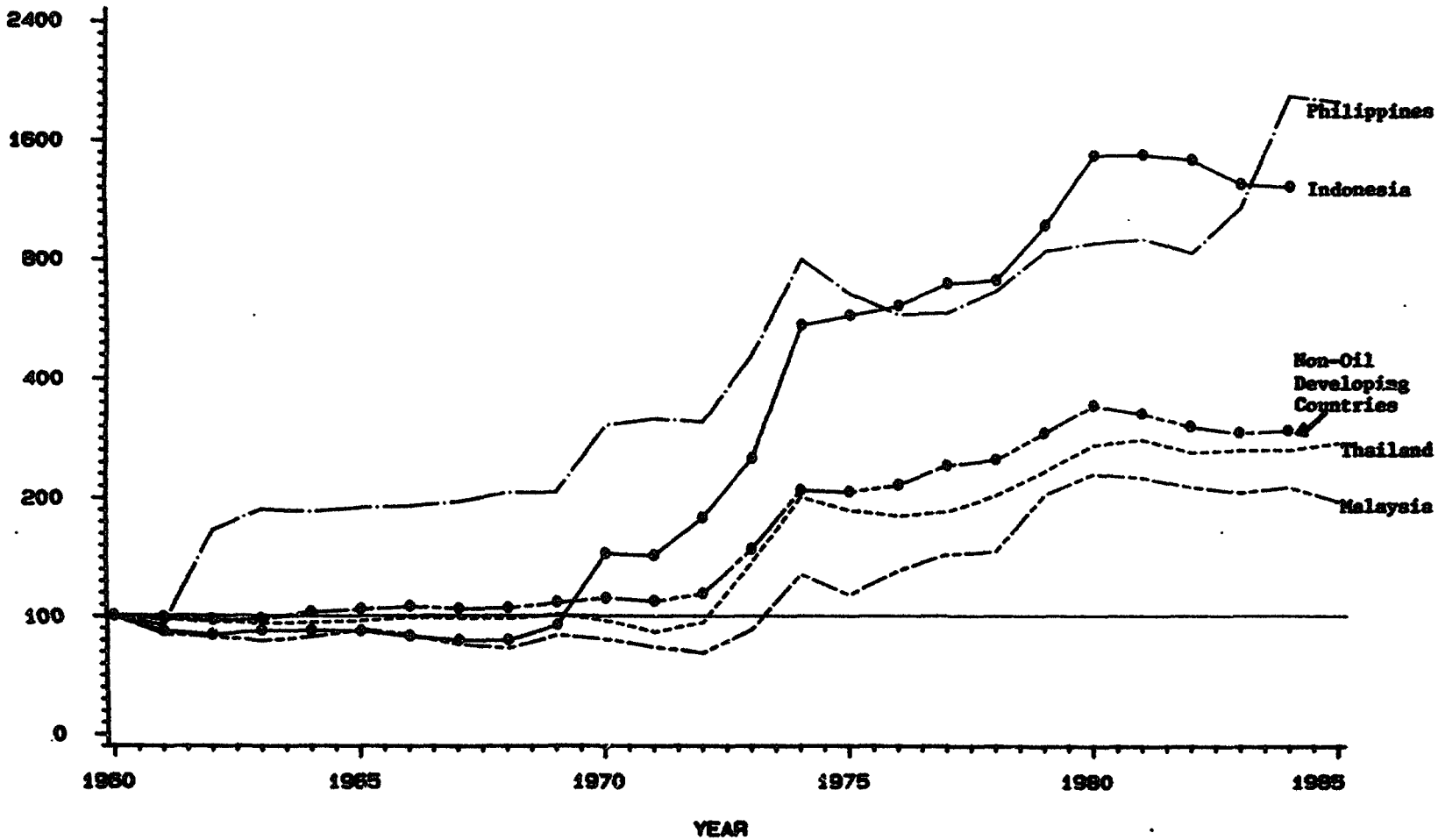
Table 2.10: MANUFACTURED EXPORTS AS SHARE OF TOTAL MERCHANDISE EXPORTS /a
(percent)

	1965	1977	1982
Indonesia	4	2	4
Philippines	6	25	49
Thailand	4	19	29
Malaysia	5	18	23
Korea	59	85	92
Hong Kong	86	96	92
Singapore	34	44	58

/a Manufactures consist of textiles and clothing, machinery and transport equipment and other manufactures.

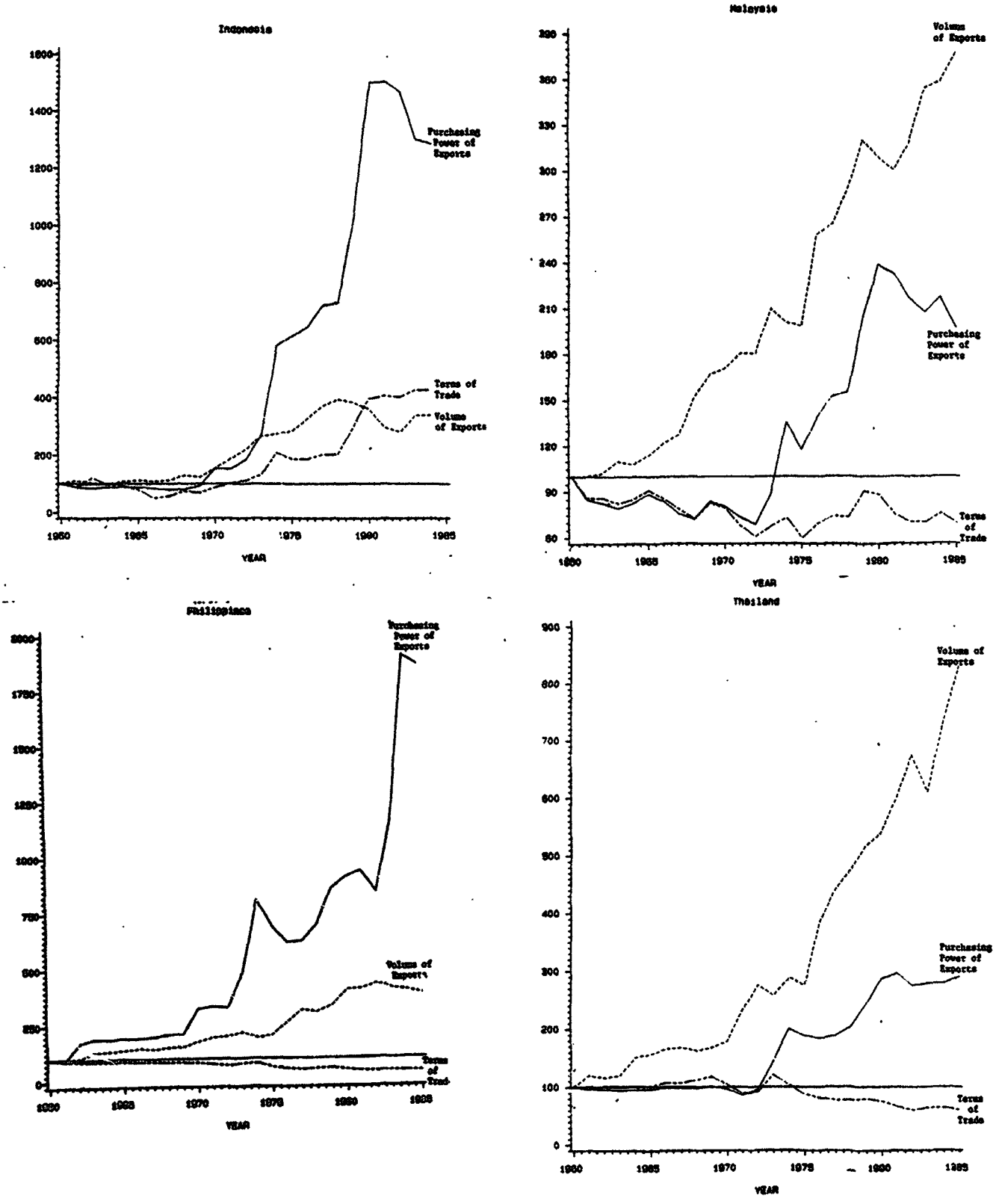
Figure 2.1

Purchasing Power of Exports for ASEAN-4 and Other Economies
(1960=100)



Source: IMF, IFS Database, July 1986.

Figure 2.2: EXPORT VOLUME, TERMS OF TRADE AND PURCHASING POWER OF EXPORTS FOR ASEAN-4 (1960 = 100)



Source: IMF Database, July 1986.

2.29 The composition of Indonesia's exports has also changed more dramatically than any of its neighbors. Not surprisingly, the country is much more dependent on fuels, minerals and metals for its export earnings than it was fifteen years ago. In no other country in the region has its dependence on one commodity group grown to the extent it has in Indonesia. Further, no other country in the region has such a concentrated (lack of diversified) export base as does Indonesia. With the current fall of oil prices the strategic implications of this pattern of trade are becoming very apparent. The productive structure of the economy must adjust to this new reality. This means that a greater importance on tradeable goods will result.

Export Promotion Policies in ASEAN-4

2.30 Indonesia is, of course, not alone in the region in having policies that protect domestic industry and other policies that attempt to offset those to promote certain exports. It is useful to review the trade policies of ASEAN-4 to see how Indonesia compares to its neighbors and competitors. Generally Thailand has a low level of protection favoring domestic industries with Malaysia quite close behind, whereas the Philippines, like Indonesia, has a strong import-substitution bias.[15/] All these countries, except Indonesia, introduced more neutral policies in the early 1970s. In Thailand the Investment Incentives Act was revised in 1972 followed by a duty-drawback system. In Malaysia the policy emphasis switched toward export promotion with the passage of the Investment Incentives Act of 1968 which provided export subsidies and accelerated depreciation on export-oriented investments, while in the Philippines an Export Incentives Act was enacted in 1970 along with the Export Processing Zone Act. Only in Indonesia was the move to open the real economy delayed until the late 1970s when tariffs were lowered and narrowed and again in 1985 when tariffs were consolidated further. However, the gains resulting from these episodes have been largely offset by subsequent increases in nontariff barriers. Thus Indonesia is alone in the region in its reluctance to provide incentives to export.

2.31 It is, in general, difficult to attribute an increase in exports to a specific export promotion measure unless it is a broad and major change such as an exchange rate realignment or a major tariff cut and non-tariff liberalization. However, it is also not particularly useful for our purposes to do so. Of interest is the broad set of policies that are put in place to establish a more neutral incentive system and a more outward-looking economy. What sets of policies have been adopted by Indonesia's neighbors that appear to have provided those countries with an export-orientation?

2.32 Thailand's principal export promotion measures consist of a tariff drawback system, preferential treatment for short-term export financing, subsidies for electricity charges and an export service center.[16/] Of these

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15/ See Agarwala, R., Price Distortions and Growth in Developing Countries, World Bank Staff Working Paper No. 575, 1983.

16/ Tariffs, both ad valorem customs tariffs and temporary import surcharges,

measures, the tariff drawback system and export financing incentives have been utilized by a large number of manufactured goods exporters as they offset to some degree the disincentives against exports.

2.33 In 1982 a major tariff liberalization was undertaken to reduce the overall protection levels and narrow the range of tariffs. Main reductions were for foodstuffs, electrical appliances, and chemical industry raw materials. Since then further reductions have taken place on a sectoral or sub-sectoral basis so that the most recent import-weighted average nominal tariff rate is estimated to be approximately 19% while the overall effective protection figure is approximately 50%.

2.34 Like Indonesia, Thailand also has domestic content legislation for a number of products but the controls are less restrictive than Indonesia's. There is no industrial licensing and few price-controlled items, but an Investment Board, administering certain incentives (but not regulating industrial investment) does operate.

2.35 In the Philippines, in addition to measures in the early 1970s, a major trade liberalization program was introduced in 1980 to be phased in over five years. As well as immediate steps to simplify trade procedures, lower the cost of export-financing, and establish twelve new export processing zones, the following tariff targets were set:

(a) reduction of maximum nominal tariffs from 100% to 50%, or effective rates of protection to a range of 10% to 80%;

(b) lowering average protection from 45% to 28%; and

(c) reduction in tariff dispersion.

While these changes have been implemented as scheduled, the continuing foreign exchange crisis and controls have made the system redundant. Further, import quotas and other quantitative restrictions are the main instruments of trade policy. Yet the Philippines has been willing and had planned to cut Q.R.'s deeply. These plans were postponed by the political crisis. There are a number of export-promotion measures such as investment incentives offering certain tax concessions and certain export subsidies but these do not offset the bias against exports of the other existing measures. Very recently the new Government introduced a trade reform package that will reduce many distortions.

2.36 The principal form of protection in Malaysia is through tariffs but Malaysia maintains the lowest average tariffs of any in the region (albeit with high dispersion between 0 and 100%). Tariff exemptions are granted for intermediate goods used in production of export goods. The average nominal (output weighted) tariff was 19% in 1982 and effective rates of protection are clustered around 29%. Import quotas have been used on a commodity specific basis as an anti-dumping device, and are often coordinated with price controls to avoid "profiteering." Malaysia also employs domestic content regulations mainly in the motor vehicle industry, and like other countries in the region it has a system of industrial (investment) licensing administered by the

Ministry of Industry. State enterprises are industries most closely regulated and proposals to make licensing automatic are being considered. Export promotion policies for manufactured goods include the establishment of free trade zones, deduction from income tax, subsidized interest rates to small scale industry, and special tax exemptions for "pioneer" industries. The set of incentives has to a large extent offset the negative bias against exports but has produced biases within the export sector. A large part of manufactured exports comes from enterprises within the free trade zones, indicating their usefulness in stimulating non-traditional exports. But these incentives reduce the possibility of producing export goods in the economy as a whole, since the EPZ incentives create a disadvantage to exporters outside the zones and prevents the economy from benefiting from economies of scale as separate plants must be established inside and outside the EPZ. This merely indicates the continued existence of overall export disincentives (an anti-export bias) in the structure of industrial incentives in the Malaysian economy. That is, the successful experience of the EPZ's in Malaysia has not been generalized to the Malaysian economy as a whole.

2.37 In comparing the experience of Indonesia and that of its ASEAN neighbors, there are three striking differences in approaches. First, neither export promotion policies nor relaxation of trade regulations were seriously considered in Indonesia until the 1980's - many years later than other ASEAN countries. Blessed with a positive balance on its trade account due to oil revenues and adequate foreign reserves, the need to stimulate non-oil exports and provide a more neutral industrial incentive system seemed unnecessary. This has, of course, changed with the recent fall in oil prices. Second, as noted earlier, Indonesia finds it much more difficult, philosophically and culturally, to make the country more outward looking. The tradition of widespread hands-on direction by government in much of commerce, and of self-reliance in production are not easily reversed. As the practice of competing for government patronage becomes more entrenched, so it becomes more difficult to break, since many individuals both in and outside of government stand to lose from such changes. Active government management of economic life has caused a high-cost economy so that the cost of production, distribution, transportation, and all other aspects of commerce are higher in Indonesia than they are abroad. These costs, unless reduced or offset by export subsidies, make Indonesia less competitive than its neighbors. Third, changes in tariffs have been reduced only to be superceded by non-tariff barriers, and Indonesia has adopted fewer export promotion measures and maintains more restrictive regulations than its neighbors.[17/] Thus much more severe biases against exports remain and the general trade environment is not as conducive to foreign investment as that of its neighboring countries. Accordingly there appear to be good reasons for the mediocre performance of Indonesian non-oil exports (especially manufactured exports) compared to her neighboring countries.

17/ For example 100% foreign ownership of firms is not allowed in Indonesia and even foreign partners must phase out their share over time. Also foreigners may not export from Indonesia -- only domestic or partly domestic firms can obtain export licenses.

III. PROSPECTS FOR INDONESIA'S MAJOR NON-OIL EXPORTS

3.01 As with all countries where a large share of export receipts is from primary products, Indonesia's future export receipts are, and will continue to be, highly dependent on international demand and price trends. Since 1973, when oil/LNG prices started to increase, Indonesia has become much less subject to the vagaries of prices of its non-oil exports as they were such a small proportion of its total export receipts. But now, with oil prices falling and with non-oil exports accounting for a larger share of foreign exchange earnings, the performance and prospects of non-oil exports are of much greater concern. As was shown in Table 2.8 Indonesia has developed a rather narrow export base with rubber and wood products alone accounting for 37% of the value of non-oil exports, and the top ten non-oil exports (of which wood products are three categories) account for over 72% of non-oil export receipts. The soft markets for its major non-oil exports that Indonesia has faced over the last two years and the prospects of these prices remaining soft for the next few years have generated interest in the longer term outlook for these commodities. Accordingly detailed studies of products of interest to Indonesia were conducted to project foreign exchange earnings. The detailed studies for major products are presented in Annex I and are summarized here. After comments on the environment for non-oil exports the discussion is organized along product lines. First, the prospects for forest products (including plywood) are described followed by agriculture and fishery products. Minerals and metals are reviewed next and finally prospects for manufactures are reported. A summary is presented in Table 3.1.

Table 3.1: PROJECTED NON-OIL EXPORTS UNDER FAVORABLE POLICIES, 1985-95

	Approximate Revenue ($ billion at current prices)			Approximate average real growth (%)
	1985/86 /a	1990/91	1995/96	1985-95
Primary commodities	2,920	5,100	9,100	6
Timber	396	635	948	5
Rubber	654	1,037	1,717	5
Palm oil	125	322	1,070	10
Coffee	819	688	934	3
Shrimp	190	340	550	7
Other agricultural products	740	2,000	3,800	12
Manufactures	2,500	4,200	7,100	7
Plywood	900	1,700	2,600	8
Textiles	750	940	1,800	8
Other manufactures	850	1,600	2,700	7
Metals and minerals	790	1,000	1,500	3
Total	6,200	10,300	17,700	6

/a Data are fiscal year estimates.

Source: World Bank staff estimates and projections.

3.02 If the necessary policies are not put in place, Indonesia's exports could fall considerably short of the favorable policy scenario. Under unchanged policy, as shown in Table 3.2, the growth targets of primary agricultural commodities would slow since considerable new investment is needed to meet the projections for these exports. The growth of metals and minerals exports would be less affected since their production requires relatively little new investment. However, the real growth of manufactured exports would fall very sharply to approximately 2% annually during 1986-95. Under these assumptions Indonesia's total non-oil exports would increase by only 3% to 4% annually compared with 6% to 7% under the favorable policy scenario. By 1995 they would be $5 billion lower and employment would be some 600,000 lower than projected under the favorable policy scenario. Consequently, the difference for both the balance of payments and employment is substantial. But to reach the higher levels envisioned by the base case will require further shifts in policies. The nature of this policy challenge is described in Chapter IV.

Table 3.2: NON-OIL EXPORT PROJECTIONS UNDER ALTERNATIVE SCENARIOS, 1990, 1995
(in US$ billion in current prices)

	1990	1995	Average real growth % 1986-95
Favorable Policy	10,300	17,700	6
Agriculture	5,100	9,100	6
Metals and minerals	1,000	1,500	3
Manufactures	4,200	7,100	7
Unchanged policy	8,500	12,700	3
Agriculture	4,800	7,800	4
Metals and minerals	900	1,100	3
Manufactures	2,800	3,800	2

Source: World Bank staff projections.

3.03 Appropriate trade policies are important not only for the revenue that they generate but also for the employment that they create. Manufactured exports from Indonesia are labor-intensive activities. Thus any increase in output of these goods has a larger employment-creating effect than increasing output in many other activities. Estimates of the number of workers employed in export activities are given in Table 3.3. The approximately 2 million workers employed directly in export industries in 1985 will grow to 3 million by 1995 if favorable policies are followed. In addition, the multiplying effects of this employment would create additional jobs in support and service industries as well as in domestic consumer goods industries. Consequently the need for appropriate trade policies in order to create more jobs is critical to absorb part of the increase in Indonesia's labor force.

Table 3.3: ESTIMATED AND PROJECTED NUMBER OF WORKERS IN VARIOUS EXPORT ACTIVITIES UNDER FAVORABLE POLICIES, 1985-1995
(in thousands)

	Direct Labor Coefficient	1985	1995	Annual % Growth 1985-95
Wood	0.31	64	91	3.6
Rubber	0.34	167	262	4.6
Coffee	0.67	275	322	1.6
Shrimp	0.83	102	150	3.9
Metals & Ores	0.13	62	76	2.0
Textiles & Apparel	0.85	286	448	4.6
Plywood	1.54	597	991	5.2
All others	0.40	486	814	5.3
Total		2,039	3,154	4.4

Source: World Bank estimates based on projected export values and direct labor coefficiencies from the 1980 66x66 Input-Output table.

A. The Environment for Non-oil Exports

3.02 In examining the prospects for exports of Indonesian exports it is first necessary to make an assumption on how favorable or unfavorable global economic conditions will be (how they will either contribute to or inhibit additional exports). Such variables as rates of inflation, changes in currency values and national growth rates crucially influence the prospects. In addition, in projecting Indonesian exports, assumptions must be made on what policy changes may be made over the period in question. The assumptions used in the subsequent assessments are now spelled out. They draw from the macro and financial assumptions of the Economic Analysis and Projections Department of the World Bank.

3.03 Average inflation rates in Europe, Japan and the United States (the major trading partners of Indonesia) are assumed to be on the order of 4%, 2% and 5% respectively until 1990, and 4.5%, 2.5% and 4.5% respectively from 1990 to 1995. The US real interest rate is assumed to hold at 4% until 1990 and is assumed to average 3% over the 1990 to 1995 period. Indicators of export demand for developing country goods in major markets expressed as average annual rates of change for Europe, Japan and the US are assumed to be approximately 2.5%, 4% and 3.5% respectively during the remainder of the 1980's and average 3%, 4% and 3.5% respectively from 1990 to 1995.

3.04 No major protectionist legislation nor any large scale liberalization in industrial countries is assumed over the period. With the recent realignment of industrial country currencies, especially the dollar, moderate growth and low inflation is assumed, and no increase in the real interest rate is projected. Monetary policies in major industrial countries have been

gradually adjusted to support better growth and declines in oil prices will provide additional stimulus to these economies. Further, intensified international cooperation in the monetary field and in foreign exchange markets portends for a period of more buoyant growth.

3.05 Within Indonesia it is clear that the pace of policy change has taken on renewed urgency with the lower oil prices. Oil prices, a critical determinant of the size of the Government's investment program, are assumed to remain weak (averaging around $18 per barrel in constant 1985 terms through 1995). Accordingly government revenues for activities to promote or finance non-oil exports will be limited compared to the recent past. It is assumed that projects underway will be completed (rubber, palm oil, fisheries) and certain other high priority projects initiated as planned (e.g. fertilizer). It is also assumed that the various policy changes favoring exports will continue so that on balance the internal terms of trade of exportables versus importables will improve. Finally it is assumed that the appropriate macro policies as followed in the past will continue.

3.06 These assumptions on the internal and external environment constitute the background against which prospects for individual products were gauged.

B. Forest Products

3.07 Forest products (logs, rough and shaped wood, lumber, plywood and veneer) are, in total, Indonesia's most valuable non-oil export, earning around $1.6 billion per year (depending on international prices). Approximately 64% of the total land area of Indonesia, amounting to 122 million hectares, is covered by tropical rain forest. Of that amount 56 million ha. have been marked for production forest and 40 million ha. have been allocated logging concessions. The general policy of the Government dictates progressive exploitation of the forest area to provide a sustained source of welfare for the population involved in the industry and to the country. Man-made forests are few although with replanting of cut areas they will increase. Government regulates the areas that are to be harvested, felling systems, forest conservation, reforestation and the type of trade (hardwood log exports are now banned).

3.08 Log production amounts to approximately 15 million cubic meters per year. Until 1980 most of the exports of Indonesia's hardwood were in the form of logs. In 1978 the government increased the export tax on logs from 10% to 20% and in 1980 it introduced a phased ban on the export of logs. This has resulted in a steep decline in log exports (hardwood log exports are now zero) and a rapid growth in plywood and veneer exports. Indonesia's decision to switch to processed wood products occurred at a time when a general slowdown in economic activity took place in industrial countries causing prices of forest products to drop sharply. This, and the way that Indonesia forced the substitution in production of logs for higher valued forest products by banning log exports, has proved to be costly to Indonesia. This is explained further in Chapter IV and Annex 3.

3.09 The major markets for sawnwood from Indonesia are Asian countries and the EEC (together accounting for 90% of Indonesian sawnwood exports) while the major markets for Indonesia plywood are the US (27%), Korea (22%), and Hong

Kong/China (22%). With the prospects of continued recovery in the industrial countries, it is anticipated that prices for forest products will keep pace with or exceed international inflation.[17] It is expected that Indonesia will capture a large share of the market because Indonesia, with its access to abundant forest resources, could have a cost advantage over Singaporean, Taiwanese, Korean, and Japanese producers of plywood and sawnwood. There has already been a major contraction in the plywood industry in Taiwan and Singapore. Even in Japan, which has been relatively slow to adjust, the number of plywood factories has fallen by two-thirds. Nevertheless, the remaining mills in Japan are still capable of meeting 80% of Japan's requirements. The pace of Indonesia's exports will largely be determined by how quickly Japan eliminates its tariff on plywood imports. The significant appreciation of the Yen in recent months has further increased Indonesia's competitiveness so that the projected 10% average volume growth for 1986-95 should be attained fairly easily provided Indonesia does not encounter increased trade restrictions. Some shake-out of plywood plants is occurring in Indonesia at the moment as the industry adjusts to the present circumstances. But considerable capacity remains and mothballed plants can be brought on stream if required. Thus Indonesia is well placed to capture the increased demand for plywood that would be forthcoming with any upswing in the international business cycle. It is also well placed to increase its export earnings from other wood products (sawnwood and shaped wood) as its relatively new industry develops and matures. Yet the absolute ban on log exports had caused some difficulties and so far appears to have been a costly policy for Indonesia in terms of overinvestment in plywood plants and sawmills. Relaxing the ban and introducing alternative policies would be to Indonesia's long term benefit.

C. Agriculture and Fisheries

3.10 Rubber is an important export commodity. Some 16 million smallholder families produce rubber (and other crops) on 14 million hectares (ha) while 1,800 estates produce mainly rubber on another 2 million ha.

3.11 World production of natural rubber has been dominated by Malaysia, Indonesia and Thailand which collectively account for 80% of total world output. Indonesia is the second largest producer and exporter of rubber accounting for around 28% of world rubber exports or approximately 1 million tons annually. But synthetic rubber is the main source of competition for natural rubber regardless of the source of natural rubber.

3.12 Production of rubber in Indonesia has been increasing over the last few years reflecting the efforts of a program of replanting, yield stimulation practices and improved organization of smallholders. Yet yields remain low and considerable expansion in production from existing plantings is possible. With the recent emphasis on tree crops, Indonesia's production and exports are anticipated to increase over 4% per year. Since competitors are not increasing their plantings because marginal production costs are close to or exceed

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17/ All prices in this section are expressed in constant dollar terms, unless otherwise specified, where the World Bank index of manufactured unit value is used as the deflator.

market prices, and since world demand for natural rubber is increasing somewhat less than Indonesian production, Indonesia will capture a larger share of the world market in the future. Rubber prices are projected to remain at approximately their present levels until the early 1990's when they should recover by 25% to 30% as oil/LNG prices rise. Accordingly, Indonesia's export earnings from rubber will increase quite modestly in the short run but more dramatically in the longer run as both export volume and prices increase.

3.13 There are several qualifications to these prospects. First, the cost of producing synthetic rubber, which is directly proportional to the cost of oil, has clearly fallen dramatically over the last year. While industrial countries have switched to using more natural rubber in automobile components (especially tires) in recent years, much lower synthetic rubber prices will cause manufacturers to revert to using a higher proportion of synthetic rubber and prices of natural rubber will fall.

3.14 Second, the ambitious program to increase Indonesian rubber production under Repelita IV has encountered implementation problems that would make it difficult to achieve even the projected annual increases of 4% per year (already well under that planned for Repelita IV).

3.15 Coffee accounts for more than 11% of non-oil export receipts. Prospects for Indonesian exports of coffee appear very good in the short run and quite favorable in the longer run. Indonesia is a major coffee producer and its exports account for around 4% of world trade. Approximately half of Indonesia's exports are sold under the International Coffee Agreement quota and the remainder are sold by bilateral arrangements. As a result of the recent damaging drought in Brazil coffee prices have increased sharply in 1986. An open question at this stage is how long the impact of the Brazilian drought will be reflected in world prices. As the drought continues it causes widespread tree mortality. In this event Brazil's long term production capacity will be impaired and higher prices would hold for a longer period. This will benefit other producing countries such as Indonesia.

3.16 Additional uncertainty surrounds the International Coffee Agreement. The International Coffee Organization (ICO) recently lifted its export quotas, effective until 1988. It is now likely that producing countries with stocks will sell them, damping the present price surge. Thus, projecting coffee prices in the current environment is highly problematical. Yet is is clear that price increases beginning in early 1986 will continue through 1988. In the longer run they are projected to fall back to approximately their 1983-85 levels which reflect the long run average cost of production. Nonetheless, Indonesia will receive the benefits of higher coffee prices at least in the short run. Further, it is in a strong position to expand its ICO export quota in the future thus assuring itself of larger market share. It is projected that while Indonesia's exports may increase between 3% and 4% per year, export revenues will increase by up to 30% in the short run and by 6% to 7% per year through the 1990's.

3.17 Vegetable Oils in Indonesia have been characterized in recent years by a rapid increase in domestic demand due to increasing population and income. Coconut oil and palm oil, each accounting for over 40% of total consumption, are the major oils. Coconut oil production in Indonesia has remained fairly flat over the last 15 years while that of palm oil has risen

dramatically. This is mainly due to the fact that palm oil is produced in large part on 20 large estates that have rapidly adopted modern technology and introduced high yielding plant material. In contrast, coconuts are a traditional smallholder crop. Only recently have coconut replantings benefited from the use of higher yielding materials.

3.18 The world distribution of palm oil production has changed markedly over the last decade, moving from West Africa to Asia. Malaysia is now the major producer and exporter with Indonesia a distant but growing second. The major importing countries have also changed. In 1975 industrial countries purchased 70% of total imports of palm oil while developing countries imported 30%. By 1980 these ratios were reversed with India and Pakistan being major importers.

3.19 Indonesian exports of oils are increasing and prospects appear quite promising. While coconut oil exports are growing only slowly, palm oil exports are showing good growth as both production and processing capacity come on stream. Growth rates in export volume of nearly 15% per year up to 1995 are expected while world prices are projected to move up towards the end of this decade from their current levels of around $243 per ton to $450 per ton (constant dollars) by 1995. Thus if Indonesian export taxes on vegetable oils are kept moderate or reduced, and existing production-enhancement efforts are maintained, prospects of oils for Indonesia appear promising.

3.20 Shrimp is the dominant Indonesian fish export, contributing around $200 million (3.4%) to non-oil exports. Indonesia is the world's fourth largest exporter contributing 7% of world exports. Production of shrimp in Indonesia fell during the early part of this decade due to restructuring of the industry, but with the development of shrimp farming, Indonesian production and exports are projected to increase at about 7% per year during the next decade. The restructuring of the industry involves switching production from sea trawling to aquaculture fish farming. In order to guarantee a supply of postlarvae (shrimp stock) for fish farming, the Indonesian Government has restricted the use of shrimp trawlers in certain areas. This resulted in a drop in shrimp production during 1984 but an assured supply of postlarvae for fish farming in future years. Various projects are underway in Indonesia to convert fish ponds into shrimp ponds, to develop new shrimp ponds, and to introduce modern husbandry techniques to fish farmers in order to raise productivity. If successful, the production projections made here could well be significantly exceeded.

3.21 Japan and the US are the largest consuming and importing countries accounting for over 70% of world imports. In these countries over 80% of shrimp is consumed in restaurants. Food consumed away from home has a high income elasticity of demand. Thus the income growth prospects for these countries as well as changing food consumption habits, bode well for shrimp consumption. While global shrimp consumption is projected to increase at over 6% per year and production from capture fisheries is fully exploited, global production from aquaculture is developing rapidly, so that while prices should hold at present real levels, it is unlikely they will strengthen. For Indonesia this means that its earnings from shrimp exports will rise as a result of increasing export volume. Since it has a greater capacity to expand fish farming than many countries, its share of the world market is likely to increase over time.

3.22 Tuna is the other important Indonesian fish export. Most tuna is exported in cans and therefore is considered a manufacture. But some tuna is frozen for export, much of it very high value fish destined to be used as sashimi in Japan. Indonesian tuna fisheries are not fully exploited and considerable scope exists for expansion. It appears that expansion of tuna canning is occurring as local processors increase output and as they form joint ventures with companies from former tuna fishing countries (especially the US) which are now excluded from many fisheries because of the 200 mile economic zone. In order to gain maximum benefit from this industry two policies that place tuna canning at a comparative disadvantage need to be reviewed. First a 50% interest subsidy on export credits encourages exporting frozen tuna. Tuna canning operations do not benefit from this subsidy and so pay a higher price for fresh tuna than they would in the absence of the subsidy. This places Indonesian canners at a cost disadvantage relative to foreign canners. The second policy concerns domestic tinplate which is priced substantially higher than the CIF price of imported tinplate. Import restrictions (prior to May 1986) prevented domestic canners from using this cheaper tinplate. Since the cost of the can is approximately 30% of the input costs, the higher cost of domestic tinplate severely hampers the profitability and competitiveness of Indonesian canned tuna and discourages foreign investors from locating new canneries in Indonesia when conditions are more favorable elsewhere.

D. Metals and Minerals

3.23 Metals and minerals (mainly tin ore, nickel matte and nickel ore, copper concentrates and bauxite) are also major non-oil exports for Indonesia and, because of extensive reserves, will remain so in the future (Table 3.4). They account for more than 13% of non-oil export receipts. Metal prices, which have been down during the 1980's, cannot be expected to strengthen until further industrial restructuring, in Indonesia and abroad, to lower global supply has run its course. Further improvements in productivity in some mines will continue to exert downward pressure on prices. Thus prices similar to those prevailing in 1985 may be expected to persist through the period under review. For Indonesia, a low cost producer of its metals and minerals, production will increase only slowly and, likewise, export revenues cannot be expected to show more than minimal growth. Great uncertainty surrounds the tin market with the suspension of tin trading on the London Metal Exchange, the collapse of the tin agreement, and the massive overhang of tin stocks which it now seems will be sold in the present depressed market. Thus the projections for tin need to be interpreted with caution and in terms of most recent market developments.

Table 3.4: NON-FUEL MINERAL EXPORT EARNINGS 1975-85
(US$ million)

	1975	1980	1983	1985/a
Tin	142.39	519.41	321.68	249.03
Copper concentrates	77.87	153.00	126.09	114.00
Nickel ore	20.90	39.44	12.84	14.95
Ferro nickel	-	24.12	25.41	23.28
Nickel matte	-	141.00	110.32	114.73
Granite	0.35	3.72	12.99	18.83
Sand	-	n.a.	n.a.	33.77

/a Estimated.

Source: Ministry of Mines and Energy - Annual Statistics.

3.24 Indonesia is endowed with one of the largest worldwide reserve areas of nickel-bearing materials in oxides, estimated to exceed 800 million tons. Nickel ore is mined by the state company, P.T. Aneka Tambang (ANTAM) and under contract by P.T. Inco. Production on the order of 300,000 net tons per year of ore is shipped to Japan and about 330,000 tons is used by the ferronickel smelter. Ingots are sold to Japan while shot is marketed in Europe. There are plans to increase smelter capacity over the next five years so that 1 million net tons per year of ore would be required. The expanded output of ingots would be sold in Japan to fill its falling production as Japan phases out its high power-consuming operations in favor of importing semi-finished nickel metal.

3.25 Tin production, while small in volume, is the largest mineral in terms of value. The state company, P.T. Timah, is the predominant producer and controls the industry in Indonesia. Profits of the company appear to have fallen steadily since 1979, largely because of declining world-wide demand. Production costs for the sector are not officially available but historical operating cost statistics indicate that, in relation to the floor price of tin immediately prior to the suspension of tin trading, only one of three major mines (Bangka Island) has costs below the floor price. If present operations were concentrated on Bangka so that current levels of output were maintained through switching, the profitability of P.T. Timah would increase.

3.26 Another operation owned jointly by P.T. Timah (25%) and private interests (75%), P.T. Koba Tin is highly profitable, having paid some $100 million in royalties and taxes to the government over the last 10 years. P.T. Koba Tin has skilled expatriate/Indonesian managers and runs a very efficient operation. This seems to indicate that for various reasons, including social/employment objectives, P.T. Timah's operating efficiency could be improved and that Indonesia could continue to export tin at a profit even at lower product prices.

3.27 Despite the substantial reserves available for mining in Indonesia, prospects for major increases in production are poor over the next five years because of excess global capacity and associated weak international prices. If demand is stimulated by the recently improved prospects for growth in industrial countries and by price declines resulting from the collapse of the ITC, then Indonesia stands to benefit from better utilization of its existing capacity. In the tin sector, prospects are particularly uncertain. Although extensive tin reserves are available and could be recovered at prices existing before suspension of trade, production has been totally constrained by export controls imposed by the International Tin Council, of which Indonesia is a member. With suspension of tin trading and the possible collapse of the ITC, the tin industry faces a period of extreme uncertainty. Although Indonesia may well be in a better long term position to survive such a crisis than producers in Malaysia and Bolivia, substantial investment or growth in Indonesian tin production is unlikely until a more certain outlook emerges.

E. Manufactures

3.28 Examining the prospects for manufactures in Indonesia or any country is a much more difficult and uncertain exercise than for many other products for the following reasons.

(a) Manufactured goods, because they are often final (consumer) goods and are specialized in their use, display greater elasticity of demand than primary products. While there are many end uses for, say, aluminum so that a change in demand in any final product would only affect a part of aluminum production, a change in demand for final or nearly final products, has a dramatic and direct impact on price and quantity because substitute end uses are not possible;

(b) Typically, manufactured goods, especially final goods, are much more elastic in their supply than many primary goods. This means that their output is able to expand or contract more readily in a shorter time and in larger amounts than, say, tree crops, in response to changing domestic or foreign demand or changing policy. Since these changes are difficult to predict assessing future levels of manufactured exports is highly conjectural. It is in this uncertain and volatile environment that comments on prospects for manufactured exports are made -- where the ability of Indonesia to adopt policies that make exporting manufactures profitable for private agents and enable it to compete in the international economy -- are critical to the outcome.

3.29 Two product groups account for more than 70% of Indonesia's manufactured exports. These are plywood and veneers (discussed earlier under forestry products) and textiles and clothing. Other manufactured exports of significance are fertilizer, cement, iron and steel products, non-electric machine parts, floor coverings, and TV, transistor and semiconductor parts.18/

18/ The list includes those manufactured products whose exports exceed 0.25% of the value of non-oil exports.

3.30 Textiles and clothing have been a rapidly growing source of export earnings for Indonesia but are likely to level off in the future as quotas under the multi-fiber agreement (MFA) are filled. Indonesia has done well in filling the various categories of its quota and has also managed to generate considerable sales outside of the MFA. Given internal policies that maintain its competitiveness by keeping input prices competitive and allowing duty drawbacks, Indonesia's textile and clothing industry will continue to make a significant contribution to exports but cannot be expected to grow at its recent rate of 30% per year.[19/] Industrial countries are the major market for Indonesian garments, the US and the EEC being the primary ones. The outlook for more rapid growth in these regions should do much to diffuse protectionist pressures in the next few years but it is unrealistic to expect large increases for Indonesian textiles and garments covered under the Multifiber Agreement (MFA). If economic conditions deteriorate in industrial countries there will undoubtedly be pressure to restrict imports of clothing even more than at present.

3.31 The prospects for increased exports to the European market are not encouraging unless Indonesia succeeds in winning additional quotas under a future MFA. And the US market which has been a major source of market growth in recent years has become much more sensitive to the potentially disruptive impact of Indonesian exports on its domestic industry. Accordingly, Indonesia's textile imports to the US are covered by a comprehensive annual agreement and consultation mechanism. Under the terms of the agreement for the next two years the growth of Indonesian textiles will be limited to 6% annually for certain product categories and 10% for others (in square yard equivalents). This arrangement does, however, offer Indonesia the opportunity to increase export earnings further if it can improve the quality -- and hence raise the value added per piece -- of its exports, but to do so will require a major effort, since it would have to compete directly with well established and successful producers from Hong Kong and Taiwan.

3.32 Nitrogeneous fertilizer is one manufactured product that Indonesia has successfully developed and one where considerable potential remains. In the past, Indonesia has been a net fertilizer importer. Despite rapid development of large fertilizer capacity, mainly aimed at meeting domestic requirements, supply remained generally insufficient to meet the fast growing fertilizer demand. The Government therefore utilized the country's abundant gas reserves for nitrogenous fertilizer production, and in a few years not only met the country's needs but also exported it (in 1977-79) to other Asian

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19/ It is by no means clear that appropriate policies will be followed as changes are often made some of which are beneficial to exporters and some of which impair exports. For example, in March 1986 a sole importer for cotton fiber was appointed. While it is too early to observe the effects of this, economic principles would suggest that cotton prices to domestic users will rise, that users of specialty cottons may be unable to get the product they need, and that generally the industry will not be well served by the sole-importer arrangement. On the other hand in May 1986 regulations to allow exporters to import inputs duty free were announced. This is clearly of great benefit to exporters provided that sole importers do not exercise their monopoly power.

countries. Because of its geographical proximity to these countries Indonesia enjoys a transportation cost advantage over suppliers from Western Europe, the United States and even the Middle East. But as domestic consumption increased Indonesia again became a net importer in the early 1980s. Since then four new urea plants have been completed, giving the country a surplus. Plans to build two additional urea plants by 1988/89 to provide urea for export are proceeding.

3.33 The Indonesian nitrogenous fertilizer industry has demonstrated over the years that it can operate at high capacity utilization and efficiency rates. In addition, it benefits from the availability of relatively low cost feedstock and is overall one of the cheapest producers in the world. The industry is now embarking on a program of debottlenecking, rehabilitation and energy efficiency improvement, as well as strengthened staff training. These steps will further enhance its international competitiveness. The prospects for this very viable industry are promising. Large markets are located close to Indonesia, its feedstock is cheap, and it has shown that plants can be well-managed.

3.34 There are many other manufactured products for which Indonesia has good prospects given appropriate policies. Examples are cement, rattan, handicrafts, and processed foods. For most of these products their export success will in large part be determined by the policies Indonesia follows which will affect their profitability. Reference to expensive tinplate inhibiting canned tuna exports has already been mentioned. The same high cost tinplate has deterred pineapple packers from investing in export-oriented projects in Indonesia, but the May 6 regulations may overcome this problem. Rattan furniture exporters face input prices that are more expensive than their competitors. Indonesia, which virtually has a monopoly on the world supply of rattan cane, provides subsidized financing for raw cane exports. The result is that foreign rattan furniture manufacturers purchase Indonesian rattan for 10-20% less than Indonesian rattan furniture manufacturers pay for their cane. Further, Indonesian manufacturers must pay higher prices for domestically produced lacquer or purchased from a sole importer than do its competitors. These two government policies alone would be sufficient to make an otherwise profitable export industry noncompetitive on world markets. Consequently, rattan furniture manufacturing for export is almost non-existent in Indonesia. Indonesian steel, produced largely by one state company, or imported through a sole importer (cold-rolled steel), is 65% higher in price than the same steel in Singapore. Slab steel accounts for over 80% of the cost of some steel products. Exports of fabricated and manufactured steel products have occurred in recent years only because of a government subsidy on steel exports. This is scheduled to be terminated in 1986. At that time many steel product exports such as wire rod will become non-competitive and exports will cease unless the new government measures of May 1986 allowing duty free entry of imported inputs to exporters or internationally competitive pricing by domestic input suppliers, are effective.

3.35 Similar accounts can be made on a product by product basis but the point is the same. Government policies vitally affect the incentive structure (profitability) of export activities. By the non-judicious use of policies a government can effectively thwart the development of the export sector. There is evidence that this has been happening for a number of products in Indonesia over the 1980s.

F. Recommendations

3.36 For forest products, although Indonesia has faced weak markets due to the recession in industrial countries and has passed regulations that have had a negative effect on earnings from forest product exports, it does have one of the largest reserves of tropical hardwood forests. With considerable installed plywood and sawnwood capacity Indonesia is well positioned to take advantage of the increasing demand for wood products expected later this decade.

3.37 As is demonstrated later, the ban on log exports has been a costly policy for Indonesia and as a result many plywood plants are now insolvent. The government should consider relaxing the ban on exports of logs and introduce a tax on logs. Domestic log users could initially pay a smaller tax than exporters of logs. By this approach Indonesia can simultaneously provide some protection to its downstream domestic industry, conserve its forest resources, and exploit any market power it may enjoy in logs. Further, government will earn revenue. Some of the revenue from the tax could be used to reduce the outstanding debt incurred in construction of plywood mills or losses of creditors. Under such a policy receipts from log exports will rise (a net gain) while receipts from plywood exports would initially fall. But until the recent world price increase plywood exports have been generating net losses so overall the policy is beneficial even though total forest product exports decline.

3.38 With respect to agriculture, government policies designed to further encourage growth in production and gains in efficiency should continue. While most primary product prices are depressed at the moment Indonesia can still produce many of them at competitive prices and is likely to expand its market share in the future. For rubber, two major changes should be considered. The rate at which old rubber trees are replaced by high yielding clones must be increased, and further efforts must be made to increase the quality of some rubber. While present production is of a quality suitable for the current US market, it does not satisfy the requirements of EC producers nor is it of sufficiently high quality to be used in the lucrative medical market. The costs of upgrading versus the potential benefits to be gained in the new markets, need to be assessed.

3.39 The continued high growth rates of coffee consumption in Japan, the Centrally Planned Economies and the countries of Southern Europe bode well for Indonesia. These countries import large amounts of robusta which is produced by Indonesia. Indonesia is currently benefiting from the lifting of sales quotas by the ICO and based on its recent pattern of sales it appears that it would benefit if quotas were lifted altogether. Thus if the ICA were to collapse it would not be detrimental to Indonesia.[21/] Cocoa, likewise, has a reasonably good outlook. Quality improvement appears to be the major area where increased emphasis is needed.

21/ Indonesia is a signatory to several International Commodity Agreements. In view of their limited success and the limitations they place on members, Indonesia should consider severing its ties with the Agreements. See World Development Report, 1986, Chapter 7, Oxford University Press, 1986, for an analysis of the failure of ICA's.

3.40 While palm oil prices are presently at very depressed levels the outlook for Indonesia is quite promising. Limitations at the moment involve inadequate and expensive processing capacity, and insufficient port and transportation facilities. Further integration between agencies and ministries involved in the efforts to develop the palm oil industry is needed in order to have an integrated and consistent policy. For example, the policy of licensing by the BKPM of a few local firms as sole manufacturers of palm-crushing equipment is not necessarily consistent with efforts being made by other agencies to increase palm oil exports. In order to establish itself as a reliable exporter government policies should provide for imports of lauric oil during times of oil shortages rather than curtailing palm oil or coconut oil exports.

3.41 For fishery products prospects are good for both shrimp and tuna. Projects to develop shrimp farming are well based and should continue. For tuna, the primary problem with competitiveness concerns the high cost of tinplate used in the canning industry. In order for Indonesia to compete in this product -- and other canned produce -- it is necessary that tuna canners obtain their cans at world prices. The new regulations of May 6, 1986, allowing duty free entry of imported inputs if domestic producers cannot supply them at world prices may alleviate this situation. If not steps need to be taken to ensure that the prices of material inputs used in tuna canning do not exceed world prices.

3.42 For mining substantial restructuring appears to be needed in light of current and prospective market conditions. Particularly in tin, where inefficient mines have remained in operation for what seem to be social/employment reasons, the government must rationalize the industry if it is to remain internationally competitive. Indonesia's foreign exchange earnings from tin have halved since 1980 as a result of falling prices and exports, and P.T. Timah has not adjusted its corporate plans to reflect this. Production needs to be concentrated on the lowest cost sea dredging operation on Bangka Island rather than reducing output proportionately across the three mining sites. The workforce of some 29,000 personnel in 1981 has been maintained while production fell more than 15%. An early retirement scheme and/or voluntary redundancy packages need to be developed to reduce surplus labor. Rehabilitation and maintenance of plant and equipment at the Bangka site should be initiated, and the role of the private sector (P.T. Koba Tin) needs to be reexamined and possibly extended in light of its high levels of profitability and overall efficiency. The Ministry of Mines and Energy and P.T. Timah should consider fully the optimal role of private companies in the tin industry. Finally, P.T. Timah must develop its marketing department to sell its output now that organized international tin trading has collapsed.

3.43 For manufactured products (except plywood and veneers) much needs to be done if the private sector response in terms of volume and variety of exports is to be realized. Garments and textiles have performed well but, given the structure of global protection, may be reaching their zenith in terms of volume. What is required now is for firms to undertake product upgrading, completely fill their EC quota, and search for niches in non-MFA countries. Further, the government should modify its formula for awarding garment quotas by auctioning a part of the quota-rights (see Annex II,

pp. 29-33). For fertilizer, prospects are promising. An extensive review of the Indonesian fertilizer sector is needed, including evaluation of future Government plans, examination of agricultural policy implications and preparation of detailed regional (Asian) supply/demand balances, so as to formulate a medium- to long-term export strategy for nitrogenous fertilizers. A preliminary assessment by the World Bank has identified Indonesia, the largest fertilizer producer in East Asia (excluding China), as a strong candidate for sustained nitrogenous fertilizer export to East Asia and the South Pacific. Such an evaluation must address the issue of pricing and end-use of natural gas. With the price of LNG uncertain, at best, alternative gas utilization in fertilizer production is very attractive. The evaluation must also address the role of private investors in further developing the industry.

3.44 Many other items, too small in volume to mention individually, have found market niches. Yet other products for export such as nitrogenous fertilizer, cement and floor coverings remain to be developed. The primary role of government in further developing these and other industries is in making the trade environment conducive to exports. Recent changes allowing freer access to inputs will certainly help but further steps to ensure the continued profitability of manufactured exports may be needed. These issues are dealt with later in the report. But the implication of prospects detailed here is that Indonesia will have to adopt policies which will encourage creation of an entire new layer of manufactured export industries over the next 10 years. Producers have to be convinced by market signals to invest in new product lines and invest in improved and more efficient technologies to meet the needs of the foreign market. This will not take place unless the recently begun reversal in the incentive framework continues. Without further changes in the incentive structure the manufactured export growth projected in Table 3.1 will not materialize. Changing the incentive framework will not be easy and inevitably some existing industries will be faced with a painful adjustment process, but the rewards to the economy of sustained manufactured export growth are more than commensurate with the sacrifices involved. Indonesia is capable of significantly increasing its manufactured export earnings and thereby directly addressing both its balance of payments and employment problems.

3.45 Regardless of the policy changes and promotion policies followed by Indonesia for manufactures, primary based exports will remain by far the dominant share of non-oil exports in the immediate future. Even if manufactured exports increase dramatically, they are starting from such a small base that it will be a number of years before revenues come close to those from primary products. Being aware of this, policymakers should not place all their attention on policies for manufactured exports but should implement more general pro-export policies that will reward exporters across the board.

IV. CONDITIONS FOR ACHIEVING INCREASED NON-OIL EXPORTS

4.01 In their attempt to stimulate exports of non-oil products Indonesian policy makers are concerned about the conditions and environment that face non-oil exporters. In its broadest sense, the environment for non-oil exports encompasses all the conditions that facilitate or inhibit the profitability of exports. For convenience those conditions are broken into four categories in this chapter. The categories are not all inclusive of the trade environment in that they are concerned with various government actions and policies, but do not consider supply constraints or demand conditions that influence trade. The first category is internal trade policy as it influences the profitability of non-oil exports. Industrial and commodity policies maintained by the Government can have strong incentive or disincentive effects on exports both directly (if they are directed at the product) and indirectly (if the policies are directed at other products which are inputs to export goods or compete for inputs with export goods). Also, exchange rate policy is a powerful determinant of trade incentives as it has such a broad and immediate impact on the economy. The second category discussed here is export promotion measures for non-oil exports. Besides having appropriate incentives for exports there are certain infrastructural needs that could be provided by government. Basically the service sector that facilitates exports must be developed as exports grow. Physical facilities, import and export clearance procedures, shipping and trucking regulations, export financing facilities, investment regulations, and ownership requirements are all parts of the institutional environment that assist or discourage exports. Additionally many governments finance other promotional activities such as operating trade centers, financing or subsidizing export fairs, maintaining an export information clearinghouse, providing export credits, and operating other financial incentives such as duty drawbacks, or import duty waivers. Finally, the external environment facing Indonesian exporters in terms of policies and restrictions of its trading partners that inhibit imports of Indonesian origin are examined. Not surprisingly, the evidence indicates that Indonesia faces a difficult international trading environment at the moment. Not only are prices weak for its agricultural and mineral exports, as shown in Chapter III, but pressures for protectionism in industrial countries have not abated. These are the major markets for Indonesian goods and Indonesia has encountered new restrictions over the last year.

A. Trade Policy

4.02 As noted earlier the collective policies and regulations of the Government that influence directly or indirectly the incentive to export -- "the trade environment" -- are the crucial determinant of export performance of any economy. The Government by virtue of its power to regulate economic activity has almost complete control over this environment. This section describes in some detail government policies that determine this environment. For Indonesia achieving the projected export growth rate will require a continued reorientation of the incentive system away from import substitution and towards exports. Even under a highly favorable policy environment it may take time before a major export response emerges since domestic producers have been accustomed to operating in a sheltered home

market and may not immediately turn their sights toward the much more competitive export market. Many companies have little or no experience in export marketing and finance and need to acquire the necessary expertise to identify and penetrate overseas markets. Because reorientating the economy towards exports is a long term task, the case for continued policy action becomes more, rather than less, urgent. If Indonesia moves toward the right blend of policy measures now, it will provide the basis for a sustained improvement in export performance in the 1990s.

4.03 Over the last year Indonesian officials have been encouraging the business community to increase non-oil exports. Businessmen have responded that their efforts have been hampered because of the "high cost economy" which reduces export competitiveness. This problem is the legacy of an industrial strategy of protecting the domestic market which has led to the creation of a wide range of high cost, comparatively inefficient industries. Consequently, policymakers' response to this problem will determine whether Indonesia enjoys the benefits of increasing its exports. International trade can benefit Indonesia -- directly through exchanging its products for others and indirectly through more efficient allocation of its productive resources -- but it does not follow that increased exports automatically bring these benefits. Everything which Indonesia produces for export has a cost in domestic resources, imported capital goods, and other inputs. If exported goods cost more to produce (in domestic and imported resources) than their prices on world markets, and can only be made with the help of large subsidies, they can lead to a net drain on the country's resources and violate GATT rules. Such exports constitute a resource transfer where Indonesia subsidizes foreign consumers. Such a policy is clearly not in Indonesia's interest and, as demonstrated in the cases of export credit subsidies and the export certificate scheme, can sometimes be self defeating because they invite a protectionist response on the part of importing countries. Better actions to make exports more competitive are ones such as those of May 6, 1986 where duty drawbacks and direct duty free importation of inputs are allowed. While this does not make incentives between import-replacement industries and exports completely neutral and while it is not the best policy since it merely compensates for existing distortions rather than removing the distortions, it is a move in the right direction, it is sanctioned under international conventions and agreements and it is a measure that could be retained after a change in trade policy to compensate for residual protection.

4.04 The connection between protection of import-replacement industries and lackluster performance of the export sector is critical but not always clearly understood. Not only do export-oriented industries have to pay more for inputs that may be produced by protected import-replacement industries, but when import-replacement industries are made more profitable than export industries, resources are attracted to them and away from export activities. Thus inputs such as skilled labor, capital, and managerial/entrepreneurial talent is attracted away from export oriented activity. Permitting exporters to obtain internationally traded inputs at international prices, as is envisaged in the May 6 reforms, only partially restores export incentives. Nontraded inputs such as capital and managerial talent still costs the export sector more than they would if import-replacement industries received less protection.

4.05 Greater participation in international trade can offer Indonesia major benefits. It offers a powerful mechanism for improving the efficiency of resource allocation and resource use in the economy and reducing costs. When trade is opened, efficient producers are rewarded with expanded access to the world and domestic markets and inefficient producers are required to reduce costs to remain competitive. However, the more extensive the distortions an economy introduces into its trade regime, the more likely it is to encourage inefficient production and to reduce the competitiveness of its domestic and export industries. The price of scarce resources increases and they are pulled toward the protected import-replacement industries. This makes it difficult for potential export products to be produced at internationally competitive prices. A structure of incentives "biased against exports" is said to exist. Neutrality of incentives so that the market determines the type and scale of production is the ideal from the point of view of efficiency.

4.06 That Indonesia has a highly protected (biased) structure of incentives has been well documented by the World Bank and others and will be repeated only briefly here.[22/] But equally serious is the recent tendency to complement existing restrictions with further import controls. While a unification and lowering of tariffs has occurred, overall protection seems to have increased because of the increasing number of categories of goods subject to quantitative restrictions, expanded importer licensing requirements and the further implementation of programs designed to reduce progressively component imports with a view to increasing local content of domestic manufactures. Thus in 1985, for a number of commodities, zero import quotas were fixed, existing quotas reduced or new quotas introduced (e.g., bulldozers, wheel loaders, excavators, artificial sweeteners, viscous rayon fibre, certain kinds of chemical industrial product groups, etc.), while the mandatory use of domestic components in domestic production was extended to a variety of industries such as machine tools, electrical motor assembly and milk products. Similarly, a number of commodities have been added to the list of those subject to importer licensing (e.g., cotton fiber, ballbearings, tirecord fabrics and newsprint). These restrictions have taken place at a time when the Government has been reducing bureaucratic regulations and attendant costs to trade. By conferring oligopolistic powers to privileged importers, reducing options of domestic manufacturers for obtaining imported inputs and components and raising the domestic costs of imports through monopolistic practices, these restrictions undermine efforts in other areas to reduce costs and improve efficiency.

4.07 Effective rates of protection (ERPs) have been estimated for 122 sectors of traded goods in Indonesia. ERPs estimate the degree of subsidy (protection) or tax (negative protection) offered to each product by the entire system of protection on outputs and inputs. A positive number indicates the extent of the subsidy through the various protective measures, zero indicates no subsidy or tax (neutral treatment) and a negative number

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22/ See, for example, Indonesia: Adjusting to Lower Oil Revenues, World Bank Report No. 6201-IND, May 20, 1986.

indicates the extent to which the product is (implicitly or explicitly) taxed through the system of protection. The results of the work are summarized here. The estimates were made after the value added tax was introduced in 1984 but before the tariff reform of April 1985 or the selective import/ investment liberalization of May 1986.

(a) The rate of subsidy due to protection from imports varies widely across sectors. For 23 of the 122 products the ERP is negative, for 28 products the ERP exceeds 100% and for six products the foreign exchange spent on importing the inputs is greater than would be spent if the final good were simply imported. Products in the negative list include mining (metal and nonmetal), animal feed, preserved meat, industrial chemicals, apparel from woven fabric, logs and forest saw milling, and crude palm oil. Products in the list where their ERP exceeds 100% include motor vehicles and motor cycles, nonwheat grain flour, glass and products, manufactured plastic products, pulp paper and cardboard, hand tools and hardware, fabricated metal products, tires and tubes, electrical appliances and sugar. Products with negative value added (where more foreign exchange is spent on the inputs than if the final good were imported) include wheat flour, sugar confectionary, bakery products and factory refined edible oil (an export product). The unweighted average non-oil ERP across all products is 133%.

(b) Import competing products receive high levels of protection (averaging over 200%) while the export sector is taxed (the average ERP is -4%). Protection is strongly biased against exports and in favor of import replacement.

(c) Natural resource based products (agriculture and mining) are taxed relative to manufacturing (average ERP of 50% versus over 300%).

(d) Finished goods are favored relative to unprocessed inputs (average ERP of over 200% versus 38%).

(e) Even considering the introduction of VAT and the tariff cuts, neither the average ERP nor the dispersion is greatly reduced. The May 6 measures will modify the negative ERP somewhat but will not alter them on the import competing sector.

4.08 It is clear from the foregoing discussion that the trade environment in Indonesia is heavily skewed in favor of import-replacement, manufactured activity and against production for exports -- be it manufacturing, agriculture, or mining. High cost industries are the product of trade and commercial policies, such as tariffs, quotas and the administrative and licensing arrangements governing imports. The protection from such policies provides the fundamental incentive to set up and establish "high cost" industries and to avoid competitive export industries. Commercial policy and the underlying incentive structure it creates is, therefore, a powerful instrument for influencing the pattern and pace of economic development. Protecting industries that provide inputs to potential export products is a sure way to curtail exports. In Indonesia's case this situation has developed in the

steel products industry, basic plastic products, fibers, and packaging materials industries. To the extent that these import-competing goods are inputs into exports they also raise domestic costs to exporters and thereby reduce the competitiveness of Indonesia's exports. Consequently, policymakers need to ensure that the thrust of commercial policy is consistent with the country's export objectives. The analysis presented here demonstrates that there is strong implicit anti-export bias in the present structure of incentives. Thus, a part of Indonesia's success in increasing non-oil exports has been in spite of the policy regime rather than because of it. If Indonesia is to meet its export and growth objectives the anti-export bias inherent in the present system must be further addressed by lowering protection to import competing industries. The Government does not appear to have a consistent policy on this, but has been steadily expanding the range of products subject to importer licensing and is proceeding with the deletion program while introducing measures to offset selectively some of these effects on exporters.

4.09 The fact that even where exports are internationally competitive, exporters cannot enjoy fully their comparative advantage because their gains are eroded by high input costs, is illustrated here by examples.

4.10 Wire Rod and Steel Products. The steel industry is dominated by P.T. Krakatau Steel (PTKS), a state company which supplies all slab steel to other companies in Indonesia. Slab from PTKS is 65% more expensive than imported slab, and the slab accounts for over 80% of the cost of some steel products. According to one producer of wire rod, a government subsidy (scheduled to be terminated in 1986) has been the only reason exporters are able to cover their cost:

Receipts:	Rp/kg	Costs:	Rp/kg
Singapore price	310.75	Raw materials (80%)	279.22
Export subsidy	39.55	Other costs (20%)	69.81
	350.30		349.03

The difference between costs and receipts is Rp 1.17/kg or $1.04/mt. By contrast, if imported slab were used:

Receipts:	Rp/kg	Costs:	Rp/kg
Singapore price	310.75	Raw materials	169.22
Export subsidy	39.55	Other costs	69.81
	350.30		239.03

Under this case the net receipts would be $99.35/mt with the export subsidy or $64.35/mt without the subsidy. Thus, exports would be profitable even without the export subsidy if imported slab were used.

4.11 Here, two government programs designed to counteract each other produce a questionable result. Indonesia apparently enjoys a comparative

advantage in the production of wire rod as evidenced by its profitability when usings steel at world prices. Rod manufacturers (until the May 6 changes) were required to use domestically produced steel at prices 65% above world prices. The subsidy allows the wire manufacturer a slim margin and permits the wire rod to be exported. However, the cost of manufacture to Indonesia is Rp 349.03/kg whereas only Rp 310.75/kg is obtained for sales in the Singapore market, a net loss of about 11%. Consequently the subsidy utilizes the Indonesian comparative advantage in wire production to subsidize the export of Indonesian steel, a commodity which costs 65% more to produce than the world price.

4.12 Tin Plate. Indonesian manufacturers of cans were (until the May 6 regulations) required to buy local tin plate from a sole domestic company. Can manufacturers sell beer and soft drink cans for Rp 170 each, while comparable cans from Singapore are Rp 85 each. Tin can prices account for 60-85% of the cost of soft drinks, 40% of the cost of canned pineapple, and 20% of the cost of canned tuna. Thus, Indonesians are at a 30-43% cost disadvantage against foreign soft drink manufacturers, a 20% disadvantage against foreign pineapple packers and a 10% disadvantage against foreign tuna packers.

4.13 Garments. The case of garments and fibers is instructive as an example of the phenomenon of the cascading effects of protection on the international competitiveness of Indonesian garments. There are currently two rayon-fiber manufactures in Indonesia. When these plants were established and running, rayon imports were prohibited to preclude "dumping". As a result, the downstream industries that use rayon have to pay a considerable premium over comparable import prices. The Government is also promoting the domestic cotton industry. In order to guarantee a market for Indonesian cotton, producers must use one part Indonesian cotton for every nine parts of imported cotton. However, Indonesian cotton is 50% more expensive than imports, even though its staple length and coloring make it less desirable for garment production.

4.14 The effect of these controls on fiber is to add approximately 10% to the cost of downstreams users -- the polyster-cotton textile manufacturers. They are provided with a 50% tariff to protect them from foreign competition -- which they otherwise could not combat given their high fiber costs. But garment manufacturers must use expensive domestic cloth, adding over 20% to the cost of the finished garment. Accordingly, domestic garment producers, who otherwise could not compete with imported garments, are given protection by a tariff of almost 100%. This is reflected in the high price of domestic clothing. At this level of protection Indonesian garments are no longer competitive on world markets. Accordingly, garment producers received (until July 1, 1986) 'rebates' for exports under the export certificate scheme. This scheme is being phased out because it did not conform to the GATT code on subsidies and will be replaced by a duty-drawback scheme. Since duty drawbacks only allow for tariff rebates on the imported component of the input, garment manufacturers will find exporting less profitable than previously and could reduce exports. Indeed it could be argued that in the absence of the multifiber agreement which guarantees Indonesia a share of certain industrial markets, Indonesia would not be competitive with other countries under its presently distorted structure.

4.15 Indonesia's deletion programs have been the principal industrial policy instruments operating on the engineering subsector. Currently they cover automobiles, motorcycles, heavy equipment, engines, tractors, generators, and machine tools.

4.16 Deletion programs are basically local content rules where progressively more domestic parts are required in finished engineered goods. The programs are rigid in limiting the number and size of models, identifying specific parts for domestic manufacture, and specifying whether they must be manufactured in- or out-of-house. These, coupled with import and investment licensing restrictions, have prevented market forces from operating to yield an efficient industrial structure. The motorcycle industry provides a good example.

4.17 The motorcycle is an important form of transportation in Indonesia accounting for more than 70% of all motor vehicles. There are six assemblers and two component manufacturers with capacity of 930,000 units per year, although actual production averaged 330,000 units during 1975-84.

4.18 Initially (1977) the sole agents/assemblers could each produce no more than five models, with engine sizes restricted to 70-200 cc. Under subsequent decrees the schedule for complete local manufacture and assembly was set, and it was determined that certain parts -- drive chains, rubber and plastic parts -- had to be made out-of-house. The decrees required local manufacture, before 1985, of all but 5 components and of all parts by 1989. To meet these requirements for in-house manufacture of engines, each sole agent is investing in plant and equipment to build four or five engines. The economic size of engine factories leading to least-cost engines is approximately 500,000 units so that these factories would operate at efficient levels only when total output is 2,500,000 units -- twelve times current levels.

4.19 Foreign brandholders require assemblers to use components manufactured abroad by the brandholder or locally by a company with which the brandholder is associated. The domestic component manufacturers are permitted to import raw materials only from the foreign brandholder. Thus, foreign brandholders have sufficient instruments to expropriate through transfer pricing all rents created in the industry by the Government's rigid controls.

4.20 In brief, the findings are that the deletion programs have:

(a) reduced employment when compared to alternative investments;

(b) reduced the value added of Indonesian products;

(c) not increased linkages between industries; and

(d) reduced foreign exchange availability.[23/]

Thus well-intended policies have had practical effects which are the opposite of those initially planned. Any benefits of technology transfer have been achieved at a very high cost. Realizing this, these policies should be reviewed to encourage efficient industrial development consistent with Indonesia's comparative advantage.

4.21 Downstream Processing. Trade policies with well-intended objectives can produce counter-intuitive results when implemented. Such is the case with regulations that force downstream processing of raw materials. The regulations banning log exports in Indonesia provide a good example of the costly and detrimental side effects that restrictions can produce.

4.22 It has long been thought that one strategy for countries to expand their industrial bases is to process their raw material exports. Proponents of this strategy believe that by adding export-oriented, downstream processing industries, countries could increase their value added to exports and, consequently, their trade earnings. Such a strategy has been endorsed by the UN General Assembly, UNIDO, and UNCTAD.[24/]

4.23 If raw materials were the only -- or the major -- element of production, this strategy might have merit. Developing countries enjoy an advantage in controlling the availability and terms of access to their own natural resources and semiprocessed commodities, and they may also have lower transportation costs. However, there are many other inputs into the production of upgraded forms and finished products. When all production costs are considered, no a priori case can be established for the proposition that it is in a country's interest to process its own materials and commodities into upgraded forms. The cost advantages in raw materials may be offset by significantly higher costs for other factors of production such as capital, skilled labor, marketing expertise, or managerial skills. It is necessary to evaluate each case to determine whether a country enjoys a comparative advantage at each stage of production.

4.24 A country can increase its economic welfare only by undertaking downstream processing where the increased foreign trade earnings exceed the domestic resource costs of the production. If the country does otherwise, then it spends more of its own resources in production for the rest of the world than the value of the foreign exchange it receives. Instead of benefitting from foreign trade, the country loses.

23/ For more details see "Indonesia: Three Trade Policies--Countertrade, Downstream Processing, and the Deletion Program," NOE Background Paper, Mimeo, World Bank, August 1986.

24/ Their arguments and conclusions are summarized in David Wall; Industrial Processing of National Resources, World Bank Staff Commodity Working Papers No. 4, 1979.

4.25 It is thought that Indonesia enjoys market power to set prices in tropical hardwood and that this power could be exploited by integrating forward into plywood production. Further, there is interest in increasing export value added through downstream processing of other export commodities. Rattan, rubber, palm oil, and leather have been mentioned as possibilities. Indonesia's experience with its plywood industry is now reviewed, and the prospective application of comparable policies in the rattan industry is discussed.

4.26 In 1978, Indonesia produced 11% of world production of nonconiferous sawlogs and veneer logs, and its exports were 40% of total world exports. The logs were exported to Japan, the Republic of Korea, Taiwan, China, and Singapore where they were processed into plywood and sawnwood.

4.27 In 1980 the Government announced the gradual phase-out of log (roundwood) exports. From a level of 5.6 million cubic meters (cu m) in 1981/82, log exports would be reduced steadily to zero by 1986. Further, export taxes on logs were increased and export quotas through 1986 were assigned only to logging concessionaires who had processing facilities in operation or under construction.

4.28 The Indonesian plywood industry grew from 29 factories in 1980 with a capacity of 1,949,000 cu m to 108 factories in 1985 with a capacity of 5,830,000 cu m. The capital cost of this expansion was estimated at $297 (1980 US$) per cu m of capacity, implying total investment in Indonesia of over $1 billion (1980 US$).[25/]

4.29 Data on production and export earnings from forest products indicate that combined receipts from plywood, sawnwood and roundwood have never been as high as the (pre-ban) 1979-80 export receipts from roundwood alone. Although export receipts from plywood grew by a factor of twelve from 1980 to 1984, receipts from logs -- a much more significant source of Indonesian export earnings -- fell by 90%. In constant dollars, for every dollar which was gained in plywood exports, four were lost in log exports. Receipts from logs fell from an annual average of $1.88 billion (1983 US$) in 1979-80 to $0.33 billion in 1981-84 while receipts from plywood rose from $0.05 billion to $0.40 billion. Sawnwood receipts fell from the 1979-80 average of $0.31 billion to $0.24 billion.

4.30 These results are partially attributable to price effects. The average real price of logs, plywood, and sawnwood (in constant dollars) fell during the period due to reduced worldwide consumption. Roundwood prices received by Indonesia fell an average of 12%, sawnwood prices declined 35%, and plywood prices dropped 26%.

4.31 Indonesia received export revenues of $4.0 billion during the first four years, 1981-84, that the export ban was in force, in constant 1983

25/ Takeuchi, Kenji, "Mechanical Processing of Tropical Hardwoods in Developing Countries," EPDCE, World Bank, 1983.

US dollars. The results of counterfactual projections show that if exports had taken place at the 1979-80 level, at lower world prices for logs due to Indonesia's production, receipts for the three years would have been $6.9 billion to $7.4 billion so that the lost receipts are $2.9 to $3.4 billion over the period.

4.32 Not only did Indonesia unnecessarily forego export receipts from logs, but it also lost money -- $956 million -- on its plywood exports during 1981-84.[26/] Overall the ban on logs has been an inefficient policy for Indonesia.

4.33 A similar export ban has been suggested for rattan. Indonesia currently is the predominant supplier of raw cane, exporting about 90% of the world's cane requirements. Exports are primarily to Hong Kong, Singapore, and Taiwan where the cane is processed and assembled into furniture. Hong Kong absorbs 55% of raw rattan exports and Singapore 25%. Although Indonesians manufacture furniture for the domestic market, furniture represented only about 1-2% of total rattan exports in 1981 and 8% in 1984.

4.34 The rattan furniture industry is relatively labor-intensive, requiring a capital investment of about $2,000 per worker in a modern factory compared to $20,000 per worker in a comparable conventional furniture factory.[27/] High freight rates for furniture have discouraged exports, but these rates have dropped recently following changes in government regulations. An official of one Indonesian rattan furniture firm speculated that there are three reasons for Indonesia's low furniture exports:

(a) Lack of production technology. Furniture in Indonesia is made by skilled craftsmen who individually perform every step in assembly and finishing. By contrast, furniture elsewhere is manufactured by semi-skilled workers on assembly lines at much lower cost. Some factories employ up to 1,000 workers.

(b) Poor designs. Indonesian furniture designs do not appeal to buyers in Europe, Japan, or the United States.

(c) Marketing expertise. Indonesians do not have enough familiarity with marketing their furniture outside Indonesia.

4.35 Some believe that Indonesia should increase the value-added of their exports by banning the exports of rattan cane, forcing the construction of processing and assembly factories in Indonesia. The cost of raw rattan is estimated to comprise approximately 30% of the cost of finished rattan furniture so that if all Indonesian rattan were exported as furniture the exports could increase by $190 million annually -- from $80 million (raw rattan) to $270 million (completed furniture).

26/ This is due to selling plywood below production cost. A complete analysis is presented in "Indonesia: Three Trade Policies", op. cit. However, it is doubtful whether logging rates during the late 1970s could have been sustained through the 1980s.

27/ See Cody, Desmond (1983) Manual of the Production of Rattan Furniture. New York, United Nations.

4.36 Proponents of an export ban cite similar bans in Thailand, Malaysia, and the Philippines. The Philippines, formerly nearly as large an exporter of rattan as Indonesia, banned cane exports in 1977, causing furniture exports to rise from $5.2 million in 1976 to $30.3 million in 1979. Some have praised the "admirable response" of Philippine exporters and suggested that "Jakarta could learn a great deal from Manila." (Asian Business, October 1981, p. 83). However, an examination of data on Indonesian and Philippine rattan exports during 1973-80 leads to the conclusion that -- at least through 1980 -- Indonesia was the principal beneficiary of the Philippines export ban.

4.37 The real price of rattan rose from $120 per ton in 1975 to $228 in 1976, to $1,165 per tonne in 1980. Indonesia increased its rattan exports from an average of 43,000 ton in the three years before the ban to 90,000 tonnes in the eight years after and was exporting 10% more raw cane after the ban than Indonesia and the Philippines combined were exporting before the ban. As shown in Table 4.1, because of the simultaneous real price and export level increases, Indonesia's receipts rose from an annual average of $5.1 million (1983 US$) before the ban to an average of $59.3 million after the ban. By contrast, the Philippines' earnings from furniture and cane combined were 80% greater than Indonesia's before the ban, but are 55% less than Indonesia's earnings since the ban.

Table 4.1: AVERAGE RECEIPTS FROM RATTAN CANE AND FURNITURE EXPORTS (MILLION 1983 US$)

	Before export ban 1973-75	After export ban 1977-79
Philippines	$8.4	$26.9
Indonesia (cane only)	$5.1	$59.3

4.38 It is not possible to tell directly from these data how much rattan cane embodied in furniture has been exported from the Philippines. However, from alternative assumptions on the cane content in furniture and data on real cane prices, the implicit cane content of furniture exports can be derived for the period 1973-79. The results provide estimates of the effects on Philippine rattan exports as shown in Table 4.2.

Table 4.2: AVERAGE ANNUAL IMPUTED PHILIPPINE RATTAN EXPORTS (Tonnes)

Before export ban (1973-75)	36,000-47,200
After export ban (1977-79)	5,900-14,600

4.39 Even under the most favorable assumptions, Philippine rattan exports fell at least 70% after the export ban. These foregone exports caused the Philippines to earn less receipts than it might have achieved without the ban. For example, if the pre-ban levels of exports had been attained, at the post-ban prices, Philippine exports could have increased by $40.4-$58.2 million (1983 US$).

4.40 Estimates of the net changes in Philippine export receipts after the ban are given in Annex 3.1, Table 9. They show that the increases in value-added to furniture manufacturing were substantially negated or exceeded by the lost receipts from cane exports. In Case A the lost cane receipts ($58.2 million) exceeded the increased value-added ($46.7 million) in furniture by more than $11.4 million while in Case B and Case C the value-added in furniture exceeded the lost revenues by $2.7 and $4.2 million.

4.41 These estimates rely on the assumption that the Philippine export ban did not increase rattan prices. Data are not sufficient to estimate individual supply curves or aggregate demand curves. However, it should be noted that combined Philippine and Indonesian export volume rose by 20-30% after the ban and real rattan prices rose an average of 415%. If the Philippines had also exported cane at its pre-ban levels then the supply of cane would have increased by an additional 21-27%. Even if 1977-79 prices would have been 50% lower without the Philippine export ban, the net loss of cane revenue would still be $20-30 million, leaving unchanged the conclusion that value added in furniture manufacturing has been substantially offset by lost rattan cane receipts.

4.42 In the case of the Philippine ban, rattan producers were prohibited from selling into a world market where rising demand was driving up prices. Under the Philippine Board of Investment and the National Cottage Industries Development Agency, "cane furniture makers in the Philippines have been showered with incentives to export." (Asian Business, October 1981, p. 83). The result of all these incentives and unmeasured investment was, at best, a negligible increase in foreign exchange and, at worst, a reduction of foreign exchange as much as 25% below what it could have been.

4.43 While it is desirable that countries should increase their exports or their foreign exchange earnings, pursuit of these goal without regard to their costs can lead to reduced production, consumption, and economic welfare. Export expansion is desirable only to the extent it improves a society's welfare. If a country uses more of its domestic resources to produce exports than it gains in foreign exchange, then it subsidizes the well-being of other countries at the expense of its own. Indonesia's experience with timber and the Philippines' with rattan illustrate the high costs of export bans as a strategy for expanding exports.

4.44 There are many components to the costs of export bans as a strategy for increasing exports:

(a) Foregone export earnings. An export ban prevents a country from exporting commodities in which it has a demonstrated comparative advantage and forces it into downstream commodities where it has

demonstrated, by its absence of that activity, that it does not. Philippine rattan exports (including embodied rattan) fell by over 70%, and Indonesian timber exports fell by 73%. In the plywood case, the foregone export earnings exceed the value added in downstream processing, resulting, after $1.0 billion to $2.1 billion investment, in a net loss of export earnings -- exactly the opposite of policy-makers' intentions.

(b) Misallocation of capital. Capital is directed into production of commodities in which there is no comparative advantage. In the Philippines this was accomplished through extensive subsidies to rattan furniture manufacturers. The result is that capital is diverted from other, more productive uses and the economy grows at a lower rate.

(c) Commodity substitution. If Indonesia were to impose on rattan exports the export ban applied to timber, foreign consumers could substitute other furniture for rattan. Indonesians cannot now export domestically-produced rattan furniture because furniture from competing producters is either better, cheaper, or both. If Indonesia were to ban rattan exports, some competitors could be forced out of business, but unless Indonesia simultaneously raised quality and reduced costs to the levels of their competitors, there is no assurance that customers would buy Indonesia's furniture. To the extent that customers choose furniture of other material, Indonesia would lose rattan exports which are not replaced by its furniture exports.

4.45 If Indonesia does possess power to set prices in the market for nonconiferous sawlogs and veneer logs, then the preferred method to exploit that power is with a tax on roundwood production. If the country desires simultaneously to subsidize its domestic downstream industry, it can apply a differential tax rate to logs harvested for local plywood manufacturers, taxing more heavily the export logs. The same conclusion holds for rattan. Indonesia presently subsidizes foreign purchasers of raw rattan. If it possesses market power in rattan it should tax rattan exports. If it desires simultaneously to subsidize the domestic furniture industry, it could tax domestically used rattan at a lower rate. In addition, the Government should seek to understand the causes of the industry's noncompetitiveness and attempt to alleviate or remove those causes.

4.46 Exchange Rates. A final aspect of trade policy is exchange rate determination. It is of crucial importance for exports for two reasons. First, it directly affects the profitability of exports and hence the allocation of domestic resources to export activities. Second, it determines the cost and therefore the competitiveness of Indonesian exports. A depreciation of the exchange rate would under normal conditions increase the foreign demand for exports and strenghten incentives to export. Empirical studies demonstrate the power of exchange rate policy for promoting export

growth.[28] An overvalued exchange rate has two detrimental effects on exports. First it results in an erosion of incentives for producing export and import-competing goods. Second, over time it usually results in a bias against exports as import-competing goods are protected by trade barriers imposed in lieu of a currency realignment.

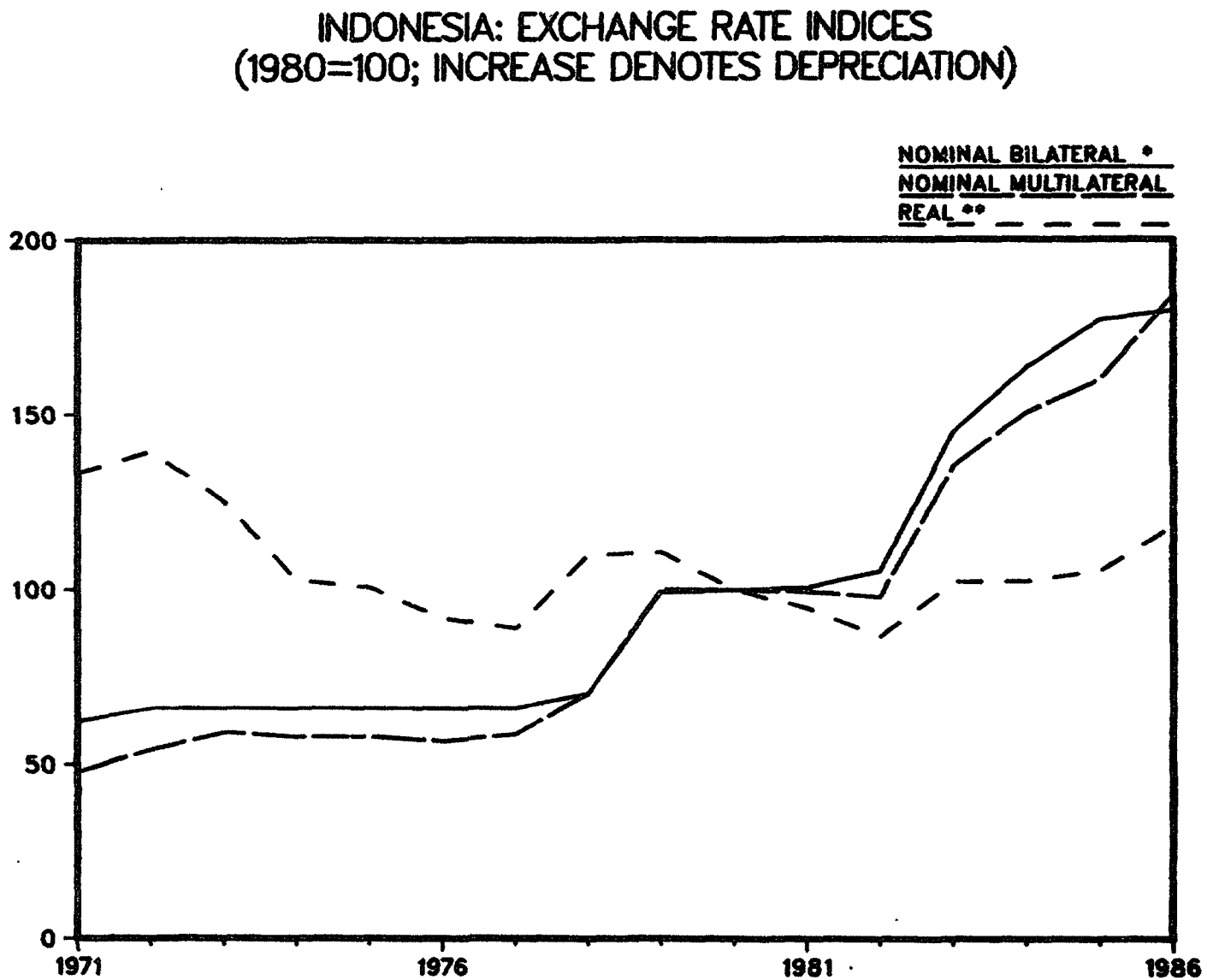
4.47 Figure 4.1 shows movements in the exchange rate indices for Indonesia. By all measures the Rupiah has depreciated over the 1980's although in real terms the depreciation is small. Nonetheless the movement of the exchange rate gives no indication of whether the present rate is an appropriate (equilibrium) rate.

4.48 Assessing whether the exchange rate environment is appropriate is therefore an important element in formulating the policy framework for non-oil exports. Although crucial to non-oil exports, the real exchange rate is determined primarily by other factors in Indonesia. The equilibrium real exchange rate reflects the dominant role of oil, non-oil terms of trade, demand composition (in particular, composition of public expenditure), commercial policy (import restrictions and export incentives) and sustainable capital flows. These are the key structural factors determining the current account balance and its financing. In addition, macroeconomic policies including the nominal exchange rate will also influence the actual real exchange rate. In turn, the real exchange rate plays a crucial role in maintaining macro equilibrium.

4.49 The equilibrium real exchange rate is the rate required to sustain external equilibrium given the structural characteristics of the economy. But this equilibrium real exchange rate is not a constant number. To the extent that fundamental or structural variables experience some change, the equilibrium real exchange rate will also change.

28/ For example, see R.M. Bautista, "Exchange Rate Changes and LDC Export Performance", Weltwirtschaftliches Archiv, 117:443-68.

Figure 4.1



* RUPIAH/U.S.$
** INDEX OF COMPETITIVENESS

4.50 One structural change affecting the equilibrium real exchange rate is the US dollar depreciation. As an oil exporter, Indonesia benefitted considerably from the strengthening of the dollar vis-a-vis major currencies during 1980-85. Consequently, export prices of major industrial countries actually declined in dollar terms. Now, the dollar has depreciated sharply. The impact of this realignment will be clearly adverse on Indonesia, abstracting from the oil price decline. Oil and LNG exports which comprise 63% of Indonesia's total export earnings are fully dollar linked. On the payment side, about 27% of goods imports are from Japan and another 30% from countries with currencies that have appreciated against the dollar. The decline of the dollar means that Indonesia has suffered a major terms of trade loss due to rising import costs. The fall in the value of the dollar will also adversely affect debt service payments since almost 63% of Indonesia's external debt is non-dollar denominated.

4.51 Exchange rate policy also needs to be viewed in terms of the relative competitive position of Indonesia. During the recent dollar decline, most competitor countries have also depreciated with the dollar, thereby improving their real exchange rate positions (Table 4.4). While Indonesia's competitive position has improved vis-a-vis Singapore and the Philippines in the region, it has lagged behind Korea and Thailand. Given the magnitude of structural transformation that lies ahead, competitiveness of Indonesia's exports and import substitutes will be of paramount importance. With the reduced level of oil revenues, the production of exports and import-competing manufactures must rise to allow the economy to grow without undue external imbalance. Exports of manufactures, in particular, will need to grow rapidly. Indonesia will have to not merely maintain but improve price competitiveness to increase export shares in world markets. Similarly, the price competitiveness of import substitutes will have to improve with progressive import substitution. For these reasons the recent (September 12, 1986) devaluation was a prudent adjustment. Indonesia has demonstrated through its exchange rate management in the 1980s that it has a responsive and responsible exchange rate policy. Such a policy will be very beneficial to the performance of non-oil exports.

Table 4.3: INDICES OF COMPETITIVENESS FOR COMPARATOR COUNTRIES /a
(1980 = 100)

		Indonesia	Korea	Philippines	Singapore	Thailand
1983	Q2	106.7	101.0	100.3	100.5	94.3
	Q3	104.2	102.5	99.0	100.9	90.6
	Q4	105.3	104.6	104.6	101.8	91.0
1984	Q1	103.5	105.4	91.6	101.7	94.9
	Q2	103.8	105.9	91.0	101.3	96.1
	Q3	101.8	103.5	88.8	100.3	92.1
	Q4	101.8	103.1	83.6	99.3	100.7
1985	Q1	101.0	102.8	78.7	98.2	105.5
	Q2	103.5	108.6	80.6	99.6	107.1
	Q3	106.2	113.3	84.0	105.4	109.3
	Q4(P)	111.6	118.0	90.4	107.5	114.7
1986 March (P)		118.3	125.7	103.4	113.8	120.4

/a Real exchange rate deflated by WPI movements.

B. Export Promotion Measures

4.52 For a country such as Indonesia that is undergoing the transition from a largely natural resource based industrial structure to one that involves the production and potential exportation of manufactured goods and one that is undertaking trade reforms, a case can be made for certain export assistance activities and the establishment of certain institutions to encourage production for exports if these correct for specific market failures.

4.53 At Indonesia's current stage of development, government assistance to exporters should chiefly consist of the removal of disincentives to export, in order to achieve neutrality, rather than the provision of specific positive incentives, since the former appear to be the most serious barrier to export growth and the latter are costly and may ultimately be self-defeating (they may produce many undesirable side-effects on the Indonesian economy, leading to new resource misallocation, and they may raise objections abroad by going against international codes of trade behavior). Indonesia's producers do not export as much as they might because orienting production towards foreign markets has not been 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 the profitability of domestically-oriented production is assured by government protection of the market from foreign competition.

4.54 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 compared 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.

4.55 Most successful export-oriented countries have made policy and institutional improvements to stimulate exports. Actions have included making credit more readily available, especially when the lenders' perceptions of the riskiness of exporting relative to producing for domestic sale have been the restricting factor; providing access to imported inputs at the same international prices that foreign competitors pay through a duty exemption or drawback scheme for exporters; and facilitating foreign shipping and marketing so that, to the extent possible given geographical considerations, they are no more complicated than their domestic counterparts and not more expensive to the exporter than to his competitors abroad. Once a manufacturer faces the possibility of exporting without significant extra direct costs or procedural difficulties in comparison to domestic sales, he may fairly assess whether or not to produce for export based upon the expected profit of doing so.

4.56 The following paragraphs review existing Indonesian export assistance policies and institutions, from the import of inputs, through production finance, acquisition of technology, training, and finally marketing. For each stage in this process, some export assistance policies have already been initiated in Indonesia but some modifications are required to remove bottlenecks or improve the efficiency of the implementing institutions. The premise on which certain export measures are based is simply that it is necessary for private producers to be provided with an incentive structure that is unbiased with respect to the profitability of the domestic versus export market.[29/] Further, these arrangements will be useful even when further trade liberalization is undertaken because residual elements of protection will almost certainly remain.

29/ Some have argued that because of certain intangible difficulties in exporting such as cultural/language difficulties, establishing contacts and market information, that a small positive bias in favor of exports, at least during the developmental stage of exporting, is desirable. See A. Krueger, Finance and Development, September 1985.

4.57 Making Inputs Available at a Competitive Price. As Indonesia begins to develop its manufactured exports, it is essential for producers to have access to inputs at internationally competitive prices. 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 and has 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 it is desirable to establish policies that approximate free-trade for exports providing that the schemes are not costly to administer and do not introduce additional, costly distortions. The more restricted the regime, the more important such policies become for export promotion.

4.58 A practical scheme to provide duty-free status to export production must 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 permanent system. Transparency and consistency are essential for firms to estimate costs, plan production and reliably supply foreign buyers.

4.59 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 later exports the goods embodied in another product.

4.60 The second type 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 benefits of each scheme are laid out in Annex II.

4.61 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 operated effectively to ensure that exporters got duty-free access to imported inputs. By far the more widely used of the schemes was 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 and its violation of GATT rules (detailed in Annex II), it has been phased out.

4.62 The duty exemption scheme established at the same time as the SE system was used very little. Less than 100 textile-industry applications for coverage under the scheme were filed between 1978 and mid-1985. It appears

that this low use was a result of the higher rebate available to some producers under the SE system. Problems that affected both schemes include delays in getting coverage and excessive disaggregation of product categories.

4.63 Any system to assist exports should satisfy three conditions:

(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.

4.64 On May 6, 1986 a revamping of the S.E. and duty drawback system was announced. The new regulations seek to enhance the competitiveness of Indonesia's non-oil exports by increasing access of producers of export goods to imported inputs by removing quota restrictions and sole-importer licensing practices in certain cases. Producer exports (defined as those who export at least 85% of their production) will now have the option of importing their requirements of raw materials and intermediate inputs without any trade restrictions; they will also be exempt from the payment of import duties and surcharges on such imports. Producers who export less than 85% of their production, indirect exporters who export their products through other companies and other domestic producers who supply inputs which are used by exporters would also be entitled to import their input requirements, if domestic suppliers are not able to provide such inputs at competitive terms. (This facility has also been extended to contractors who procure materials and capital goods for government projects funded by foreign loans, with a view to improving project implementation). Imports by such groups (other than producer exporters), will, however, be subject to import duties and surcharges, but import duties paid by them would be refunded through a drawback facility established within the framework of the new policy. In essence, the direct imports facility and the drawback scheme would help insulate exporters from the high costs of domestic production of inputs and partly offset the disincentive effects of the abolition of the export certificate scheme. New administrative arrangements have been set up to implement these new schemes through the establishment of a new administrative unit within the Ministry of Finance - ("P4BM" - Pusat Pengelolaan Pembebasan dan Pengembalian Bea Masuk). The P4BM would be responsible for granting permission to producers/exporters to undertake direct imports of inputs, for making price and quality comparisons between domestically produced goods and imports before authorizing such imports, granting refunds to exporters under the drawback scheme and conducting post-export audits to ensure accuracy under the drawback regarding input use and rebates.

4.65 For industries basically geared to exports, the new duty exemption scheme offers an attractive incentive, since exporters do not have to wait for rebates and hence their working capital costs are reduced. And when exporters are allowed to import goods directly they are also sheltered from the cost

penalties of dealing with licensed importers. From a policy point of view the duty exemption scheme is also attractive, because by definition exporters cannot be over-rebated, and hence cannot be accused by Indonesia's trading partners of benefitting from hidden subsidies.

4.66 For exporters who export less than 85% of their output the revamped duty drawback scheme has the advantage that it is much easier for exporters to claim back the duties paid on imports by local suppliers. With the introduction of VAT such a scheme can be modified to include VAT and other indirect tax charges, thereby further directly reducing exporters' costs. In this way, it encourages exporters to use local suppliers who might otherwise not be competitive with directly imported inputs. These exporters will also be entitled to import goods otherwise subject to import restrictions if local suppliers are unable to match the conditions offered by overseas suppliers.

4.67 Under the new duty-drawback regulations, exporters will submit a duty rebate claim -- based on their own self-assessment of the duties they have paid on imported inputs -- to a newly established unit within the Ministry of Finance (P4BM), together with standardized supporting documentation. The unit will make a decision within 30 days and, if the decision is favorable, the exporters will receive 75% of the rebate claimed with the remainder payable within 60 days. Exporters will be required to maintain supporting documentation and will be selectively audited. In principle, the proposed scheme seems to meet the policy objective of providing speedy and fair duty rebates, and the decision to employ only selective audits should keep administrative costs within reasonable limits. The real test of the scheme will be in implementation. Exporting firms are likely to face some additional costs compared to an ICS scheme, since they will have to make their own estimates of the duties they pay on exports and will have to keep detailed and accurate records of their activities. However, the greatest uncertainty exporters are likely to face is the auditing procedure. This will necessarily involve a close degree of contact between individual firms and government officials. This opens up the potential for abuse and the negotiation of rebates, since a considerable degree of judgment is required in assessing the engineering, accounting and commercial practices of individual firms. Uncertainties over the outcome of such a practice might discourage participation by smaller exporters. It will be important that when the scheme is established the potential pitfalls of such an approach are avoided. The Government should not hesitate to be flexible in developing this scheme, to ensure that it meets the desired objective of providing transparent, certain, and speedy duty rebates to exporters, with the minimum necessary administrative costs and complications.

4.68 Under the May 6 package the Government is in effect establishing dual pricing in the economy, where exporters can obtain tradeable inputs at world prices and production for the domestic economy remains insulated from international competition. As noted earlier, this scheme will not fully compensate exporters because only tradeable inputs are eligible for pricing at internationally competitive levels and the cost to firms of fulfilling administrative requirements is greater than if quotas were generally removed and tariffs lowered or eliminated. Further, resource allocation will still be inefficient since heavily protected industries remain. But the effect of the

May 6 changes may benefit more than just the export sector. And if domestic suppliers adopt a dual-pricing policy in order to continue supplying inputs to exporters, non-exporters will become aware of the large price disparities between goods priced internally and internationally. Pressures will arise to equalize these prices.

4.69 An additional option to provide neutral status to producers is to establish geographically defined bonded zones either as export processing zones (EPZs) or export estates. EPZs are especially suitable for firms which export all of their outputs and use almost all imported inputs. Export estates, on the other hand, allow producers access to the domestic market and aim to encourage the greater use of local raw materials. 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. It would seem suitable to expand the use of bonded zones in Indonesia for assembly and fabrication operations with very high import content, and steps in this direction were taken in the May 6 package. Indonesia's labor cost advantages would seem to make it a potentially attractive site for foreign investors who could contribute materials, managerial and design skills, and equipment. Indonesia in turn clearly could benefit from the employment and foreign-exchange generation bonded zones would provide. But first regulations and conditions that make the zones competitive with such zones in neighboring countries must be established. For example, if 100% foreign ownership is not allowed in Indonesia but is allowed elsewhere, Indonesia will be a less attractive site for foreign investment.

4.70 Providing Financial Services to Exporters. In Indonesia the commercial banks have concentrated on financing industries and services geared to meeting the needs of the domestic market, or providing trade credits to finance imports and local distribution. This focus has meant that there are few skilled bankers familiar with the problems of export finance since the banking system has not had significant demand for special financial services. One of the most important tasks facing the financial community is to build the necessary skills and infrastructure to meet the needs of exporters. As exports increase and the demand for these services expands, competition between banks will generate these services. Eventually they should be able to help these clients translate business ideas into sound commercial propositions and work jointly with exporters to develop realistic export plans.

4.71 The Government has made a considerable effort to assist and encourage the banks to provide better services to exporters. The 1982 Export Decree established an export credit system to provide exporters with better access to working capital and trade finance, backed by insurance and guarantee facilities. Under present arrangements, which are currently under review, any exporter with proof of a purchase order from abroad is eligible for a credit for 85% of working-capital or preshipment needs.[30/] The interest rate charged

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30/ 70% of the total where partly or wholly foreign ventures are concerned.

is currently 9% p.a.[31/] This has raised concern among some trading partners that the mechanism subsidized exports. However, it was recently agreed between the United States and Indonesia that after April 1987, the interest rate on export credits would gradually rise to market levels so that by 1990 it would be the same as for similar domestic working-capital credits.

4.72 There remain several shortcomings in services provided to exporters that will need to be addressed. For example, Indonesia' current export-credit mechanisms are not accessible to indirect exporters, because the procedures needed to process credit applications from indirect exporters have not been designed or implemented. In addition there have also been teething problems associated with the export guarantee and insurance facilities. The responsibility for administering both the guarantee and insurance schemes was transferred to P.T. Asuransi Ekspor Indonesia (ASEI) at the end of 1985. The challenge to making the guarantee and insurance schemes effective, and thereby reducing the intermediation costs of export credit, lies in institution-building in both P.T. ASEI and the banks as they develop the necessary technical skills to evaluate export risks. Crucial tasks for P.T. ASEI will be to build a sound financial basis for the long-run operation of the guarantee and insurance schemes so that they do not continue to drain scarce Government resources. In addition to solving (together with Bank Indonesia and the affected banks) the problems of claim rejection, and designing mechanisms to reduce the risk of defaults, the entire export insurance scheme needs to be studied in order to put it on a commercially viable footing. If the export insurance scheme has been incurring losses either the premiums are too low or Indonesia is not receiving from its foreign buyers its own cost of exporting -- such risky exports should be discouraged not subsidized. Any exporter can minimize the risk of not being paid for his exports by selecting his clients carefully, by collecting a higher proportion of payment prior to shipment, by deposits in escrow accounts, or by self-insuring (adding a premium to his offering price to compensate for the risk).

4.73 When insurance is available the exporter may shift his risk to the insurer. The premium collected by the insurer must be sufficient to pay for claims against the fund plus administrative costs, otherwise exporting these goods is not economic and the insurance scheme subsidizes foreign buyers. But a major problem with such insurance schemes is that the exporter is usually better able to evaluate the risk than is the insurer. Exporters will purchase insurance only on their "risky" transactions. Thus the phenomenon of "adverse selection" arises -- where increasing losses occur to the insurer and the pool is absorbed. It is for this reason that both crop-insurance schemes and export-insurance schemes are not available from the private sector (in the absence of government subsidies or regulations) in industrial countries. Thus before Indonesia expands further scarce resources developing P.T. ASEI, it needs to consider carefully the mode of operation of export insurance and whether better (cheaper) alternatives might be developed.

31/ A higher rate, in the 20-25% 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%.

4.74 Other Export Promotion Policies. As described earlier, the most immediate and important policy goal of the Government should be to provide Indonesian exporters the opportunity to exploit their comparative advantage in international trade. This means above all that the general incentive framework must be unbiased between export and domestic markets. Thus, the exchange rate policy must continue to be guided by the need to maintain competitiveness and export profitability, and exporters must enjoy access to inputs of appropriate quality at competitive prices. These two conditions are the starting points for a successful non-oil export drive. A supportive institutional structure is also required to strengthen the export capabilities of Indonesia's producers.

4.75 The Government is aware of the need to reduce the burden of its administrative regulations on the economy, particularly for exporters. The most highly publicized and successful policy to date is INPRES IV, which drastically simplified customs and port procedures and liberalized shipping rules. These measures have dramatically reduced the costs of moving goods through the ports and have lowered shipping costs. This is of direct benefit to exporters and of considerable indirect benefit, since most exports involve the use of some imported goods. The major advantage of INPRES IV is that procedures are clear, approvals are automatic, and the scope for abuse has been sharply curtailed. In this sense, it is a model for other forms of Government deregulation.

4.76 While the experience of other exporting countries suggests that the basic and necessary condition for successful export development is to create a favorable general incentive framework for export activities, there are a range of additional areas where Government can play a useful role.

4.77 An example is its ongoing effort to establish under the auspices of the Ministry of Trade a set of bodies to standardize and improve export product quality. They are DISTANT, which sets product standards, the PPMB laboratory network which provides a testing service, and NAFED, the national export promotion agency. Much remains to be done to make these bodies useful and effective, and doing so is not a costless activity. The Government should evaluate the usefulness of these institutions in terms of their costs and the value of the benefits they provide.

4.78 The successful implementation of an export quality standardization program is of great importance at this stage in Indonesia's non-oil export development. If Indonesia's exports are to continue to expand it must further enhance its reputation for producing products of a standardized quality so that sales can be made by description without buyer inspection. In the past, many of Indonesia's traditional exports such as timber, rubber, coffee and pepper have been sold at a discount because of lack of product uniformity, cleanliness or other quality control problems. Indonesia's shrimp exports are, for example, subject to special inspection by the USFDA which deters US importers from purchasing them.

4.79 From a survey conducted by the World Bank of US importers of Indonesian products, it appears that Indonesia has improved its reputation to supply products to set standards. In whatever category of products were examined, US importers had a high regard for Indonesian products. Indonesia is capable of producing and exporting uniform and high quality products and commodities. Importers opined that Indonesia could be a growing force in world markets and that they are looking to Indonesia more and more as a primary source of their imports. At the same time US importers noted the difficulty of conducting business in Indonesia due to unreliability of the business community, erratic banking procedures, and the need to make "side payments." "Knowing who you are dealing with" is important since once such business relationships have been forged, transactions tend to be reliable, smooth and uneventful.

4.80 A further role Government can play in conjunction with producers association is in improving Indonesia's export marketing effort, although the earlier comments on the cost-effectiveness of such programs must be kept in mind. This is the major task facing NAFED and the newly established Export Support Board (ESB). NAFED is developing a data base for use by exporters and foreign importers and further improvements in this facility are being made. If this service helps exporters by enabling them to get information on overseas markets then it should be turned over to KADIN (the National Chamber of Commerce) to operate. Otherwise the service should be terminated. NAFED has also played a more direct promotional role by sponsoring exporters on trade missions and assisting them in overseas trade fairs but participants reported serious organizational shortcomings in these activities. Consideration is being given to providing financial assistance for market surveys and to help exporters find foreign buyers. While this approach is essentially catalytic, it can assist Indonesian producers who are unfamiliar with overseas marketing as well as foreign buyers. However, there are limits to what NAFED or the Export Support Board can be expected to do and should do in this area given the overall budgetary constraints facing the Government and its role in commerce. It is ultimately in the interests of producers to develop this type of marketing intelligence for themselves which they will do only if they believe that exporting will be profitable on a long-term basis. However, until greater export expertise is accumulated in Indonesia, it is not inappropriate for the government at least partially to underwrite the cost of acquiring export information. At the same time the Government should encourage private sector groups to play a larger role in such export promotion activities. Their willingless (or lack of willingness) to do so provides a good test of the need and value of those activities.

4.81 Foreign Investment. Prior to May 6, 1986, the conditions in Indonesia for foreign investment were not encouraging, making Indonesia a less attractive location for foreign investment in export-oriented business than other Asian countries. The main provisions of Indonesian foreign-investment law were:

(a) All foreign investment must take place through joint ventures with Indonesian partners, with maximum foreign ownership of 80% which must be reduced to 49% within ten years of establishment.

(b) Employment of foreigners by the joint venture is strictly limited, and although the top few management posts may be held by expatriates, 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.

(c) The Capital Investment Coordinating Board (BKPM), whose role is to formulate investment policies and plans for Indonesia, issues an annual list of investment priorities and determines which are open to foreign investment. The subsectors open to foreigners have been reduced in number over time with activities being closed off once it is judged that existing plants have the capacity to meet domestic demand.

(d) For partially-foreign joint ventures, the debt-equity ratio must be approved by BKPM, and external borrowing should cover overseas purchases.

(e) The minimum size of capital for a joint venture is $1 million.

(f) Capital and profits may be freely repatriated, and profits may not be reinvested in Indonesia.

(g) Land for any use may not be owned by foreigners, nor can it be used as collateral for loans to a company operating or building on it.

(h) Tax incentives, are no longer available (since 1984) for foreign investors in Indonesia.

(i) Foreign investors may not market their products domestically, but must channel them through an Indonesian national trade enterprise.

(j) Foreign joint ventures must use Indonesian inputs and equipment whenever available.

4.82 The more liberalized rules of May 6 will make foreign investment in Indonesia more attractive but whether it will be sufficiently so to attract a greater volume of foreign activity remains to be seen. The changes currently being implemented include:

(a) The restricted list is narrowed to provide wider opportunities for foreign investors.

(b) Profits of joint ventures may be reinvested in existing or new businesses.

(c) Certain high risk, high technology or remotely located joint ventures may begin with domestic capital of only 5%, reaching 20% "national participation" after 5 years.

(d) Exceptions to the $1 million minimum investment are now allowed.

(e) The length of a license for joint ventures is increased from 30 years to 60 years in certain cases.

(f) Payment of the value-added-tax on imported capital goods is postponed until the firm begins production and may be spread over five years.

(g) The sharing ratio of local/foreign ownership in palm-oil estates and shrimp breeding is relaxed.

4.83 Other areas where foreign investors have found difficulties in the past that still remain are the necessity of employing Indonesians in certain supervisory and management posts for which qualified people cannot be found or are more costly than expatriates, and in prohibitions against firms' marketing their own products in Indonesia, which prevents them from using their expertise in this area. Counterbalancing this is the freedom to remit profits and dividends abroad.

4.84 Interviews with foreign investors in late 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 -- foreign investors did not even consider export-oriented activities. Much foreign investment has been in import-substitution products, and has been able to bear high local costs due to the protective structure. This is ironic because the purpose of protecting markets is to encourage domestic investment. Thus protection is creating artificially high profits to the partial benefit of foreign investors and at the expense of higher prices to domestic consumers. Further, the scale and level of plant efficiency has been restricted to the size of the local market, and production is not geared for export. This situation may now change as a result of modifications in the investment framework, and will improve further as the costs of producing for export are reduced for all firms, whether local or foreign joint ventures, in Indonesia.

4.85 However, two areas where gains specific to foreign ventures might be made are in employment regulations and marketing restrictions. Foreign investors will not bring in their best technology and internationally competitive product designs if they are not allowed to bring in essential operators, foremen, maintenance staff and other technically or managerially skilled people. Anecdotal evidence of the difficulty (or impossibility) of obtaining entry permits for technical development personnel of major export products are a concern and one that can be readily rectified.

4.86 One type of foreign investment that is all but banned is trading companies. 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 and informing their overseas branches of the availability of such products. Trade then occurs through an Indonesian intermediary.

4.87 Indonesia only allows 100% foreign investment in one limited free-trade zone on Batan Island in the northwest of the country. The purpose of this zone is not clearly defined, and its use has not been actively promoted. There is intense international competition among nations providing such zones so they do not succeed when undertaken half-heartedly. 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.

4.88 In summary, Indonesian policies have discouraged foreign investment compared with other countries in the region, and as a result foreign investment in Indonesia is relatively small and in the wrong industries. Yet the benefits potentially available through increased foreign investment appear considerable. Such aspects as employment generation, skill upgrading through on-the-job training (including management), technology transfer, the transfer of marketing and design expertise, and the competitive and demonstration effects on indigenous Indonesian firms are all positive aspects of foreign investment.

4.89 The recently relaxed guidelines on foreign investment make Indonesia more attractive than was previously the case. But many rules remain and need to be repealed if Indonesia is to compete with its South East Asian neighbors in attracting foreign investment. Despite its large domestic market Indonesia has developed a reputation of being a difficult environment in which to undertake foreign investment. Indonesian workers can be more productive and better paid when they work with complementary factors of production -- whether they are foreign or domestically owned. To restrict investment in any manner perpetuates unemployment and limits development of worker skills. Foreign firms should have access to the same incentives as domestic firms. Ownership of land by joint domestic/foreign ventures should be allowed so that joint ventures can use the land for collateral and in order to further encourage private foreign investment in the tree-crops sector. Foreign owned firms should be allowed to export directly. Regulations requiring increasing domestic ownership over time should be relaxed or waived to allow higher levels of foreign ownership. There are benefits to be gained by Indonesia and ASEAN by having an ASEAN-wide code of incentives and regulations for foreign investment. This way members of ASEAN would not be bidding down the benefits of foreign investment with each other. Indonesia is in a good position to take the leadership in this proposal for cooperation.

4.90 Regulation. It is not only foreign investment that is impeded by cumbersome regulations. A number of manufacturing firms indicated that the cost of doing business in Indonesia is high -- in some cases so high as to make production for export prohibitive. Some of the costs are licensing fees and uncertainties associated with the licensing process, high telecommunications cost and high export transactions costs. Many of these costs result from Governmernt regulations. Keeping these costs down is a way that government could protect manufacturing without imposing any of the kinds of costs that protection carries with it. Thus, a policy of reducing or eliminating unnecessary barriers to business activity is useful. A major source of innovation in many countries comes from firms which start small, learn about producing and marketing through experience, and ultimately reach considerable

size and play an important economic role. Cumbersome or expensive licensing requirements are particularly likely to prevent such firms from starting. Often these firms which are successful ultimately sell out to larger firms, which may be good at management, promotion, and expansion, but less skilled at innovation. Thus barriers which prevent small firms from starting end up robbing larger firms of a source of information and innovation, reducing employment and removing a laboratory in which the small businessmen can develop and utilize their entrepreneurial and managerial skills.

4.91 While Indonesia's institutional infrastructure and mechanisms to support development of non-oil exports suffer from major gaps, the Government is cognizant of these gaps and has taken and continues to take steps in many instances. The World Bank is also active in assisting the government in strengthening trade institutions. However, the ultimate effectiveness of new and improved measures will depend on the efficacy of the private and public sectors. Some areas are such that the government must provide greater opportunities to the private sector, which, in turn, must take more initiatives to promote exports, while success in other areas will depend largely on government's own decisions. The key areas, where actions must be taken urgently, are discussed below.

4.92 First, Indonesia needs a strong exporter association that genuinely represents the export community, vigorously promotes exporters' interest and actively consults with the Government. The existing industry and trade associations, such as the Indonesian Chamber of Commerce and Industry (KADIN) and the Indonesian Exporters Federation (GPEI), have not been able to systematically identify the constraints inhibiting Indonesia's non-oil exports and impress upon the Government that the existing foreign trade regime is clearly detrimental to Indonesia's overall industrial efficiency and export environment.

4.93 Second, a high level government task force, perhaps patterned after the US Presidential Task Force on Regulatory Reform, could be established to suggest ways of reducing government regulations and administrative requirements. The proliferation of these over the years has placed a burden on entrepreneurs doing business in Indonesia. A priority concern for the task force would be to examine the rationale and value to Indonesia of sole-importer arrangements in Indonesia. While the negative effects of these arrangements may have been eliminated for exporters by the May 6 package, they remain for non-exporters and exporters not eligible under the program.

4.94 Third, Indonesia needs to strengthen its image in overseas markets of being a quality-conscious supplier of semi-processed agricultural products (e.g., rubber, wood, coffee, fish/shrimp). The proposed export quality improvement program under the Export Development Project will contribute towards improving the image, but the Indonesian business community needs to further develop quality consciousness in exports especially in areas such as standardization, timeliness, processing, packaging, shipping and marketing.

4.95 Fourth, there is a need to assess the role of large trading companies in enhancing the prospects of exports of Indonesian handicrafts, semi-processed and manufactured products. The study of trading companies proposed

under the Export Development Project should be completed by June 1987 and will provide guidance on this issue. The Government has already made arrangements with one firm (Cargill) to provide marketing services to Indonesian firms interested in exporting to Eastern Europe. The firm will be the sole agent in clearing products obtained through barter from Eastern Europe and will receive a commission or percentage for arranging such trades. Besides the known problems of barter trade such as separation of contracts, purchase obligations, penalties, pricing difficulties, quality aspects, the lack of transferability of obligations, credit and financing problems, and guaranteeing consumation of transactions, it is well established in the literature on countertrade/bartertrade that the net revenue resulting from the trade to each country is below that which would result from direct sales on the world market. Accordingly the efficacy and cost effectiveness of the arrangement with Cargill should be assessed after a year of operation.

4.96 Fifth, overseas trade promotion through trade promotion centers and commercial attaches is weak. The concerned officials normally do not have enough knowledge of the host country's (region's) business practices and market needs. They also usually lack knowledge of the potential of specific Indonesian firms to supply the needs of the host country. Before attempts to strengthen them are made, the costs of doing so and of mainaining such a program versus the benefits likely to be gained from them should be assessed.

4.97 Finally, ambiguities in the roles of various official agencies directly associated with export development (e.g., national planning, policy formulation, determining procedures, trade promotion, setting priorities) have tended to exacerbate their shortcomings. This is being addressed under the Export Development Project where a study to review and make recommendations for improving government institutional support for export development is being initiated. The report will define the tasks of each agency, set task priorities and suggest the integration and streamlining of government regulations and procedures.

4.98 The Government is aware of the need to strengthen export assistance measures and export-related institutions. With World Bank financing it established in March 1986 the Export Support Board. Its function is to manage the Export Support Fund which provides technical assistance to the export community in the areas of international marketing and production management (including demonstration operations in modern quality management systems), and firm-specific staff training. The Board will review and approve proposals submitted by potential users of the Fund. The Fund will be used to finance expenditures incurred in direct technical assistance to exporters and export-oriented producers (marketing, quality management and staff training) and in technical assistance to private organizations to strengthen specialized export support services. The Fund will focus on manufactured, processed and semi-processed products. In addition, the Board will provide an informal forum to the Minister of Trade on export matters of concern to the private sector.

4.99 Unlike the existing official export promotion agency, a special feature of the Board is to reinforce the complementary roles of the public and private sectors. While the Board has been established by the Government and will report to the Minister of Trade, it will function as an autonomous body. Its

chairman and a majority of its members will be prominent export-oriented businessmen. The guiding principles for the Board include cost sharing between Government and participating firms, freedom by participating firms to choose service suppliers, quick and impartial decisions, and active solicitation of proposals from actual/potential and direct/indirect exporters. The Board/Fund will be on a three year trial basis under World Bank financing. Before completion of the trial period, the private sector will be encouraged to come up with a scheme to manage and operate the Board/Fund on a self-financing basis.

4.100 In addition to the Export Support Board the government is strengthening the quality support network by improving the capability of the network of accredited agencies (such as the Central Test and Quality Control Laboratory) to provide the business community with quality testing of products, advice on using quality control and testing equipment, assistance in implementing advanced quality management systems, and guidance on technological matters. The program will include feasibility studies for new technical centers for quality assistance in such areas as packaging, design, furniture, textiles/garments, processed food; and training of staff from quality control agencies. The improved system will be designed to promote voluntary certification and labelling (except in health and safety related areas).

4.101 The success of the export quality improvement strategy hinges largely on the extent to which producers/exporters adopt modern quality management systems where their adoption is economically justified. In order to motivate the export community to use such systems, Indonesia will soon have demonstration projects partially financed by the Export Support Fund. Three or four product groups will be selected and from each product group two manufacturing establishments will be chosen for introducing advanced quality management systems. The program is expected to make Indonesian exporters aware of the value and cost of quality improvement methods.

4.102 Further, with World Bank financial support the government is establishing an Exporter Training Program. The program will strengthen the exporter training capabilities of Indonesian training/educational institutions and consultancy organizations, and provide on-the-job training to government officials, potential and actual exporters, export-oriented manufacturers and suppliers of specialized services to exporters. Two to four local training institutions will be created so that Indonesia eventually becomes self-reliant in training capabilities in a range of export-related topics: from export marketing to export product development, and from export finance to legal aspects of foreign trade. The program will comprise about 40 workshops, seminars, symposia, etc., and will train approximately 800 participants, besides about 35 trainers.

4.103 Finally, the Government is establishing an export-oriented industrial estate primarily to attract foreign producers to enter joint ventures with local firms for export production. The export estate is an innovative concept which combines the best features of an export processing zone and an industrial estate. The Government is now considering alternative site and management arrangements. A special feature of the proposed estate is recognition of the importance of developing direct linkages between export

firms and the domestic economy. Therefore, the estate is likely to include limited access to domestic markets and a preference for developing resource-base industries. Conventional export processing zones have no such access and they are generally not integrated with the domestic economy beyond employing inexpensive labor.

4.104 The foregoing description of Indonesia's institutional infrastructure for supporting the non-oil exports suggest that the Government has identified a number of institutional constraints inhibiting the non-oil export growth and is developing mechanisms to alleviate them. However, Indonesia still suffers from major gaps that must be addressed through joint efforts of the public administration and the business community. Moreover, the country needs to acquire a national export mentality that can be fostered only by a strong political commitment to an outward-oriented trade strategy. Such a commitment entails all levels of government, industrialists, bankers, traders and workers. Therefore further steps are required in interrelated areas such as industrial, trade and investment policies, regulations and procedures, which would complement the institutional measures under active implementation.

4.105 Countertrade. Not all export promotion measures undertaken by the government are useful or successful, and the likely cost and side-effects of promotion policies need to be carefully assessed. An example of an unnecessarily costly attempt to promote Indonesian exports is the countertrade program.

4.106 In 1981, Indonesia announced its policy that foreign companies which were awarded government contracts for construction or procurement in excess of 500 million rupiah (about $450,000) must export an equal value of selected Indonesian products. Countertrade and barter have been practiced around the world, under many arrangements, with the objective of increasing exports, reducing trade deficits, minimizing outlays of hard currency, and avoiding exchange controls or commodity agreements.[32/]

4.107 The Indonesian policy requires that commodity exports keep pace with or precede imports and that the exports must be in addition to the "normal" trade transactions with the country affected. It was originally expected that $8 billion in government projects would be tied to the countertrade requirements through REPELITA III which ended in 1984. However, as of July 1986 only about $1.5 billion in government contracts subject to countertrade have been signed since the requirement was imposed. Of this, about $0.7 billion in goods have been imported (and $0.6 billion in goods have been exported), with $1.4 billion in imports (and exports) contracted but not yet executed. Indonesia's non-oil exports during this period were more than $9.1 billion. Thus less than 6% of exports are involved with countertrade.

4.108 During the early months of the program there was inevitable confusion -- both within Government and potential suppliers -- about how the

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32/ See Roger, Neil (1985) "Countertrade: A Developing Country Policy Prespective," mimeo, ERS, World Bank.

program would be administered. Very few corporations are organized to fulfill countertrade obligations economically, and the Government permitted assignment of responsibility for countertrade to third parties upon approval. There emerged in Indonesia a group of brokers with specialized skills in countertrade. Working on behalf of companies supplying the Indonesian Government they found foreign buyers for Indonesian exports to satisfy the supplier's obligations. Their work typically consisted of identifying transactions which were being negotiated among third parties in the normal course of business then arranging to submit these to the Government in fulfillment of their client's countertrade obligations.

4.109 Initially, few brokers were available, procedures were uncertain, and there was difficulty in obtaining deliveries of sufficient quantities of export commodities. Brokers report receiving commissions as high as 13%, and to obtain cooperation from exporters, they had to pay exporters a commission of as much as 4-5%. As procedures were clarified and standardized, as competition among brokers increased, and as government countertrade-linked purchases dropped, the commission rates fell. They are reported today to be as low as 1%, with exporters receiving only 1/8% to 1/4%.

4.110 The countertrade requirement alters the business practices of firms selling to the Indonesian Government. Firms are required to submit a single bid reflecting the cost of supplying two separable products or services:

(a) Delivering to the Indonesian Government a given bundle of commodities, products, facilities, or services at a specific time and location as required in the Government's tender.

(b) Exporting from Indonesia a quantity of commodities and products equal in cost to the firm's bid.

4.111 In general, there is no reason to believe that a firm which is the lowest cost supplier of a given item such as fertilizer, a cement plant, or railroad cars is also the lowest cost exporter of Indonesian fish, rubber, plywood, or tin. Importing and exporting are distinct activities, and firms which are efficient at one are not necessarily efficient at the other. It would be an improbable coincidence if, in any selected instance, a <u>specific</u> trading company is the <u>most</u> efficient at both.

4.112 The least cost method for the Government to achieve both the importing and the exporting goals is to tender both for bid, allowing firms to bid on either and/or both, and to see which firms offer the lowest costs. Should the importing and exporting be complementary, then a single firm would offer a combined bid with the lowest cost for both. Otherwise, it would be less costly to use the services of separate firms for importing and exporting. Indirect estimates of the cost of the program indicate that countertrade requirements have caused the Indonesian Government to pay <u>at least</u> $17 million to $[illegible] million more for procurement of the affected commodities than it would

otherwise have paid.[33/] In addition, the Government has incurred other costs for staff to implement and administer the program and for delays connected with deliveries under the program due to protracted negotiations.

4.113 The countertrade program has a goal of forcing foreign suppliers to utilize Indonesian exports, but its effect is to cause the Government to pay unnecessary premiums for imports at a time when it is trying to reduce both its purchases abroad and its fiscal expenditures. If Government wants to retain the countertrade program, then the program should be modified. Instead of requiring that suppliers accept a countertrade obligation, the Government should allow it as an option. Firms bidding on government contracts could submit two bids, one which has a countertrade component and one which does not. The difference between the price offered in the two bids would allow the Government to know the cost of countertrade and to determine, in each instance, whether the prospective benefits of the countertrade justify the cost.

C. The External Environment - The Rest of the World

4.114 While the policies which have inhibited exports are within the control of the Indonesian government importing countries trade policies could determine the limits to which Indonesia can succeed in some commodities. A major concern of Indonesian policy makers and exporters is that if Indonesia expands its exports it will encounter new trade barriers. At present the greatest concern over trade barriers in Indonesia is felt by textile and plywood producers. Currently, in other product groups, Indonesian exports are generally too small or too stagnant to suffer from systematic import controls.[34/] However, as the recent experience of textile exports shows, once the imports of "sensitive" products reach a significant level or display dramatic growth, new restrictions may be imposed. In the case of the US market, where Indonesian textile exports have been rising rapidly, the number of Indonesian textile products subject to specific limits has escalated sharply from nine in 1983 to 18 in 1984, and 34 in 1985. This means that almost all existing Indonesian textiles fall under restraints. In addition, as a result of this recent penetration of the US clothing market and under pressure from the US garment industry, the US Government determined that Indonesia was subsidizing its clothing exports via its export certificate scheme and was therefore subject to countervailing duties. Accordingly, in early 1985, following bilateral discussions between the two governments, Indonesia agreed to phase out its export certificate scheme and other export subsidies replacing them with a non-excessive duty drawback scheme consistent with the codes of GATT. In return the US agreed not to countervail. These examples illustrate that trade and trade relations have become especially

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33/ These costs are estimated from brokers' commission rates which varied from 1% to 13% of the $1.7 billion contracted under the countertrade program.

34/ Dynamic growth of imports, so-called "import surges", is one way almost certainly to trigger import restrictions.

sensitive where traditional (sometimes described as "senile") labor-intensive industries in industrial countries are affected. Indonesia faces two problems in expanding its exports of manufactures. First, Indonesia is competitive in labor-intensive manufactures -- exactly those products considered as sensitive by importing countries. Second, Indonesia is a relative latecomer to exporting such manufactures, so that it is facing restrictions when it reaches much lower market shares than achieved by traditional developing country exporters such as Korea, Hong Kong and China. Consequently, the recent drift toward increased trade restrictions in industrial countries is of major concern when studying the potential for increasing Indonesia's exports.

4.115 Indonesia faces two types of trade barriers: tariffs levied on Indonesian products; and nontariff barriers (NTBs). The average tariff rates facing Indonesia do not appear to be a significant barrier to Indonesia's exports. Table 4.4 shows that, in aggregate, these charges currently stand at quite modest levels. The average for total exports does not exceed 2.5%, and is lower than the average facing world exports. Only agricultural exports and plywood to Japan, and industrial exports to Australia appear to be subject to significant tariff charges. However, these overall statistics conceal very different intra-sectoral tariffs, so that for some specific goods tariffs constitute a very important trade barrier.

Table 4.4: AVERAGE POST-TOKYO ROUND NOMINAL TARIFF PROTECTION FACING INDONESIAN EXPORTS IN MAJOR SELECTED 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
Memo Item:				
Total (world) exports /b	n.a.	2.4	5.8	2.9

/a Weighted averages of the post-Tokyo Round MFN and preferential rates. To derive them, first, a tariff average for each tariff position was calculated using actual 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.

/b Average post-Tokyo Round Nominal Tariffs facing world exports.

Source: World Bank estimates based on UNCTAD Data Base on Trade Measures.

4.116 A closer examination of the tariff structure indicates that, in cases like fish, coffee, hard fibers and wood, the degree of escalation in tariffs facing Indonesia actually increased after the Tokyo Round due to disproportionately large tariff reductions for primary and intermediate stage items which were made at that time (Annex II p. 5). In these instances it seems that, despite the lowering of tariffs, the increased degree of escalation implicitly discourages Indonesia's effort to expand its exports of fabricated goods. For example, the average post-Tokyo tariff for wooden furniture (6.6%) is more than three times that for semi-manufactured wood, while a similar degree of escalation is also evidenced in the fruit processing chain (tariffs rise from 4.8% to 16.6% 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 shown in Table 4.4, while the average for leather manufactures is more than 8%. Thus, tariff escalation continues to be a problem for Indonesia (and other developing countries) and, in cases, the magnitude of the problem has increased as a result of the Tokyo Round negotiations.

4.117 One of Indonesia's specific concerns has been the higher tariff differential imposed by Japan on hardwood plywood compared with softwood plywood. Here there has been some progress and Japan has recently agreed to reduce tariffs on both hardwood and softwood plywood in two stages. Under the agreement the tariff on hardwood plywood with a thickness above 6 mm will be reduced from 17% currently to 10%, in line with the new rate for softwood plywood (mainly imported from the US) which is being lowered from 15% to 10%. The tariff on hardwood plywood with a thickness of less than 6 mm will be reduced from the current 20% to 15% in April 1988. Consequently, despite the progress in reducing tariffs, plywood under 6 mm will still face a differential tariff. This is an important issue for Indonesia since Japan represents an enormous potential market. In 1985 Indonesia exported approximately 300,000 cu meters of plywood to Japan, equivalent to one third of Japan's imports. However, Japan's consumption of plywood amounts to approximately six million cu meters annually. Indonesia is exceptionally well placed to capture more of this market in the future. However, the high and discriminatory tariff barriers faced by Indonesian producers still constitute an important obstacle to increased exports. In view of the fact that most of the machinery for Indonesia's factories was purchased from Japan, it is surprising that the Government was unsuccessful in negotiating lower plywood tariffs sooner.

4.118 In addition to tariff barriers, Indonesia faces various forms of nontariff barriers: quantitative restrictions and "voluntary" export restraints, price controls, monitoring measures including antidumping and countervailing duties, and measures increasing the landed cost of imports. These measures are nontariff barriers in the sense that they serve to 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 employed by several European countries are often viewed by exporters as precursors to control and thus create uncertainty and encourage "self-restraint" among exporters - irrespective of whether explicit protective action is subsequently taken.

4.119 Table 4.5 presents estimates of the extent of all NTBs facing Indonesian non-oil exports in 1983 in four major industrial markets -- Australia, the EEC, Japan and the USA -- and compares them with similar estimates for total world non-oil exports and for non-oil exports of developing countries. For all markets shown, in terms of the percentage share of products by value, the NTB indices estimated for Indonesia which range between 4.2% for the USA and 20% for Japan are much lower than the average calculated for world and developing countries. However, the percentage of products exported by Indonesia covered by NTBs is somewhat higher than the average for developing countries. This suggests that Indonesia's export product mix is such that its non-oil exports are more significantly impeded by NTBs than other countries (particularly in the EEC and Japan), and that the degree of this impediment is more severe than in the case of total (world) non-oil exports or non-oil exports from all developing countries.

4.120 With the exception of a few markets Indonesian agricultural products face very high nontariff obstacles. Only in the US, and Australia and some smaller markets, is the extent of NTBs small.[35/] In other countries, NTBs cover as much as 67% (Japan) of Indonesian agricultural products (Table 4.6). Overall, while the NTBs on agricultural products are frequent and varied, they seem to be more prevalent in the case of fresh, unpreserved products than for processed foods.[36/] This finding is opposite to that described for tariff barriers where tariffs escalate with the degree of processing of raw materials. Taking both tariffs and nontariff barriers together, it appears that agricultural exports from Indonesia are impeded by trade barriers whether they are exported in fresh or processed forms.

4.121 As far as textiles are concerned, Indonesia is a signatory of the Multifiber Agreement (MFA), an umbrella agreement between exporters and importers which governs 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 monitoring only ("double checking"). An agreement with Finland is currently being negotiated. 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 are applied on certain imports; 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. Consequently, the coverage and frequency NTB indices for textiles and clothing are particularly high (Table 4.6). Overall, 88.6% of total value of Indonesia's exports of textiles were (are) subject to nontariff barriers, especially quotas and "voluntary" export restraints in 1984.

35/ Australia, however, maintains very stringent health and sanitary requirements equivalent, in many cases, to a prohibition.

36/ An important exception to this is processed fish products, which face quantitative restrictions in the Japanese market.

Table 4.5: THE SHARE OF NONTARIFF BARRIERS FACING INDONESIAN NONOIL EXPORTS IN SELECTED MAJOR INDUSTRIAL MARKETS, 1983

	1981 import value (US$ million)				Share of import facing NTBs in 1983/a				Share of products facing NTBs in 1983/b			
	Australia	EEC	Japan	USA	Australia	EEC	Japan	USA	Australia	EEC	Japan	USA
Nonoil imports from Indonesia	80	1,089	1,437	908	11.9	19.6	15.7	4.2	25.6	29.2	14.4	21.5
Nonoil imports from world	18,053	217,877	69,411	178,253	24.1	21.1	16.9	17.3	18.1	13.8	9.3	6.6
Nonoil imports from developing countries	2,904	63,086	24,358	55,384	27.9	26.9	17.5	18.9	19.5	20.9	11.3	3.9

/a Percentage of 1981 imports covered by NTBs in total imports from given sources.

/b Percentage of tariff line items covered in total number of items imported from a given source.

Source: World Bank estimates based on UNCTAD Data Base on Trade Measures.

Table 4.6: NONTARIFF BARRIERS OF INDUSTRIAL COUNTRIES APPLIED TO EXPORTS OF INDONESIA, JUNE 1984

	Agriculture /a		Textiles /b		Other Manufactures	
	% of value /c	% of products	% of value	% of products	% of value	% of products
Japan	67.3	40.8	60.1	4.6	0.0	4.6
USA	0.1	1.4	99.7	88.8	0.0	4.5
EEC 10	51.6	15.5	97.5	88.6	9.6	3.6
Australia	1.3	17.6	4.0	34.6	11.5	24.7
all industrial countries	30.4	17.0	88.6	72.5	2.4	5.4

/a CCCN 0101 - 2402
/b CCCB 5001 - 5302
/c Note: Value and products category distributions are based on the structure of exports from Indonesia in 1981.

Source: World Bank estimates based on NTB information from UNCTAD Data Base on Trade Measures.

4.122 The important point for future export growth, however, is that less than 3% of Indonesia's exports of "other manufactures" by value are subject to NTBs in the major industrial country markets of Japan, the EEC and the US. And for industrial countries as a group only 5.4% of the product categories exported by Indonesia are subject to NTBs. One reason why the incidence of NTBs is so low on nontextile manufactures is because Indonesian exports to industrial countries of other products are insignificant. Similarly cement and steel have been exported to other South Asian markets and have not been restricted in industrial countries.

D. Recommendations

4.123 In general the recent external trading environment has been difficult for Indonesia with low commodity prices and binding trade barriers for some major manufactured goods (garments/textiles, plywood). Yet Indonesia, because its manufactured exports are so small, has, with the exceptions noted above, not suffered serious problems of market access and probably will not before its manufactured exports become much larger than at present. Given this environment a more open trading system and a responsive exchange rate, are the best policy.

4.124 Currently Indonesian trade policy is strongly biased against exports. Changes such as those of May 6 are constructive and move the economy in the correct direction (in terms of lowering the input costs of exporters) but they are only a beginning. Import-replacement industries still remain

artificially profitable and therefore continue to bid up the prices of domestic resources used both in their production and in the production of exportables. Thus the May 6 changes should be seen merely as one step in the multistep transition process toward freer trade. The transition from the existing to an improved trade regime need not be sudden but must be comprehensive to be effective. It is likely that after a major liberalization and restructing has occurred, residual elements of protection will remain. For this reason and in order to assist in the transition, selective retention of some export promotion measures is acceptable especially ones that are counter-balancing measures.

4.125 In formulating trade policy (or any policy) Indonesian officials should take an economy-wide view of the changes, considering carefully the interrelationships and interactions of the various policy measures before implementing them. Also government officials should recognize that no one has perfect foresight and should remain flexible to changing or withdrawing the policy if it later proves to have unacceptable large (negative) consequences. Ad hoc and piecemeal changes, and tailor-made regulations should be avoided since they are very inefficient, have unpredictable side effects, tend to accumulate over time, and are seen as responding to special interests. This does not mean that partial measures, such as those of May 6, should be avoided. These measures, while partial, were clearly made within the larger context of a phased move equalizing the incentives of exports and import replacements, and are consistent with good policymaking.

4.126 In terms of barriers facing Indonesian exports, it is clear that barriers to trade in raw products, textiles and plywood play a limited role in restricting and inhibiting Indonesia's trade opportunities. While some suggestions are presented here on what can be done there is little in the way of economic advice that can be offered and little that the Government does not already know. Besides the normal commercial response of completely filling quotas, avoiding import surges, diversifying exports, and meeting the various regulatory requirements, the Government must continue its diplomatic efforts to keep trade open. In every bilateral and multilateral forum where it has the opportunity, Indonesia should emphasize three aspects of its case for greater access to foreign markets. First, it is instituting policies and making adjustments consistent with the codes of GATT. That is, it is a responsible trading partner, is fulfilling its international obligations, and, unlike many industrial countries, has demonstrated its willingness to make the difficult adjustments to meet these obligations. Second, there is an element of futility in industrial countries providing advice and aid to Indonesia on the one hand while they increasingly restrict trade opportunities on the other hand. By restricting trade, industrial countries that provide advice and aid to Indonesia are in effect encouraging (forcing) Indonesia to use and allocate its resources inefficiently and to develop in a way and at a rate that is suboptimal. Industrial countries bear greater costs from their restrictions than does Indonesia and have more to gain from their removal. Finally, Indonesia needs to distinguish its case for greater access to industrial country markets from that of its competitors -- especially Hong Kong and Singapore. It needs to emphasize that it is at a much earlier stage of development and has a much lower income than its neighbors, and that it generally commands a very small market share in any one country.

4.127 With respect to trade policy, it is necessary for Indonesia to complete the process of equalizing incentives between import-replacement and export industries if non-oil exports are to expand vigorously. Protection offered to import-replacement industries is too high and too dispersed. Indonesia should consider shifting the major instrument of import policy from quantitative restrictions (QRs) to tariffs, and gradually reducing the level and range of tariffs over time. An effective duty exemption/drawback scheme should be maintained so that imports are available to exporters at international prices. Restrictions on the number of licensed importers entitled to import particular categories of goods should also be eased. Exceptions for narcotics, arms, munitions and explosives, where strict controls are required, would clearly still apply. Although the reform package could be implemented over a number of years, its major components and timing should be decided and announced in advance.

4.128 While the deletion programs have been slowed, they should be greatly modified. While there is considerable political support for these programs, because of their costliness it is necessary that their proliferation be arrested and that alternative means of developing those subsectors be explored. Tariffs should be considered to replace these programs, so that the choice of which components to produce locally is made on the basis of market considerations. For both automobiles and motorcycles, restructuring to eliminate the present excess production capacity, along with removing the sole agents' control over production, needs to be undertaken urgently. Removal of at least the worst inefficiencies embodied in the present industry structure should be undertaken as a priority. These programs attract substantial investment away from other sectors and impose unnecessary costs on Indonesian consumers.

4.129 With regard to export assistance measures Indonesia has been active in developing and modifying many programs that assist non-oil exports, but several aspects remain. Financial/banking services to assist exporters need to be further developed. These services will naturally expand as exports grow, but the government could promote this by liberalizing the access of foreign banks to Indonesia, and particularly to those that choose to operate outside of Jakarta. The skills and expertise of foreign banks would provide immediate benefits for exporters and speed the training/adoption process of local banks. Strengthening the gathering and dissementation of trade related information by partially underwriting the cost of a commercial library/trade information center, by publishing a newsletter, and by being more active in trade fairs abroad could all be useful if properly developed and limited to cost-effective government programs.

4.130 The response to the recent changes in investment regulations needs to be monitored, and further easing of restrictions should be made. Industrial licensing policies should be reviewed to reduce the present restrictions on domestic competition and to avoid promoting industries which require excessive protection. In many cases, investment licensing could be largely automatic. Restrictions on issuance of visas for foreign businessmen and technicians should also be eased.

4.131 Many recommendations in this chapter are not new to Indonesia and are similar to recommendations emanating from many World Bank reports on trade for several countries. The reason is simply that the path of development chosen by Indonesia is not atypical for a developing country. Many countries that have reached a state of development similar to Indonesia's --where the domestic market for import-replacement goods has been filled -- have adapted their policies to be more outward looking, and have forced sheltered domestic industries to adjust to international competition. Examples are Brazil, Colombia, Israel and South Korea. Such a reorientation of incentives does not necessarily imply a contraction of the industrial/manufacturing sector but it does mean that some (possibly considerable) restructuring and rationalization of production toward those lines of goods where Indonesia is competitive, will result. (Accordingly Annex III presents a summary of recent liberalization experience of other developing countries).

4.132 The adjustment costs associated with the transition process should not be used as justification to postpone the process since the costs must be borne at some time and the benefits of freer trade are also deferred by waiting. The costs of Indonesia's inward-looking policy include reduced employment, lower wages, lower consumption and reduced growth. Though these are not easily measured nor seen, they have been borne too long and outweigh the costs of transition. Resource switching from the nontradeable to the tradeable sector is now occurring in response to the drop in oil prices. If this resource allocation is guided by a heavily distorted incentive structure, it will result in significant efficiency losses for the economy. Thus removing distortions becomes a matter of considerable urgency for several reasons. Recognizing that further changes are inevitable if Indonesia is to strengthen non-oil export performance, increase employment opportunities, produce greater equity, and increase economic efficiency should provide a strong case for Indonesian policymakers who must defend such changes. Further, delaying change will only make it more difficult to accomplish in the future as vested interests become more entrenched and powerful.

4.133 Indonesia has a comparative advantage in the production of many products both natural resource based (agriculture, forestry) and labor resource based (garments and textiles, assembly, light fabrication). The country appears to be in a position to move along the product cycle of trade by replacing some exports of other countries such as Hong Kong, South Korea and Taiwan as these countries move to more capital and skill intensive products for exports. A continuation of the government's commitment to exploit fully these areas of comparative advantage and to provide the conditions for the economy to develop at its full potential is required.