

POLICY BRIEF

Working towards mutually beneficial economic relations

Indonesia's expected challenges in pursuing an FTA with the EU

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Policy Brief: Trade Knowledge Network (TKN) Southeast Asia

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Introduction

Indonesia and the European Union (EU) took a major step recently to cement their economic relationship through the signing of a Partnership and Cooperation Agreement (PCA). The agreement, which was signed following the meeting between senior officials from both sides in Jogjakarta, on 13th and 14th July 2009, covers diverse areas of cooperation, such as trade, investment, human rights, climate change, migration, as well as efforts to address organised crime and communicable diseases. As the PCA with Indonesia is the first such agreement to be signed by the EU with an Asian country, it reinforces Indonesia's diplomatic standing in the eyes of European policy-makers.¹ The signing of the PCA was also made possible following the recent decision by the EU to lift the 2007 ban on the four Indonesian airlines, including its national carrier Garuda Indonesia, from flying to Europe on safety grounds, a move that caused some resentment in Jakarta.² With the lifting of the ban and the signing of the PCA, the trade relationship between Indonesia and the EU, which is valued at US\$ 28.4 billion a year, is expected to expand in the coming years.

Despite this encouraging progress in political relations between Jakarta and Brussels, the signing of the PCA is likely to present considerable challenges, particularly for Indonesia. Among other things, the agreement will pave the way for the negotiations on the long-awaited Free Trade Agreement (FTA), under the wider framework of the ASEAN-EU Free Trade Agreement (AEUFTA), to resume in the near future. The discussion over the establishment of the AEUFTA have been suspended following, *inter alia*, the disagreement between the two sides over the political deadlock and human rights issues in Myanmar as well as the aforementioned ban imposed upon Indonesian airlines. Since then, Brussels has decided to pursue negotiations with individual ASEAN member countries with the hope of accelerating the signing of the PCAs and FTAs with them. Despite the airlines ban, Indonesia appeared to be the most enthusiastic among the ASEAN countries in wanting to conclude the PCA agreement with the EU.

The discussions on the AEUFTA and the subsequent Indonesia-EU FTA (IEUFTA) began to emerge in 2005, at a time when global trade talks under the auspices of the World Trade Organization (WTO) came to be significantly challenged not only by the differences emerging amongst its member countries, but also by the rise of Bilateral Free Trade Agreements (BFTAs), concluded either between countries, between regional groupings, or between a regional grouping and a country. Frustrated by the deadlock in the multilateral-level negotiations, both the EU and ASEAN (and its individual member countries, including Indonesia) have in recent years taken a pro-active stance in pursuing a BFTA policy strategy. For the EU in particular, its ability to secure market access to the ASEAN region, including that of Indonesia, has become even more critical in light of the economic slowdown resulting from the recent global financial crisis.

However, given the economic imbalance between the EU and Indonesia, economic relations between the two sides remain in favour of the EU. Today, the EU, as a regional bloc, has become an entity capable of exercising influence beyond that of other global economic superpowers. The EU rules on labelling, content, manufacture, design and safety, for example, have become the rules that most global

1 The EU had recently concluded a Free Trade Agreement (FTA) with South Korea. However, it should be noted that FTA and PCA are somewhat different. While the former includes primarily trade and investment issues, the latter covers more comprehensive areas of cooperation, and can serve as the *umbrella* agreement for the former. It is not, however, necessary that the signing of a PCA precedes the signing of an FTA. Depending on the interests of its partners, the EU often considers signing an FTA prior to the signing of a PCA.

2 Islam, S., 2009.

manufacturers follow.³ Within the EU there are many large multinational corporations (MNCs) with a global reach, many of which are already doing business in the Indonesian market. Indonesia and its ASEAN neighbours, on the other hand, have not yet evolved into a strong economic entity capable of competing with the EU at the global level. Furthermore, Indonesia is still struggling to put into force domestic economic reforms, which are key to stimulate the country's socio-economic development. It is thus likely that the adjustment costs to be paid by the Indonesian and the other Southeast Asian economic actors would be high, should an IEUFTA and AEUFTA be finally agreed upon and concluded. In order to redress this imbalance, the proposed IEUFTA and the subsequent AEUFTA, must take into account the development interests of both Indonesia and ASEAN.

Key Issues in the EU-Indonesia FTA

There can be little doubt that the proposed Indonesia-EU FTA (IEUFTA) is likely to deepen the existing asymmetry in the economic relations between the two sides, particularly if short-term adjustment costs to be incurred by Indonesia are not addressed in the forthcoming FTA negotiations. From an EU perspective, the agenda items central to the FTA negotiations will likely focus on elements such as the incorporation of a strict IPR regime, the promotion of service sector liberalization and so on. However these would be not only extremely difficult, but also costly to implement for Indonesia. The following are some of the main concerns to be expected in both the future negotiations and implementation of the IEUFTA.

1. Policy space

Policy space matters for Jakarta because it allows the Indonesian government the sovereignty to determine the appropriate trade, investment and industrial policies that could help its own development amid the pursuit of economic liberalization. In the multilateral setting, Indonesian trade policy-makers often argue for a list of *sensitive* products that should be excluded from liberalization initiatives (known as the Special Products or SPs) and the Special Safeguard Mechanisms (SSM) that allows the government to impose contingency restrictions on imports to deal with special circumstances, such as a sudden surge of imports. These are seen as the components of policy space that Indonesia requires to cope with the adjustment costs generated from trade liberalization. The EU and other major developed countries, in contrary, consider these initiatives as a form of protectionist policy aimed at limiting their market access to the developing economies. However, given the different levels of development between the involved parties in this FTA, it is imperative that Jakarta be accorded with the necessary concessions crucial to limiting the negative impacts of this trade liberalization.

2. Diverging views on how to achieve economic development

In relation to the issue of policy space above, *development* will likely prove another contentious issue under the IEUFTA. Although it is imperative for the IEUFTA to prioritise the developmental objectives of the weaker side, which in this instance refers to Indonesia, Jakarta and Brussels seem to have different views on how economic *development* could be achieved through this trade agreement. Past FTA negotiations between the EU and its Southern partners have shed light on the key elements deemed crucial by the EU to promoting sustainable economic development. Among other things, the EU favours extending technical assistance to its partners, places more emphasis on regional integration, and

³ Reid, T. R., 2004, p. 232.

grants more flexible timeframes for the implementation of an FTA. Indonesia, on the other hand, sees the achievement of economic *development* under the IEUFTA to include the freedom to use the above-mentioned SPs and SSM, market access facilitation, allowing subsidies for small-scale production, and providing a firm commitment to investing in the country (as opposed to the *mere potential* of attracting investors).

3. The General System of Preferences (GSP) scheme

The GSP is primarily a scheme whereby developed countries facilitate market access for developing and least developed countries through the granting of trade concessions. The GSP scheme plays a significant part in the EU's external trade policy. The EU's GSP scheme offers either lower tariffs or completely duty-free access for imports from developing countries to the EU. Although most ASEAN countries are beneficiaries of the EU's GSP scheme, the relative economic growth of the region has redefined the suitability of many ASEAN member countries to be accorded such status. Indonesia is considered under the terms of the new EU-ASEAN GSP scheme that was adopted in June 2005, as now 'graduated from the EU's GSP scheme'. Thus since then, a number of Indonesian products, such as animal and vegetable fats, wood products, basketware and so on, no longer enjoy GSP privileges. Given the limited ability of Indonesian economic actors, particularly small and medium-sized ones, to carry out operation beyond national borders, EU GSP policy *vis-à-vis* Indonesia should be reassessed.

4. Market access and subsidies

Market access and subsidies will also play key role in determining the conclusion of the IEUFTA. For most producers and manufacturers in Indonesia, the EU's current policies concerning these two issues are contradictory. While low tariff rates for non-manufactured agricultural products may give the impression that the EU encourages the export of ASEAN produce to its markets, the stringent sanitary and phytosanitary (SPS) measures imposed at the EU borders can severely impede ASEAN exporters in further penetrating the EU market.⁴ At this point in the distribution chain, ASEAN producers find themselves in the disadvantageous situation of having already incurred transportation costs without eventually being able to sell their goods. Furthermore, assuming these produce do pass these EU's WTO-Plus SPS standards,⁵ ASEAN exporters are forced to compete with heavily subsidised domestic goods.

As regards to the manufactured products, these are usually hit by high tariff rates, a significant handicap which can often price any ASEAN product out of the EU market. Indonesian manufacturers often speak of two key problems confronting them in relation to the EU: tariff peaks and tariff escalation. The EU maintains a number of high tariffs in limited positions of Common Commodity Nomenclature (CCN), and these cover products, such as textiles, rubber, furniture, agriculture and food, all of which are relevant to Indonesia. As far as tariff escalation is concerned, this means the EU imposes zero or very

4 The EU, for example, has refused entry of Indonesian shrimp and other seafood products on the basis of health and sanitary reasons. The Union is concerned with the antibiotics used in Indonesian shrimp farming, also known as *chloramphenicol*, and require Indonesian shrimp and other seafood products to go through the Rapid Alert System, which is normally used to inspect residual bacteria. Indonesian shrimp and seafood exporters, however, raised their objection to this regulation, pointing out that the substance is naturally produced in the soil and plankton which is eventually fed to the shrimps. A zero content of chloramphenicol in shrimp is, therefore, impossible. For further details, see Alimi, 2006, 6.

5 The so-called WTO-Plus standard primarily refers to the arrangements in bilateral or regional trade arrangements whose scope goes beyond those achieved at the WTO level.

low tariff rates for unprocessed products, but very high tariffs on processed products. This has acted as a barrier to the development of some industrial sectors. Confronted with high tariffs for processed products and low tariffs for unprocessed ones, it is easy to imagine a developing country abandoning plans for industrialization and opting instead for agricultural production.⁶

In relation to this, Jakarta and Brussels need to clarify *whether the IEUFTA aims to encourage Indonesia to remain as a low-level producer (e.g. exporting raw materials and agricultural products) or whether it aims to encourage the development of manufacturing industries in the Southeast Asian region. If the issue of tariff peaks remains unresolved, for example, one could forgive Jakarta for thinking that perhaps it is the trade policy of the EU to keep its partner as farmers and fishermen, rather than manufacturers.* Furthermore, the issue of subsidies needs to be addressed in the IEUFTA. Whilst the continuous use of large agricultural subsidies in the EU remains a matter of concern amongst Indonesian agricultural exporters, the use of domestic subsidies for small-scale or grassroots producers might still be a useful tool to ensure the welfare of Indonesian farmers.

5. Foreign investment

With regard to foreign investment, the IEUFTA must do more than just create the *mere potential* for foreign investment. Most mainstream studies, such as Kettunen (2004) and one that was commissioned by the European Commission,⁷ promise that an FTA between the EU and ASEAN would increase the flows of European investment into ASEAN, including Indonesia. However, there are non-economic factors, such as security, that may influence the flows of foreign investment into Southeast Asia. The IEUFTA, therefore, must secure a concrete commitment from both Brussels and Jakarta to invest in the two regions. Whilst foreign investment is acknowledged to be the prime mover of the development process, this promise remains a pipedream if no real capital investment flows into the regions, particularly into ASEAN. Any conditions laid out by the EU which aim to liberalize foreign investment laws in the region must be met by a concomitant concrete undertaking that significant foreign investment ensues in the form of long-term capital flows from major European manufacturers. The EU, for instance, could assist and facilitate the promotion of Indonesian market opportunities to European investors and develop appropriate measures with Jakarta to determine how the ‘right types’ of investment could be expanded in Indonesia. In the absence of this concrete undertaking, the IEUFTA will be no different from the current crop of FTAs which strip countries of their policy space and leave their industries wide open for exploitation by foreign opportunists.

6. Extensive liberalization at the expense of the poor and marginalised

As with most BFTAs, the proposed IEUFTA and the AEUFTA need to be examined critically. The EU, as mentioned earlier, favours the so-called *new age* FTAs, with commitments that go beyond those achieved at the multilateral level (or WTO-plus). The EU-led FTAs are normally comprehensive agreements, embracing not only the conventional trade in goods, but also areas such as service sector liberalization, investment, Intellectual Property Rights (IPRs), competition policy, public procurement (as opposed to the relatively more limited government procurement), and other issues. As with many other developed countries, the members of the EU are growing increasingly frustrated at the slow

6 Tariff peaks and tariff escalation as a method of breeding farming or fishing nations without any manufacturing bases has been discussed in other works (see, for example, Robles, A. C., 2007).

7 Consortium Euro-Asia Centre University of Limerick (Ireland) and the *Institut Français des Relations Internationales* (IFRI), 2006.

progress of global trade talks. With its vast experience of carrying out an *enlargement process* in the Eastern European region, the EU is keen to strike up integration initiatives with countries or regional groupings in the Southern hemisphere for the purpose of penetrating new markets.

However, it has been generally observed that North-South BFTAs tend to generate more benefits for developed countries,⁸ and this could prove to be an issue of importance in the IEUFTA negotiations. The incorporation of Trade-Related Intellectual Property Rights (TRIPs)-plus arrangement under the IEUFTA, for example, could further benefit large European pharmaceutical and agro-industrial companies at the expense of the Indonesian poor. According to one estimate, yearly profits of US\$ 32 billion have already been generated from drugs *discovered* by these companies as a result of their prior use in indigenous medicine.⁹ This is not to mention the loss of access and control that would be experienced by local farmers in Indonesia, such as access and control over seeds, etc., should a TRIPs-plus arrangement become a key component in IEUFTA negotiations.

7. The participation of civil society and the marginalised sectors in the process of FTA negotiations

The importance of civil society and marginalised sectors in the IEUFTA policy-making process cannot be overemphasised. Civil society and marginalised sectors provide crucial and valuable alternative inputs to policy-makers seeking a mutually beneficial trade agreement. Although Indonesia counts as one of the largest democracies in the world, democratic governance in trade policy-making can still be improved, and the EU should in this respect use its leverage, as a leading democratic entity, to influence Jakarta so that the IEUFTA reflects the opinions and aspirations of not only large economic actors, but also of civil society. However, it has been observed that while big democracies such as the US and the EU promote global democracy, their own attitude towards public participation in trade decision-making processes has often been undemocratic.¹⁰ Trade negotiations, which are likely to affect many sectors of society, must be kept open, transparent and accountable to public scrutiny. It is better to have lengthy consultations at national and regional levels than to ignore the possible impacts of trade on key development factors such as the society and the environment.

Policy Recommendations

The IEUFTA is likely to deepen the asymmetrical economic relations between Indonesia and the EU, particularly if the development objectives of the former are ignored in the forthcoming negotiations and implementation of this trade agreement. Precisely because of this, a number of factors need to be incorporated in the final text of the IEUFTA. These include taking into account and striking a balance between Jakarta's interpretation of the ways in which the IEUFTA should contribute to the development of Indonesia and EU's own interpretation of economic development.

Overall, Indonesia can certainly benefit from this trade agreement if the EU is willing to: (1) allow the use of SP / SSM; (2) expand its existing GSP scheme; (3) improve market access facilitation for ASEAN's exports to the EU; (4) allow the use of subsidies for low-level agricultural producers; (5) provide concrete commitments for long-term capital investment into Indonesia; (6) agree to the use of flexible timeframes

8 See, for example, UNDP Regional Centre in Colombo, 2005, p. 5; Chandra, A. C., 2005; Khor, M., 2005.

9 UNDP, 1999.

10 Chandra, 2007.

for the conclusion and implementation of IEUFTA; and, more importantly (7) ensures the participation of civil society groups in the IEUFTA policy-making processes.

The use of SPs and SSM, in particular, must be justified in the IEUFTA as they can act as guarantees to ensure the sustainability of items or products deemed sensitive by Indonesian economic actors. Indonesia is still coping with the challenges posed by trade liberalization in general. Permitting the use of SPs and SSM could be a goodwill gesture on the EU's part to demonstrate that the motives behind the IEUFTA are not to secure an unfair advantage.

However, the rigidity of the EU's position in multilateral trade negotiations is a clear indication of how difficult it can be to resolve these issues. Although there are some political gains derive from this arrangement, policy-makers in Jakarta must move carefully prior to making free trade commitments with one of the most economically powerful regional groupings in the world. It is important for Jakarta to focus now on its domestic economic reforms prior to engaging in a bilateral FTA with the EU. It is only after these objectives are achieved that the establishment of a balanced, equitable IEUFTA can possible be pursued.

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