

Toward a US-Indonesia Free Trade Agreement

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January 18, 2007
Washington, DC

A potential bilateral Free Trade Agreement (FTA) between the United States and Indonesia is the subject of an upcoming study, "Toward a US-Indonesia Free Trade Agreement", by Gary Hufbauer and Sjamsu Rahardja, assisted by Agustin Cornejo and Costantino Pischedda. Hufbauer and David Katz of the Southeast Asia office of the US Trade Representative (USTR) discussed the potential economic benefits an FTA would mean for both countries, areas that would need to be addressed to successfully conclude an FTA, as well as political prospects for such an agreement in the future.

Hufbauer led off with a discussion of the economic benefits of an FTA. But first he acknowledged that politics dominates any discussion of FTAs. On the positive side, Indonesia has a number of elements that make it geopolitically attractive: its leadership role in international affairs, its position in the US War on Terror, its natural resources and position on strategic shipping lanes, as well as a key ASEAN player which could counterbalance growing Chinese influence in the region.

On the other hand, prospects for an FTA are hampered by free trade "fatigue" in the US; delays and challenges to implementing critical reforms in Indonesia; heavy demands on Indonesia by the US that are part of the FTA process; closer ties with the US are not a "political plus" in Indonesia today; and the Doha Round is in need of more immediate attention.

That said, the economic arguments for an FTA between Indonesia and the US are quite clear. The US is the second most important market for Indonesia's exports, and Indonesia is a potential "continent-sized" export market for US businesses. Continued growth in Indonesia could lead to greater demand for US consumer goods, capital goods and services. Finally, an FTA with the US represents the "gold standard" with high thresholds which would lock-in important reforms.

Hufbauer noted that two-way trade between the US and Indonesia has been more or less the same since 1998, and US Foreign Direct Investment (FDI) is 5% below what it was in 2001. US and foreign investors are continuing to call for an improved business climate in Indonesia.

Using econometric modeling, Hufbauer predicts that two-way trade between the US and Indonesia would increase 35%, with US exports increasing by 25% and Indonesian exports increasing by 45%. US export growth to Indonesia would be led by services and established manufactured goods like chemicals, machinery and equipment. Indonesia to US export growth would be focused on textiles, clothing and footwear. Hufbauer's models do not suggest increased agricultural trade, particularly once rice and sugar (both protected) are excluded.

The trade barriers involved that would have to be resolved in an FTA include high US tariffs on textiles and clothing, high Indonesian tariffs on certain manufactured products, as well on agricultural tariffs and subsidies on both sides.

Non-tariff barriers (NTB) are also a significant issue, and removing NTBs will be essential to liberalizing agricultural trade. The NTBs at play include Indonesian Halal requirements, import letters of recommendation and other import licensing, in addition to BSE-related measures which greatly restrict US exports of beef, poultry, temperate fruits and other commodities.

Liberalizing services will be a critical component for the US in any FTA with Indonesia. A US FTA will mandate liberalization beyond what is called for under the WTO. A US-Indonesia FTA will mandate that Indonesia continue to liberalize the services sector by reducing establishment barriers and phasing out other restrictions like local presence requirements.

A US-Indonesia FTA will also have significant benefits for Foreign Direct Investment (FDI). While Indonesia’s investment climate is considered “open”, many investors worry about red tape, the unpredictable legal system, and the difficulty of enforcing property and contract rights. An FTA would promote greater transparency and improve the “rules of the game” for foreign investors.

Protection of intellectual property rights have been a major sticking point in US FTA negotiations with developing nations. In the Indonesian context, pharmaceuticals, educational materials, and copyright are particularly sensitive areas. The US remains concerned about pirated products and the weak response of Indonesian authorities.

Labor and environmental standards will be significant issues in any US-Indonesia FTA negotiations. Hufbauer argued that any US-Indonesia FTA should adopt the basic labor and environmental provisions of the CAFTA-DR pact. Areas of particular concern are restrictive Indonesian labor laws as well as illegal logging.

The View from USTR

David Katz began by noting the importance of viewing the totality of the relationship between the US and Indonesia in making the decision to go forward with an FTA. Katz noted that a US-Indonesia FTA should be considered in the context of the WTO globally, regionally at the ASEAN level, as well as the bilateral relationship.

Looking at an FTA in the global context, Katz argued that an FTA with Indonesia would not conflict with the WTO and would be “WTO plus”. The level of commitment shown by the government of Indonesia (GOI) indicates their level of commitment towards bilateral agreements. The US has been encouraging the GOI to be proactive in the current Doha Round trade talks.

At the regional level, trade between the US and ASEAN is enjoying high growth and US exports have increased five fold from \$9 billion in 1980 to \$50 billion in 2005. ASEAN is the 4th largest trading partner for the US and enjoys a \$50 billion trade surplus.

In 2002, President Bush created the “Enterprise for ASEAN Initiative” which targets the creation of a network of bilateral FTAs among ASEAN members who are members of the WTO and have a pre-existing Trade and Investment Framework Agreement (TIFA) in place. A US-ASEAN TIFA was also put into place.

Katz then outlined the status of trade negotiations with the ASEAN member states:

- Thailand – stalled since the coup
- Malaysia – FTA talks began last year; a TIFA was agreed to in 2004
- Philippines – has a TIFA in place
- Brunei – has a TIFA in place
- Vietnam – just joined the WTO
- Cambodia – TIFA in place in 2006, with FTA talks coming soon
- Laos – the US is supporting its joining the WTO

US-ASEAN trade talks have focused on promoting trade and investment in certain areas, as well as a single customs window, pharmaceutical and other technical standards. All these talks also have direct bilateral implications.

On the bilateral level, Indonesia-US two-way trade totaled \$16.5 billion through September 2006. The TIFA that was put in place in 1996 is designed to build stronger economic ties through a “building blocks” approach, in which specific component areas of a future FTA are worked on. Katz noted there have been five formal TIFA meetings with numerous offline engagements.

Some successes under the TIFA Indonesia regime include the extension of preferential GSP treatment in response to the 2005 tsunami and the first private sector dialogue ever held under any TIFA arrangement. A recent MOU on textiles was also concluded that addresses the illegal transshipment of textiles. This would safeguard legitimate textile imports. Textile imports from Indonesia are about \$3 billion a year.

Intellectual Property Rights are a priority critical for any FTA, Katz stated. There have been two reviews to assess progress in Indonesia on IPR, which have led to two plans for the GOI. In November 2006, Indonesia was lowered to the “watch list” from the “priority watch list.”

Another area of concern was addressed on the margins of the recent APEC meeting, resulting in an MOU on illegal logging. This MOU creates a mechanism to share information and establish formal cooperation.

Looking towards 2007, momentum towards an FTA will continue to build, according to Katz. A bilateral investment treaty is being explored, along with additional dialogues under TIFA. These discussions will focus on services, the agricultural trade, and increased cooperation on IPR.

Discussion

Q: Why are textiles so important in FTAs? They have low value-added and the market is saturated. Also, in TIFA negotiations, why can't they lead to concrete agreements that rise to the FTA standard?

Hufbauer: textiles are our “Mount Everest” of protection. If they are carved out, then an FTA will not be possible. The textile market is not saturated, in fact. And the US has the ability to sell to Indonesia high technology textiles.

Katz: The “building block” approach in TIFA talks can and does lead to concrete agreements that make FTAs much easier to reach agreement on.

Q: Indonesia needs to say they want an FTA. What signals have you gotten?

Katz: The GOI has said that it wants to continue to “engage.” Admittedly, they there have been no signals on an FTA. USTR sees value in continuing under the TIFA.

Q: In other FTAs (such as with Singapore, Chile, and Australia) issues always arise – what issues do you anticipate with Indonesia?

Hufbauer: Sticking points on the Indonesian side include investment and IPR in pharmaceuticals. On investment, Indonesia has many outstanding investment disputes that it has not resolved, and which need to be. There is concern that Indonesia could follow the Russian model of falsely using environmental standards to squeeze foreign investors. There are already small hints of this taking place. On IPR in pharmaceuticals, there is a poverty dimension that is important to the Indonesians.

Katz: US FTAs are hard across the board to reach. Obviously, some disputes are harder to resolve than others, and require senior level commitment.

Q: FTAs are spreading around the world. How do we compete with China on these? They offer lower standards and more benefits.

Katz: The US is cognizant of how we’re doing, and we think we’re doing fine. We look at China-ASEAN and EU-ASEAN trade agreements as positive as long as they are rules based and WTO compliant. And there is no exclusion of the US.

Q: What is the role of exchange rates in FTAs?

Hufbauer: I have advocated for more macro-level discussions in FTAs. The US would have a hard time concluding an FTA with a country without a floating exchange rate and open capital markets, and this is not a problem in the case of Indonesia.

Q: What is the status of investment reforms in Indonesia? Will the passage of the investment law lead to a bilateral investment treaty?

Katz: The proposed investment law has been in the DPR for the last 3-4 years. It is still under consideration by Commission VI. There is no hard link between an investment law and a bilateral treaty, but it is clearly a positive step.

Q: What is the importance of legal reform?

Hufbauer: Indonesian judicial shortcomings are widely recognized, but would probably not be tackled in an FTA. A recent World Bank study showed that the lack of a real judiciary in Indonesia is a real impediment to growth.

Katz: It is encouraging to see President Yudhoyono and his administration take this seriously.