9

Conclusion

The case for trade and investment cooperation between the United States and Indonesia rests on the dual propositions that closer ties could anchor and reinforce the reform process already underway in Indonesia and more broadly, that economic reform, based on market principles, can create new and better jobs, raise living standards, and stymie Islamic radicalism. Historically, geopolitical considerations have shaped US-Indonesia relations, and that reality will determine the fate of any US-Indonesia FTA proposal. Throughout this book, however, we have focused on economic analysis, not on the crucial geopolitical preconditions.

As sketched in chapter 1, US-Indonesia relations have been cordial for most of Indonesia's history. Indonesia was a reliable anticommunist bulwark from the mid-1960s through the end of the Cold War. Since September 11, 2001, the war on terrorism has driven Washington's strategy toward Indonesia. The Bali bombings in October 2002 and subsequent attacks on Indonesian soil demonstrated that terrorism is a serious common threat, strengthening security cooperation between the two countries. As the world's largest Muslim country and a secular state, Indonesia is a moderate voice in the Organization of the Islamic Conference and other settings. In addition, Indonesian foreign policy is focused increasingly on promoting democracy and opposing extremism in neighboring states and the Muslim world at large, as evidenced by President Yudhoyono's recent trips to Burma and Saudi Arabia. As mentioned above, the current US approach to relations with Muslim countries is informed by the belief that prosperous market-oriented economies, run on democratic principles, are far less likely to breed terrorists and threaten world peace. In this context, an FTA could buttress Indonesia's political and economic reforms and at the same time enlarge the economic dimension of US ties with Indonesia.

Chapter 1 also touched on economic concerns that FTA talks might unleash. Cultural and geographic distances are not likely to be strong obstacles in the new global wave of FTAs, which establish criss-cross commercial networks among agreeable partners rather than creating political alliances. A US-Indonesia FTA would be another building block in US commercial strategy toward Southeast Asia. Indonesia occupies an intermediate position among current and perspective US FTA partners in the intensity of bilateral trade and investment relations. Such conditions favor a US-Indonesia FTA, because when two countries have important commercial links, not only do business firms have a tangible reason to support the FTA but the prospects are also much better for a substantial dollar increase in bilateral trade and investment.

Because high barriers limit trade in both directions, an FTA could substantially augment commerce between the United States and Indonesia, stimulate investment in Indonesia, and deliver economic benefits to the Indonesian people. Our empirical analysis, presented in chapter 8, suggests an overall gain in two-way trade of between 40 percent and 70 percent, depending on the econometric model employed. Bilateral trade expansion would focus on agriculture and manufactures. The FTA could deliver to Indonesia annual gains of around 0.6 percent of GDP, with little trade diversion. We also expect that the actual benefits would be higher for Indonesia because of the dynamic gains associated with increased productivity.

Skeptics of a new FTA initiative might question its timing. Given the political calendar in Washington and the extreme difficulty of current negotiations in the World Trade Organization (WTO), we doubt that a US-Indonesia FTA would compete with the Doha Development Round for attention in Congress. In other words, FTA talks, possibly leading to legislative ratification, need not interfere with multilateral trade negotiations.

US critics may point to Indonesia's corruption and its weak environment and labor practices as reasons to back away from an FTA. In our view, this criticism overlooks the positive impact of an FTA on the social dimensions of Indonesian life. An FTA can extend the bilateral relationship between the United States and Indonesia beyond common security concerns to the economic arena and provides a platform for building on the aforementioned social reforms already under way in Indonesia.

In agriculture, sugar and rice will be particularly sensitive import products for both countries. In Indonesia, tobacco and alcoholic beverages are also likely to be sensitive products. Sanitary and phytosanitary (SPS) standards and other regulatory measures that limit US imports of Indonesian agricultural products (e.g., cocoa, fruits, and shrimp) should be examined. Indonesia must take steps both to improve compliance with SPS standards and to remove unnecessary barriers. Likewise, Indonesia should review its

SPS restrictions on imports of US beef and poultry with a view to remove them at an early date.

Indonesia plays a key role in the world market for liquefied natural gas and is also a major global producer and exporter of tin, coal, copper, and nickel ores. US firms are leading producers and investors in the Indonesian energy and mining sectors. To reduce legal and political uncertainty for foreign firms, the Indonesian government should clarify the regulatory framework for energy production and review the draft mining law. The principal contributions of a US-Indonesia FTA for hard-rock mining and energy will be threefold: to nudge the domestic legislative and regulatory processes forward; to establish an arbitration mechanism for disputes arising after the FTA is ratified; and to open new opportunities for investment.

A US-Indonesia FTA could create significant trade opportunities in manufactures. Apart from tariffs on textile and clothing products, US tariffs are generally low, and while Indonesian openness is increasing, several manufactured goods are still subject to high tariffs. In both the United States and Indonesia, some imports are also subject to nontariff measures, such as technical standards in the United States and import licensing in Indonesia. A US-Indonesia FTA should eliminate tariffs on manufactured goods within 10 years at the latest and immediately liberalize much existing trade. Truly sensitive items as identified by tariff peaks—such as Indonesian imports of motor vehicles, some plastics, and certain items made of base metals—should qualify for long transition periods.

Better market access for textiles and clothing (T&C) and footwear will be crucial for Indonesia. T&C negotiations should be based on reciprocity, in that US market access should be conditioned on similar efforts from Indonesia. Ideally, Indonesia will be able to overcome domestic protective interests by advertising the large gains that the FTA offers. Indonesian T&C producers should accept the established US approach of promoting vertical integration between US textile firms and clothing producers in partner countries through strict rules of origin (ROOs), though such ROOs should contain high de minimis exceptions, on par with the US-Singapore FTA.

The two countries should form a joint working group on standards and related matters; the group should identify technical requirements, product labeling standards, and certification measures that hinder commerce and can be resolved through mutual recognition agreements or by harmonizing US and Indonesian approaches.

Efforts to insert environmental and labor standards in trade agreements have proven quite controversial, as discussed in chapter 4. Harmonizing environmental standards to the highest levels could penalize Indonesia, a country of relatively limited means. In many instances, labor standards are best determined at the national level. Yet since the 1990s, Congress has linked labor and environmental provisions with trade pacts, and a US-Indonesia FTA will follow this recent pattern. With these practical realities in mind, we recommend that a US-Indonesia FTA should adopt the basic labor and environment and dispute settlement framework of the Central American Free Trade Agreement–Dominican Republic (CAFTA-DR). The Indonesian government should amend its statutes as necessary and undertake vigorous enforcement efforts. Indonesian firms that export to the United States should adopt codes of conduct for labor matters that reflect the International Labor Organization (ILO) Declaration on Fundamental Principles and Rights at Work. Mechanisms for monitoring compliance with environmental regulations should be established and strengthened. This will require technical and financial support from the United States and the World Bank. The United States should adopt strong measures against importing illegal timber and wood; in addition, given the transnational nature of commerce in illegal logs, the United States should encourage Indonesia, Singapore, and Malaysia to conclude a binding agreement with good enforcement tools to prohibit exports and imports of illegal wood in all forms.

Both Indonesia and the United States have national and subnational "buy-national" procurement rules and other restrictions, as summarized in chapter 5. Indonesia should sign the plurilateral WTO Government Procurement Agreement (GPA) with a schedule of commitments that mirrors those set forth in CAFTA-DR. The United States should grant unconditional most favored nation (MFN) rights for government procurement to Indonesian firms at both the federal and state levels, and Indonesia should reciprocate. The operations of Indonesian state-owned enterprises (SOEs) should also become more transparent.

Indonesia has an open investment regime, and barriers are relatively low. However, improving the confidence of foreign investors in Indonesia remains a paramount objective, as chapter 6 underlines. Given Indonesia's questionable business environment and unreliable judiciary, an investor-state dispute mechanism will be essential to a US-Indonesia FTA, with the possibility of denying FTA benefits to investors that engage in significantly corrupt activities. In addition to the provisions negotiated in the FTA text, investment promotion requires sustained Indonesian domestic reform. Legislative approval of the proposed investment package and continuous progress in addressing corruption in Indonesia are both necessary.

The increased transparency and competition for Indonesian SOEs that would improve US-Indonesia trade relations in the area of government procurement are also important reassurances for foreign investors. Privatizing certain SOEs and allowing foreign companies to bid for the assets could increase competition in some industries. In strategic industries, ensuring transparency in bidding for procurement contracts could help. With US cooperation where relevant and appropriate, Indonesia should resolve the major outstanding investment disputes involving US investors before US-Indonesia FTA talks commence.

Services trade between Indonesia and the United States holds much potential for both countries, as chapter 7 observes. Our econometric analysis suggests that an FTA could expand export services from the United States to Indonesia by about 22 percent, though it predicts a decline in service exports from Indonesia to the United States by 4 percent. However, important benefits of a US-Indonesia FTA for Indonesia lie in promoting a more efficient services sector, which in turn can improve Indonesia's competitiveness by lowering costs in key areas, such as transportation, telecommunications, financial services, and business and professional services.

The US-Singapore FTA can be a model for a US-Indonesia FTA in the area of services. In the former agreement, reciprocal provisions cover a wide range of activities. All limitations on the number of service providers, the value of service transactions, the quantity of services output, and the number of persons that may be employed per sector have been removed. Both Indonesia and the United States should abolish citizenship and residency requirements for senior professionals, managers, and directors. Also, as in the US-Australia FTA, the US-Indonesia FTA should establish a professional services working group to review professional diplomas and credentials and recommend the mutual recognition of degrees and standards that are essentially equivalent.

Indonesian firms might have only limited interest in enhanced access to the US telecommunications and information services market, but the United States should use the FTA to advance its liberalizing agenda. In particular, the United States should permit ownership of cable networks, direct satellite broadcast, provision of satellite services, and provision of information services by bona fide Indonesian firms.

At the time of this writing (early 2007), neither the United States nor Indonesia is ready to engage in FTA negotiations, as in both Jakarta and Washington, other priorities are well ahead of bilateral trade relations. Indonesia's immediate economic goal is to push performance beyond levels achieved before the Asian crisis of 1997. Indicators show some success. Income per capita in 2005 surpassed the figure reached in 1995; the government's fiscal position has improved; and the rupiah has stabilized. Still, as a fledgling democracy, Indonesia continues to struggle with sensitive issues that require political consensus, and several questions dominate the political debate. How should relations between the central government in Jakarta and individual provinces be managed? How can natural resources be best developed? How can a better array of basic services be provided while combating poverty and reducing corruption? Faced with such priorities, Indonesia prefers to engage in trade agreements that are less comprehensive and easier to implement than standard US FTAs.

Negotiating an FTA with Indonesia is also not high among US trade priorities, though for different reasons. Trade promotion authority (TPA) is scheduled to expire on June 30, 2007. Following the November 2006 election, Democrats gained control of both the House and the Senate. Some 28 House Republicans were replaced by as many Democrats who can fairly be characterized as trade skeptics. The TPA was originally enacted in 2002 by a close vote of 215–212 in the House of Representatives, with 174 Democrats voting against it. In the wake of the party shift in November 2006, the likelihood of extending the TPA, already doubtful, has further diminished. But unless the TPA is extended or renewed, the US Trade Representative (USTR) cannot contemplate the launch of FTA talks with a major trading partner such as Indonesia. If the TPA is extended in 2007 or renewed after the 2008 presidential elections, the USTR still needs to be convinced that an FTA with Indonesia makes sense in political and economic terms.

Given these political realities, the United States and Indonesia might consider a so-called stepping-stones approach, which might enable the two countries to resolve issues one at a time, building trust as they go along, rather than confronting all questions in a single big package.[1] By acknowledging an array of impediments and focusing on those that can be resolved, both parties might commit to sequential actions that gradually achieve freer trade and investment.

The stepping-stones approach would entail ministerial dialogues to address specific issues under the umbrella of the existing trade and investment framework agreement (TIFA). Cooperation under the TIFA might commence on questions such as these:

- ***Customs facilitation.*** Improved customs facilitation is crucial for enhanced Indonesian access to the US market, and vice versa. For this to happen, US security concerns must be answered. Both parties should work toward real-time radio tracking of all cargo containers, electronic customs clearance, procedures and personnel to inspect containers (both ship and air), and agreement on the means of certifying that goods meet the requisite ROOs.
- ***Behind-the-border protection.*** Regulations on product labeling, SPS standards, technical standards, and professional accreditation increase the cost of accessing markets for US and Indonesian suppliers alike. Working committees could gradually reach agreement on common standards or mutual recognition of different standards. Among SPS issues, working committees could resolve halal standards, criteria for US chicken parts, testing for bovine spongiform encephalopathy, and similar questions.
- ***Intellectual property rights (IPRs).*** Indonesia should work closely with the United States to enforce its own IPR laws and to resolve the sensi-

1. The phrase "stepping stones" implies that both parties acknowledge areas of difficulty, yet are committed to sequential actions to achieve realistic objectives. By contrast, the phrase "building blocks," first introduced to the trade lexicon by Ambassador Robert B. Zoellick, implied a US strategy to use bilateral FTAs to achieve freer global trade through the force of competitive liberalization. See Robert B. Zoellick, "Unleashing the Trade Winds: A Building-Block Approach," at usinfo.state.gov (accessed on December 18, 2006).

tive issues surrounding pharmaceutical and educational materials. Indonesia will need to cut the supply chains that feed counterfeit products to the market. Compulsory licensing and parallel imports should be confined to specific products and the list of eligible items should become progressively shorter over time. The United States should extend technical assistance to improve Indonesia's patent and copyright offices.

- ***Bilateral investment treaty.*** The United States will view Indonesia's willingness to sign a bilateral investment treaty (BIT) as a litmus test for the nation's ability to negotiate an FTA. A BIT will commit Indonesia to ensure minimal business conditions at both the central and provincial levels, requiring a political agreement between central ministries and provincial governors. Cooperation toward a BIT might commence by resolving high-profile disputes between Indonesia and US business firms.

For both parties, a US-Indonesia FTA is worth pursuing for political as well as economic reasons. If a full-blown FTA is not possible in the near future, a sequential approach could still pay off in creating opportunities for American businesses. Even incremental gains in freer trade in goods and services, coupled with a larger inflow of direct investment, can boost Indonesian economic growth and lift millions out of poverty. But the benefits of a full FTA would be greater still, anchoring labor, environmental, and anticorruption policy reforms in Indonesia and fostering closer relations between the United States and a country that is a moderate voice in the Islamic world.