

# Strategic Analysis Paper

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## The Lacklustre Australia-Indonesia Economic Relationship

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### Key Points

- Bilateral trade has fallen due to reduced Indonesian commodities exports to Australia.
- Manufacturing and tourism are likely become major future drivers of Indonesian exports. Motor vehicle and precious metal scrap exports also hold potential.
- The Indonesian services trade is dominated by the tourism sector, which is also the leading contributor to the Indonesian economy in the context of trade with Australia.
- Australian investment in Indonesia remains low due to the generally poor business environment there.
- The IA-CEPA trade agreement will, upon implementation, play an important role in boosting bilateral trade and investment.

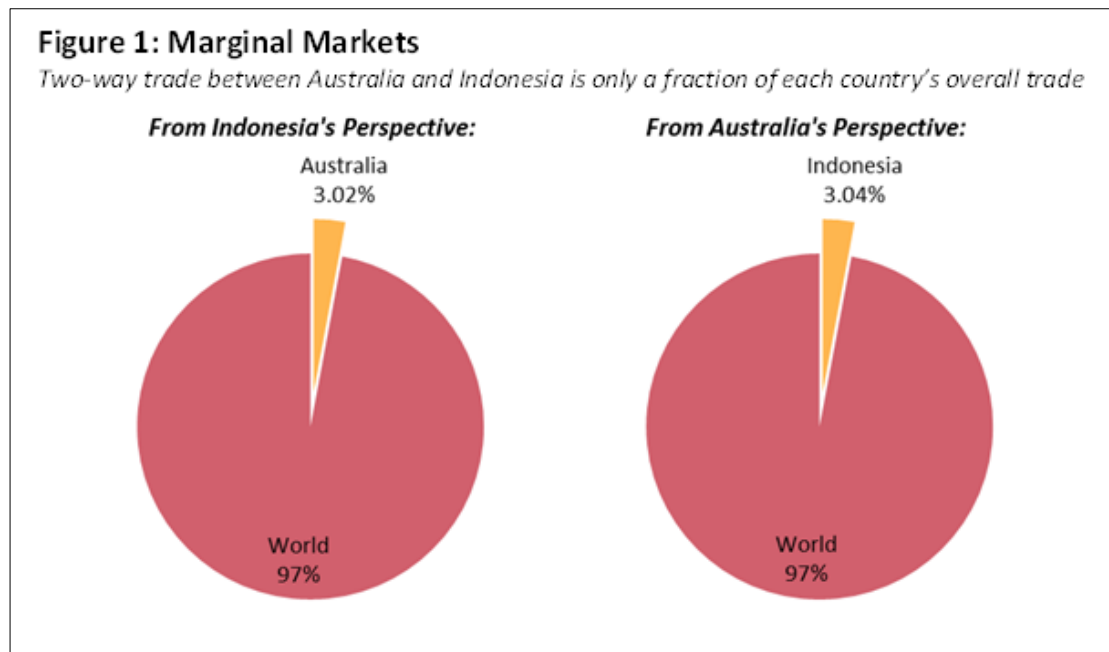
### Summary

Indonesia is one of Australia's most important bilateral partners. Its geographical position in South-East Asia, its large land mass, as well as its close proximity to Australia should put the country towards the top of the priority list in developing close bilateral ties not only in a strategic sense, but also in an economic sense. Indonesia is currently the eighth-largest economy in the world in terms of gross domestic product based on purchasing power parity

(PPP) and is expected to become the fourth-largest by 2050.<sup>1</sup> With significant growth expected as the size of its middle class continues to expand, Indonesia provides an opportunity for Australian businesses to tap into a large and increasingly affluent market. So far, however, Australia’s economic relationship with Indonesia has failed to reflect the full geostrategic importance of the wider relationship.

## Analysis

### *Bilateral Trade*



As seen in Figure 1, Indonesia makes up a fraction of Australia’s goods market in terms of combined exports and imports. On the other hand, Australia is a somewhat significant player in Indonesia’s goods market, although by no means one of its top trading partners. According to 2016 figures, Indonesia’s largest trading partners include China (which accounts for 13% of Indonesia’s trade), Japan (13%) and Singapore (11%). For Australia (according to 2017 figures), the three top trading partners are China (27%), Japan (11%) and United States (7%). While the overall bilateral trade figures may be less than impressive, it does not mean that trade with Australia is insignificant from the Indonesian perspective. As of 2016 (the most recent figures available), Australia remained the largest provider of coal, wheat and live cattle to Indonesia.

<sup>1</sup> PwC, ‘The Long View: How Will the Global Economic Order Change by 2050?’, February 2017, p. 7.

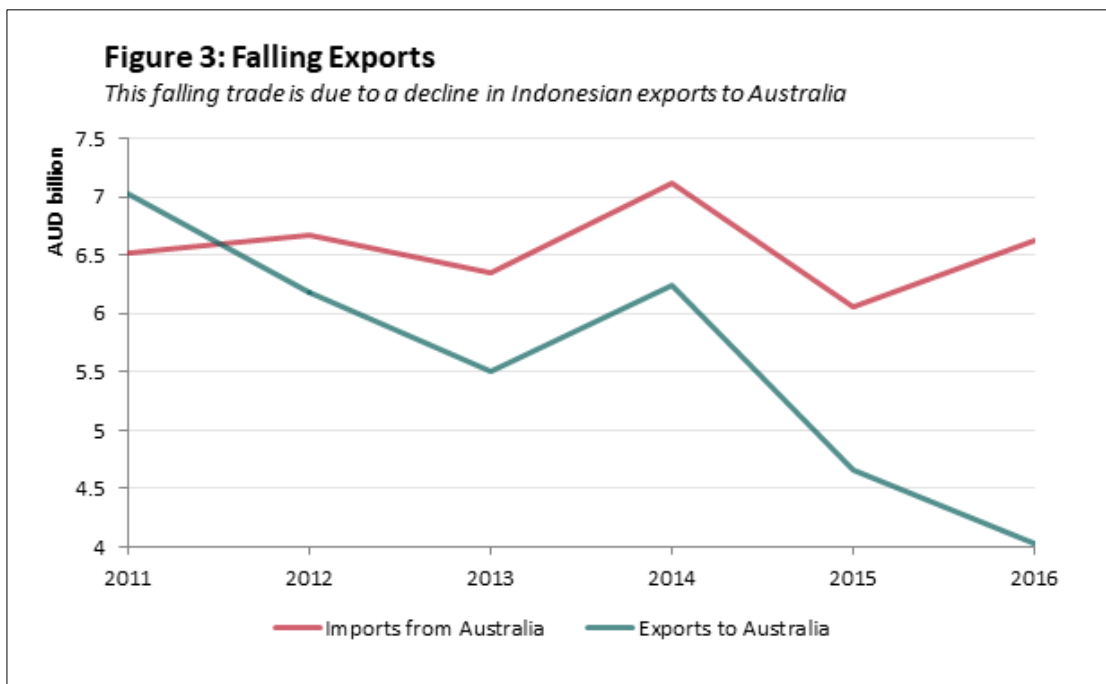
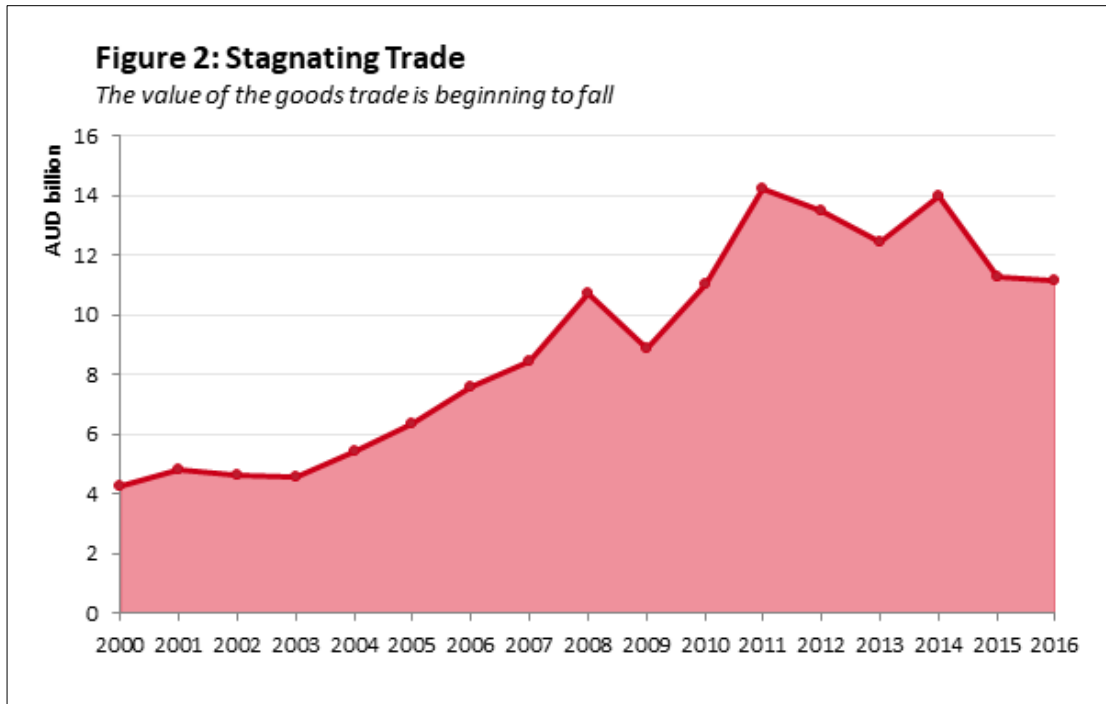
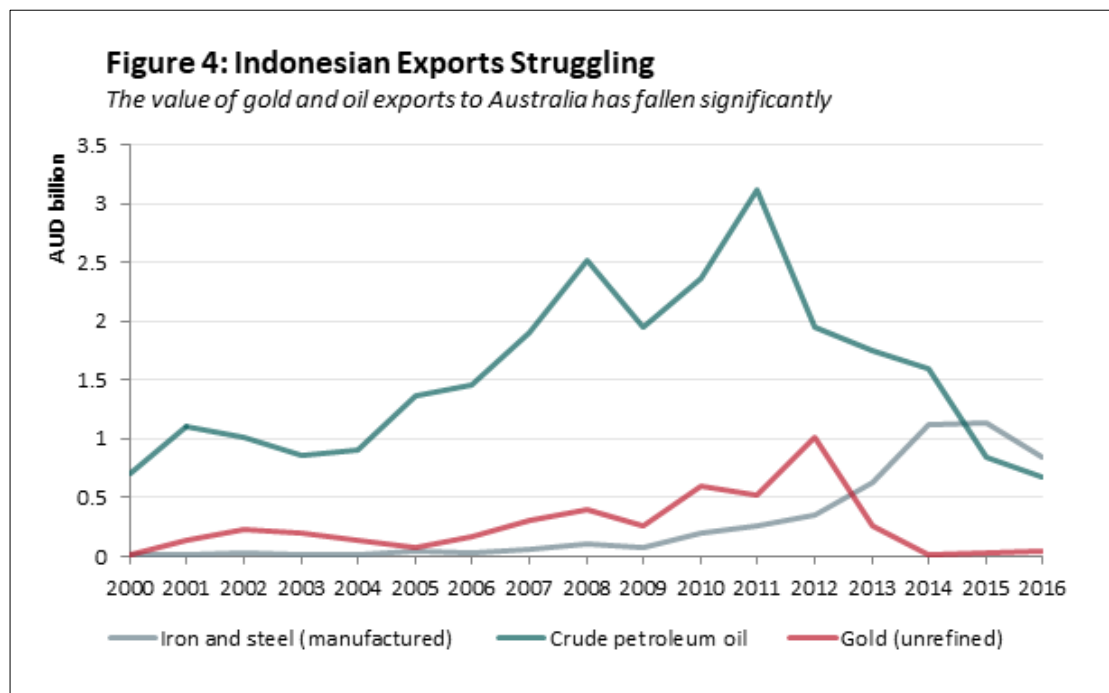


Figure 2 also shows that the overall value of the bilateral goods trade is beginning to shrink. Since 2011, trade values have fallen by 23 per cent (\$3 billion). Taking a closer look at Indonesia’s trading relationship with Australia (Figure 3), it appears that the drop in trade coincides with a dramatic shift in the nature of the trading relationship itself since 2011. Between 2000 and 2011, the relationship was such that, due to the value of imports closely matching the value of exports, it never resulted in a trade deficit of more than \$500 million

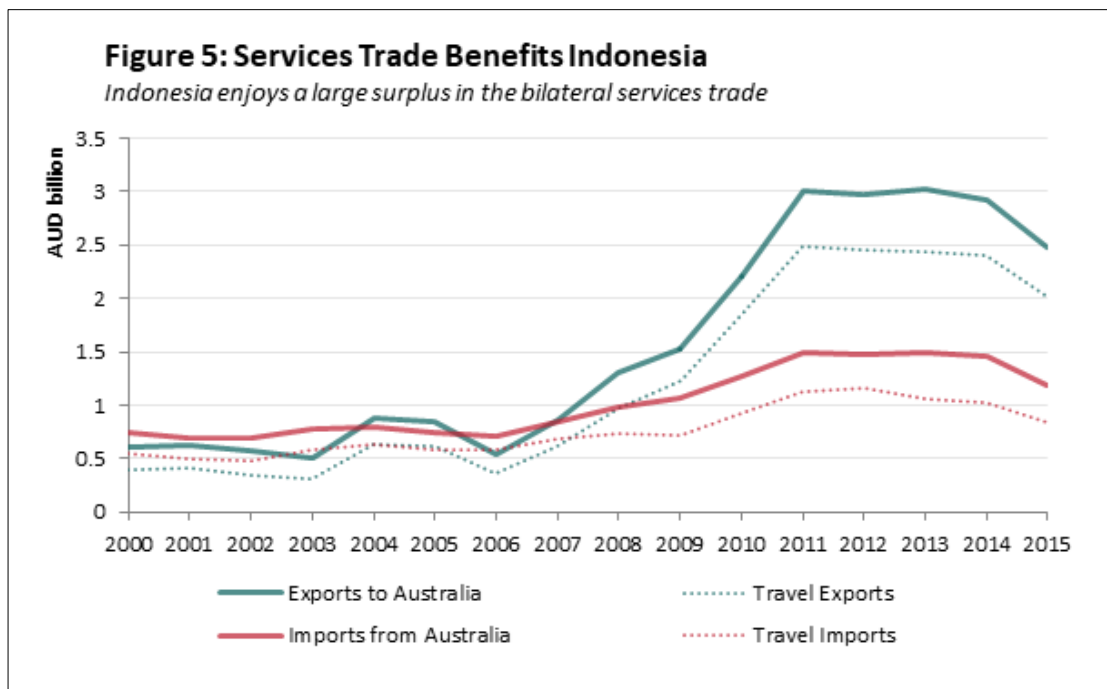
for either country. Since then, Indonesian exports to Australia have fallen in value, resulting in a trade deficit for Indonesia of \$2.6 billion in 2016, the largest shortfall in the trading relationship to date.

Two major commodities behind the fall in exports are crude petroleum and unrefined gold. In the case of oil, falling global prices are mostly responsible for the drop in export values, although the net weight of oil exports did fall significantly after a spike in 2011 and has since plateaued. The drop in gold exports on the other hand, has more to do with falling Australian demand. The net weight of Australian gold imports from around the world has dropped by 57 per cent since 2008.



As seen in Figure 4, those falls have been somewhat mitigated by exports of manufactured iron and steel products which have grown significantly since 2009. This is partly due to the [efforts of President Joko Widodo](#) to spur economic growth through the manufacturing industry as commodity prices fall. Indonesia’s fast-growing consumer class, its youthful age demographic and low minimum wages make the country a suitable location for manufacturing, which remains the [highest-performing sector](#) of the Indonesian economy. There is potential for Australian companies to become involved in this sector such as, for instance, Kmart Australia, which announced in June 2017 that it had moved its manufacturing operations from China to Java. Other exports to have seen recent growth are copper products, paper and wood.

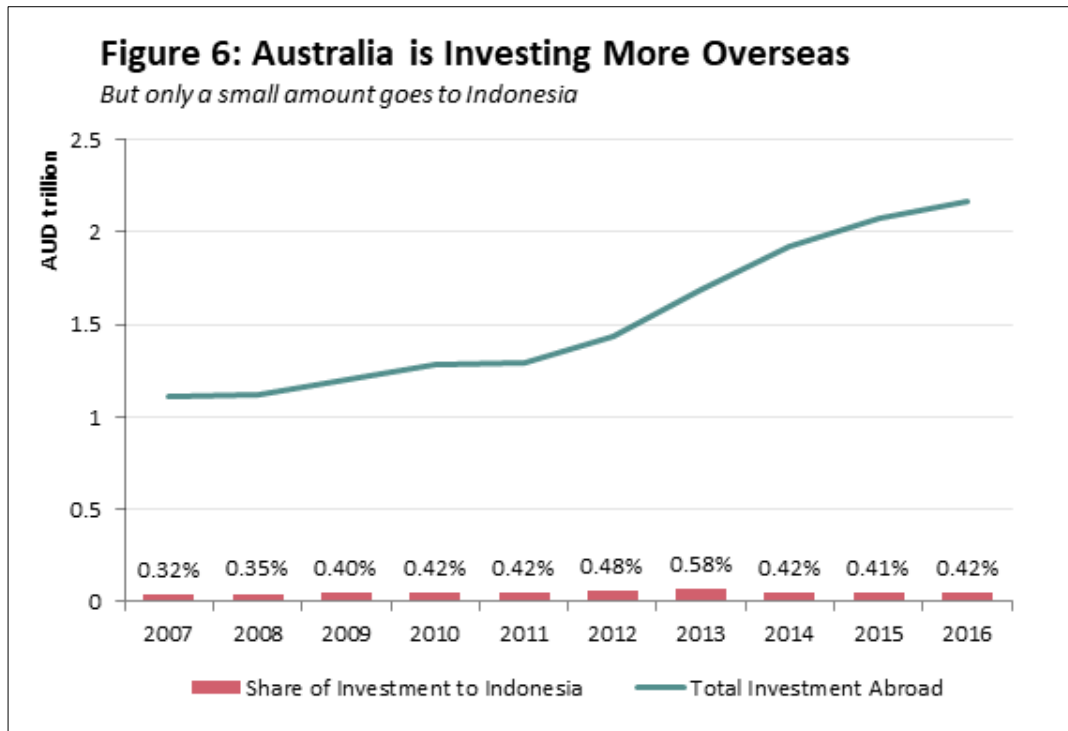
There could also be opportunity for Indonesia to expand its exports of precious metal scrap and motor vehicles to Australia. Indonesia is already a major world exporter of those products, while Australia is a major importer. Indonesian exports of those products to Australia, however, are almost non-existent.



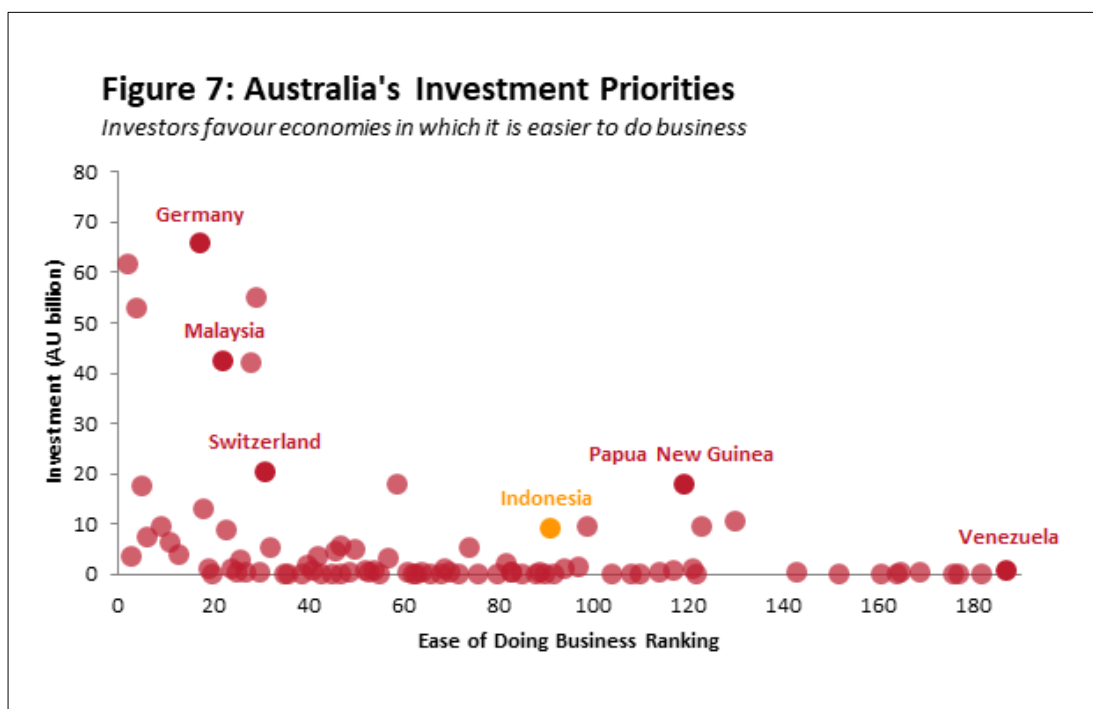
Fortunately, though, it is not all bad news. Unlike the trade in goods, the services trade has seen large surpluses for Indonesia due to significant growth in services exports since 2006, as shown in Figure 5. The primary factor behind that increase is the growth of travel services, particularly [personal travel services](#), which make up the majority of both service imports and exports. Travel exports to Australia are a vital part of Australia’s trading relationship with Indonesia and are the single largest source of income for Indonesia in that relationship, accounting for 28 per cent of all exports, including goods and services. Adding the surplus from the services trade to the deficit from the goods trade helped to reduce the overall Indonesian trade deficit from \$1.4 billion to \$101 million in 2015.

Looking more closely at travel services, the [World Trade Organisation](#) provides the following definition: ‘travel-related services includes services provided by hotels and restaurants (including catering), travel agencies and tour operator services, tourist guide services and other related services.’ This means that the expenditure of Australian tourists visiting Indonesia counts as “exports” of travel services to Australia. Thus, even though a person may be part of the Australian demographic, because the product or service purchased was produced or sold within Indonesia, that product or service has effectively been “exported” to Australia. Tourism (termed as travel exports) is one of the largest sources of revenue for Indonesia in its trading relationship with Australia, generating \$2 billion of revenue for Indonesia in 2015.

**Australian Investment in Indonesia**



Looking at the investment statistics in Figure 6, it can be seen that, while overall levels of outward investment from Australia have shown steady growth, Indonesia still only receives a small share of Australian overseas investment. Of the \$2.2 trillion invested overseas by Australia in 2016, Indonesia received only \$9.2 billion, significantly less than Singapore which received \$61.5, the largest destination for Australian investment in South-East Asia. Indonesian investment in Australia is also small. In 2016, Indonesia invested \$1.2 billion in Australia, accounting for just 0.03% of all foreign investment coming into Australia. A major factor behind the low levels of Australian investment in Indonesia is its poor business environment.



According to the rankings used by the [World Bank](#), Indonesia is placed ninety-first of 190 economies in the “Ease of Doing Business Ranking” (EDBR). It is very likely that that poor ranking is reflected in the low levels of Australian investment in Indonesia. As seen in Figure 7 (which excludes some economies for readability), there is some correlation between Australian investment in a particular economy and its EDBR, which is significantly greater for those economies ranked between 1 and 32. The areas in which Indonesia performs most poorly include the enforcement of contracts, starting a business, registering a property and dealing with construction permits. Fortunately, Indonesia is making some [progress](#) on implementing business reforms. As noted in a previous [Strategic Analysis Paper](#), since 2016, the Indonesian authorities have made it easier to start a small business by cutting red tape and reducing the time taken to register a business, introducing an online system for filing tax returns and the payment of health insurance contributions, and improving access to electricity. Despite those reforms, however, investment remains low. The Australian Department of Foreign Affairs and Trade (DFAT), in response to an [inquiry](#) into the growth potential of Australia’s trade and investment relationship with Indonesia, notes the following reasons for a lack of investment: limitations on foreign investment, including restricted sectors and investment caps; limitations on expatriate work visas; permits and costs associated with visiting directors, consultants, auditors and lecturers; and shortages of skilled local staff and low levels of labour productivity.<sup>2</sup>

The impediments to foreign investment need to be addressed, given the urgent need for investment to support numerous, much-needed infrastructure projects. According to a [report](#) by the Asian Development Bank, Indonesia needs approximately \$1.6 trillion in investment if it is to meet its investment needs by 2030. Currently, investment in Indonesian infrastructure is only thirty per cent of what is actually needed, resulting in a significant infrastructure gap. Australia has an opportunity to play a key role in helping to close that infrastructure gap. The Australian Government will [contribute](#) \$28.3 million in official development assistance towards infrastructure and trade in Indonesia in this year’s budget. While it may not a significant contribution in its own right, equating to only 0.0018% of the infrastructure gap, it is worthwhile to note as a positive gesture in the relationship. The Australian Department of Foreign Affairs will also be contributing approximately \$300 million towards the [Indonesia Australia Infrastructure Partnership](#) over the next ten years which aims to improve the effectiveness of infrastructure spending from the Indonesian Government.

### **Looking Ahead**

The Indonesian and Australian Governments are still completing negotiations for the Indonesia-Australia Comprehensive Economic Partnership Agreement (IA-CEPA). During the [July 2017 meeting](#) between Prime Minister Turnbull and President Widodo, the two leaders confirmed the goal to conclude negotiations by the end of 2017 so the IA-CEPA could be launched this year. Despite a series of last minute meetings, however, both sides have yet to

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<sup>2</sup> Joint Standing Committee on Trade and Investment Growth, ‘Inquiry into the growth potential in Australia’s trade and investment relationship with Indonesia: Submission 27’, Submission by the Department of Foreign Affairs and Trade, Australian Trade and Investment Commission, Export Finance and Insurance Corporation and Tourism Australia, 31 March 2017, p. 15.

come to an agreement and negotiations have been scheduled to conclude in March. According to DFAT, IA-CEPA [aims to address](#) impediments to bilateral trade, including both tariff and non-tariff barriers, to improve access to each other's services markets. IA-CEPA is also intended to fix the impediments to greater Australian investment in Indonesia and vice-versa. Once IA-CEPA is concluded and implemented, there should be [little reason](#) for the bilateral trade relationship not to achieve the same the closeness and depth as the security relationship. Senior economist Dr Kiki Verico notes that increased trade is possible if 'Australia increases its FDI inflows in Indonesia's production sector and then imports Indonesian-made products back to Australia.'<sup>3</sup> That will hopefully reverse the trade slowdown experienced since 2011 and help to address the large deficit in the goods trade.

As noted above, the Indonesian perspective, tourism is perhaps the most valuable aspect of the bilateral trade relationship from. When earnings from the services trade, which is primarily driven by tourism, are added to those from the goods trade, Indonesia's trade deficit falls from \$1.4 billion to \$101 million (using 2015 statistics, the most recent available). With the exception of Australian foreign direct investment, tourism is now Indonesia's largest source of revenue in the economic relationship with Australia. That is likely to continue to be the case for the medium- to long-term future, as there are already programmes in place to further expand this important sector. As has been discussed in the [Strategic Weekly Analysis](#), the Indonesian Government plans to double the number of inbound international tourists to approximately 20 million by 2019 and to increase the tourism industry's contribution to GDP to eight per cent. This will primarily be done through the development of ten new tourist hubs across the Indonesian archipelago that have been dubbed the "ten new Balis". Labuan Bajo, located to the east of Bali on the island of Flores, will be marketed to Australian tourists as part of that programme. While tourism will continue to grow naturally, significant investment will be needed to fund the infrastructure required to expand the tourism sector if it is to successfully accommodate those extra tourists.

Continuing to identify and implement reforms and a successful conclusion of the IA-CEPA will be key factors in encouraging further Australian investment. President Widodo is [aiming](#) to elevate the Indonesian economy to fortieth place on the World Bank's EDBR in 2018, which, if realised, will, in a very short space of time, place Indonesia just behind the economies that are most favoured by Australian investors. Even if that does occur, it may still take a significant period of time before more Australian businesses and individuals are confident about investing in Indonesia. That is unfortunate for Indonesia because of the urgent need to attract investment in the infrastructure and tourism sectors so as to facilitate further economic growth. It seems unlikely, therefore, that, in the short-term at least, Australia's investment relationship with Indonesia will play a key role in facilitating that economic growth.

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<sup>3</sup> 'Two Neighbours, Partners In Prosperity: Submission towards the IA-CEPA', Indonesia-Australia Business Partnership Group, August 2016, p. 76.

## **Conclusion**

Australia's economic relationship with Indonesia can currently be described as lacklustre, although it is slowly moving in the right direction. As the Indonesian Government focusses on diversifying the economy and moving it away from its dependence on commodity exports, the manufacturing sector will continue to grow. Not only will that be beneficial to the trade relationship generally, it will also provide opportunities for intrepid Australian businesses and investors. A major impediment, however, is a lack of confidence. Indonesian reforms will address this to some extent, but it will take some time until they start to have an effect and awareness of them grows. Hopefully, the IA-CEPA will remedy that to some extent and boost the economic relationship. It is imperative that Australia focusses on strengthening the economic relationship with Indonesia. If the predictions prove to be correct, Indonesia will be the fourth-largest economy in the world by 2050 in terms of GDP by purchasing power parity.<sup>4</sup> In the future, having a weak, underdeveloped economic relationship with one of the world's largest economies, right on its northern doorstep, will represent a significant missed opportunity for Australia.

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*Any opinions or views expressed in this paper are those of the individual author, unless stated to be those of Future Directions International.*

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<sup>4</sup> PwC, 'The Long View', p. 7.