

Trade Policy Review Body

TRADE POLICY REVIEW

INDONESIA

Report by the Secretariat

This report, prepared for the fourth Trade Policy Review of Indonesia, has been drawn up by the WTO Secretariat on its own responsibility. The Secretariat has, as required by the Agreement establishing the Trade Policy Review Mechanism (Annex 3 of the Marrakesh Agreement Establishing the World Trade Organization), sought clarification from the Government of Indonesia on its trade policies and practices. Parts of Chapters II, III and IV are without detailed comment from the authorities.

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SUMMARY OBSERVATIONS

1. Since its last Trade Policy Review in 1998, Indonesia has undergone considerable economic, political, and social change in the aftermath of the severe 1997 financial and economic crisis. It has implemented major trade, structural, and macro policy reforms. These reforms, not yet complete and relatively painful for poorer households, have successfully stabilized the economy and fostered economic growth. Major democratic reforms together with rapid moves to decentralize government and enhance regional autonomy have also had an important impact on the economy.

2. Despite noticeable improvements, the economy remains fragile, burdened by a large public debt overhang, fiscal pressures, and as yet somewhat weak economic governance, institutions and rule of law. Recent external and internal developments, such as the global economic downturn and the Bali incident in October 2002, have also hit the economy hard, depressing key export markets, subduing tourism, and heavily reducing foreign investment on which the economy critically depends. Confronted by these economic challenges, the Government has renewed its efforts to accelerate structural and macro reforms.

(1) ECONOMIC ENVIRONMENT

3. Indonesia's economic recovery has slowed since 2000 when real GDP growth was 4.9%; however, after falling to 3.4% in 2001 it rose to 3.7% in 2002. Growth has been driven mainly by consumption, financed by credit and rising minimum wages. The somewhat subdued growth since 2000 reflects adverse macroeconomic developments, unresolved structural economic problems, and high domestic risk, which hampered production and investment. Macroeconomic conditions seem to have stabilized, underpinned by fiscal consolidation. Budget deficits widened from 1.6% to 2.7% in 2001, but fell to 1.7% in 2002. Inflation peaked at

almost 12% in 2002, and the rupiah has stabilized and even strengthened. Monetary policy is centred on a mixture of monetary and inflation targets adopted since 1999. Substantial international reserves, providing almost 11-months import cover in 2002, reflect sizeable current account surpluses, which have generally offset large capital account deficits. Investment, especially foreign, has fared badly.

4. Growth, and hence continued efforts to alleviate poverty, will require further trade and other structural reforms, including strengthened governance and institutions. Also, wage rises need to reflect productivity improvements to help keep exports of traditional labour-intensive industries competitive and to curb rising unemployment. The Government plans to develop a national poverty reduction strategy by 2004, focused on pro-growth and development policies, including trade liberalization.

5. Trade as a share of GDP fell from 35.1% in 2000 to 27% in 2002; however, foreign trade patterns have hardly changed. Indonesia is heavily dependent on manufactured/petroleum exports and manufactured imports. Most merchandise trade is with East Asian countries, especially Japan and the Republic of Korea. Singapore remains by far Indonesia's main ASEAN trading partner.

6. A new National Investment Team is to help restore a climate conducive to investment; this is urgently needed if Indonesia is to attract foreign capital and thus resume robust growth. Although relatively open, investment procedures are being streamlined, including the operation of the Investment Coordinating Board, and legal provisions made more transparent. A new investment law based on national treatment is to replace the 1967 legislation in 2003. However, uncertainty over the devolution of authority to approve non-oil investment and impose regional taxes under decentralization

plans has seemingly reduced investor confidence.

(2) TRADE POLICY FRAMEWORK

7. Indonesia has implemented trade and other structural reforms mainly unilaterally, as key components of its structural reform programme, but also in line with multilateral commitments. Unilateral reforms substantially exceed WTO obligations in some key areas, such as financial services. However, there have been signs recently of policy changes affecting a few sensitive areas (such as rice, sugar, and steel), which may reflect a more protectionist stance.

8. Despite major political and administrative changes, including decentralization, trade policy formulation is still the responsibility of the Ministry of Trade and Industry and has changed little since the previous Review. Greater transparency and public scrutiny of trade policies is needed, especially in sensitive sectors, where trade policy seems to be set on a more ad hoc basis.

9. The much-awaited legislation establishing the Anti-Corruption Commission was passed in November, and significant state divestment occurred in banking and telecommunications. Further amendments to bankruptcy provisions are envisaged in 2003. In this context it might well be necessary to reinforce many key structural reforms aimed at strengthening the rule of law need to be reinforced, including trade and business legislation, improving the commercial environment, corporate and economic governance, and building enforcement institutions, such as commercial courts. The limited revisions to the bankruptcy legislation in 1998 and the establishment of the Commercial Court failed, for example, to restore confidence in the legal system and provide necessary security for creditors. Divestment of state entities, another reform priority, has also lagged. However, some reforms seem to have accelerated since late 2002.

10. Indonesia's regional trade liberalization is limited to the ASEAN Free Trade Area (AFTA). Indonesia (together with the other five original ASEAN members) has agreed to accelerate the phase-in of a maximum 5% Common Effective Preferential Tariff (CEPT) by end 2003; at end 2002, 99% of Indonesian tariff lines were covered, with an average tariff of 4%. Indonesia no longer excludes sensitive or other products from the CEPT.

11. While committed to the multilateral trading system, Indonesia wishes to accelerate regional integration. It is actively pursuing preferential trading arrangements, through ASEAN, which has agreed to establish an ASEAN-China Free Trade Area within ten years, and to examine the formation of an East Asian Free Trade Area (ASEAN+3, with China, Japan, and Korea). As an APEC member, Indonesia also remains committed to the voluntary Bogor Goals of achieving comprehensive, non-discriminatory open trade and investment by 2020. It also wishes to establish comprehensive bilateral trading arrangements with major trading partners, such as Canada, Chile, Japan, and the United States.

(3) TRADE POLICY DEVELOPMENTS

12. The tariff is increasingly becoming Indonesia's main trade policy instrument. The average applied MFN tariff has declined from 9.5% in 1998 to 7.2% in 2002, reflecting mainly unilateral reductions. Some 93% of rates are bound, but there remains a large gap between bound and applied rates (30.4 percentage points, on average) imparting a degree of unpredictability to the tariff. Agricultural tariff averages (8.4%) slightly exceed industrial levels (7.2%). While most MFN tariffs (83%) are 10% or below, relatively high rates (of up to 170%) apply mainly to certain drinks and transport equipment. Current applied tariffs exceed final bound rates on 41 items, mainly alcoholic beverages. Tariff dispersion has fallen overall, but escalation exists for final

products, especially for food, beverages, and tobacco, and wood and furniture.

13. Almost all applied rates are *ad valorem*, thereby making the tariff more transparent (and possibly less distorting). However, the Government has on occasion, as in the cases of rice and sugar, replaced *ad valorem* with specific duties, possibly concealing higher tariff protection. Specific duties on sugar were seemingly raised in late 2002. Although few, such rises constitute special treatment for sensitive sectors. There are no tariff quotas.

14. Custom clearance procedures and computerized documentation requirements have facilitated imports and exports. Registration of importers has remained a major requirement. Indonesia implemented the WTO Customs Valuation Agreement as of 2000; it uses the transaction value and does not apply minimum or check prices.

15. The scope of import restrictions and licensing appears to have increased through new special import licences from 2002. These affect sensitive products, such as rice, sugar, footwear, and textiles, and are granted on the basis of domestic need. Non-automatic licences also enforce import controls, including embargoes, mainly on health, quarantine, environmental, and security grounds. Product coverage of import restrictions is unclear, and the licensing regime remains opaque. The restrictiveness of non-automatic import licensing is accompanied by exclusive import rights accorded to domestic producers of certain sensitive products, such as rice, cloves, alcoholic beverages, sugar, and some types of iron and steel.

16. Non-discriminatory standards are generally based on or have been aligned with international norms. Mandatory standards (technical regulations) were extended to fertilizers and raw sugar. Almost all other standards are voluntary. Indonesia participates in international standardization

bodies. It has increased its involvement in mutual recognition agreements. New food labelling requirements were passed in 1999, and for imports of GM products in 2001.

17. Indonesia has been an active user of anti-dumping actions, although the trend appears to be downward. Of 27 cases initiated since 1998 (until June 2002), 15 resulted in provisional measures and nine in definitive anti-dumping duties; seven remained in operation in February 2003. Actions have mainly affected base metals and chemicals imported from regional suppliers. Safeguards legislation enacted in late 2002, largely in response to domestic manufacturers' concerns, allows higher import duties for between 6 and 48 months. Institutional arrangements, such as the body responsible for investigation, are still being implemented.

18. Government procurement is a significant instrument of industrial policy. New legislation in 2000 revised discriminatory procurement practices aimed at encouraging greater domestic content in order to assist local industry and expand employment. Foreign procurement is possible only if there are no domestic products available, or they do not meet technical requirements, and then only for contracts above certain thresholds (e.g. Rp 10 billion for goods) and in cooperation with small or medium-sized enterprises. Domestic price preferences on goods have doubled to 15% (remaining at 7.5% on services). Indonesia participates actively in the WTO Working Group on Transparency in Government Procurement.

19. Countertrade provisions also apply to public procurement; foreign firms tendering for certain government contracts, including construction, must meet export performance requirements. While such countertrade has declined owing to the large slowdown in public tendering since the crisis, it is likely to rise as government procurement increases. There are no local-content provisions (outside government procurement). All local-content schemes notified as TRIMs were eliminated

ahead of schedule in January 2000, and extensive tariff and tax incentives for automotive local content have been abolished.

20. Only registered and approved exporters can sell restricted exports. Export controls include bans, quotas, licensing, and "supervision". These are applied widely to promote higher-value-added activities, to upgrade export quality, and to ensure adequate domestic supplies of essential products at reasonable prices, as well as in accordance with international commitments, such as CITES (to protect endangered species) and the arrangements to restrict textiles and clothing. Export bans on round logs and wood chips were re-applied in 2001, (ostensibly for environmental reasons), as well as on urea (to combat fertilizer shortages) in 2000 and on mineral sands in 2002. Export controls, (notably their coverage and economic effects) remain non-transparent. Export inspection was shifted from a private contractor to Customs in August 2001.

21. Indonesia continues to maintain a "voluntary" bilateral quota on manioc exports to the European Union. It also regulates certain commodity exports under various plurilateral export and supply management arrangements aimed at reducing world over-supply and the resulting depressed prices. Such voluntary export quotas applied to coffee until 2002, when the arrangements terminated, and to rubber until mid 2002, when the international rubber price rose above the "confidential" reference price set under the Tripartite Rubber Cooperation (TRC), which was signed with Malaysia and Thailand in December 2001. Trade with Israel remains banned.

22. *Ad valorem* export taxes to promote downstream processing and higher valued products have been rationalized. Coverage was reduced from 12 to four commodity groups (rattan, wood, mineral sands, and palm oil) and rates previously ranging from 10% to 40% reduced to 1%, 3%, and 15%. Taxes are levied on minimum "check" prices to simplify

tax collection and to combat avoidance through under-invoicing. While reviewed regularly, such prices do not always correspond to world levels, thereby adding further administrative discretion and uncertainty over the level, and thus incidence, of such taxes.

23. Direct export assistance is minimal. Export subsidies were not used during the review period. Duty exemption/drawback schemes and free-trade export and bonded zones facilitate exports, albeit using few financial incentives. Bonded zone operators must seemingly export at least two thirds of output, excluding components; domestic sales cannot exceed 50% of the value of exports (special, higher, limits apply to automotive producers). Full foreign equity is allowed for five years (maximum 95% equity thereafter) in bonded zones, if all output is exported. A state-owned bank (BEI) took over central bank operations providing commercial trade (export and import) finance and guarantees in September 1999. The state-owned Export Insurance Indonesia (ASEI) provides non-oil export insurance, including for small and medium enterprises, and became a general insurer in 2002.

24. Indirect taxes, such as VAT, sales, and luxury taxes have, in principle, been non-discriminatory since 2000. The luxury tax exemption for domestic cars was eliminated after a WTO dispute in 1998. However, some discriminatory elements seem to remain, such as lower sales taxes on Indonesian-made kretek cigarettes. It is also unclear whether regional levies, "retributions", and taxes are non-discriminatory; this uncertainty has been heightened under the decentralized provincial tax powers. Luxury taxes were lowered in early 2003, partly to help domestic producers compete with smuggled imports.

25. Producers are assisted financially mainly by industry and/or region-specific tax incentives; these were seemingly revised in new legislation effective from 2001. Trade and production distorting agricultural market

support includes rice payments through BULOG. A fertilizer subsidy for small-scale rice producers was re-introduced in 2003; however, its apparent payment on only domestically made fertilizers seems inconsistent with the intention of assisting consumption rather than production. A petroleum fuels subsidy, although being curtailed, favours industrial and public sector users, and world market prices apply to only a few activities, such as foreign flagged vessels. Public R&D support promotes high technology activities. Subsidized credit schemes for SMEs and farmers no longer apply.

26. In order to protect consumers, price controls have been retained on sensitive items, such as rice, petrol, LPG, salt, and cement, as well as on key public utilities and services like electricity, basic telecommunications, and transport.

27. An independent Commission for the Supervision of Business Competition (KPPU) was formed in June 2000 to implement Indonesia's 1999 anti-monopoly legislation. Most KPPU cases have concerned tender collusion involving state-owned enterprises or government agencies. It can initiate its own inquiries. KPPU may also provide "non public" opinions to government on the competitive effects of specific anti-dumping actions, and has done so in two cases (wheat flour and carbon black). Export cartels are excluded from the legislation.

28. Indonesia has sought to strengthen protection of intellectual property rights (IPRs) by expanding its international commitments. It joined WIPO's Copyright Treaty in March 2002, and now participates in seven of its 21 treaties. Indonesia is considering ratifying other treaties, such as the Performance and Phonograms Treaty. Although it missed the 2000 TRIPS implementation deadline, Indonesia introduced legislation on industrial designs, layout-designs of integrated circuits, protection of plant varieties, and trade secrets

in late 2000, and had amended patent, trade mark, and copyrights laws by July 2001. However, institutional constraints continue to impede effective implementation and enforcement. Concerns exist over increased piracy and the effectiveness of the judicial system.

(4) **SECTORAL POLICY DEVELOPMENTS**

29. Despite on-going trade reforms, certain sensitive sectors continue to receive special government assistance. In agriculture, such policies largely reflect concern over food security, and the belief that this concern can be best met by achieving self-sufficiency in staple commodities, especially rice. Market price support for rice (albeit below WTO *de minimis* levels of 10% of output) allows floor producer prices to be set up to 30% above production costs; thus, domestic prices of rice were some 20% to 30% above world levels during the review period. Consumer subsidies, at substantial albeit declining budgetary cost, help offset these cost increases.

30. While BULOG's rice import monopoly was eliminated in 1999, it continues to intervene in the market to stabilize domestic prices. The future of operations as a semi-profit organization appears uncertain.

31. Past regulatory controls, including export restrictions, would seem to have had little success in addressing over-exploitation of forests. Export restrictions, such as the re-imposed ban on round logs, generally do little to stem over-exploitation, and instead tend to boost processed timber products, such as plywood, by possibly depressing domestic log prices, which may also encourage wasteful logging, processing and conservation practices. Promoting sustainable forest management is difficult; logging concessions greatly exceed sustainable yields and illegal logging is widespread.

32. In forestry, the authorities are addressing weak law enforcement,

institutional and policy failures, including poor monitoring. New forestry policies are aimed mainly at combating illegal logging, restructuring forest-based industries, and developing reforestation activities. Indonesia has introduced selective cutting and planting systems for loggers, and in July 2002 issued regulations to ensure that only legal operators logging within sustainable limits could operate; logging quotas were reduced sharply. From 2002, loggers must pay in advance levies to the Reforestation Fund, a move designed to minimize non-payment and misuse of such funds.

33. *The state-owned entity, Pertamina, licenses all trade in petroleum products, and requires that foreign firms enter into production-sharing contracts to explore and exploit oil and gas reserves. The petroleum market is to be deregulated. Legislation passed in October 2001 will end Pertamina's monopoly on oil and natural gas development within two years (by 2003) and on the distribution (including trade) of such products by 2005. A new oil and gas authority (BALAK) was formed in 2002 to take over certain aspects of Pertamina's management, such as granting oil and gas concessions. New taxes on mining and environmental regulations have also been introduced, not always with clear application.*

34. *While private firms now dominate power generation, transmission and distribution remain the monopoly of the state-owned electricity company (PLN). Reforms, while considerable, fell short of the planned establishment of a fully competitive multiple buyer/seller power market by 2003. Instead, according to new legislation passed in September 2002, the electricity market is now to be fully deregulated by 2007. Electricity charges are also being increased to reflect costs.*

35. *Since 1998, tariff protection for the manufacturing sector has been reduced from an average applied MFN rate of 9.5% (based on the ISIC) to 7.2%. Nonetheless, high tariffs*

ranging from 60% to 170% remain for certain sectors, such as chemicals, fabricated metal products, and transport equipment. Non-tariff restrictions, especially special licensing requirements, also apply to certain goods, (such as textiles and footwear), along with exclusive import rights to local producers of certain goods (including alcoholic beverages, textiles, and some iron and steel products). Some industries are accorded tax holidays and other incentives. Trade distorting measures, including prohibitions, countertrade agreements and tax exemptions for imports of components by state-owned enterprises, have been used in the aerospace industry.

36. *The automobile sector has undergone major policy changes since the industry's collapse in 1998. Import substitution policies gave way to an export-oriented Automotive Development Policy in June 1999. Accordingly, import restrictions on cars were abolished, and tax incentives for local content removed. Tariffs on motor vehicles, still high at 80%, were substantially lowered from 200%. Rates on CKD (completely-knocked-down) kits were also reduced, from 65% to 25-50% depending upon engine size, and on components to 15%. Increased luxury sales taxes, of up to 75%, depending upon engine size, target imports. Imports of certain used cars are banned.*

37. *Financial services reforms have been at the heart of Indonesia's recovery programme. These focused on bank rehabilitation including state re-capitalization. The Indonesian Bank Restructuring Agency (IBRA) is due to close in early 2004. Despite major success, the banking system remains weak and bank intermediation sub-optimal. Minimum capital adequacy ratios for some banks remain above the 8% limit (increased from 4%) and the share of non-performing loans above the target of 5%.*

38. *Bank Indonesia's statutory independence and prudential supervisory powers have been strengthened, with greater emphasis on compliance and enforcement. It*

is adopting the BIS's Basel core principles on effective supervision. A Financial Supervisory Authority is planned by mid-2005 to regulate all financial institutions, including banks; enabling legislation has slipped, however, and is now due in mid 2003. A selective deposit insurance scheme is to replace the blanket guarantee of bank liabilities by 2004.

39. Banks must be Indonesian-owned or joint ventures (with maximum 99% foreign equity). To operate, foreign bank branches must be among the 200 largest world banks, have at least an international "A" credit rating, and a minimum operating fund of Rp 3 trillion. Bank Indonesia applies an economic needs test in issuing bank licences. It must approve opening (and closing) of bank branches, including foreign representative offices. Restrictions on the number of foreign bank branches outside Jakarta no longer apply.

40. Regulation and supervision of insurance activities, currently conducted by the Ministry of Finance, have been strengthened. Foreign branches are not allowed; joint ventures are required (80% maximum foreign-ownership of equity). No restrictions apply to overseas reinsurance.

41. Partial liberalization of basic telecom services is to be accelerated under new legislation effective in September 2000. The national call monopoly is progressively being replaced by a statutory duopoly comprising two majority state-owned companies, the incumbent, Telekom and Indosat. Telekom's monopoly on local calls was terminated in 2002 (instead of by 2011) and will cease on long distance calls in 2003. The statutory duopoly in the international call market is also to be expanded to three carriers from 2003 (instead of 2005); Telekom will join the incumbents, Indosat and Satelindo (partly owned by Indosat). Foreign equity in all three carriers remains limited. In late 2002, the Government divested 42% equity in Indosat overseas.

42. While the new arrangements are an improvement, maintaining a fixed number of carriers may limit the resulting efficiency gains. The regulatory framework is also being enhanced to safeguard competition; monopoly practices and unfavourable competition are outlawed.

43. Cabotage restrictions apply to road transport, and foreign investment is prohibited in public transport (taxi and bus services). Rail and bus fares are subsidized. Foreign investment of up to 95% in joint ventures is allowed in public train services. Scheduled domestic air services are open to new carriers; foreign operators must form joint ventures, with maximum equity of 49%. Bilateral agreements govern international air services, and prohibit cabotage. Foreign investment in inter-island shipping services is prohibited, and cabotage restrictions apply. Provinces are increasingly regulating tourism. Foreign investment limits generally restrict equity to 49%, unless resorts are located in specified regions.

(5) PROSPECTS

44. Trade liberalization, other structural reforms, and enhanced stabilization policies have contributed to Indonesia's economic turnaround following the Asian crisis. It has increased its openness to trade through unilateral, as well as multilateral liberalization. However, robust economic growth is yet to be achieved, and further structural and other economic reforms are needed. While the Government appears to have recently renewed its resolve to undertake major reforms, Indonesia could take advantage of the multilateral system to further lock in and advance its unilateral reforms in several areas (e.g. deregulation and privatization).

45. This would also help boost investor confidence and, if matched by necessary institutional and economic governance reforms, would facilitate foreign investment, a key to Indonesia's future prospects.

Accelerated privatization and further reforms to state-owned enterprises together with deregulation and measures to improve competition could also help improve the economic environment.

46. *Indonesia generally applies its trade policies on a non-discriminatory basis. However, it appears to be pursuing greater regional efforts, individually and within ASEAN. The pursuit of "open regionalism"*

would help Indonesia and its WTO trading partners maximize benefits and avoid possible trade diversion arising from discriminatory trade agreements.

47. *Continued trade liberalization accompanied by economic reforms in other areas should help to provide the basis for the sustained growth of the Indonesian economy. Its trading partners can greatly assist Indonesia's efforts by ensuring stable and unrestricted access to their markets.*