UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT

POLICY ISSUES IN INTERNATIONAL TRADE AND COMMODITIES
STUDY SERIES No. 28

TRADE POLICY AT THE CROSSROADS – THE INDONESIAN STORY

by

David Vanzetti
Trade Analysis Branch
United Nations Conference on Trade and Development, Geneva

Greg McGuire
and
Prabowo
United Nations Support Facility for Indonesia Recovery, Jakarta

UNITED NATIONS
New York and Geneva, 2005

NOTE

The purpose of this series of studies is to analyse policy issues and to stimulate discussions in the area of international trade and development. This series includes studies by UNCTAD staff, as well as by distinguished researchers from academia. In keeping with the objective of the series, authors are encouraged to express their own views, which do not necessarily reflect the views of the United Nations.

The designations employed and the presentation of the material do not imply the expression of any opinion whatsoever on the part of the United Nations Secretariat concerning the legal status of any country, territory, city or area, or of its authorities, or concerning the delimitation of its frontiers or boundaries.

Material in this publication may be freely quoted or reprinted, but acknowledgement is requested, together with a reference to the document number. It would be appreciated if a copy of the publication containing the quotation or reprint were sent to the UNCTAD secretariat:

Chief
Trade Analysis Branch
Division on International Trade in Goods and Services, and Commodities
United Nations Conference on Trade and Development
Palais des Nations
CH-1211 Geneva

Series Editor:
Sam Laird
Officer-in-Charge, Trade Analysis Branch
DITC/UNCTAD

UNCTAD/ITCD/TAB/29

UNITED NATIONS PUBLICATION
Sales No. E.04.II.D.40
ISBN 92-1-112651-7
ISSN 1607-8291

PREFACE

Many countries are at the crossroads with their trade policy and unsure on which way to turn on major strategic trade policy issues. In this context, the purpose of this paper is to stimulate public policy debate on a future trade policy for developing countries with Indonesia as a case study. Indonesia is a particularly interesting case given that it is still recovering from the 1997 Asian financial crisis. For this study, a general equilibrium model is used to help assess the effects of Indonesia pursuing alternative trade policy paths. While general equilibrium analysis is less than perfect, simulating a series of policy options is an additional source of analysis that can be used in formulating trade policy. It offers an insight into the scope of the potential impacts of alternative trade policy scenarios.

It is intended that this paper will be helpful in preparing a consultative White Paper on Indonesia's trade policy. The Jaringan Kebijakan Publik Indonesia (or JAJAKI as it is commonly known in Indonesia) is an Indonesian Public Policy Network that actively engages stakeholders in the development of policy. JAJAKI will be used as a forum for active discussion among stakeholders in shaping a White Paper on Indonesia's future trade policy. More information about JAJAKI can be found at www.jajaki.or.id.

This is a joint paper between the United Nations Conference on Trade and Development (UNCTAD) in Geneva and the United Nations Support Facility for Indonesia Recovery (UNSFIR) in Jakarta. The report benefits greatly from the contribution of each organization. UNSFIR has published this paper as Working Paper Series No. 04/06 in Jakarta.

UNSFIR is a joint project of the Government of Indonesia and the United Nations Development Programme (UNDP) that aims to stimulate the examination of policy options for Indonesia at an important point in the country's development. UNSFIR's work aims to stimulate wide public discussion of the issues involved in order to build a new social and political consensus for effective and sustainable policy implementation. More information about UNSFIR can be found at www.unsfir.or.id.

ABSTRACT

Following the crises of the late 1990s and the subsequent slowdown in the world economy, many countries in the developed and developing world are at the crossroads in their trade strategy, uncertain whether to advance with trade reforms, to stand still or increase protection. While the case for liberalization has been widely accepted as a long-term goal for economic policy, the gains from trade have not always been forthcoming and macroeconomic crises have exacerbated the situation. The delayed and uncertain benefits of reform, plus the costs of adjustment, the need to offset tariff revenue losses, and the possible benefits of some degree of intervention to foster industrialization have all contributed to this indecision. Support for the WTO multilateral negotiations now appears half-hearted, and there are calls for increased protection. Following the slow progress of multilateral negotiations, attention has inevitably turned to regional and bilateral agreements.

Indonesia provides an interesting case study of the potential benefits and costs of alternative trade strategies that are under active consideration in many developing countries. The ASEAN region has recently announced a deepening of its commitments and is considering widening the agreement to include countries such as China, Japan and the Republic of Korea. A bilateral agreement with the United States is also a possibility. Against this background, Indonesia's options on trade policy range from increasing protection to actively pursuing bilateral, regional and multilateral initiatives.

The results of a global general equilibrium analysis point to several interesting implications for policy makers. The results from the model show that increasing protection results in economic losses while a stand still and more liberalization produces economic gains. After undergoing full adjustment, estimated annual gains to Indonesia from a conservative Uruguay Round-style outcome within the WTO system total an estimated $380 million (0.22 per cent of GDP). However, annual gains from a completely liberalized ASEAN plus China, Japan and Republic of Korea regional trade agreement are estimated at $2.3 billion, again after adjustment. Indonesia could capture half of these benefits by liberalizing unilaterally. The major source of the gains from unilateral, regional and multilateral liberalization is improved efficiency following removal of tariffs on politically sensitive sectors such as motor vehicles. This improves productivity in many downstream sectors. There are significant trade diversion effects from regional integration, with non-members worse off as a result. The results have implications for other countries having second thoughts about their strategy.

CONTENTS

Tables

Figures

I. WHICH WAY FORWARD?

Multilateral trade liberalization is a two-edged sword for many countries. The opening up of markets provides a welcome opportunity for the development of exports. On the other hand, it also brings increased competition, not only in export markets but also in domestic markets. To take advantage of market opportunities, resources need to flow from inefficient sectors to those where productivity is greater. The reallocation of land, labour and capital inevitably involves some costs of adjustment, and meanwhile tariff revenues may fall before alternative sources can be used. Where capital and labour markets are functioning poorly, and where Government administration is poorly developed, the negative effects of trade liberalization may appear to outweigh the potential but distant benefits, especially in an ailing macro-economy such as has been experienced in Indonesia since the crisis of 1997–1998. For these reasons, many countries are having second thoughts about further trade liberalization.

In the long run, developing countries have little choice but to continue down the liberalization road as the world becomes increasingly integrated. Liberalization is recognized as a desirable objective of economic policy for all economies and WTO Members have committed themselves to moving towards this objective. While openness is the end goal, the real question is how to get there, with the loudest voices – and many vested interests – calling for a *standstill* in current liberalization or an increase in protection. The various trade strategy options include increasing protection in selected industries, or doing nothing, through to unilateral, bilateral, regional and/or multilateral liberalization.

The appeal of increasing protection is that sensitive industries can be sheltered from foreign competition, perhaps on a temporary basis, with the hope that in time protected industries will become competitive. There are examples of industries that have become competitive after Government funding (for example, Japanese motor vehicles), but Governments often find it difficult to remove the protection. The US steel sector is a painful example. A more compelling argument may be that of the externalities associated with locating industries in clusters, so that subsidizing or providing infrastructure or other support for one industry in the cluster may benefit other industries located in the same cluster. High-technology industries may be such an example. However, protecting an industry through border measures often means that users of intermediate inputs have higher costs.

Standing still is another option that is considered during periods of macro-economic weakness because it avoids the costs of adjustment. Structural adjustment necessitated by technological change or trade liberalization is one of the biggest problems facing policy makers, and it becomes more difficult as the pace of change quickens. Structural adjustment essentially relates to moving primary factors such as land, labour and capital out of declining industries. There is limited scope for moving land out of agriculture, apart from converting it into forestry. The scope for moving labour out of agriculture is also somewhat limited, as this is likely to involve retraining and relocating resources. Retraining of labour can be a major cost, and many people find it stressful to have to face a period of unemployment and retraining after working in one job for many years. This is a real economic and social cost, albeit difficult to quantify, and should not be taken lightly. Sectors with a substantial proportion of aged workers, such as the rice-growing sectors of Malaysia or Japan, face serious social and political costs in restructuring, particularly in the absence of social safety nets.

A further justification for *standing still* is concern over a potential fall in tariff revenues, especially where there is a lack of administrative capacity to put in place alternative income, capital, value added or consumption-based taxes.

Nonetheless, liberalization for economies that position themselves to reap the gains provides benefits that cannot be ignored. Unilateral liberalization has its own rewards through improved efficiency in the allocation of resources, and many countries have been encouraged to go at least partly down this path, albeit somewhat hesitantly. Removing domestic distortions is important because taxes on imports raise costs to users of intermediate inputs. For example, taxes on motor vehicles raise the cost of transport and make it difficult for export sectors to compete. One approach is a uniform tariff, which removes many of the domestic distortions but leaves in place a distortion between traded and non-traded goods, for example many services industries that, while not directly involved in trade, provide inputs for export industries.

But trade liberalization by itself is overvalued exchange rate. The tax system may need to be reformed to move away from dependence on tariff revenues as tariff rates are reduced. Safety nets need to be in place to protect workers and encourage entrepreneurs to undertake risky investments. These reforms need to be sequenced in such a way as to avoid undesirable consequences or outright failure.

There is also a lack of consensus about the best path for achieving long-term growth. Development economics is prone to fads, primarily because what works for some economies does not work for others. While a competitive exchange rate, fiscal discipline, trade liberalization, a sound investment climate and secure property rights are considered necessary, they are no longer considered sufficient. Other variables include good governance, low levels of corruption, flexible labour markets, inflation targeting and social safety nets. There is an increasing emphasis on the appropriate institutions, such as well-developed legal and financial systems, as necessary conditions for sustained growth. Furthermore, the empirical evidence is mixed, as some countries (for example, in Latin America) have largely followed these conditions with little apparent benefit, while others (for instance, in Asia) have managed to sustain high growth rates without fulfilling all the conditions.

If there is much to be gained, at least in the longer term, from autonomous liberalization, then even more may be gained when a number of countries choose to follow