



The Impacts of ACFTA to Indonesia-China Trade

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Summary

In this commentary, we try to analyze the advantages and challenges that ACFTA offers for the Indonesian economy, considering particularly the trade balance between Indonesia and China during the period 2005-2010. While the agreement holds some positive implications, such as wider access to the large Chinese market for Indonesian exporters, and greater product choices and lower product prices in the domestic market, some adverse effects, especially related to the industrial sector, need to be addressed. The performance of exports from the industrial sector has been declining relative to total exports to China since 2005. The factors contributing to the adverse performance could include poor infrastructure, limited access to capital, and an unfavorable investment climate as compared with China and the neighboring countries. In addition, both China and Indonesia need to promote and ensure fair implementation of the agreement. Any findings on the contrary need to be followed up either bilaterally or through ASEAN organization.

The ACFTA regulation

Since January 1, 2010, the ACFTA has become fully effective in implementing zero tariffs on 6,682 tariff posts in 17 sectors, including 12 in manufacturing and five in the agriculture, mining and maritime sectors. The ACFTA envisages tariff barriers being lowered and eliminated between China and the ASEAN countries, which are divided into Normal Track and Sensitive Track. Normal Track is further divided into two models, namely Normal Track I and Normal Track II. Likewise, Sensitive Track is divided into two models: Sensitive List and High Sensitive List. In principle, the ACFTA envisages the ASEAN-6 (Indonesia, Malaysia, the Philippines, Singapore, Thailand and Brunei Darussalam) and China bringing down all tariffs to zero in 2010, and the newer members (Cambodia, Laos, Myanmar and Vietnam) doing the same by 2015.

Normal Track I consists of regulations on tariff reduction in accordance with the following thresholds: First, each party shall reduce to 0-5% not later than July 1, 2005 the tariff rates for at least 40% of its tariff lines placed in the Normal Track; second, each party shall reduce to 0-5% not later than January 1, 2007 the tariff rates for at least 60% of its rates lines placed in the Normal Track; and last, each party shall eliminate its tariff lines placed in the Normal Track not later than January 1, 2010. In the meantime, Normal Track II permits each member country to formulate tariff lines under Normal Track, not exceeding tariff lines, and shall eliminate all its tariffs for tariff lines placed in Normal Track II not later than January 1, 2012.

Table-1: Normal Track formula

X: Applied MFN Tariff Rate	ACFTA Preferential Tariff Rate (Not later than January 1)			
	2005	2007	2009	2010
$X \geq 20\%$	20	12	5	0
$15\% \leq X < 20\%$	15	8	5	0
$10\% \leq X < 15\%$	10	8	5	0
$5\% < X < 10\%$	5	5	0	0
$X \leq 5\%$	Standstill	Standstill	0	0

Source: ACFTA; MFN is Most Favored Nation; The first date of implementations shall be July 1, 2005.

In the Sensitive Track model, ASEAN and China are allowed to place 400 tariff posts at the Highly Sensitive (HS) 6-digit level, and 10% of the total import value based on 2001 trade statistics in the Sensitive Track. The Sensitive Track enjoins parties to reduce their tariff rates for products placed in the Sensitive Track list to 20% not later than January 1, 2012. These tariff rates shall be subsequently reduced to 0-5% not later than January 1, 2018. Meanwhile, the tariff lines placed by ASEAN and China in the Highly Sensitive List should be not more than 40%. The applied MFN tariff rates of tariff lines placed in the respective Highly Sensitive Lists shall be reduced to not more than 50% not later than January 1, 2015 for ASEAN-6 and China, and January 1, 2018 for the newer ASEAN members.

Potential Implications of ACFTA for ASEAN Countries

The ACFTA, involving the third largest free trade area after the European Union and the Northern American Free Trade Agreement (NAFTA), is an agreement among China and the 10 member states of ASEAN.

The ASEAN consists of states in different stages of development and with different economic structures, and so, the implications of the free trade agreement with China will be different for different members. The reduced trade barriers will give ASEAN exporters more favorable access to the Chinese market than that enjoyed by exporters from countries with no such agreement with China. Export expansion opportunities look promising particularly for countries producing goods in high demand in China: raw materials, and some agricultural and intermediate goods. This makes Indonesia and Malaysia (palm oil exporters) as well as Thailand and Singapore (food producers and exporters), for instance, potentially major beneficiaries of the ACFTA. Given the rising costs of labor in China, the strengthening of economic cooperation could also boost China's investment in countries in the region, a trend that could benefit the poorest ASEAN members the most: Laos, Cambodia and Myanmar.

Indonesia-China trade

With regard to the Indonesia-China trade relationship, the tariff barriers are actually being lowered and eliminated since 2005. However, this has not necessarily been in line with the improvement of Indonesia's trade performance. In 2004, before the ACFTA regulation was implemented, Indonesia recorded a surplus against China of USD195 million. In fact, the surplus increased to USD819 million in 2005 after the first implementation of the ACFTA regulation starting July 1, 2005. The surplus rose further to USD1.7 billion in 2006. The second round of tariff reduction was implemented on January 1, 2007 but Indonesia still recorded a surplus, although the surplus decreased by 35% over the previous year to USD1.1 billion.

It seems the impact of the first and second rounds of implementation of the ACFTA regulation was not significant, as in 2007 the decline in trade surplus had to do more with the drop in commodity prices at the end of the year (for example, coal price declined by 33.9% YoY). This continued into 2008, when Indonesia turned to book a deficit of USD3.6 billion. During the year, China's investment in Indonesia grew quite significantly, which led to the import value almost doubling to USD15.3 billion from USD8.5 billion in the previous year; the imports were dominated by auxiliary materials such as aluminum, iron, steel and electronics. In 2009, the deficit decreased to USD2.6 billion, mainly because of a 15% rise in non-oil and gas exports with imports of the same falling nearly 10%. During the year, both the export and import values declined, reflecting indirectly the impact of the global economic crisis (Refer to Table-2 below).

Post-implementation of ACFTA

In 2010, when principally all the tariffs changed to zero, the deficit more than doubled over the previous year to USD5.6 billion. In January 2011, the deficit further widened by 40% versus the same month in 2010. As such, the ACFTA regulation appears to have impacted the trade balance during 2010 and in the first month of 2011.

Table-2: Indonesia-China Trade Flows from 2004-Jan 2011 (in USD)

Year	Export (E)	Import (I)	Surplus / Deficit (E - I)
2004	4,297,233,109	4,101,331,096	195,902,013
2005	6,662,353,805	5,842,862,513	819,491,292
2006	8,343,571,337	6,636,895,111	1,706,676,226
2007	9,675,512,723	8,557,877,121	1,117,635,602
2008	11,636,503,721	15,247,168,927	(3,610,665,206)
2009	11,499,327,261	14,054,809,205	(2,555,481,944)
2010	14,080,900,000	19,688,000,000	(5,607,100,000)
Jan-10	1,010,900,000	1,406,000,000	(395,100,000)
Jan-11	1,152,700,000	1,815,200,000	(662,500,000)

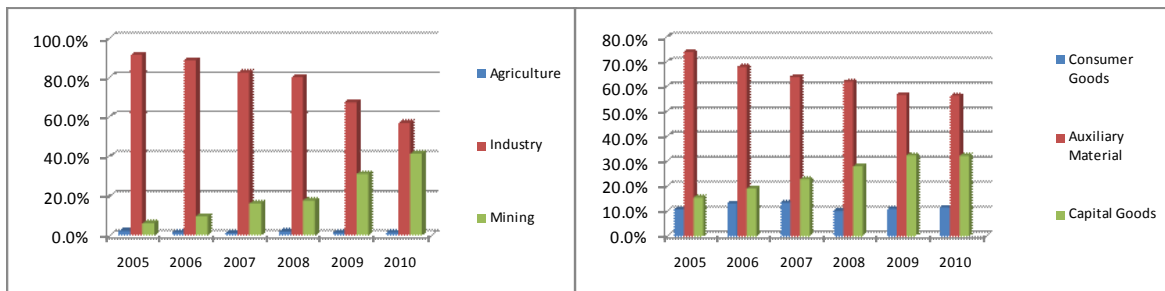
Source: the Central Statistics Agency (BPS)

Being the largest ASEAN country and rich in resources, Indonesia is of strategic importance for the development of the region. Both exports and imports have been growing significantly since the first round of ACFTA implementation, as corroborated by the over four-fold increase in the total trade between Indonesia and China to USD33.8 billion in 2010 from USD8.4 billion in 2004.

However, the growth performance is relying on the strength of specific sectors of both countries. For instance, mining is the major sector for Indonesia’s exports to China. Exports from this sector rose sharply to USD5.82 billion, or 41.4% of the total export to China, in 2010 from merely 6.2% in 2005. The improving export performance of mining sector is being caused mainly by rising prices. Coal is the major contributor in the mining sector, representing over 29% of the total export to China. The contribution of the industrial sector, on the contrary, has been declining, and fell to 56.9% in 2010 from 91.4% in 2005. Meanwhile, the contribution of the agriculture sector has been relatively stable.

On the import side, auxiliary materials have been the dominant contributor since 2005, accounting for USD11.1 billion, or 56.4% of the total imports from China, in 2010. However, the contribution has been declining. On the other hand, the contribution of imports of capital goods rose significantly to 32.2% of total imports in 2010 from 15.5% in 2005, mainly because of the larger volumes of telephones for cellular networks, laptops, monitors and other electronic parts. In the meantime, the contribution of imports of consumer goods remained relatively stable during 2005-2010. Refer to Chart-1 below.

Chart-1: Export – Import between Indonesia and China 2005-2010



Source: The Central Statistics Agency (BPS)

Implications of ACFTA for Indonesia-China trade

As discussed, from the consumers’ point of view, the ACFTA may have positive implications, as they could find the market flooded by products with perceived lower prices and they could have more choices. For exporters, it has given them greater access to the most populated country in the world. On the industry side, the ACFTA has made investments in Indonesia more attractive for foreign investors, including those from China, supported by the growing market and the availability of raw material resources.

Rapid economic growth has made China one of the most important players in the world, and its products have achieved an almost worldwide reach. This is believed to have resulted from the strengths of its domestic industries. Among other things, easy bank loans have kept the prices of products low even as natural resources are abundant in the country. The supporting infrastructure for the expansion of industry and trade is also well-established.

A comparison between the macroeconomic indicators of Indonesia and China shows that China’s condition is generally more favorable than that of Indonesia. For example, industrial production growth in Indonesia was only 2% in 2009 while China reached 8.1%. The average lending rate for China’s commercial banks is just 5.31%, as against Indonesia’s 13.6%. Further, infrastructure development in Indonesia is seen as being far behind China’s referring to Table-3.

We believe there are more issues to address with regard to improving the macroeconomic indicators for Indonesia. For instance, Indonesia's investment process is considered lengthy as compared with that of its neighboring countries. According to the International Finance Corporation (IFC), Indonesia ranks 121 among 183 countries in terms of the ease of doing business (as of 2011), even as Singapore ranks 1, Thailand 19, and Malaysia 21. Further, in terms of time required to register a business, Indonesia takes 47 days, Malaysia 17 days, Thailand 32 days, and the Philippines 38 days. As such, the related production cost is high in Indonesia and this pushes up the selling prices to much above China's.

Table-3: Macroeconomic Indicators, Indonesia and China

As of December 2009	Indonesia	China	
Population	240.3	1,340.00	million people
Population growth	1.14	0.66	%
GDP per capita	4,000	6,500	USD
Labor force	113.3	812.7	million people
Unemployment rate	7.7	4.3	%
Inflation	5.5	-0.8	%
Lending rates of banks	13.6	5.31	%
Industrial production growth	2.0	8.1	%
Long road	391,009	3,600,000	kms
Toll roads	772	53,913	kms
Electricity production	134.4	3,451.0	billion kwh
Electricity consumption	119.3	3,438.0	billion kwh

Source: Kontan newspaper, February 3, 2010

All the above raises concerns over the further impact of the ACFTA on Indonesia's domestic industries.

Conclusion

Some implications of the ACFTA for Indonesia are summarized in the following bullet list:

1. Indonesia's exporters have better access to China's large economy, which creates better opportunities for local businesses to export more goods. On the other hand, Indonesia will also be an open market for China's products. During the period of 2005-2010, Indonesia's exports to China grew by an average of 16.1% per annum, while imports grew by 27.5%. Such growth rates are far above what an individual country can achieve. The increase in export has been attributed mainly to the mining sector, while auxiliary materials have dominated import growth.
2. Exports from the industrial sector may have been adversely impacted by the ACFTA, as shown by its weakening contribution to total exports: 56.9% in 2010 from 91.4% in 2005. Another indication is the much lower industrial growth rate of 2% as compared with China's 8.1% during the period stated. As the macroeconomic comparison table above shows, China is more favorable at least in terms of infrastructure and commercial banks' lending rates, which support its industrial sector.
3. We expect the disadvantages to the industrial sector to continue at least in the short to medium term. In the long run, there might be some improvements in this sector because of the significant increase in

capital goods imports (USD6.34 billion in 2010 from USD0.90 billion five years ago), and if some short- to medium-term domestic issues are resolved.

4. The poor state of infrastructure may become the major challenge to improvements. According to the World Economic Forum Report in 2010, Indonesia ranks 96 among 133 countries in infrastructure quality even as China ranks 19, Malaysia 27, and Thailand 41. Another challenge is the high interest rate environment, particularly versus China and the neighboring countries.

Suggested follow-up actions

The following follow-up actions are suggested to alleviate the adverse impact of the ACFTA on Indonesia's industrial sector:

1. The industrial sector seems to have been impacted quite adversely by the agreement. A government survey shows that textiles, furniture, metals, machinery and electronics are the sub-sectors that have been affected the most. The government, industry players and other stakeholders should sit together to find the best way to alleviate the adverse effects of the agreement on these sectors. Should there be an option, renegotiation of the agreement with China is necessary.
2. Factors that have contributed to the industrial sector losing its competitiveness, particularly against China, need to be identified. The government survey also reported that expensive raw materials, high and unstable energy prices as well as limited access to capital are factors that need to be addressed to improve the sector's performance. The availability and reliability of infrastructure are other factors requiring significant improvement, as the macroeconomic comparison table above brings out.
3. Some qualitative factors also need to be addressed, including the ease of doing business and the time required to register a business in Indonesia. Against both parameters, Indonesia is far behind China and neighboring countries such as Singapore, Malaysia and Thailand.
4. Fair implementation of the ACFTA needs to be promoted by both countries. Any reports or findings pointing to such practices as dumping need to be followed up by the government either bilaterally or through ASEAN organization. The follow-up actions here may include imposition of the necessary safeguards for the unfairly affected sectors.

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