Indonesia: Strategic Location for GVC in ASEAN

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Indonesia Services Dialogue (ISD) is a *tripartite mechanism* composed of the private-sector, government and academia/research institutions which aims to foster collaborative dialog on service sector.
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Why Services?

- Services are the main driver of Indonesia’s economic growth and job creation
- Services have been instrumental in reducing poverty in Indonesia over the last decade
- Services play an important role in enabling the growth and transformation of the economy through critical inter-sectoral linkages
- Services restrictions are holding back growth and reducing competitiveness
- Removing services restrictions is a proven strategy to boost growth in Indonesia
- More open services trade and investment will lead to efficient services but the benefits are not automatic
- Efficient and high quality services will boost exports of services creating a virtuous cycle
Services Are the Main Drivers of Indonesia Economic Growth

- Services are the **largest contributor** of value added economy
- Direct contribution of services to GDP growth has increased over time – from **52.66%** in 2002 to **66.33%** in 2012 (BPS 2013)
- The contribution of services in Indonesian trade is much greater when embodied services are recognized
Between 1984-2008 the growth of Services Sector manifested into about 80% of rural poverty reduction and 86% of urban poverty. Thus, services sector supports:

1. 8 out of 10 people who are successful to move out from poverty line in the rural level
2. 9 out of 10 people who are successful to move out from poverty line in the urban level

Source: SMERU 2010
Services are the Biggest Employment Provider

- Services employment share to other sector has increased over time – from 39% in 2000 to 45% in 2010
- During 2000-2010, services has contributed highest provider in creating new employment

Source: BPS - 2010

Source: ILO - 2013

Services Contribution to New Employment 2000-2010
About **34%** of services sector production is intermediate demand from other production sectors.

Only **66%** final product from services sectors is directly consumed by end consumers.

Services sector absorb **23%** services sector production to be utilized by their own activities, whilst manufacturing sector is utilizing an average of **10%** output from services sector.

As an intermediate input (i.e. goods and services procured by the firm), the share of services is **31.55 percent**. As a share of total inputs (i.e. intermediate plus primary inputs such as the labour and capital directly employed by the firm), services account for **16 percent**.

Sources: (AIPEG 2013)
How Important is ASEAN for Indonesia: Export Perspective

Graph showing the export perspective from 1990 to 2013, with ASEAN, JPN, CHN, EU27, USA, KOR, and Others as categories.
How Important is ASEAN for Indonesia: Import Perspective
FDI from ASEAN+6 in 2013 has reached USD 13.8 Billion or 48.2% of total FDI, whilst from EU and US reached USD 4.8 Billion or 16.8% from total FDI.
Value of FDI

ASEAN

Chart 1
Value of annual foreign direct investment inflows (US$ millions)

Source: UNCTAD
### Table 1

<table>
<thead>
<tr>
<th>Country</th>
<th>Size of the economy (US$ billions)</th>
<th>Population (millions)</th>
<th>GDP per capita (US$)</th>
<th>Trend rate of annual economic growth (real GDP) 2013 to 2018 (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>ASEAN</td>
<td>2,397.54</td>
<td>625.31</td>
<td>3,770</td>
<td>5.64</td>
</tr>
<tr>
<td>Brunei</td>
<td>16.18</td>
<td>0.42</td>
<td>38,760</td>
<td>3.10</td>
</tr>
<tr>
<td>Cambodia</td>
<td>16.20</td>
<td>15.14</td>
<td>1,070</td>
<td>7.44</td>
</tr>
<tr>
<td>Indonesia</td>
<td>868.35</td>
<td>250.80</td>
<td>3,460</td>
<td>6.18</td>
</tr>
<tr>
<td>Laos</td>
<td>11.00</td>
<td>6.78</td>
<td>1,620</td>
<td>7.35</td>
</tr>
<tr>
<td>Malaysia</td>
<td>313.16</td>
<td>29.72</td>
<td>10,538</td>
<td>5.64</td>
</tr>
<tr>
<td>Myanmar</td>
<td>44.85</td>
<td>61.95</td>
<td>724</td>
<td>7.06</td>
</tr>
<tr>
<td>Philippines</td>
<td>272.07</td>
<td>98.39</td>
<td>2,770</td>
<td>5.94</td>
</tr>
<tr>
<td>Singapore</td>
<td>297.94</td>
<td>5.40</td>
<td>55,183</td>
<td>4.76</td>
</tr>
<tr>
<td>Thailand</td>
<td>387.25</td>
<td>67.01</td>
<td>5,780</td>
<td>4.49</td>
</tr>
<tr>
<td>Vietnam</td>
<td>170.55</td>
<td>89.71</td>
<td>1,901</td>
<td>6.38</td>
</tr>
</tbody>
</table>

Source: Economist Intelligence Unit; data for 2013
AEC holds the promise of major benefits for companies operating in the region to **reap greater economies of scale and improve efficiency** by harmonizing their operations across a wider area. Possibilities for **greater fragmentation of their supply chains** where they can break up their activities into distinct parts and put them into places with the most appropriate costs and skills.

Having a single market will also help to **reduce complexity**, as companies will be able to **standardize products, services, business models and marketing plans**. Despite the huge diversity across ASEAN, their customers are becoming more similar and can be served with a more unified approach. In some cases, companies think that the opportunities to harmonize and standardize their front office client-facing activities in ASEAN remain limited. However, they feel that **back-office and sales support functions (such as finance, HR and planning)** can be run on a regional basis.

As capital markets become more joined-up, companies will be able to **access deeper pools of liquidity for raising money**. As labor markets become more integrated, companies will find it **easier to recruit, retain and manage their workforce on a regional basis**.

Given falling trade barriers and deepening harmonization of industry standards across ASEAN.
Barriers in ASEAN: Regulatory Tangles

- **Lack of joined-up regulations.** In banking for example, the credit card business is best run at scale. The more customers that a bank has, the more efficient the business becomes, not only by having centralized back office processing, but also through better data analytics around a bigger pool of customers, which in turn improves risk management. Yet, in ASEAN, banks are largely prevented from running their credit card businesses across borders. Customer data is required to be kept in-country rather than processed in neighboring places.

- One of the greatest impediments to going regional is “the need to be close to customers”. But companies also ranked issues such as un-harmonized industry regulations and inconsistent rules around professional services qualifications as being equally troublesome.

- If ASEAN countries can tackle these different rules then the opportunities for the services sector to achieve scale will rise. But other factors could be equally important. **Technology has huge potential to help services firms** implement a more regional approach.
Barriers in ASEAN: Regulatory Tangles...2

Chart 22
How important are these barriers to adopting a regional approach to providing services across ASEAN?
(Scale of 0 = no barrier to 4 = significant barrier)

- The need to be close to customers
- Different business practices between countries
- Varying industry regulations across ASEAN countries
- Varying regulations governing professional qualifications
- Different levels of market access to foreign firms
- Varying quality of IT and communications infrastructure
- Language barriers
- Different tastes and preferences of local markets
- Data protection rules

Source: Economist Corporate Network
Tertiary enrolment remains very low in some ASEAN countries, while over 50% of employers surveyed agreed that University graduates both added value to the workplace.
Professional Qualifications

Chart 23
How uniform across ASEAN are standards and regulations governing professional qualifications for staff in your industry? (% of respondents)

- Not at all uniform: 38.0%
- Somewhat uniform but not improving: 22.5%
- Somewhat uniform and improving: 36.6%
- Highly uniform: 2.8%

Source: Economist Corporate Network
More and more companies are setting up pan-regional management teams with an ASEAN-focused strategy;
Companies are rapidly building a pan-regional sales platform that reaches into every corner of ASEAN;
The ASEAN bloc remains deeply diverse;
But the region’s 10 economies are increasingly integrating with each other;
Customers across the region are becoming more similar;
And the products and services that companies offer across ASEAN are becoming more standardized.
Global supply chain (GSC):
The supply chain refers to a system of organization, people, technology, activities, information and resources involved in moving a product or service from supplier to customer. Supply chain activities transform natural resources, raw materials and components into a finished product that is delivered to the end customer. GSCs require trade infrastructure, trade finance, trade intermediaries, logistics providers, transport services, and information flow.

Global Production Chain (GPC):
A production chain refers to linkages within or among a group of firms in a particular GVC for producing specific products, such as particular types of computers, mobile phones and automobiles. The focus of GPCs is on the production of goods and service. In addition to the requirements of the GSC, GVCs need markets, firms, innovation, technology, rule of law, and finance.

Source: (APEC PSU, 2012).
MNC decisions on where to invest and with whom to partner are driven by GVC locational determinants that depend on the GVC segment, task or activity. Governments are in a position to selectively target GVCs and GVC segments in line with their endowments and development objectives.

Various factors determine an MNC’s choice of host country locations, including economic characteristics (e.g. market size, growth potential, infrastructure, labor availability and skills). Moreover, the policy framework (e.g. rules governing investment behavior, trade agreements and the intellectual property regime) and business facilitation policies (e.g. costs of doing business and investment incentives) are also important.

Source: UNCTAD (2013)
Many locational determinants are relevant regardless of the specific value segment. A stable economic, political and social environment and robust commercial law and contract regimes are important preconditions for all GVC stages. Business facilitation measures aimed at reducing transactions costs or supporting foreign affiliates or local firms also make the overall environment conducive to GVC inclusion.

**Locational Determinants:**

**Knowledge creation stage**

At the knowledge creation stage (which includes innovation, research and development (R&D), design and branding), the existence of an appropriate intellectual property regime and the availability of suitable labor force (in terms of cost, education, science and technology competences) are key determinants. Also important are the presence of research clusters or design/creativity clusters.
Main operational stages
In manufacturing, the choice of location depends on the availability of relatively low-cost skilled/unskilled labor, the quality of the logistics infrastructure, distance to final markets and the availability of inputs. The availability of industrial parks, customs and border procedures and trade facilitation, policies supporting skills development, and laws governing contract manufacturing are important.
For raw material and agriculture, the principal determinants are the existence of natural resources, the capacity of infrastructure to support their extraction and transport and policies governing their utilization and consumption.
In services, the specific characteristics of the labor force (language skills and education, as supported by policy initiatives) are important, as is the reliability of telecommunications infrastructure.

Source: AIPEG (2015)
Distribution and support stages
For distribution and logistics the availability and quality of transport and logistics infrastructure, availability, quality and cost of inputs (transport, communications, energy), networks of locally based distribution and logistics companies in relevant industries (e.g. wholesaling, storage, distribution, etc.)
For service functions (e.g. HQ, IT, human resources, legal, auditing) the availability and quality of telecom infrastructure and services; Suitability and characteristics of available labor force (cost, language proficiency, education); Services trade restrictions and promotions; Policy supporting skills development through education, science and technology competences; Confidentiality and data protection laws; Laws governing services outsourcing contracts, and "Liveability" of location (i.e. convenience & quality of life, quality of international schools, etc).

Source: AIPEG (2015)
<table>
<thead>
<tr>
<th>Product development</th>
<th>Manufacturing</th>
<th>Distribution</th>
<th>Sales</th>
<th>After-sale services</th>
</tr>
</thead>
<tbody>
<tr>
<td>Research &amp; Development</td>
<td>Manufacturing services</td>
<td>Packaging</td>
<td>Legal services</td>
<td>Financial services</td>
</tr>
<tr>
<td>Engineering services</td>
<td>Management services</td>
<td>Printing, publishing</td>
<td>Accounting services</td>
<td>Insurance services</td>
</tr>
<tr>
<td>Technical testing</td>
<td>Management consulting</td>
<td>Transport services</td>
<td>Financial services</td>
<td>Rental/Leasing</td>
</tr>
<tr>
<td>Design services</td>
<td>Transport services</td>
<td>Logistics</td>
<td>Advertising</td>
<td>Maintenance and repair</td>
</tr>
<tr>
<td>Market research</td>
<td>Building-cleaning services</td>
<td>Warehousing</td>
<td>Wholesale and retail trade</td>
<td>Technical testing</td>
</tr>
<tr>
<td>Telecommunications</td>
<td>Telecommunications</td>
<td></td>
<td></td>
<td>Information services</td>
</tr>
<tr>
<td>Computer services</td>
<td>Computer services</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: AIPEG (2015)
Costs consists of transport costs, port costs, freight and insurance costs, tariffs and duties, costs associated with non-tariff measures, mark-ups from importers, wholesalers and retailers. Transport costs may be replaced with communication costs (although services can also be provided by other modes of supply such as through natural persons that have to travel to the country where the consumer is located) and various non-tariff measures. Coordination costs are also very important in global value chains since geographically dispersed activities have to be managed in a consistent way. Technological progress in ICT has increasingly allowed the coordination and monitoring of activities located at a large distance while containerization have reduced transport. Lower trade costs however are not limited to technological advances. An important driver was also the liberalization of trade and investment as well as regulatory reforms in key transport and infrastructure sectors. Policies have played an important role in improving efficiency and explain the fragmentation of production as much as advances in transport and communication technologies.

Source: AIPEG (2015)
The WTO and the OECD conducted a joint monitoring exercise to identify the main barriers that developing country firms face. Three main barriers for developing country firms seeking to participate in value chains:

a. Inadequate infrastructure
b. Limited access to trade finance, and standards compliance.
c. Apart from transport and ICT infrastructure, unreliable supplies of electricity.

Source: AIPEG (2015)
### Main barriers hindering developing countries' participation in value chains, 2013 (per cent)

<table>
<thead>
<tr>
<th>Developing country suppliers</th>
<th>Lead firms</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Difficulties connecting developing country suppliers to value chains</strong></td>
<td><strong>Difficulties connecting developing country suppliers to value chains</strong></td>
</tr>
<tr>
<td>Transportation costs and delays 42%</td>
<td>Customs procedures 52%</td>
</tr>
<tr>
<td>Access to trade finance 40%</td>
<td>Transportation costs and delays 38%</td>
</tr>
<tr>
<td>Customs procedures 36%</td>
<td>Licensing requirements (domestic or trade) 33%</td>
</tr>
<tr>
<td>Import duties 23%</td>
<td>Import duties 33%</td>
</tr>
<tr>
<td>Supply chain governance 23%</td>
<td>Meeting volume requirements 22%</td>
</tr>
<tr>
<td><strong>Supply side constraints</strong></td>
<td><strong>Obstacles to establish commercial presence</strong></td>
</tr>
<tr>
<td>Access to finance 48%</td>
<td>Business environment 50%</td>
</tr>
<tr>
<td>Labour skills 39%</td>
<td>Regulatory transparency 48%</td>
</tr>
<tr>
<td>Business environment 38%</td>
<td>Inadequate standards infrastructure 38%</td>
</tr>
<tr>
<td>Regulatory transparency 30%</td>
<td>Transport infrastructure 33%</td>
</tr>
<tr>
<td>Transport infrastructure 29%</td>
<td>Labour skills 30%</td>
</tr>
</tbody>
</table>

Source: AIPEG (2015)

Note: Shares are calculated based on the sectors for which the respective issue could be selected as an answer, e.g., import duties could not be selected by tourism and transport and logistics firms.
GVC activity is organized around large manufacturing hubs and the larger the distance to the main manufacturing hubs in Europe, North America and Asia the lower the backward engagement, which suggest that there is a premium to locating close to large ‘headquarter’ economies. However, trade and other policies can also play a significant role. Low import tariffs, both at home and faced in export markets, and engagement in regional trading agreements (RTAs) can all facilitate backward and forward GVC engagement. Inward FDI openness tends to have a significant association with both backward and forward integration. Logistics performances, including trade facilitation, intellectual property protection, the quality of infrastructure, as well as the quality of institutions are estimated to have strong impacts on GVC integration.

Source: AIPEG (2015)
Ability of services firms to take a regional approach to their business is much harder than in the manufacturing sector due to the nature of a service business, whereby human contact is an important part of the delivery.
In general, structural and policy drivers of GVC participation can vary significantly by sector and with the level of development. In terms of outcomes, they find that both the buying and the selling activities in value chains, where countries tend to either source foreign inputs for export production or provide inputs to foreign partners for their export production tend to bring about economic benefits. These relate to enhanced productivity, sophistication and diversification of exports, even if there is some heterogeneity across income groups. Another key finding is that the volume of the activity may matter as much as the domestic value added share or sophistication. Thus, important benefits can be derived from specializing in less sophisticated assembly activities according to comparative advantages and performing them on a large scale.

Source: AIPEG (2015)
A significant share of Indonesia’s integration with the world is through the extractive industries - Mining & Quarrying. Outside this sector, Indonesia has the lowest total GVC participation in ASEAN after Brunei.
Indonesia’s is increasing its participation in production networks, but still relatively lower compared to its ASEAN neighbors. Only 39 percent of Indonesia’s manufacturing trade was network related (comprising trade in P&C and Final goods).

Table  Production Network Participation (as a share of Total Manufacturing Exports), 2010

<table>
<thead>
<tr>
<th>Country</th>
<th>Parts and Components</th>
<th>Final Assembly</th>
</tr>
</thead>
<tbody>
<tr>
<td>Malaysia</td>
<td>54.6</td>
<td>22.2</td>
</tr>
<tr>
<td>Thailand</td>
<td>30.1</td>
<td>34.3</td>
</tr>
<tr>
<td>China</td>
<td>25.7</td>
<td>32.5</td>
</tr>
<tr>
<td>Indonesia</td>
<td>21.5</td>
<td>17.7</td>
</tr>
<tr>
<td>Viet Nam</td>
<td>11.2</td>
<td>7.6</td>
</tr>
</tbody>
</table>

Source: AIPEG (2015)
A key feature of the GVC model is the use of imported inputs in one’s exports. The increase in imported inputs does not necessarily come at the expense of local value adding as the case of China’s electronics shows, gross exports and domestic value added in gross exports grew at an annual rate of 23.7% and 20.12%, respectively along with a significant increase in the share foreign value added.

*China, Electrical and Optical Equipment Exports (Smaller share of much bigger pie...)*

Source: OECD TiVA 2013
In the case of Indonesia, electronics export grew at an annual rate of 11.8% and 12.4% in gross and net (domestic value added) terms during the same period with a lower share of foreign value added in 2009 compared to 1995 and compared to China.

*Indonesia, Electrical and Optical Equipment Exports (Bigger share of slightly bigger pie...)*
Perception of Private Sector
National Industry Development (i.e. SNI – National Standard Indonesia which is commensurate with global standard, Indonesian National Single Window implementation and adoption by relevant Ministries, etc);

Infrastructure Development (i.e. implementation of policy which supports bankable PPP, effective budget allocation to implement the national logistic system: alignment for strategic ports, airports, trains and ships connectivity);

Logistics Development (i.e. National Policy on Logistics, CATS – Custom Advance Trade System), reduction of dwelling time, INSW implementation, On-line TPS in Tj Priok, KPPT – Integrated Custom Service Area such as Cikarang, Auto gate system, i-care INALOG, etc);

Investment Development (i.e. Implementation of OSS Center, enhancement of DNI, harmonization of various laws and regulations, effective tax allowances etc);

Trade Development (i.e. e-SKA implementation, drafting of e-Commerce Government Regulations, bilateral and regional FTA discussions).
The integration of Inaport and Inatrade on Indonesia’s National Single Window System should be accelerated to allow for the flow of goods and documents to be simultaneously processed, thereby reducing costs in ports.

To increase connectivity between regions, and given Indonesia’s diverse geographical terrains, there should be stronger commitment to develop a multimodal services.

Local governments, which have relatively higher commitment to the development of a logistic sector in their regions, should be recognized as champions for the development of the sector.

Given the multi-sector nature of the logistic sector, a focal point needs to be appointed to coordinate various institutions responsible for the sector, including local governments. The appointment of any focal point or coordinating body should have a strong legal framework such as Law or Presidential Decree with clear matrix of roles and responsibility for each related ministries and bodies.
• Review on the negative list of investment for the investment in logistics sector. The 2014 DNI regulates lower foreign equity limitation for some activities in logistics sectors, e.g. multimodal logistic services and cold storage facility.

• The development of integrated industrial zones in various parts of the archipelago should be accelerated. The planning and implementation of industrial zones development should inherently include the planning and implementation of integrated logistic system. Ensuring the already-appointed Special Economic Zones to have integrated logistic system can be the start.

• Policy should be mainstreamed and increasingly integrated to the global value chains (GVCs).

• The development of global value chains requires active transportation both for imports and export that will reduce trade costs between countries.
• **Solving challenges in logistic sector.** Many challenges in distribution sector are challenges in the logistic sector. Moreover, underdevelopment of distribution sector in less-developed regions in Indonesia may not caused by lack of demand in the regions, rather due to lack of transportation and logistics services available in order to create trade.

• **Regulations affecting distribution sector are widely spread in different ministries and local government regulations.** These regulations may aim to regulate the production part of the industry, but end up regulating the distribution process of the industry. The regulatory check-up should complement the Ministry of Trade’s efforts in concluding implementing regulations that are part of the commitment of the new Trade Law.

• **Depoliticizing Minimum Wage,** Government must accelerate efforts to create guideline in depoliticizing minimum wage. The idea of the guideline is to link minimum wage with productivity. Hence, having the guidelines can promote predictability and fairness in the decision of minimum wage rate, without hurting business climate.

• **Opportunities from E-Commerce.** Technology is one of the pathways for services competitiveness in the region. Given the geographical barriers, SMEs face barriers in accessing a wider market. In this regards, e-commerce may become one of the solutions for intra-trade in Indonesia and inta-trade in ASEAN. Hence, assisting the making of blueprint of e-commerce becomes not only important because e-commerce is part of distribution channel, but also because e-commerce can be key aspect in developing the sector to be more competitive and inclusive.
World Bank and BPS have predicted that Indonesia will suffer a shortage of 10 million skilled workers by 2025.

To achieve a modest target of 6 percent annual GDP growth, Indonesia will require around 50 million skilled workers.
Iput for Professional Certifications
1. **Technology Innovation** to enhance level of competency and added value for all services industry;

2. **Research & Development centers**, with cooperation with the industry, association and provide incentives to companies who invested in R&D and training & development;

3. **Certification Program** for University degree Engineers and technical trades skills;

4. **Encouragement Program** for high school students to enter Engineering degree and to provide incentives for professionals to pursue career in Engineering;

5. **Quality Enhancement of Universities** which offer Engineering School and dan acceleration of Engineer Profession Program in Universities;

6. **Implementation of Indonesian Engineers Diaspora Program**, similar to Talentcorp Malaysia which provides incentives for professionals who repatriate back to Indonesia;

7. **Relax the regulation on movement of skilled labors and professionals**, because lack of skilled workers and required professional may prevent optimal growth of the industry.

8. **Revisit Indonesia’s National Education policy** to allow more opportunity for all Indonesians to obtain high quality education.
Thank you