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Strengthening U.S.–Indonesia Economic Relations

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The United States has a truly massive economic relationship with East Asia. U.S.–East Asia trade exceeds $1 trillion annually, and two-way investment is more than $4 trillion.

The U.S. also has many complaints about the economic relationship. Some refer to the huge trade deficit America runs with the region, others with specific mercantilist practices. One response to complaints is these are fast-growing countries that the U.S. would be unwise to treat primarily as rivals.

What if there were no trade-off? What if there were a fast-growing East Asian country that has clear potential to be a huge long-term partner but does not run large trade surpluses or seek one-sided trade benefits?

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There is such a country: Indonesia. Yes, Indonesia faces challenges and retains barriers to market access. But it is not *institutionally* wedded to these barriers or to export subsidies, as other East Asian economies seem to be. Indonesia's success calls for more attention from the American private sector, and the U.S. government can help.

What Crisis? The period from 2004 to 2011 shows an alarming trend for most economies. Not Indonesia. The economy grew better than 5 percent every year in that stretch except 2009, when it grew 4.5 percent. Last year, the economy expanded an impressive 6.5 percent to about $825 billion. Indonesia is not alone in East Asia in achieving rapid growth, but it has less company in other important areas.

Indonesia is one of the few large economies running healthy, positive real interest rates. The nominal interest rate stands at 5.75 percent, even after a recent cut, while 2011 consumer inflation stood at 3.8 percent. The budget deficit last year was less than 1.3 percent of GDP (though there should be no deficit at all in light of rapid growth).

Further, the balance of payments showed only a $12 billion surplus in 2011, down from $30 billion in 2010. Growth has not depended either on unsustainable domestic stimulus or on foreign demand. Indonesia responded to the financial crisis with more economic freedom and has benefited as a result.[1] All this makes Indonesia exceptional even among high-performing economies in East Asia.[2]

Most observers would diagnose Indonesia's chief economic threat as price instability. Inflation could easily exceed 5 percent in 2012, but this is still well within the normal range for a developing economy. A bigger risk at present is actually infrastructure. Indonesia needs better infrastructure both to reduce logistics costs and to accommodate a powerful urbanization process. The central government names infrastructure as the top budget priority in 2012, ahead of social spending and defense. A bill was passed enabling government land development,[3] but the spending and the bill could easily take the country off track.

State infrastructure spending should be a response to the success of market-based economic reform; it should not be a substitute. The goal should not simply be more roads and airports but ones that correspond to high-use transport systems. Housing projects can look impressive for a few years, but if their location is divorced from economic opportunity, they will soon turn to slums.

If programs are chosen for political gain rather than prosperity, Indonesia will spend huge sums for short-lived gains. India, for example, has started down the path of substituting infrastructure for reform only to see large budget deficits and slowing growth.[4] This could be the future for Indonesia unless infrastructure development is commercially viable.

How America Can Gain. Indonesia's success offers opportunities that seem to have been underappreciated to date by American business. Foreign investment in Indonesia climbed 20 percent to a record $19.3 billion in 2011. American data for investment overseas in 2011 are not yet available, but the stock of American investment in Indonesia actually fell in 2010, so U.S. companies clearly did not anticipate the increased interest.[5]

Indonesia's exports to the U.S. are diversified, but textiles are important and will become more so as production moves out of China. Indonesian imports tell another story of American underperformance. Total Indonesian imports grew 31 percent last year. On Indonesian figures, American exports alone gained only 12 percent; on American figures, they gained 7 percent.[6]

American exports will get a boost from Lion Air. Established in 2000, the airline has taken advantage of Indonesia's rapid income gains to mushroom in size to the point where it last month confirmed the largest-ever civilian purchase of Boeings. U.S. agriculture exports could also rise considerably as Indonesia gets richer. Agriculture is often protected, but Indonesia's disinterest in balance-of-payments surpluses could make it a willing buyer, especially for soybeans and cotton.

In services, Indonesia's long demographic expansion may last only one more decade. Productivity must rise to compensate, which requires better education and training immediately. The American and Indonesia governments have consistently cooperated on education, but demand on the Indonesian side is becoming sufficient for large-scale U.S. private-sector involvement as well.

There are, of course, problems in the Indonesia–U.S. relationship. American companies, and many others, complain of corruption as a barrier to the Indonesian market. Another issue is frequent changes in governing regulations for trade. The World Bank ranks Indonesia 129th of 183 countries in its Doing Business survey, a drop from the previous year. The combination of corruption, regulatory change, difficulty in starting a business, and contract enforcement makes for a highly uncertain commercial environment.

How America Can Help. A large state-led infrastructure program invites more corruption and distracts from reform that would reduce uncertainty and encourage entrepreneurship. At the same time, commercially driven infrastructure development would be exceptionally valuable. In trade, there is

1. See "Indonesia," in Terry Miller, Kim R. Holmes, and Edwin J. Feulner, *2012 Index of Economic Freedom* (Washington, D.C.: The Heritage Foundation and Dow Jones & Company, Inc., 2012), at *http://www.heritage.org/index/download*.
2. Novrida Manurung and Widya Utami, " Indonesia Unexpectedly Cuts Interest Rate to Support Growth Amid Slowdow," *Bloomberg*, February 9, 2012, at *http://www.bloomberg.com/news/2012-02-09/indonesia-unexpectedly-cuts-interest-rate-to-support-growth-amid-slowdown.html* (March 2, 2012); Jimmy Hitipeuw, "Indonesia's Inflation Reaches 3.79 Pct," Kompas, January 3, 2012, at *http://english.kompas.com/read/2012/01/03/01121785/Indonesias.Inflation.Reaches.3.79.Pct* (March 2, 2012); Jimmy Hitipeuw, "Indonesia's Actual Budget Deficit 1.27Pct of GDP Vs 2.1Pct Target," Kompas, January 5, 2012, at *http://english.kompas.com/read/2012/01/05/1438145/2011.Indonesias.Actual.Budget.Deficit.1.27Pct.Of.GDP.Vs.2.1Pct.Target* (March 2, 2012); and Andreas Ismar, "Update: Indonesia Balance of Payment Narrows in 4Q," *Capital*, February 10, 2012, at *http://english.capital.gr/news.asp?id=1407696* (March 2, 2012).
3. Press release, "Economic Outlook and State Budget Year 2012," Republic of Indonesia Ministry of Finance, October 31, 2011, at *http://www.depkeu.go.id/Eng/Read/?type=ixPers&id=21489&thn=2011&name=eco_update_oct.pdf* (March 2, 2012); and Novrida Manurung and Hidayat Setiaji, "Indonesia Parliament Passes Land Bill in Boost to Yudhoyono's Growth Plans," *Bloomberg*, December 16, 2011, at *http://www.bloomberg.com/news/2011-12-16/indonesia-parliament-passes-land-bill-in-boost-to-yudhoyono-s-growth-plans.html* (March 2, 2012).
4. Derek Scissors, "What Indian Economic Reform Could Mean for the U.S.," Heritage Foundation *Backgrounder* No. 2598, August 18, 2011, at *http://www.heritage.org/research/reports/2011/08/what-indian-economic-reform-could-mean-for-the-us* (March 2, 2012).
5. Press release, "Domestic and Foreign Direct Investment Realization Quarter 4 Year 2011," Indonesia Investment Coordinating Board, 2011, at *http://www3.bkpm.go.id/contents/news/1013/domestic-and-foreign-direct-investment-realization-quarter-4-year-2011* (March 2, 2012); and Kevin B. Barefoot and Marilyn Ibarra-Caton, "Direct Investment Positions for 2010 Country and Industry Detail," Bureau of Economic Analysis, July 2011, at *http://www.bea.gov/scb/pdf/2011/07%20July/0711_direct.pdf* (March 2, 2012).
6. Ministry of Trade Republic of Indonesia, "Trade Balance Indonesia with the United States," at *http://www.kemendag.go.id/statistik_neraca_perdagangan_dengan_negara_mitra_dagang/* (March 2, 2012); and U.S. Census Bureau, Foreign Trade, "Trade in Goods with Indonesia," at *http://www.census.gov/foreign-trade/balance/c5600.html* (March 2, 2012).

considerable potential for goods and services that reflect comparative advantage and mesh in supply chains if various barriers can be overcome. The U.S. and Indonesia should take these actions:

- For the benefit of potential investors, the U.S. should designate Indonesia infrastructure programs as "commercial" or "political." This designation would not only inform American companies but may be used indirectly by the Indonesian government to assess projects.

- As an example of trade complementarity, the U.S.–Indonesia dialogue on trade and investment should focus on eliminating and preventing barriers for Indonesian textiles and American cotton.

- Both countries should reduce formal and informal barriers to private-sector education cooperation—American programs in Indonesia and Indonesian students in the U.S.

- The U.S. should start to move toward a bilateral investment treaty with Indonesia.

Opportunity Awaits. Indonesia's sustained progress should receive more attention in the U.S. American efforts to change the behavior of major East Asian partners are better spent expanding the trade and investment relationship with a fast-growing regional economy not obsessed with external surpluses. There is a long way to go in the bilateral economic relationship, but there is much in the way of opportunity.

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