POLITICAL PULSE

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# The Stars Align on Indonesia's Controversial Import Substitution Policies

*A declining exchange rate is creating a strong incentive for the Indonesian government to adopt even more protectionist trade policies to advance its import substitution goals.*


Photo credit: Kompas.id - *https://www.kompas.id/baca/english/2024/04/24/en-berbagai-sektor-industri-yang-tertekan-depresiasi-rupiah*

On 7 May, President Joko Widodo (Jokowi) inaugurated a state-of-the-art telecommunication device testing facility in Depok, a city just outside Jakarta. Called *Indonesia Digital Testing House*, this new facility cost Rp980 billion (US$61 million) and represents Jokowi's dream of creating a thriving electronic industry in the country. In his inauguration speech, Jokowi expressed concern over the increasing influx of imported goods in the electronics sector. He highlighted a significant trade deficit of Rp30 trillion in this sector and emphasized the importance of the new lab in enhancing Indonesia's position in the global electronic supply chain. This announcement largely attempts to legitimize a recent government policy restricting imports of 78 products, ranging from air conditioners to televisions to laptops. The policy, formulated in 2023, was a response to Jokowi's disappointment with the influx of imported products on Indonesian e-commerce platforms.

**The US dollar has strengthened against the Rupiah by as much as 9% over the past year**

Source: Bank Indonesia


Chart: Castle Asia • Created with Datawrapper

The inauguration took place mere days after the Rupiah reached its lowest point since 2020, at 16,302 per dollar, following a steady year-long decline. Naturally, discussions about the need to develop import substitution industries became intermingled with talks about the urgent need to stabilize the exchange rate. The Indonesian government and central bank closely monitor the exchange rate, the importance of which is perhaps rivaled only by the inflation rate. This close monitoring is largely due to the high degree of pass-through from exchange rates to domestic prices, making the two closely linked. Indonesia's experience in the 1997 Asian crisis has left a significant impression on the relationship between exchange rate stability and external debt in both the public and private sectors, and the country's status as a net oil importer has aggravated the situation. Currency depreciation now poses significant adverse impacts on fiscal sustainability due to the substantial subsidies the government must spend annually to protect consumers from price shocks in the energy sector.

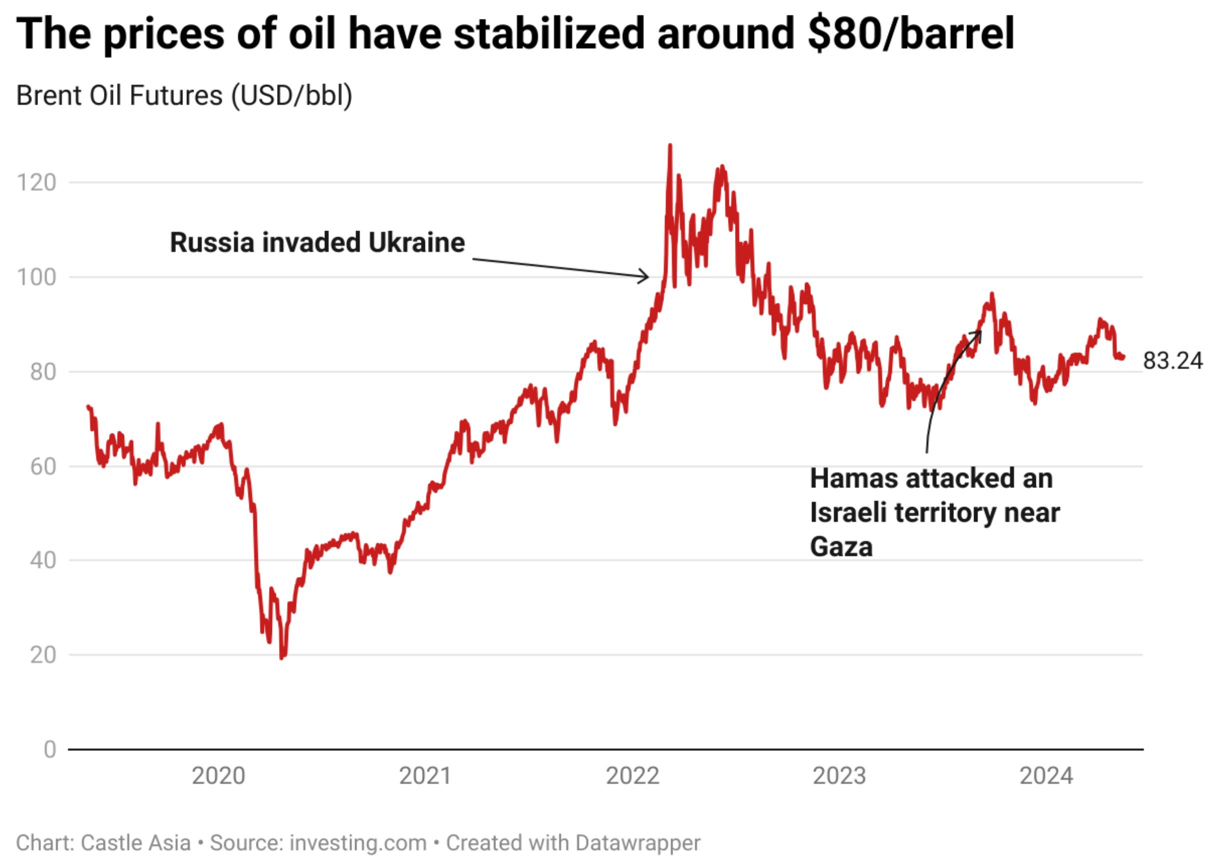
What are the causes of the ongoing depreciation of the Rupiah, and what will this mean for Indonesia's trade policy going forward?

**Strong US, Slowing China and an Unstable World**

It is important to note that the current Rupiah depreciation run has taken place during a period of positive trading performance. Indonesia has recorded a trade surplus for 47 consecutive months. While foreign exchange reserves have fallen in recent months due to international debt payments, they remain high by historical and international standards, sufficient to cover 6.5 months of imports. Thus, more than anything, the primary factor contributing to the Rupiah's depreciation, which is totally out of Indonesia's control, is the high benchmark rate set by the Federal Reserve, the US central bank, which aims to tame US inflation. This has caused capital outflows from other markets, including Indonesia. In the wake of Covid-19, the American economy has grappled with stubbornly high inflation due to a combination of rising commodity prices, supply-chain problems and an increase in money supply. Interestingly, despite energy prices falling, supply-chain problems easing and excess pandemic savings having been used up by Americans, inflation remains high, driven by a strong job market. Due to persistently high inflation, the Fed has repeatedly delayed rate cuts. When the year began, the market believed US rate cuts later this year were certain. Now there is a great deal of doubt about whether or not they will come this year and certainly not anytime soon. Recently, Fed Chairman Jerome Powell said that considering recent inflation data, "It's more likely we'll be holding the policy rate where it is."

Another factor is China's slowing economic growth. Since China began to rise as an economic powerhouse, Indonesia's fate has become increasingly tied to it. Indonesia's part in China's growth story began with the supply of commodities to fuel that growth. Now, China is Indonesia's most important trading partner and was the source of 28% of Indonesia's imports and the destination for 22% of exports in 2022. While China's growth has decelerated over the past several years, Indonesia's exports continued to benefit from strong commodity prices. Now as commodity prices have begun to fall, so has the value of Indonesian exports to China, dropping 16.24% in Q1 2024 compared to the same period last year. The decline is attributed to China's economic slowdown and falling commodity prices, particularly affecting coal, crude palm oil (CPO), and iron and steel exports. This declining export revenue from China has also contributed to the depletion of Indonesia's foreign exchange reserves and the depreciation of the Rupiah.

The third factor is the geopolitical turmoil in Ukraine and the Middle East. Russia's invasion of Ukraine in February 2022 caught the world by surprise and triggered a global energy crisis. In January 2022, oil prices were around $76 per barrel oil; in March, following the invasion, they soared to over $120. While oil prices have since subsided to around $80 per barrel, near pre-war levels, the Hamas-led attack on Israel on 7 October has complicated the situation further. Although neither Israel nor Palestine is a major oil producer, the prospect of neighboring countries becoming involved in the conflict has made the market anxious about the security of oil and gas supplies from the Middle East. While this anxiety has not triggered the kind of price shock caused by the Russian invasion of Ukraine, it has the potential to bring about significant disruption. These geopolitical tensions have significantly impacted global energy prices, leading to increased uncertainty in the markets. This surge in energy costs has fueled inflationary pressures worldwide and prompted investors to seek safe-haven assets like the US dollar. As a result, capital outflows from emerging markets like Indonesia have intensified, placing downward pressure on the Rupiah. With investors retreating from perceived riskier assets due to the volatility in energy markets, the stronger US dollar further amplifies the depreciation of the Rupiah.




**More Protectionism Is Coming**

There are several reasons why the ongoing currency depreciation is likely to incentivize the government to become more aggressive in pursuing its import-substitution policies.

First, in Indonesia, currency depreciation always serves as a bitter reminder of the country's fragile trade balance. Before the ongoing record long-run trade surplus, Indonesia often ran a trade deficit, which consequently translated into acute anxiety about inflation and the social unrest that it caused, as well as the country's ability to service its external debts. In these situations, introducing import restrictions is often seen as a solution to achieve a healthier trade balance. This experience also makes the import-substitution strategy an ongoing obsession among policymakers.

Second, a depreciating currency makes imports expensive and exports cheap, creating an incentive to localize the supply chain of input materials for exported products. The depreciation of the Rupiah also means that Indonesian assets are now cheaper for foreign investors. This is an important upside. In recent years, the government has discovered that Indonesia struggles to be competitive with regional peers like Vietnam in areas like industrial land prices. Therefore, if the current exchange rate persists for a significant period, we are likely to observe an uptick in the flow of foreign direct investment into Indonesia. Unfortunately, the nickel export ban and the subsequent influx of investments to the nickel processing industry have emboldened the government to impose export bans on other minerals, so a surge in FDI is likely to be misinterpreted as a sign of success of the recent import restriction policies. In fact, it is Indonesia's imposition of expensive domestic content requirements and forced cooperation with domestic partners, often state-owned enterprises, that has prevented it from becoming a significant part of the global supply chain. Unless global players are able to choose their own partners and access the best inputs at the best prices, the majority will continue to avoid Indonesia.

Third, a prolonged depreciation gives rise to widespread concern about its impact on inflation and external debt, prompting a sense of urgency in the government and the central bank to stabilize the exchange rate. In theory, a depreciating Rupiah should make Indonesian exports more competitive in international markets, potentially leading to an increase in export revenue and, subsequently, a strengthening of the currency. However, the benefits from currency depreciation on exports may be limited by a slowdown in key export markets, especially China. In this case, the central bank could intervene using monetary policy tools, such as raising its benchmark rate and issuing securities at higher rates. The government, on the other hand, often uses trade policy to stabilize its currency. In the past, the government imposed import restrictions on several product categories to reduce trade deficits and maintain a stable exchange rate. While attractive and occasionally successful in deterring the import of non-essential consumer products, import restrictions and higher tariffs on equipment and technology products raise local costs and reduce the competitiveness of Indonesian products, discouraging investment in global supply chain businesses.

Ultimately, maintaining a healthy trade balance will be even more of a priority for the incoming Prabowo government. Prabowo has made several promises, such as free school lunches and continuing the new capital development, which may require that he scraps Indonesia's long-honored fiscal conservatism and take on more debt. Currently, Indonesia has a strict legal limit that the budget deficit cannot exceed 3% and debt cannot be more than 60% of GDP. Maintaining a positive trade balance is critical to reducing incentives for the new president to bust the budget limit and make his government struggle to service its debt. Without improvement in the country's export performance, Prabowo may feel forced to introduce even more protectionist policies. However, to achieve sustainable economic growth, he should complement the country's import substitution strategy with policies that enhance competitiveness, such as improving infrastructure, investing in education and fostering innovation. A balanced approach can help mitigate the risks associated with protectionism.

**No Guarantee of Success**

While the situation may create a strong temptation for the government to pursue a more aggressive import substitution strategy, it is unlikely to be successful. Many other countries have sought to challenge China's domination in manufacturing, but few have been able to accomplish anything meaningful. This is mainly because it is very difficult to compete head-on with China's manufacturing ecosystem, which has virtually everything that businesses want from a manufacturing hub, including a world-class infrastructure, business-friendly regulations the availability of highly motivated and skilled talent and ease of acquiring input materials. Moreover, implementing protectionist measures often disrupts Indonesia's existing manufacturing activities by cutting them off from essential input materials. Indeed, there have already been numerous complaints from the footwear industry that recent import restrictions on certain input materials have made them unable to meet domestic demand.

The government should take complaints very seriously. Indonesia already has one of the most restrictive trade regimes in Southeast Asia. According to the National Secretariat for the Prevention of Corruption, an interagency body, out of 11,415 Harmonized System (HS) codes that Indonesia has, 7,200 or 63,16% fall under the Prohibition and Restriction category. This is far above the ASEAN average, which stands at 17%. Relying on trade restrictions to pursue an import substitution strategy does not guarantee success, but it certainly guarantees to harm existing businesses and discourage global supply chain investors. Ultimately, a balanced and strategic approach that fosters competitiveness and innovation will be more effective in achieving long-term economic growth and stability.