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Singapore | 4 Jul 2013

China-Indonesia economic relations: Challenges and prospects

By Zhao Hong (Guest Writer)

EXECUTIVE SUMMARY

- Post-1998 changes in Indonesia's domestic politics coincided with China's "good neighbour" policy and "charm diplomacy" toward Southeast Asia, and bilateral relations have been showing significant signs of improvement and closer cooperation.
 - Indonesians no longer see China as an ideologically threatening state, but as an economic powerhouse providing positive spillovers to its cash-strapped neighbours in Southeast Asia. China's perceptions of Indonesia have also changed significantly.
 - However, despite recent improvements in bilateral ties, there is still uncertainty over China's long-term strategic intentions in Southeast Asia. While economic cooperation has progressed, strategic cooperation between the two countries is moving at a much slower pace.
 - Indonesia stands to benefit significantly from the implementation of the ASEAN-China Free Trade Area (ACFTA) which will provide it with easier access to new markets for its manufactured products and raw materials.
 - Investments from China will also play a pivotal role in achieving the Indonesian government's target of accelerating and expanding infrastructure development in the country.
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INTRODUCTION: INDONESIA AS AN EMERGING POWER

Indonesia remains one of the best-performing developing countries in Asia. In purchasing power parity terms, it is already the largest economy in ASEAN, registering a gross domestic product (GDP) of US\$1,100 billion and GDP per capita of US\$4,700 in 2011. It was also one of very few economies that continued to grow throughout the recent global recession, achieving a GDP growth rate of 6.2 per cent in 2012. It is also expected to maintain an average growth rate of 6.5 per cent per year from 2011 to 2015.

With the success of recent political reforms, Indonesia has re-emerged as a regional power.¹ With its growing weight, it is actively seeking a bigger presence on the world stage, and is making efforts to raise its diplomatic profile and to play the role of a 'middle power' in the region.² Under President Susilo Bambang Yudhoyono, Indonesia's role as the unofficial leader of ASEAN has reinvigorated, and it has expressed the desire to be ranked among the BRIC economic club of Brazil, Russia, India and China.

During the recent South China Sea disputes, Indonesia declared that it had a pivotal role to play not only in mediating and defusing tension, but in presenting ASEAN's collective view of the quarrel. According to *Jakarta Post*, Indonesia's role must be to convince Beijing that how China is perceived by its neighbours holds great importance for the outcome of the disputes.³

At the global level, Indonesia became a member of the G20 major economies in 2009, giving it a higher profile as a strong voice of ASEAN and making it an increasingly important player in global governance.⁴ The country is also part of the Organization of Islamic Conference, and President Yudhoyono recently indicated Indonesia's willingness to play the part of being a "bridge between the Islamic and the western worlds".⁵ Its influence on the emerging regional architecture, therefore, is expected to be significant. Coupled with significant natural resource trade flows into the world economy—the country accounts for 13 per cent of global coal exports and is a major producer of palm oil—it has been suggested that Indonesia may get picked up by the rising tide of a booming China and India.⁶ Indeed, Indonesia increas-

1 In the decades following independence in 1945, many Indonesian leaders felt that the country's size, resources and revolutionary history entitled Jakarta to a leadership role in Southeast Asia.

2 A number of academics, such as Carsten Holbraad (*Middle Powers in International Politics*, 1984) and Jonathan H Ping (*Middle Power Statecraft: Indonesia, Malaysia, and the Asia-Pacific*, 2005), have already argued that Indonesia deserves to be categorized as a middle power.

3 Ristian Atriandi Supriyanto, "Indonesia and the South China Sea dispute", *The Jakarta Post*, July 4, 2011.

4 At the ASEAN summit in Thailand in October 2009, it was agreed that ASEAN finance ministers would in the future always meet before G20 meetings to coordinate their positions, effectively meaning that other ASEAN countries are recognizing Indonesia's role as a channel for them to access major world powers. [Sri Wahyuni, "ASEAN seeks stronger G20 voice", *The Jakarta Post*, October 25, 2009]

5 "Towards Harmony among Civilizations", speech by Susilo Bambang Yudhoyono at the John F. Kennedy School of Government, Harvard University, September 29, 2009.

6 Alex Dunnin, "Arise Chindonesia," *The Financial Standard*, October 21, 2009.

ingly sees the importance of China in facilitating its rising position in regional and international affairs.

CHANGING PERCEPTIONS OF CHINA

Indonesia was the first Southeast Asian country to establish official diplomatic relations with China, which it did in July 1950. The first 15 years of that relationship, however, were replete with problems and suspicions, culminating in Indonesia's decision to freeze diplomatic ties in October 1967.

The resumption of diplomatic relations in August 1990 did not immediately remove thorny issues between the two countries, however. Suspicion and sensitivity continued to characterize Indonesia's attitude toward China. Although Indonesians began to recognize Beijing's importance, their distrust of the country's ethnic Chinese minority continued to affect perceptions of China. Such negative views have also been exacerbated by concerns over China's regional role and policies in Southeast Asia, especially regarding the South China Sea and China's growing military capability.⁷ There was initial worry that China's claims in the South China Sea might also infringe upon Indonesia's sovereignty over Natuna Island.⁸

China-Indonesia relations began to show significant signs of improvement since dramatic changes in Indonesia's domestic politics began in May 1998. These coincided with China's "good neighbour" policy and "charm diplomacy" towards Southeast Asia. A newly democratizing Indonesia seems to pursue a very different attitude and policy toward China. The imperative for improving relations became important to Indonesia's foreign policy during the Abdurrahman Wahid era and has since been followed through by every successive government in Jakarta.

The basis for active bilateral cooperation received a stronger impetus when Indonesian President Yudhoyono and Chinese former President Hu Jintao signed a "strategic partnership" agreement between the two countries on 25 April 2005 in Jakarta. During Yudhoyono's visit to China in July the same year, officials concluded several major agreements covering not only traditional areas of cooperation in trade and investment but also defence technology cooperation, suggesting that China-Indonesia relations have revived significantly.

Indeed, Indonesia has increasingly become more comfortable and confident in dealing with China. Instead of seeing China as a threat to its national security and internal stability, it now uses it as a reference for economic success. More and more Indonesians consider China, compared to the U.S., as an increasingly positive partner. For example, the 2011 *Pew Global Attitudes Survey* indicated that the share of

⁷ Rizal Sukma, "Indonesia-China relations: the politics of re-engagement", *Asian Survey*, August 2009.

⁸ Although China's "nine-dotted line map" overlaps part of the Exclusive Economic Zone extending from Natuna Islands, Beijing has repeatedly assured Jakarta in unofficial diplomatic interactions that it acknowledges Indonesia's sovereignty over Natuna Islands.

Indonesians saying that they had a favourable opinion of China increased from 58 per cent in 2010 to 67 per cent in 2011, while views toward the U.S. went down slightly from 59 per cent to 54 per cent during the same period.⁹ The survey also reported that 46 per cent of Indonesians believed that the bilateral relationship with China will become the most important one in ten years time, while only 23 per cent believed that the U.S. relationship would be the most important.

Although Indonesian elites favour U.S. engagement in the region and dislike the thought of a dominant Chinese role, they have far more confidence in Chinese commitment to the region than they have with U.S. commitment.¹⁰ In fact, most Indonesians no longer see China as a revolutionary power that is threatening both the regional and global structure, but as an economic powerhouse providing positive spillovers to its cash-strapped neighbours in Southeast Asia. As Yudhoyono has stated, “our target in developing relations with China is to look for an opportunity to fulfil our national interests. We have to get something from the rise of China, especially in economic terms.”¹¹

China’s perceptions of Indonesia have also changed significantly. Indonesia’s image as an anti-Chinese nation has begun to fade away in spite of the existence of some residual negative perceptions of the anti-Chinese riots in 1998. Indonesia is also becoming an integral part of Beijing’s engagement policy with Asia.¹²

GROWING ECONOMIC INTEGRATION

These mutually positive perceptions thus provide a good foundation for economic cooperation. Despite the global meltdown, the two countries achieved the target of US\$30 billion in bilateral trade in 2008. Indeed, between 2006 and 2010, bilateral trade increased from US\$19.1 billion to US\$66.2 billion. This amounts to an impressive 300 per cent growth in the four years. The two countries have now agreed to increase the volume of bilateral trade to US\$80 billion by 2015.¹³

Increasing bilateral trade with China has also helped Indonesia reduce its overdependence on Western markets and other export destination countries. For example, from 2005 to 2011, the export market share to the Euro Area decreased from 10.5 per cent to 8.8 per cent, while that to the U.S. decreased from 11.6 per cent to 8.2 per cent. At the same time, that to China increased from 3.8 per cent to 11.5 per

⁹ Christine Susanna Tjhin, “The Panda on Our Eyelids: How Indonesians View China”, *The Jakarta Post*, August 18, 2011.

¹⁰ Bates Gill, Michael Green, Kiyoto Tsuji, and William Watts, *Strategic Views on Asian Regionalism: Survey Results and Analysis*, Washington, D.C., CSIS, February 2009, p.15.

¹¹ *Media Indonesia*, October 27, 2005.

¹² Tang Shiping, “Grand strategy: searching for China’s ideal security environment,” *Zhanlue yu Guanli [Strategy and Management]*, no. 6, December 2000.

¹³ Zhou Yan, “Indonesia seeks more Chinese investment”, *China Daily*, May 3, 2011.

cent (Table 1). China, India and other developing Asian countries played a key role in mitigating the effects of Indonesia's decelerating exports to developed countries.

Table 1: Shares in Indonesia's Export, by Selected Destinations, 2003-2011

Country	2003		2010		2011	
	US\$ Billion	Share (per cent)	US\$ Billion	Share (per cent)	US\$ Billion	Share (per cent)
Total	64.1	100	158.1	100	200.6	100
Euro Area	6.7	10.5	14.5	9.2	17.6	8.8
U.S.	7.4	11.6	14.3	9.1	16.5	8.2
Japan	13.6	21.3	25.8	16.3	33.7	16.8
Developing Asia	11.8	18.4	47.8	30.2	63.4	31.6
China	3.8	6.0	15.7	9.9	23.0	11.5
India	1.7	2.6	9.9	6.3	13.4	6.7

Source: IMF, *Direction of International Trade Statistics Yearbook 2012*.

The fast growing China-Indonesia economic relations also reflect two trends – China's growing demand for energy and raw materials and China's increasing investment in Indonesia. Soon after China became a net importer of coal in 2007, Indonesia became one of its important suppliers of the fuel. In July 2010, Shenhua – China's largest coal producer – announced a US\$331 million coal project in Sumatra, and in October the same year, China's sovereign wealth fund injected US\$1.9 billion into Bumi Resources – Indonesia's largest coal producer.¹⁴

Apart from energy supplies, Indonesia has also emerged as an important supply source of raw materials and an important investment market. By the end of 2011, more than 1,000 Chinese enterprises had invested in the country, with an investment value of US\$592.2 million, which amounted to a staggering 19-fold increase from 2003 (US\$29.8 million).¹⁵ Indonesia has definitely become one of the most important destinations for Chinese enterprises.

¹⁴ Anthony Deusch, "Asia giants' scrabble for coal reaches Indonesia", *Financial Times*, September 9, 2010.

¹⁵ Ministry of Commerce of China, *2011 Statistical Bulletin of China's Outward Investment*.

PROBLEMS AND CHALLENGES

Despite recent improvements in China-Indonesia ties, there is still anxiety about China's strategic role in the region and questions remain on "how China is going to use its new stature and influence in achieving its national interests and objectives in the region."¹⁶ In particular, Indonesia and some other ASEAN member states are uncertain about China's long-term intentions in Southeast Asia.

Jakarta's wariness can be seen in the slow pace of strategic cooperation between the two countries. While this has improved since the post-Suharto period, it has not progressed at the same pace as the economic relationship. The 2005 strategic partnership between these two countries envisages greater engagement in not only conventional bilateral areas but also issues of regional and global importance. But strategic cooperation in some important areas, especially security issues, has not been translated into action. Arguably, suspicion and security concerns prevail and have prevented bilateral trade and investment cooperation from progressing further. Despite Indonesia being the biggest country in Southeast Asia, the growth in its trade with China has been much slower than that for other ASEAN countries. Among the 10 ASEAN countries today, Indonesia is only the fourth in terms of trade volume with China, after Singapore, Malaysia, and Thailand.

Jakarta believes that the growing non-oil and gas trade deficit with China is the main impediment to the expansion of bilateral trade. According to Indonesia's data, it had a \$1.1 billion trade surplus with China in 2007, but a \$3.3 billion deficit in 2011. Rising fears that this widening trade gap will affect its national economic security have raised calls from certain Indonesian businesses to renegotiate the ASEAN-China Free Trade Area (ACFTA) that took effect in 2010, stirring debate over how Indonesian industries will be able to remain competitive as the country seeks improved trade ties with Beijing.

In bilateral investment, Indonesia's FDI in China has been insignificant when compared with that of some ASEAN countries. In 2009, the value of Indonesia's FDI in China was US\$111.7 million, accounting for only 2.4 per cent of ASEAN 6's total value of FDI in China.

For China, its overall investment commitment in Indonesia also remains comparatively small. In 2011, China's total outward FDI reached US\$74.7 billion, while its FDI in ASEAN was a mere US\$5.9 billion. China's FDI in Indonesia at the same time was US\$592 million, accounting for 10 per cent of China's total FDI to ASEAN (Table 2).¹⁷

¹⁶ Rizal Sukma, "Indonesia's response to the rise of China: growing comfort amid uncertainties", in *The rise of China: responses from Southeast and Japan, NIDS Joint Research Series No. 4* (Tokyo: National Institute of Defense Studies, 2009).

¹⁷ In the same year, the U.S. committed US\$930 million, making it the third largest investor in Indonesia behind Singapore and UK.

Table 2: China's FDI in ASEAN (US\$ million)

Countries	2003	2004	2005	2006	2007	2008	2009	2010	2011	Accumulation by 2011
Brunei	-	-	1.5	-	1.2	1.8	5.8	16.5	20.1	661.3
Cambodia	22.0	29.5	5.2	9.8	64.5	204.6	215.8	466.5	566.0	1,757.4
Indonesia	26.8	62.0	11.8	56.9	99.1	174.0	226.1	201.3	592.2	1,687.9
Laos	0.8	3.6	20.6	48.0	154.4	87.0	203.2	313.6	458.5	1,276.3
Malaysia	2.0	8.1	56.7	7.5	-32.8	34.4	53.8	163.5	95.1	797.6
Myanmar	-	4.1	11.5	12.6	92.3	232.5	376.7	875.6	217.8	2,181.5
Philippines	1.0	0.05	4.5	9.3	4.5	33.7	40.2	244.1	267.2	494.3
Singapore	-3.2	48.0	20.3	132.2	397.7	1,551.0	1,414.3	1,118.5	3,269	10,602.7
Thailand	57.3	23.4	4.8	15.8	76.4	45.5	49.8	699.9	230.1	1,307.3
Vietnam	12.8	16.9	20.8	43.5	110.9	119.8	112.4	305.1	189.2	1,290.7
Total	119.5	195.7	157.7	335.6	968.2	2,484.3	2,698.1	4,404.6	5,905.2	22,057.2

Source: Ministry of Commerce of China, 2011 Statistical Bulletin of China's Outward FDI, p.54.

PROSPECTS

The China-Indonesia strategic partnership signed in 2005 aimed to consolidate not only bilateral relations, but also contribute towards an ASEAN-led community-building process.¹⁸ Beijing understands that strengthening relations with Indonesia will help to forge closer ties between China and ASEAN as a grouping, and benefit China in achieving some of its policy objectives and benefit its strategic interests.

Indonesia also stands to benefit from the implementation of the ASEAN-China Free Trade Area (ACFTA), which will provide it with easier access to new markets for its manufactured products and raw materials. While there could be a short-term impact in terms of lower profits and job losses in Indonesia's labour-intensive industries such as textiles, garments, and footwear, the potential gains in the medium and long term are expected to be significant.

There is potential for these industries to become more dynamic and competitive with capital inflow from Chinese companies, which is needed in not only financing and upgrading the production of components, but also in selling goods to countries

¹⁸ "China, Indonesia forge strategic partnership", *People's Daily Online*, April 24, 2005.

worldwide, including China. Indonesia can also strengthen its competitiveness by developing strong cooperation with China both in investment and the upgrading of old machinery. The Chinese Ambassador to Indonesia, Zhang Qiyue suggested that “Indonesian textile manufacturers could import high-technology machinery from China at one-third of the price of machines imported from Europe or the U.S. because of the ACFTA”.¹⁹ To promote intra-industrial trade between the two countries, China can encourage private enterprises to outsource production to Indonesia, employing more Indonesian workers, and exporting final products back to China for ultimate consumption.

China can also enlarge its FDI in Indonesia, particularly in infrastructure sectors, beyond agreed-upon targets established in earlier partnership agreements. Indonesia’s poor infrastructure has been the major impediment to the country’s economic growth and social development. The country’s infrastructure index remains very low: 76th for physical infrastructure; 103rd in terms of port quality; and 98th in electricity supply.²⁰ Although the Yudhoyono government has made infrastructure development a top priority in its *Master Plan for the Acceleration and Expansion of Indonesia’s Economic Development* unveiled in May 2011, government infrastructure spending in 2011 as a share of GDP had fallen by nearly 50 per cent as compared to the first half of the 1990s, and is well below that of other faster-growing Asian economies. In short, investments from China will play a pivotal role in achieving the Indonesian government’s target of accelerating and expanding infrastructure development in the country.

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19 “Indonesian manufacturers should not blame China: Ambassador”, *The Jakarta Post*, April 14, 2011.

20 Makarim Wibisono, “Indonesia and global competitiveness”, *The Jakarta Post*, October 10, 2011.

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