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## **Strategic Distance is Favoured in China-Indonesia Ties**

*By John Lee*

### EXECUTIVE SUMMARY

- There is little evidence that Beijing is attempting to use economics to seduce or compel Jakarta to make strategic decisions that the latter would not otherwise make.
- Even if China attempted to do so, the structure of the Indonesian economy, the trend of its economic development model, and its open approach, indicate that Beijing would have little capacity to influence significantly Jakarta's strategic decisions.
- An entrenched mindset of maximising strategic independence and autonomy means that Indonesia will continue to avoid overtly 'picking sides' and dodge strategic entanglements even as it seeks outside assistance to accelerate economic development.
- This will likely mean that Jakarta will continue with a posture of offering 'friendly ambivalence' vis-à-vis China as a defensive and small-target hedging strategy.

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## INTRODUCTION

With widespread perceptions of an economically ascendant China in the region, and China's emergence in 2010 as Indonesia's largest trading partner, it is no surprise that some believe Jakarta will gradually but inexorably move into Beijing's political, strategic and economic embrace. Is this observation accurate, and is China acquiring the economic levers to entice or compel Indonesia to move deeper into its sphere of influence?

This report argues that it would be a mistake to overplay the extent to which Indonesia ought to be monitored as a major strategic battleground or 'swing state' in the contest for influence between China and the U.S. – in the way Beijing is jostling for influence, say, in Bangkok.<sup>1</sup> This is so for two reasons.

First, while it is clear that Jakarta's relations with Beijing have improved dramatically since diplomatic ties were restored in 1990, there is little evidence that China is attempting to use its economic weight to exercise meaningful leverage over Jakarta's current and future strategic options. Critically, even if China wished to do so, the structure of the Indonesian economy, the trend of its economic development model and its open approach suggest that Beijing has little economic capacity to influence significantly Jakarta's strategic decisions in the foreseeable future, even as good relations with China is clearly important for Indonesia's economic prospects.

Second, geographic location, large population size, and potential economic growth and size make Indonesia an enormously important player in East and Southeast Asia. But an entrenched mindset of maximising strategic independence and autonomy means that the country – in the absence of extreme provocation - will continue to eschew overtly 'picking sides' and avoid strategic entanglements even as it seeks outside assistance to accelerate economic development. Moreover, even if Beijing subsequently uses all tools of economic statecraft at its disposal to 'win over' Jakarta, a domestically fragile Indonesia will still be large and powerful enough to resist any onerous strategic demands placed upon it by regional great powers.

## SINO-INDONESIAN TRADE

Bilateral trade between Indonesia and China has grown significantly from US\$14.9 billion in 2006, to US\$25.5 billion in 2009, to US\$36.1 billion in 2010, to US\$66.2

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<sup>1</sup> See John Lee, "China's Economic Influence in Thailand: Perception or Reality?", *ISEAS Perspective* No. 44, July 11, 2013 <[http://www.iseas.edu.sg/documents/publication/iseas\\_perspective\\_2013\\_44\\_chinas\\_economic\\_influence\\_in\\_thailand\\_perception\\_or\\_reality.pdf](http://www.iseas.edu.sg/documents/publication/iseas_perspective_2013_44_chinas_economic_influence_in_thailand_perception_or_reality.pdf)> accessed August 26, 2013.

billion in 2012<sup>2</sup> – with a joint target that it reaches US\$80 billion by 2015.<sup>3</sup> It may have begun from a low base, but growth in Sino-Indonesian trade has generally reflected growth levels commensurate with both intra-ASEAN trade and ASEAN trade with China in 2000-2012. Sino-ASEAN trade grew at about 22% per annum in 2000-2012<sup>4</sup> while Sino-Indonesian trade for the same period was a little above 23%.<sup>5</sup>

Even so, China has undoubtedly become a more significant trading partner for Indonesia in comparative terms. In 1990 China accounted for 3.1% of Indonesia's total trade. This rose to 5% in 2000, 12.3% in 2010 and 21% in 2012.<sup>6</sup> As Sino-Indonesia trade grows robustly, the balance of trade between the two countries has shifted in China's favour.

**Table 1: Sino-Indonesian Balance of Trade**

	<b>Exports to China (US\$ billions)</b>	<b>Imports from China (US\$ billions)</b>	<b>Indonesian deficit (US\$ billions)</b>
<b>2006</b>	5.4	5.5	0.1
<b>2008</b>	7.7	14.9	7.2
<b>2010</b>	14	19.6	5.6
<b>2012</b>	32	34.3	2.3

Source: Indonesia Ministry of Industry; China Ministry of Commerce.

The ongoing trade deficits with China are conspicuous because Indonesia has enjoyed surpluses in combined trade with all countries for every year except 2012. For example, Indonesia had an overall trade surplus of US\$39.63 billion in 2007, US\$19.68 billion in 2009 and US\$26.06 billion in 2011. In 2012, it suffered a small trade deficit of US\$1.63 billion.<sup>7</sup> This means that China has been the major driver in Indonesia's declining balance of trade.

<sup>2</sup> Indonesia Ministry of Trade and World Bank figures.

<sup>3</sup> See "Chinese Ambassador Liu Jianchao receives interview with MNC Economic Channel: Sino-Indonesia trade and investment cooperation promising," *Press release by Economic and Commercial Section of the Consulate-General of the People's Republic of China in Medan*, May 2, 2013 <<http://medan2.mofcom.gov.cn/article/chinanews/201305/20130500110478.shtml>> accessed August 19, 2013.

<sup>4</sup> See China Ministry of Commerce figures reported in "China-ASEAN Trade to hit \$500 billion," *Xinhua*, July 23, 2013 <[http://www.chinadaily.com.cn/business/2013-07/23/content\\_16818854.htm](http://www.chinadaily.com.cn/business/2013-07/23/content_16818854.htm)> accessed August 19, 2013.

<sup>5</sup> Indonesia Ministry of Trade figures.

<sup>6</sup> IMF Directions of Trade figures and author's calculations.

<sup>7</sup> Indonesia Central Statistics Agency figures. See commentary in Linda Yulisman, "RI suffers first-ever annual trade deficit," *The Jakarta Post*, February 2, 2013 <<http://www.thejakartapost.com/news/2013/02/02/ri-suffers-first-ever-annual-trade-deficit.html>> accessed August 19, 2013.

A closer look at the structure of Indonesian trade generally, and trade with China specifically is revealing. Indonesian export of oil and gas to China may be an important component of overall trade but it has become relatively less so over time. It was valued at US\$2.8 billion in 2006, and US\$3.8 billion in 2008, but by 2010, it had dropped to US\$1.6 billion. The trend is a 12.31% decline per annum over the period. In contrast, Indonesian non-oil and gas exports to China have grown in volume, from US\$5.4 billion in 2006, to US\$7.7 billion in 2008, to US\$14 billion in 2010, with over 24% growth per annum over the period. In 2012, the figure was US\$20.86 billion.<sup>8</sup>

Even so, the growth in Indonesian non-oil and gas exports to China is exceeded by growth in Chinese non-oil and gas exports into Indonesia over the same period. These Chinese imports amounted to US\$5.5 billion in 2006, US\$14.9 billion in 2008 and US\$19.6 billion in 2010.<sup>9</sup> This equates to over 36% per annum growth.

This point is important because trade with China potentially threatens the indigent and less efficient non-oil and gas sectors, particularly industrial manufacturing and consumer products. When one excludes oil and gas from Sino-Indonesian trade statistics (significant sectors even if they are becoming less important to the modernising Indonesian economy), the trade imbalances with China become even starker. In 2012, Indonesia suffered a US\$8.1 billion deficit with China when oil and gas sectors are excluded.<sup>10</sup> This is by far the largest non-oil and gas trade deficit with any country for that year, beating a deficit of US\$5.81 billion with Thailand and US\$5.46 billion with Japan. In contrast, Indonesia has a US\$8.43 billion non-oil and gas surplus with India, US\$3.13 billion surplus with the U.S. and US\$2.15 billion surplus with Malaysia in 2012.<sup>11</sup>

Anecdotal evidence that cheap Chinese manufacturing components and manufactured goods are flooding the Indonesian market is reaffirmed when one considers the nature of these goods. Of all such goods from China in 2011, 23.6% were electronics, 20.2% machinery and other productive equipment and parts, 10.1% textiles, 9.2% steel and derivative products, and 8.2% chemicals (with other products comprising 28.5%).<sup>12</sup>

These figures are strongly suggestive of two things. First, and most obvious, an increasing number of cheap China-made consumer goods are entering the Indonesian market. While it is the case that the value-add and assembly of these goods may well include several regional countries such as Thailand and Malaysia, the 'Made in China' stamp will nevertheless not escape Indonesian attention. For example, laptops

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<sup>8</sup> Indonesia Ministry of Trade figures.

<sup>9</sup> Indonesia Ministry of Trade figures.

<sup>10</sup> Indonesian Central Statistics Agency figures.

<sup>11</sup> Indonesian Central Statistics Agency figures.

<sup>12</sup> Indonesia Ministry of Industry figures.

and cellular phones top the list of electrical goods arriving from China;<sup>13</sup> imported Chinese textiles, garments and footwear have been seen as a threat to Indonesian firms for well over a decade;<sup>14</sup> while local food processing firms are complaining that they are losing out to China-processed food entering Indonesia.<sup>15</sup>

Second, Indonesian manufacturers are becoming more reliant on China-made goods such as electric components, turbines and lubricants which dominates Chinese exports of machinery and equipment into Indonesia. Bear in mind that Indonesian manufacturers are also increasingly reliant on manufacturing parts and components from neighbouring economies such as Malaysia, Vietnam and Thailand. The fact that Indonesia requested for flexibility and delayed reductions on 309 tariff lines (subsequently reduced to 228 tariff lines in 2010) under ACFTA's 'Sensitive Track' provisions probably speaks more about Indonesia's lack of competitiveness and readiness for export manufacturing than it does about the damage done by imports from China to the Indonesian manufacturing sector and the economy generally.<sup>16</sup>

When it comes to exports to China, Indonesia has had to rely increasingly on relatively low value-added sectors such as mining and agricultural products, and withstand the volatility of increases and falls in hard and soft commodities prices for products such as natural gas, coal and cooking oils. Indonesian mining products exported to China as a proportion of total exports to China have increased from 26.2% in 2000, to 44.3% in 2005, to 46.8% in 2010 – in an era of relatively high commodity prices which may not last. Export of Indonesian agricultural products to China as a proportion of total exports to China has increased from 20.8% in 2000, to 22.5% in 2005, to 29.3% in 2010.<sup>17</sup> Indeed, studies show that Indonesian exports to China continue to rely on national-resource intensive and unskilled-labour intensive sectors – the lowest-value added export sectors – and have done so for the past decade. In contrast, it has struggled to increase its share of exports in high value-added sectors comprising capital-intensive and technology-intensive products and services.<sup>18</sup>

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<sup>13</sup> See Linda Yulisman, "RI suffers first-ever annual trade deficit," *The Jakarta Post*, February 2, 2013 <<http://www.thejakartapost.com/news/2013/02/02/ri-suffers-first-ever-annual-trade-deficit.html>> accessed August 19, 2013.

<sup>14</sup> See Anne Booth, "China's Economic Relations with Indonesia: Threats and Opportunities," *SOAS Working Paper*, October 2011 <<http://www.soas.ac.uk/cseas/events/file72193.pdf>> accessed August 19, 2013; Fabio Scarpello, "Imports threat to Indonesia's textile art form," *South China Morning Post*, April 5, 2012 <<http://www.scmp.com/article/653175/imports-threat-indonesias-textile-art-form>> accessed August 19, 2013; Tei Chuen Yuh and Mohamed Aslam, "The ASEAN-China FTA: Manufacturer Associations' Views on Impacts to the ASEAN Textile and Clothing Sector," *Institute of China Studies Working Paper* No. 2012-2, May 2012 <<http://ics.um.edu.my/images/ics/workingpaper/2012-2.pdf>> accessed August 22, 2013.

<sup>15</sup> See Evan A. Laksmana, "Variations on a Theme: Dimensions of Ambivalence in Indonesia-China Relations," *Harvard Asia Quarterly* 13:1 (Spring 2011), pp. 24-31 <[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1979863](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1979863)> accessed August 19, 2013.

<sup>16</sup> For example, see Anwar Nasution, "How to make use of ACFTA and other FTAs," *The Jakarta Post*, April 11, 2013 <<http://www.thejakartapost.com/news/2013/04/11/how-make-use-acfta-and-other-ftas.html>> accessed August 9, 2013.

<sup>17</sup> UN Comtrade figures.

<sup>18</sup> See Rudy Rahmaddi and Masaru Ichihashi, "The Changing Pattern of Export Structure and Competitiveness in Indonesia's Manufacturing Sectors: an Overview and Assessment," *IPEDR* 36 (2012) <<http://www.ipedr.com/vol36/002-ICETD2012-D00003.pdf>> accessed August 22, 2013.

The current government in Jakarta, many policy elites, and economists appear committed to ACFTA and regional free trade generally, reasoning that it is in Indonesia's best long-term interest.<sup>19</sup> The diplomatic cost of bucking regional free trade trends in the form of substantial retreat into protectionism would also be considerable. But it is clear that rapid increases in Sino-Indonesian bilateral trade volumes remain somewhat disconcerting for many in Indonesia – and the rising trade deficits for Indonesia will further fuel the perception that China rather than Indonesia is the greater beneficiary of the trade relationship.

## CHINESE FOREIGN DIRECT INVESTMENT IN INDONESIA

Figures on Chinese FDI into Indonesia as a proportion of all FDI into Indonesia are dwarfed by figures for other major investor countries; as **Table 2** shows across the recent time series. It is clear from that table that China is far from being a dominant investor in Indonesia.

**Table 2: Inward FDI by country as a percentage of all FDI**

	2004	2005	2006	2007	2008	2009	2010	2011	2012 (Q1)
U.S.	N/A*	41.3	N/A*	16	11.2	3.3	4.2	0.5	4.4
Netherlands	65	8	27	25.3	8.1	N/A*	N/A*	0.3	1
U.K.	10.5	0.6	0.6	N/A*	3	8.3	2.5	5.8	4.4
Japan	N/A*	18.5	21.5	16.2	12.3	18.3	27	27	33.5
South Korea	12	2.9	6.4	3.6	2	1.7	2.5	3.2	3.6
Malaysia	6.3	1.7	5.6	3.3	10.9	6.4	2.5	1.2	N/A*
Singapore	4.4	8.9	21.9	12.1	25	20.8	39.8	42.8	39
ASEAN	10.8	10.6	27.6	16	36.5	28.3	42.9	43.3	38.8
China	15.6	3.6	2.5	1.7	5.7	7.3	2.6	1.2	2.7

Source: Central Bank of Indonesia; author's calculations

\*Means there was negative FDI inflows (i.e., net outflows from that country) in that year.

<sup>19</sup> For example, see Winarno Zain, "The pain, gain from ACFTA," *The Jakarta Post*, April 25, 2011 <<http://www.thejakartapost.com/news/2011/04/25/the-pain-gain-acfta.html>> accessed August 19, 2013; *Indonesian Economic Quarterly: Looking Forward* (World Bank, September 2010) <[http://www-wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/2010/09/28/000333038\\_20100928015604/Rendered/PDF/567900WP0IEQ1S132B01PUBLIC10ENGLISH.pdf](http://www-wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/2010/09/28/000333038_20100928015604/Rendered/PDF/567900WP0IEQ1S132B01PUBLIC10ENGLISH.pdf)> accessed August 20, 2013; "Indonesia needs China more in ACFTA," *Xinhua*, April 19, 2010 <[http://news.xinhuanet.com/english2010/business/2010-04/19/c\\_13257916.htm](http://news.xinhuanet.com/english2010/business/2010-04/19/c_13257916.htm)> accessed August 19, 2013.

It is also clear that Chinese investment in Indonesia is trending downwards, relative to those of other major investor countries from earlier in the century (despite a spike in 2008-2009 when the Global Financial Crisis severely disrupted capital and liquidity in advanced economies).

## NET ASSESSMENT OF CHINESE ECONOMIC ACTIVITY IN INDONESIA

The patterns and nature of Chinese FDI (and trade) strongly suggest that China views Indonesia in two main ways when it comes to their economic relationship.

First, Indonesia is a valuable economic partner when it comes to seeking out reliable and diverse supply of natural resources.<sup>20</sup> Chinese interest is likely to increase, with estimates that the Indonesian resources market could be worth US\$270 billion by 2030.<sup>21</sup> Even so, resources are declining in importance to the Indonesian economy even if it will remain a significant sector. Indeed, the domestic consumption segment is projected to be worth well over US\$1 billion by 2030, while the Indonesian agricultural and fisheries sectors are projected to be worth almost twice as much as the hard resources sector in 2030.<sup>22</sup> Chinese foreign capital will be important in developing all these Indonesian sectors in the future, and in helping to address the country's other infrastructure shortfalls. But there is no evidence that Indonesia is becoming overly reliant on Chinese capital to develop these sectors given the availability of capital from other investors in Asia, America and Europe, now or in the future.

Second, Chinese firms are eagerly eyeing off the burgeoning Indonesian domestic consumption market for cheap goods, sectors in which Chinese manufacturers are well placed to exploit. It is estimated that almost one hundred million extra people could join the Indonesia consumer class<sup>23</sup> by 2030 if growth continues at recent rates.

However increases in cheap Chinese goods entering Indonesia do not create leverage for Beijing over Jakarta. On the contrary, and as pointed out earlier, growing trade deficits with China create resentment amongst many in Indonesia who believe that foreign firms and countries such as China are overly benefitting from the country's rising levels of domestic consumption. Besides, Indonesia is attempting to lower

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<sup>20</sup> Bear in mind that an estimated third of the oil production by Chinese national oil firms operating in Indonesia is still sold locally, and not transported back to China: see Erica S. Downs, "The Fact and Fiction of African-Sino Relations," *China Security* 3:3 (Summer 2007), pp. 42-86 <<http://www.brookings.edu/views/articles/fellows/downs20070913.pdf>> accessed August 25, 2013.

<sup>21</sup> See McKinsey Global Institute, *The archipelago economy: Unleashing Indonesia's potential* (New York: McKinsey & Co, 2012), pp. 18-9 <[http://www.mckinsey.com/insights/asia-pacific/the\\_archipelago\\_economy](http://www.mckinsey.com/insights/asia-pacific/the_archipelago_economy)> p. 9.

<sup>22</sup> As above.

<sup>23</sup> This is defined as those with annual net income of US\$3,600 or above at 2005 PPP levels: see McKinsey Global Institute, *The archipelago economy: Unleashing Indonesia's potential*, p. 4.



reliance on low-value added resources such as palm oil, coal, coffee, rubber and iron ore when it comes to export makeup.<sup>24</sup>

Moreover, China is a very small player in the critical sector of Indonesian manufacturing which dominates inward FDI flows – attracting over 45.5% of all FDI in 2012, over 42% in 2011 and over 37% in 2010. In those years, Chinese firms constituted less than 1% of all FDI in manufacturing, meaning that they play little role in creating local manufacturing jobs which is a high priority for Jakarta. Neither is Indonesia benefitting greatly from technology transfers and other know-how from Chinese manufacturing firms located in the country.

In contrast, in the years from 2010 to 2011, FDI from Japan constituted 33.9% of all FDI into the manufacturing sector, FDI from America was 4.1%, and FDI from the rest of ASEAN was 36%.<sup>25</sup> Not surprisingly, technology transfer, positive ‘industrial spill-over’, and managerial know-how transfer by firms from all of these places is far more critical for the development of the Indonesia economy, than from China.<sup>26</sup>

In summary, there is little evidence that Chinese companies invest in Indonesia for strategic or political reasons. In any event, the relatively modest Chinese FDI foothold in Indonesia would not present Beijing with any such leverage.

## FRIENDLY AMBIVALENCE IN SINO-INDONESIAN TIES

With respect to bilateral relations, both countries will continue to emphasise strong progress towards a comprehensive relationship as envisaged by the *2005 Strategic Partnership* agreement. In reality, Jakarta’s approach to Beijing in strategic and economic matters will remain engaged but deliberately ‘ambivalent’<sup>27</sup> for a number of reasons.

First, China’s economic rise will continue to be seen as a potential threat to certain segments of the Indonesian economy even as many of the benefits are real and obvious, especially since structural weaknesses and poor competitiveness of its economy persist. While this *Perspective* argues that economic over-reliance on, or domination by the Chinese economy has not occurred and is unlikely to occur in the future, the important point is that China’s continued economic rise is not perceived universally as a win-win scenario by many Indonesians. Due to high Indonesian economic reliance on other countries such as Japan, the U.S. and other more advanced

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<sup>24</sup> Henry Sender, “Indonesia faces daunting obstacles in value chain,” *Financial Times*, July 18, 2013 <<http://www.ft.com/intl/cms/s/0/27744290-efae-11e2-8229-00144feabdc0.html#axzz2cykkeOBX>> accessed August 25, 2013.

<sup>25</sup> Central Bank of Indonesia figures.

<sup>26</sup> Peter Gammeltoft and Lepi T. Tarmidi, “Chinese Foreign Direct Investment in Indonesia,” CIBEM Working Paper Series, November 2011 <[http://openarchive.cbs.dk/bitstream/handle/10398/8397/Peter\\_Gammeltoft\\_2011.pdf](http://openarchive.cbs.dk/bitstream/handle/10398/8397/Peter_Gammeltoft_2011.pdf)> accessed August 22, 2013, p. 25.

<sup>27</sup> See Ian Storey, “Indonesia and China: ambivalent relations,” *Southeast Asia and the Rise of China* (New York: Routledge 2011), pp. 191-211.



ASEAN countries for trade, investment and expertise, economic engagement with Southeast Asian neighbours and the U.S. is likely to remain at least as important as engagement with China in the future. In other words, despite the lofty rhetoric that accompanies Sino-Indonesian agreements, Indonesia will not allow itself to be captured by China's economic orbit at the expense of economic relations with other major economies.

Second, although Jakarta's political and strategic relationship with Beijing has improved significantly over the past decade, lingering distrust of Chinese motivations and behaviour will have only deepened due to the much more assertive Chinese behaviour over its claims in the South China Sea since 2009. Although Jakarta and Beijing have so far avoided the level of tension that has flared up between China on the one hand and Vietnam and the Philippines on the other, it will not be lost on Indonesian policy makers that China's rise means that it is becoming more rather than less difficult to manage and placate strategically, even as its economy becomes more integrated into the region. Specifically, the sovereignty issue of the Indonesia-administered Natuna Islands is still unresolved, with its gas-rich waters being encompassed by the Chinese nine-dash line.<sup>28</sup>

This brings us to regional diplomacy. Indonesia is large enough to demand a prominent voice in the region and in its institutions such as ASEAN. But it will remain too weak to play a significant unilateral role. That being the case, Jakarta will continue to view ASEAN centrality (and maintaining an influential role within ASEAN) as the key to managing ongoing relationships with great powers and as essential for reducing tension with these great powers.

Even so, despite insisting that ASEAN can remain united in the face of pressure from any large power,<sup>29</sup> a cautious Jakarta is unlikely to 'push the envelope' in exercising collective strategic and diplomatic leadership if Beijing rejects ASEAN-led initiatives to solve or stabilise the disputes – even as it joins other major ASEAN members in welcoming a sustained American strategic and military presence in the region. Indonesia however, ensures that it remains a small or non-existent target of possible Chinese ire by framing its reticence to lead on that front as maintaining its own 'neutrality'.<sup>30</sup>

This means that while China has few meaningful economic levers to pull vis-à-vis Indonesia, Jakarta will continue to punch beneath its absolute weight – preferring instead to use 'friendly ambivalence' towards China as a defensive and hedging strategy.

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<sup>28</sup> See Ann Marie Murphy, "Indonesia in Asia's Changing Balance of Power," *World Politics Review*, March 11, 2013 <<http://www.worldpoliticsreview.com/articles/12779/indonesia-in-asia-s-changing-balance-of-power>> accessed October 14, 2013.

<sup>29</sup> See Teddy Ng, "Indonesian foreign minister says ASEAN will remain united in face of China," *South China Morning Post*, October 6, 2013 <<http://www.scmp.com/news/asia/article/1325472/indonesian-foreign-minister-says-asean-will-remain-united-face-china>> accessed October 14, 2013.

<sup>30</sup> See Ristian Atriandi Supriyanto, "Indonesia's South China Sea Dilemma: Between Neutrality and South Interest," *RSIS Commentary* No. 126, July 12, 2012 <<http://www.rsis.edu.sg/publications/Perspective/RSIS1262012.pdf>> accessed August 26, 2013.

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