TPSA | CANADA–INDONESIA TRADE AND PRIVATE SECTOR ASSISTANCE PROJECT

TPSA Project and the Indonesian Ministry of Trade Host a Policy Dialogue on Industrial Development and Global Value Chains

Enhanced understanding by policy-makers and industry actors on the merits of a GVC/GPN approach to resource-based industrialization will go a long way toward helping Indonesia develop better economic and trade policies.

Background

To support the development of effective economic and trade policies in Indonesia, the Canada–Indonesia Trade and Private Sector Assistance program collaborated with the Centre for Foreign Trade Analysis and Development, Indonesian Ministry of Trade, to organize a one-day policy dialogue on industrial development and global value chains in the coffee and cocoa industries. The dialogue aimed to inform policy-makers and industry actors of the merits of resource-based industrialization and the relationship between global value chains (GVCs)/global production networks (GPNs) and industrialization.

Novi Anggriani explains Canada's objective to ensure that women and men benefit equally from international trade.

Over the last decade, the Indonesian government has actively promoted a policy of *hilirisasi* (downstreaming), defined as the "development of industry in an attempt to strengthen the industrial structure of the agricultural, mining, and oil-based chemical sectors."[1] This resource-based industrialization strategy aims to add value to raw materials prior to their export.

GVCs and GPNs are useful conceptual frameworks within which to understand such industrialization strategies. Value-added processes are seen as an outcome of compatible interactions (strategic coupling) between lead firms within the GVCs/GPNs and local institutions (e.g., state agencies, business associations, or labour associations). These processes allow functional upgrading to occur, whereby a firm/sector moves up in the GVC. Participation in globally competitive production networks, in turn, is seen to be a key determinant of regional development and poverty alleviation. Such a perspective has important implications for both trade and industrial policy in Indonesia.

Canada

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IN PARTNERSHIP WITH
KEMENTERIAN PERDAGANGAN REPUBLIK INDONESIA
MINISTRY OF TRADE

Activity Description

The policy dialogue, held on August 28, 2018, at the offices of the Ministry of Trade, was attended by 97 participants (56 men and 41 women) representing a wide range of stakeholders that included seven key line ministries, the Canadian Embassy, 10 business associations (mostly from the cocoa and coffee industries), research centres, universities, international organizations, and the private sector.

Moderator Djatmiko Bris Witjaksono, head of the Centre for Foreign Trade, Indonesian Ministry of Trade, officially opened the dialogue and welcomed the keynote speakers and other participants. He thanked TPSA for organizing the dialogue and commended it as the most well-organized development project with which he has thus far partnered.

> "The workshop helped me to understand the concept of global value chains, and the information and experiences shared in the dialogue will be very useful in improving trade policy in Indonesia."
>
> —DELIMA HASRI DARMAWAN
> *Head of Advisory Board,*
> *Specialty Coffee Association of Indonesia*

TPSA's Indonesian project manager, Said Babuud, then gave an overview of the project's goal, scope, activities, and achievements to date. This was followed by a speech by Novi Anggriani, senior development officer at the Canadian Embassy in Jakarta. Ms. Anggriani briefly explained Canada's Feminist International Assistance Policy and its goal of achieving inclusive growth, where women and men benefit equally from development outcomes and gender equality becomes the guiding principle of project design and implementation. She also corroborated TPSA's achievements and contribution to improved trade between Indonesia and Canada.

Four substantive presentations followed. Dr. Jeffrey Neilson (University of Sydney) began by positioning GVCs/GPNs as the conceptual framework of his research, undertaken in collaboration with Dr. Angga Dwiartama (Bandung Institute of Technology) and funded by the Australian Centre for International Agricultural Research. Dr. Neilson discussed Indonesia's *hilirisasi* policy in the cocoa and coffee industries from a GVC/GPN perspective and explained that, unlike decades ago where countries exported only finished products, current global trade is dominated (60 per cent) by intermediate goods. In effect, different stages of the production process take place in different countries. The GVC/GPN approach, popularized in the 1990s, is useful to understanding this phenomenon and has helped explain the upgrading process that has taken place, particularly in East Asia. Upgrading is the process of moving to higher-value activities (e.g., adding value to a product) in order to increase the benefits of participating in GVCs/GPNs. A country or region uses upgrading strategies to improve its position in the global economy.

South Korea is an example of a country that has moved up the value chain from a supplier of electronic intermediate goods (mainly to western countries) to a producer of its own electronic brand (e.g., Samsung). South Korea made this upgrading process possible through building its productive capacity and competitiveness by learning from global buyers. In turn, enhanced industrial productive capacity has helped boost regional development. This process is known as strategic coupling. The concept proposes that regional development occurs as a result of interactions between lead firms and regional assets and institutions.

Dr. Dwiartama noted that *hilirisasi* has a broad meaning, including attempts to use government policy to strengthen specific industrial sectors and efforts by government to change industrial structures in order to achieve productivity-based economic growth. *Hilirisasi* is being widely implemented, especially in the agricultural and mineral industries. Its broad objectives include accelerating economic growth, expanding employment opportunities, increasing foreign-exchange earnings and domestic value-added, and strengthening industrial structures. Critics, however, say that the government has often made inaccurate decisions due to insufficient information and that *hilirisasi* programs have not always been directed at the right groups. For example, instead of targeting manufacturers, the programs have often been aimed

Djatmiko Bris Witjaksono introduces the four workshop presenters.

at farmers. Other criticisms include rent-seeking behaviour and protectionist government tendencies and policies.

Dr. Neilson summarized the cocoa industry's *hilirisasi* program that, using an export tariff policy instrument, has had some success, but encountered some challenges as well. After Indonesia applied the export tariff, cocoa-bean exports decreased and investment in cocoa processing (grinding) increased, including from Cargill, Barry Callebaut (in collaboration with national company Garudafood), Guangcong, Olam, and Kalla group. Exports of intermediate goods increased as a result of these investments, and collaboration between local and global firms strengthened. The new supply-chain structure has allowed firms and farmers to work together more closely, reducing the need for intermediaries. This has led to improved cocoa-bean prices at the farm level. However, contrary to expectations, better cocoa-bean prices and investment have not boosted domestic cocoa-bean production or quality. Farmers' capacity to produce high-quality beans remains limited. In addition, domestically produced chocolate cannot compete in the global marketplace.

According to Dr. Neilson, a major challenge in the cocoa *hilirisasi* program is for the government to shift from a producer-oriented to a buyer-oriented approach. A number of government-sponsored producer-oriented programs have not done well: For example, the Cocoa Industrial Cluster in South Sulawesi is not fully functional, as it was established without considering market conditions and GPN potential. The National Cocoa Movement (*Gernas Kakao*) has not succeeded in boosting domestic cocoa production and has been unable to take advantage of lead chocolate firms' production know-how. These programs have focused on the production side without either sufficient market considerations or any attempt to collaborate with global buyers.

Drawing lessons from the cocoa industry, Dr. Neilson highlighted the following:

1. The success of *hilirisasi* policy will depend on its compatibility with lead firms' strategies.
2. The concept of strategic coupling (compatibility between main actors/lead firms and regional assets) will help identify which industry or industries to expand.
3. If cocoa lessons are applied to the coffee sector, it is safe to assume that imposing tariffs on green coffee-bean exports will not lead to increased roasted-coffee exports. This is because the policy strategy (green-bean export tariff) is inconsistent with lead firms' focus on buying green (not roasted) coffee beans. However, it should be noted that there are good prospects for instant coffee exports.
4. The competitiveness of the processed-food industry can be enhanced by adopting a more open import policy, so that Indonesia can play a strategic role in GVCs/GPNs.
5. Analyzing *hilirisasi* from a GPN perspective can help identify effective policy instruments that can strengthen a given industry and sustainably capture value-added.

A presentation on domestic value-added policy and industrialization in Indonesia was given by Dr. Arianto Patunru of Australian National University. Indonesia's industrialization focuses on strengthening manufacturing industries (from upstream to downstream) to create value-added. Many other developing countries have similar industrialization ambitions in terms of value-added creation. The rationale is that increased domestic value-added will create more domestic employment and enhance the contributions of domestic manufacturing to overall economic growth. Policy instruments commonly used are raw-material export bans, restrictions on intermediate goods imports, and local-content requirements.

Dr. Patunru's research challenges this commonly held belief. He argued that, in the context of export-oriented (rather than import-substitution) industrialization, embracing domestic value-added

policies could have the opposite effect by impeding job creation and economic growth. This is partly because in global production-sharing (or GPS) and GPN, import content is naturally high, so per-unit domestic value-added is low. The value capture that contributes to high employment generation and gross domestic product (GDP) is in production volume/vast market potential. Apple iPhone assembly in China is a good example: The assembly value-added is less than five per cent, but there is sizeable production. Furthermore, in global production-sharing, intermediate goods are usually capital-intensive while final goods (assembly) are labour-intensive. If a country with an abundant labour force persists in producing capital-intensive goods that are not its comparative advantage, it will lead to inefficient resource reallocation that only benefits a few sectors (in the short term).

> "The dialogue forum was very useful for me as a public-policy researcher, because it was able to bring together the regulator (government), academic (research), and business communities."
>
> —PROFESSOR D. S. PRIYARSONO
> *Senior Lecturer, Faculty of Economics and Management, Bogor Agricultural University*

Dr. Patunru further argued that participation in the GPS/GPN, which relies on high imported intermediate inputs and low value-added per unit, can potentially promote job creation and economic growth. Data from the coffee, cocoa, textile, and garment industries support this argument. The former two industries have high local content but low job creation, while the latter two have low local content but high job creation. This runs counter to the commonly held assumption that strengthening domestic content and domestic value-added (sometimes cited as the *hilirisasi* rationale) will boost employment opportunities. Therefore, in designing export development policy, policymakers need to focus more on the potential of a given product or industry rather than per-unit value-added. In the era of GPS/GPN and GVC, policies that facilitate linking Indonesian manufacturing to global production networks have the potential to create employment and reduce poverty.

Mr. Adhi Lukman (of GAPMMI, the Indonesian Food and Beverage Business Association), the last presenter, supported the previous presenters' views that Indonesia must participate in GVCs to promote economic development. He also suggested that cooperation between Canada and Indonesia should not be limited to trade, but also encompass the development of downstream and upstream industries in order to develop globally competitive products. Growth potential is promising in the food and beverage industry, with its continuously increasing GDP contribution. Although large companies contribute the most in terms of market value, small and medium-sized enterprises (SMEs) dominate in terms of absolute number. The challenge, therefore, is how to help these SMEs enter GVCs. Recently, there has been a trend toward increased cooperation between large global corporations and local companies.

Mr. Lukman noted that the value of trade between Indonesia and Canada is still very small, and endorsed more trade between the two countries, including for halal food. However, he views the food and beverage industry as over-regulated, especially concerning food-safety standards. Mr. Lukman noted that Canada is a potential market because it is an import-friendly country. He commended TPSA for publishing step-by-step guides to exporting to Canada.

Following the presentations, Mr. Djatmiko invited questions or comments from the audience. Government green-coffee and cocoa-bean import tariffs were an important issue raised during the discussion. The tariffs were thought to make Indonesian processed coffee and cocoa exports less competitive. Imported green coffee beans are usually required for blending with Indonesian

Workshop participants offer comments on the presentations.

coffee beans before the blended coffee is sold or exported. Imported cocoa beans are needed because domestic production has been decreasing and is insufficient to supply manufacturers exporting semi-processed cocoa. One participant noted that the current lack of raw cocoa beans has left manufacturers operating far below their capacity, and a few lead firms are considering moving their operations to Africa. There was a call for the government to abolish import tariffs on raw materials or intermediate goods for export, although tariffs on finished products (e.g., chocolate, cocoa powder, instant coffee) were welcomed.

There was also discussion on the upstream/production level. One participant noted that decreased cocoa production is not because farmers do not have farming technology and know-how, but because there is no economic incentive to grow cocoa. Unlike coffee, where the better the quality, the higher the price, better cocoa-bean quality does not translate into a better price. Coffee farmers seem to have confidence (that cocoa farmers do not possess) that their products will sell domestically or internationally. The flourishing of specialty cafes all over Indonesia is becoming a part of popular culture, which parallels the global trend for good-quality coffee. Cocoa and chocolate consumers, on the other hand, are not yet so sensitive to quality levels. One participant suggested that a national cocoa-production movement (*Gerakan Nasional Kakao*) should be revived to help the cocoa sector and focus on providing economic incentives to farmers to grow cocoa.

Participant Feedback

Participants were happy with the training and hoped that similar training would be offered in the future. Participants rated the training "excellent" (11 per cent), "very good" (54 per cent), "good" (34 per cent), or "fair" (1 per cent).

All participants reported that their knowledge had increased as a result of their participation, with 46 per cent reporting it had "increased significantly" and 53 per cent reporting it had "increased to some extent."

Ninety-six per cent noted that the skills they learned during the seminar would be used in their work at least occasionally. Half of the participants indicated that their new level of confidence in applying the skills learned was "excellent" or "very good," 43 per cent said "good," and 7 per cent said "fair."

> "This is a very good forum where TPSA is able to gather various stakeholders and policy-makers in one room to discuss two important agriculture commodities in Indonesia and link issues from agriculture, manufacturing, processing, and trade."
>
> —PRANOTO SOETANTO
> *Indonesia Coffee Exporter Association*

Section 6: Key Takeaways/ Conclusion

The GVC/GPN framework is a useful analytical tool to understand industrialization processes such as *hilirisasi* and how they relate to regional development and poverty reduction. Cocoa and coffee GVCs/GPNs provide real examples to diagnose the efficacy of *hilirisasi* and its policy instruments (such as tariffs). Participants recognize that each commodity has a unique GVC/GPN structure and dynamic; a policy applied in one sector is not necessarily transferrable to others. In order to take advantage of GVC/GPN participation, policy interventions must take into account how GVCs/GPNs in a particular industry operate and are governed (e.g., lead firm strategies, interactions with local actors).

Participation in GVCs/GPNs is important for Indonesia's economic development, although different actors voiced different policy concerns. Business actors want a more open import policy for intermediate goods (raw materials for their exported products) and import restrictions on finished products. Government officials are primarily concerned with how to protect and increase farmers' and producers' profit margins. One government official indicated that although lead firms (usually multinational corporations) are a sensitive issue in Indonesia, especially if they control vast assets in a given industry, the government should facilitate their investment if they can demonstrate that they help small farmers.

Left to right: Yusianto (Indonesia Coffee and Cocoa Research Institute), Said Babuud (TPSA Indonesia Project Manager), Angga Dwiartama (Bandung Institute of Technology), Pranoto Soenarto (Indonesia Coffee Exporter Association), Delima Hasri Azahari Darmawan (Specialty Coffee Association Indonesia), Djatmiko Bris Witjaksono (Head of Centre for Foreign Trade, Ministry of Trade), Jeffrey Neilson (University of Sydney), Adhi Lukman (GAPMMI, Indonesian Food and Beverage Business Association), Sukrisno Widyotomo (Indonesia Coffee and Cocoa Research Institute), Greg Elms (TPSA Field Director), Mogadishu Djati Ertanto (Section Head, Ministry of Industry).

Many questions and comments raised during the discussion also highlighted the fact that industrial policies like *hilirisasi* cannot be developed in isolation from broader trade and investment policies. Indonesian ministries must work closely to develop a coherent industrial policy framework.

About the TPSA Project

TPSA is a five-year, C$12-million project funded by the Government of Canada through Global Affairs Canada. The project is executed by The Conference Board of Canada, and the primary implementation partner is the Directorate General for National Export Development, Ministry of Trade.

TPSA is designed to provide training, research, and technical assistance to Indonesian government agencies, the private sector—particularly small and medium-sized enterprises (SMEs)—academics, and civil society organizations on trade-related information, trade policy analysis, regulatory reforms, and trade and investment promotion by Canadian, Indonesian, and other experts from public and private organizations.

The overall objective of TPSA is to support higher sustainable economic growth and reduce poverty in Indonesia through increased trade and trade-enabling investment between Indonesia and Canada. TPSA is intended to increase sustainable and gender-responsive trade and investment opportunities, particularly for Indonesian SMEs, and to increase the use of trade and investment analysis by Indonesian stakeholders for expanded trade and investment partnerships between Indonesia and Canada.

The expected immediate outcomes of TPSA are:

- improved trade and investment information flows between Indonesia and Canada, particularly for the private sector, SMEs, and women entrepreneurs, including trade-related environmental risks and opportunities;
- enhanced private sector business links between Indonesia and Canada, particularly for SMEs;
- strengthened analytical skills and knowledge of Indonesian stakeholders on how to increase trade and investment between Indonesia and Canada;
- improved understanding of regulatory rules and best practices for trade and investment.

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ENDNOTE

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