

## Challenge 5

### Indonesia and Japan 2045:

### Strengthening the Economy through Investment

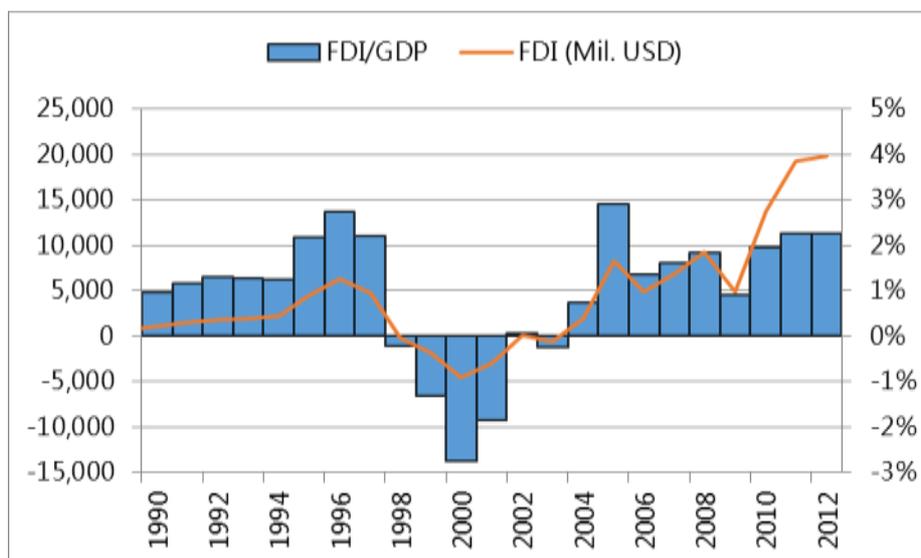
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#### Introduction

The trend in foreign direct investment (FDI) inflows in Indonesia since 1990 shows several periods of ups and downs (Figure 5-1). In the early 1990s, Indonesia experienced booming labour-intensive industrialisation. One of the contributing factors was export-oriented FDI, which grew towards its peak in 1996. When the 1998 financial crisis hit Indonesia, investors drew back their capital. FDI reached its highest outflow in 2000, marking the most severe effect of the crisis along with the start of the reformation of the political regime in Indonesia.

Figure 5-1. Foreign Direct Investment Inflows in Indonesia, 1970–2012



FDI = foreign direct investment, GDP = gross domestic product, USD = US dollars.

Notes: The left-hand axis shows FDI inflows measured in millions of US dollars (current prices). The right-hand axis shows the ratio of FDI to GDP as a percentage.

Sources: UNCTAD; World Development Index, World Bank.

Recovery after the 1998 crisis seemed to be slow, but FDI continued to rise until 2005 when the share of FDI to gross domestic product (GDP) surpassed its pre-crisis level. The legislation of a new investment law in 2007, followed by its derivative laws, marked the reformation of Indonesia's investment policy, which was expected to take effect afterwards.

The global financial crisis hit around 2008, leading to a slowdown in FDI inflows. However, from 2009, Indonesia experienced a massive jump in FDI, reaching double its 2008 value in 2011. As Figure 5-2 shows, much of this jump came from Japan. The share of FDI to GDP was steady, and the jump in the FDI value shows that while developed economies were hit by the global crisis, they (especially Japan) still maintained a substantial interest in Indonesia.

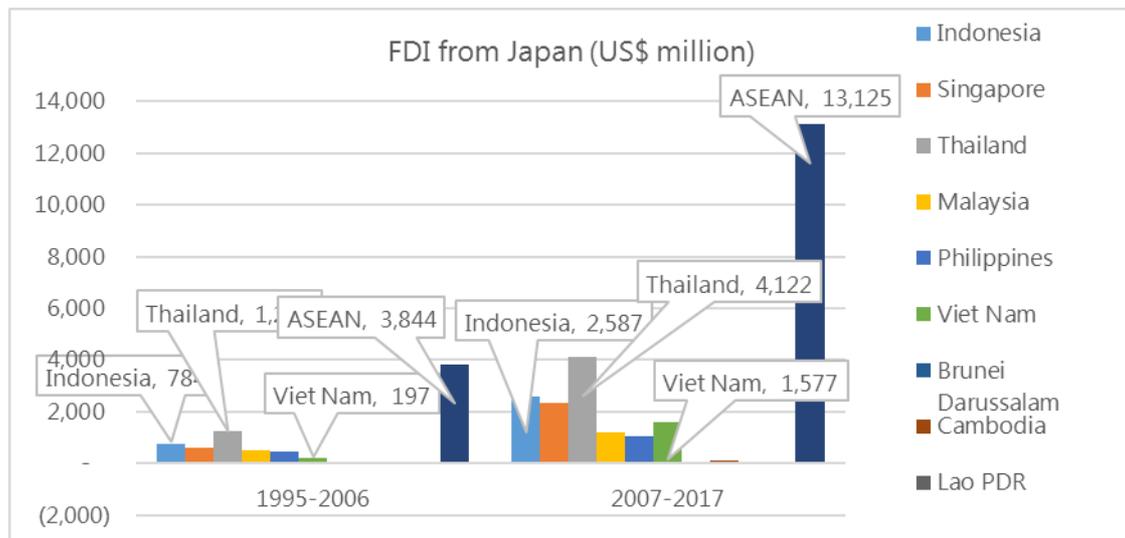
Figure 5-2. Trend in Foreign Direct Investment from Japan to Indonesia



Source: World Bank, World Development Indicators; JETRO; Bank of Japan.

Figure 5-3 shows that the relative position of Indonesia amongst the other major Association of Southeast Asian Nations (ASEAN) countries has not changed since the mid-1990s. Indonesia is still the second-largest recipient of FDI after Thailand. The amount of FDI in Indonesia has increased by around threefold in recent years compared to the earlier period of 1995–2006, but this is also a trend we observe in the other ASEAN countries. Thus, Japan’s investment in the ASEAN region has increased significantly in the past decade after the 2008–2009 global financial crisis, and this may have been due to the much higher opportunities in the Southeast Asia region after the crisis relative to those in other parts of the world.

**Figure 5-3. Foreign Direct Investment from Japan to Southeast Asia**



ASEAN = Association of Southeast Asian Nations, FDI = foreign direct investment, Lao PDR = Lao People’s Democratic Republic.

Source: JETRO; CEIC; Bank of Japan.

### Brief History of Industrialisation in Japan

Japan is one of the leading industrialised countries in the modern world, and its industrialisation has a long history that began even before the Meiji Restoration of 1868. Some scholars have dated the country’s industrialisation process back to the age of the

samurai, which began around the end of the 12th century, while the common view marks the Meiji Restoration as the cornerstone of Japan's modernisation and industrialisation. Nevertheless, industrialisation in Japan has been on a long journey, responding and reacting to every foreign force and influence it has been exposed to, shaping itself along the way, and transforming Japan into a respected industrialised economy.

The view that Japan's industrialisation began during the period of the samurai might not be far from the truth. After being shaken by two unsuccessful invasion attempts by the Mongolians in 1274 and 1281, the government ran out of land to distribute to the samurai who had fought the Mongolians, and long internal fights amongst the samurai leaders ensued. Despite the unstable politics, during that period, rice cultivations started to flourish throughout Japan. Active trade with China and Southeast Asia was also taking place. This agricultural production and trading culture would later play a crucial role in shaping Japan's economy and industry during the Edo period, which started in 1603 after Ieyasu Tokugawa unified Japan and settled a new government in Edo. This relatively stable period is now viewed as a dynamically evolving period, rather than a stagnant dark age, which provided Japan with the necessary and important conditions for industrialisation.

The Edo government is mainly known for its centralised political system and deliberate international isolation that lasted more than two centuries (1639–1854). However, the Edo period was also characterised by independent farmers who were critical towards government acts. Being mainly agriculture based with rice as its main commodity, Japan in the Edo period started with land expansion to increase production but soon realised the associated losses coming from overexpansion, such as floods and deforestation. The farmers gradually moved to land intensification instead, with the increased use of farming technology, such as traditional fertilisers and the double-cropping method. The surge in production stimulated the commercialisation of agricultural products and a flourishing of simple manufacturing products. As Japan was isolating itself from international trade and agricultural products had to be physically moved, a nationally unified transportation system was naturally developed, and the national market became integrated.

Japan's isolation from international trade was finally shaken by the arrival of four American military ships in 1853 led by Commodore Perry. The United States (US) demanded that Japan open itself to commercial relations and allow US ships to use Japan's ports. In 1858,

the Edo government unilaterally signed comprehensive commercial treaties with the major powers, including the US, without either imperial permission or national consensus. The signed treaties put Japan at a disadvantaged position against their Western commercial partners at face value. While not supported by the elites, the changes provided Japan with a larger market for its primary commodities, and its silk and tea found huge overseas markets for the first time. More importantly, it opened new ideas and horizons for the Japanese, who later absorbed foreign ideas and technology rapidly, partly out of fear of being colonised by foreign superpowers.

The internal political conflicts eventually culminated in civil war, and the Edo government was finally defeated in 1868. A new government was established, with the emperor being settled in Edo, which was renamed Tokyo, marking the beginning of the Meiji government era. The new government's priority quickly evolved from avoiding being colonised by the West to rapidly catching up with them and placing Japan in the same league as those colonisers – the Meiji government deemed this was the most effective way to survive and thrive in the new international dynamics they found themselves in.

As far as the industrialisation process is concerned, import substitution was the most prominent feature of Meiji policies. By the end of the Meiji era (1912), Japan was successfully industrialised in light industries, especially textiles. Embracing the newfound overseas market for its raw silk at the beginning of the Meiji period, Japan quickly learned how the US put itself in a more advantageous trading position by protecting its silk weaving industry while using Japanese silk yarn as the raw material. Japan also imported cotton clothes from the British and learned the necessary technology. Eventually, Japan gained an adequate competitive advantage against British textiles and drove them out of the Asian market.

The Meiji government was aggressive in its import substitution and Western technology absorption efforts. They sent a high-level official delegation and students to the US to renegotiate the unequal treaties and to study Western technology and systems. Despite an unsuccessful initial attempt to renegotiate the treaties, the mission brought back important insights that gave birth to pivotal policies and movements in Japan's industrialisation. Returning to Japan, the Japanese Finance Minister at the time, Toshimichi Okubo, vigorously promoted industrialisation by hiring foreign advisors, hosting domestic industrial

fairs, and constructing railroads and roads, amongst other industrialisation-oriented policies. Gradually, the import substitution moves also began to include human resources, starting with paying high salaries to foreign experts and engineers before eventually shifting to generating strongly capable Japanese engineers to lead the industrialisation process. In addition, the Meiji government was also very careful not to let important national projects, such as mines and infrastructure, fall into foreign hands through debt or other means. All these policy characteristics also caused the Meiji period to be known as the translative adaptation period (Maegawa, 1998).

The rapid Westernisation of Japanese society took place during the Meiji period and mainly comprised the revision of the unequal treaties with the West. Japan's diplomacy during the Meiji period perceived this as a necessary condition for joining the ranks of first-class countries and, thus, putting Japan in a more equal position with the West. Tariff rights were finally restored in 1911, and court rights were regained in steps during 1894–1899. In terms of the direct foreign influence on the economy, the contribution of foreign savings to industrialisation was relatively small during the Meiji period, and almost all necessary funds were raised domestically. Japan in the Meiji period did not welcome FDI or foreign loans for industrialisation, except for public sector borrowing in the late Meiji period for war purposes. In general, FDI inflows remained negligible in terms of both the establishment of enterprises and stock purchases by foreigners during the Meiji period.

Entering the 20th century, World War I (WW1) erupted and affected many countries, including Japan. As the major European powers fought each other, their international trade was suspended and gave way to Japan to fill the global trade gap. Japan suddenly enjoyed an enormous export-led boom in all sectors, especially marine transportation and shipbuilding. Between 1913 and 1919, the industries with the highest output growth included the machinery, steel, chemicals, and textiles industries. These industries maintained strong growth despite the recession in the 1920s, and by the 1930s, Japan could finally produce most machinery domestically.

When WW1 ended in 1918, small businesses in Japan experienced setbacks as their exports halted, which led to a big economic crash in 1920 when the post-war recession took its toll on Japan. Japan's government reacted by rescuing weakened industries and banks saddled with bad debt while trying to strengthen more peaceful international relationships with

other countries. However, these recovery attempts and peaceful diplomacy were abruptly cut by Japan's invasion of Manchuria in 1931. These military moves eventually put Japan in a total state of war, which lasted for years with expanded opponents, and all economic efforts had to be reorganised for war.

During the wartime, the growing light industries in Japan were strongly suppressed, and the once-booming textile industry was virtually eliminated. Japan focused its resources on key military products, such as ships and warplanes, which gave a boost to heavy industries. However, Japan soon found itself deficient in the raw materials and energy sources needed for supporting the military industry. It then began to invade Southeast Asia with its eyes on their raw materials and energy sources while being at war with the US, which was building an increasing number of ships and planes. The US eventually forced Japan to surrender after dropping atomic bombs on the Japanese cities of Hiroshima and Nagasaki in 1945.

In 1946, a document called 'The Basic Problems of Japan's Economic Reconstruction' by Saburo Okita and Yonosuke Goto<sup>1</sup> was published, giving insights into Japan's quick recovery. Japan realised that it could no longer rely on agricultural products and textiles as the rest of Asian would soon gain better competitive advantages in those sectors. It began, instead, to focus on skilled labour-intensive industries, and it has continued to do so ever since. Under the restricted import regulations imposed on Japan by the US at the time, Japan decided to import steel, coal, heavy oil, rubber, and buses to self-generate the energy sources needed to reconstruct the whole industry (Ohno, 2006). The Ministry of International Trade and Industry was created in 1949 (later renamed the Ministry of Economy, Trade, and Industry in 2001) to revive Japan's industrialisation boom, but in industries with higher value added as the country already possessed the necessary know-how and a strong foundation in technology-based industry. These strategic movements, along with a tight and disciplined fiscal regime, stopped the post-war inflation and eventually allowed Japan to enter a high-growth period from the mid-1950s. In doing so, the country was launched into the ranks of the leading industrialised economies.

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<sup>1</sup> An English translation of this report is now available. S. Okita (ed.) (1992), *Postwar Reconstruction of the Japanese Economy*. University of Tokyo Press.

## The Future of FDI from Japan to Indonesia

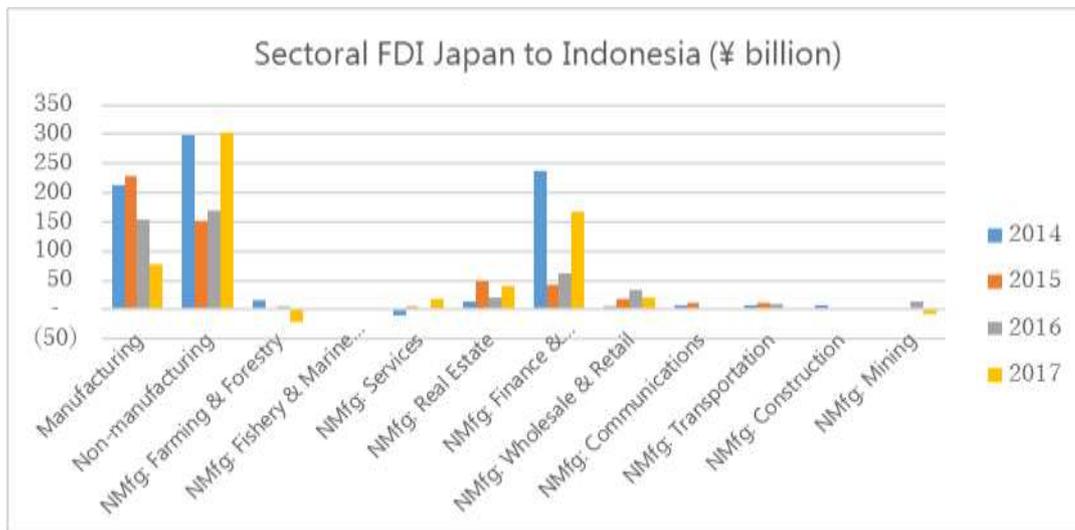
The description of the brief history of industrialisation in Japan tells us that indeed it takes time for a country to build a strong industry. Japan started its industrialisation in the early 19th century. Another insight we can learn is that focusing on demand can provide a path to industrial development in a country. Also, technological development is both naturally embedded in the process and constantly needed for upgrading, and innovation is necessary to promote a unique country-specific competitiveness.

What, then, can Indonesia expect from Japan in terms of direct investment and the fostering of a much closer bilateral relationship with Indonesia in the future or by 2045 when Indonesia will celebrate 100 years of independence? The following are some ideas for answering this question.

Indonesia could expect increased and more evenly distributed direct investment from Japan. As Figures 5-4 and 5-5 show, FDI from Japan to Indonesia has been distributed to only a few sectors in the Indonesian economy, with a tendency for growing FDI in services. The picture for the overall economy is mixed. Figure 4 shows that FDI to non-manufacturing increased in the past five years or so, while this was not the case for FDI in manufacturing. The declining FDI for manufacturing is disappointing from the perspective of Indonesia and clearly is an issue the two countries, especially Indonesia, need to resolve.

A similar picture can be seen for FDI in manufacturing. Figure 5-5 shows a very unequal distribution of investment in Indonesian manufacturing. The investment is mostly directed to industries in the transport sector, with small amounts going to the chemical, electronics, and machinery industries. It is worth noting that, as others have also documented, FDI from Japan to the Indonesian automotive sector is one success story for Indonesia. The deeply rooted presence of Japanese automakers in Indonesia, Toyota especially, has brought the industry to the level of an internationally competitive sector, marked by the ability of the sector to provide significant manufacturing export revenues.

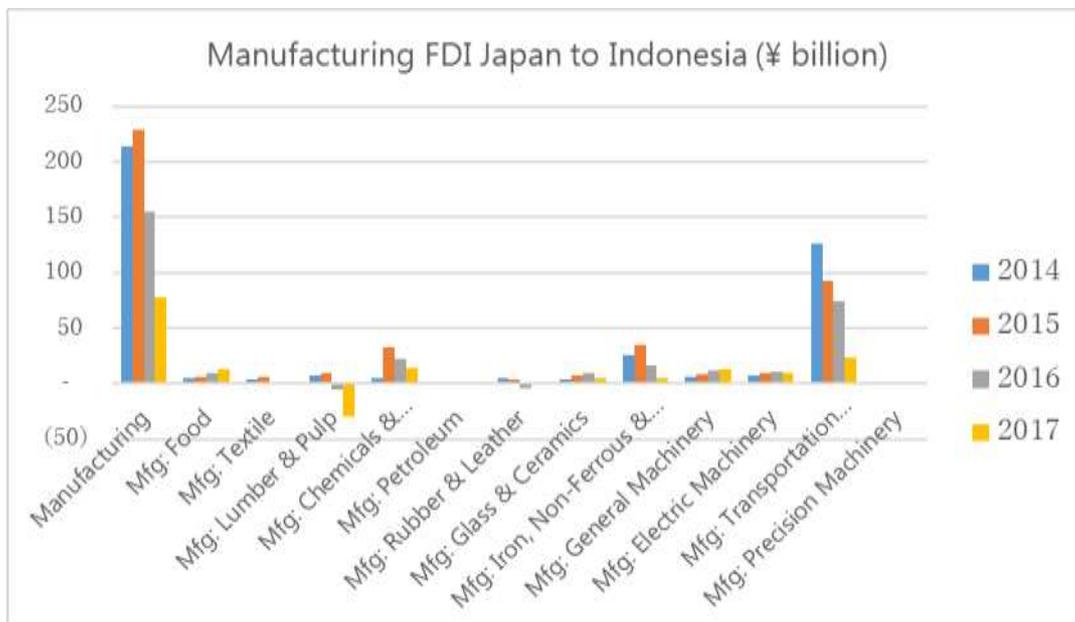
Figure 5-4. Distribution of Foreign Direct Investment from Japan to Indonesia



FDI = foreign direct investment, NMfg = Non-manufacturing.

Source: CEIC; Bank of Japan.

Figure 5-5. Distribution of Foreign Direct Investment from Japan to Indonesia in Manufacturing



FDI = foreign direct investment, Mfg = Manufacturing.

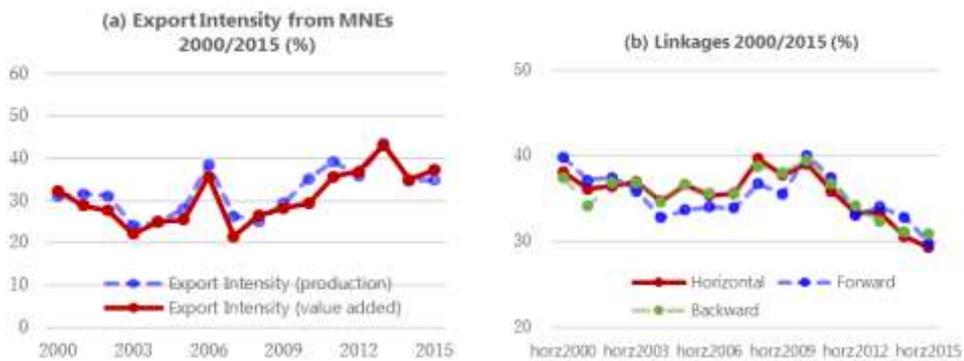
Source: CEIC; Bank of Japan.

Embedded in the idea of increasing FDI from Japan to many other sectors is the

expectation of more specific FDI to support the idea of increased digital production, e.g. the implementation of Industry Revolution 4.0 and the increased participation of Indonesian manufacturing in global value chains (GVCs), two important characteristics for today's global manufacturing operations and those in the future.

Regarding GVCs, at this moment, there is an indication of a growing 'disconnection' between domestic industries and the operations of multinational enterprises (MNEs) in Indonesian manufacturing. Figure 6 shows this. On the one hand, the exports of MNEs in the country have increased significantly since 2009 (Figure 5-6a), but, on the other hand, the linkages from the MNEs to other sectors (i.e. backward and forward linkages) have declined substantially within the same period (Figure 5-6b). This reflects some disconnection between MNEs and domestic firms, which means that MNE-led GVCs so far have not really engaged domestic manufacturers.

**Figure 5-6. Exports and Linkages of MNEs in Indonesian Manufacturing**



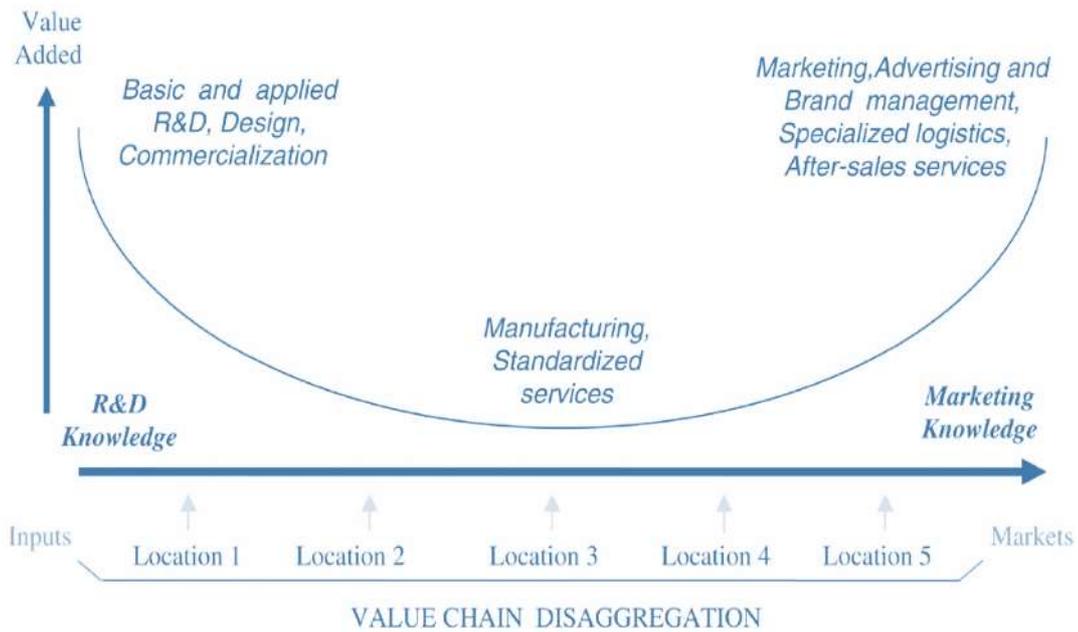
MNE = multinational enterprise.

Source: Statistik Industri Manufaktur Besar dan Sedang; own calculations.

Implicit in the discussion of the idea above is the expectation to see much higher and widespread FDI from Japan not merely in terms of quantity. Expectations of the specific type of FDI from Japan pertain to quality. That is, the FDI is expected to be of high quality in the sense that it could bring the adoption of more advanced technology. Included in this way of thinking is high-quality FDI in the services sector, which is expected to boost the capability of the services sector in Indonesia and, in turn, facilitate the greater and deeper participation of Indonesia in GVCs. More advanced GVCs integrate production stages from

being only purely networks of manufacturing production to also cover the services elements of manufacturing processes, as depicted in the so-called ‘smiley curve’ presented in Figure 5-7.

Figure 5-7. Smiley Curve: The Integrated Manufacturing Production Process



R&D = research and development.

Increased FDI from Japan in the longer term could hopefully increase the exporting capabilities of all Indonesian manufacturing firms, including and especially domestic firms. This is because given some period of time, high-quality FDI could significantly increase the technological adoption of domestic producers, which is required in order to achieve the quality of products that can compete in export markets.

Higher quality FDI, however, may not easily flow into Indonesia without greater cooperation between the two countries. Cooperation is necessary in addition to the business motives because there are many requirements for Indonesian firms to be able to capitalise on the much higher quality FDI from Japan. The capitalisation of high-quality FDI requires the availability of professionals, engineers, and other skilled workers that are able to work with the advanced technology brought by the FDI. Also, R&D infrastructure,

such as laboratories and testing facilities, are a must if Indonesian firms are to maximise the potential benefits from the FDI. Indonesia, therefore, needs to ensure the availability of all these before the high-quality FDI enters Indonesia.

In addition, because the nature of modern manufacturing involves a lot of value added from the services sector, Indonesia also needs to conduct reforms to allow the greater participation of foreign services providers.

There is, then, further room, or opportunity, for expanding and intensifying cooperation between Japan and Indonesia in this context. More explicitly, the two countries may devise cooperation mechanisms to increase the flow of professionals or other skilled workers from Japan. This could be done through cooperation between the governments or at the company level.

The cooperation is expected to be beneficial for Japan because it would provide job opportunities for senior citizens in Japan who have entered the retirement phase but are still willing to share their valuable knowledge elsewhere. Given the size of the potential training or knowledge upgrading for professionals or other skilled workers in Indonesia, the positive impact that Japan could gain from this cooperation could be quite significant. It is, therefore, an idea worth exploring for real implementation in the future.

For the company-level approach, the government could relax some immigration regulations related to the flow and stay of professionals and other skilled workers from Japan. This could be included as a commitment for Indonesia under the bilateral free trade agreement (FTA) between Japan and Indonesia, for example. At present, the most open commitment made by Indonesia in an FTA is in the ASEAN–Australia–New Zealand FTA, whereby foreign professionals, as part of their movement within companies, are allowed to stay in the country for a maximum of two years for the duration of their working permits (see Table 5-1). To allow for the smooth transfer of knowledge from Japanese professionals, the working permit durations would clearly need to be extended rather significantly.

### Concluding Remarks

With the reference year of 2045, this chapter presents some ideas for enhancing cooperation between Japan and Indonesia in the future and for cooperation in the area of

foreign investment. FDI from Japan to Indonesia needs to increase significantly in the future, and the distribution of FDI across sectors must become more even to support the adoption of advanced technologies by industries in Indonesia. These changes can be expected to increase the capacity and, later, the performance of Indonesian exports in the future. Stronger expectations of FDI from Japan in the future mean that investment needs to be of a high quality, considerably higher than its current level. Again, this is for the objective of allowing faster technology adoption by industries in Indonesia.

**Table 5-1. Intra-corporate Transferee Commitment in the AANZFTA and ASEAN MNP**

Country	AANZFTA			ASEAN MNP		
	Intra-corporate Transferees			Intra-corporate Transferees		
	sectoral coverage (%)	Number of committed sectors of max. 154	Initial length of stay	sectoral coverage (%)	Number of committed sectors of max. 154	Initial length of stay
Brunei Darussalam	99.4	153	3 years	99.4	153	3 years
Cambodia <sup>a</sup>	99.4	153	2 years	99.4	153	2 years
Indonesia	31.2	48	2 years	61	94	2 years
Lao PDR	18.8	29	6 months	68.8	106	1 month
Malaysia	25.3	39	Not to exceed 10 years <sup>b</sup>	70.8	109	Not to exceed 10 years <sup>b</sup>
Myanmar	13.6	21	1 year	38.3	59	1 year
Philippines	29.9	46	1 year	59.1	91	1 year
Singapore	98.7	152	2 years	98.7	152	2 years
Thailand	39.0	60	1 year	55.2	85	1 year
Viet Nam	63.6	98	3 years	70.1	108	3 years

AANZFTA = ASEAN–Australia–New Zealand Free Trade Agreement, MNP = Movement of Natural Persons, Lao PDR = Lao People’s Democratic Republic.

Notes: a) Cambodia’s MNP Agreement lacks this but its AANZFTA includes ‘07Bf’ (Trading for own account or for account of customers, whether on an exchange, in an over-the-counter market or otherwise, the following: money market instruments (cheques, bills, certificate of deposits, etc.), foreign exchange, derivative products incl., but not limited to, futures and options, exchange rate and interest rate instruments, including products such as swaps, forward rate agreements, etc., transferable securities, other negotiable instruments and financial assets, including bullion;

b) Malaysia, two years or so, in practice (results of an interview with a Malaysian economist).

Source: Adapted from Fukunaga & Ishido (2015).

The expectation of higher quality FDI from Japan means that Indonesia needs to first increase its domestic absorption capacity and, at the same time, increase its capabilities in human capital and R&D infrastructure. Indonesia also needs to open its services sectors more for FDI from Japan to facilitate the establishment of its industries in GVCs. Improvement in Indonesia's human capital would expand and intensify cooperation between Japan and Indonesia. The two countries could devise cooperation mechanisms to allow a much higher flow of professionals or other skilled workers from Japan, which could be done at the government or company level.

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