The Art of Trade War: Spurring Investments in Indonesia amidst the US-China Trade War

Hilda Yanuar Jong[1]

Abstract

The US-China trade war creates significant opportunities for developing countries, as global manufacturers need to relocate their production facilities out of China to avoid future tariff hikes. However, Indonesia as the biggest economy in the ASEAN is not experiencing any substantial advantage relative to its neighbors, especially compared to Vietnam. While there is no clarity on how long the trade war will last, it is important for Indonesia to strategize quickly to capitalize the opportunities. This paper addresses the question of how Indonesia should strategize through country comparison and analysis of two types of policy competition, namely incentives-based (IBC) and rules-based competition (RBC). In the short-term, Indonesia should be more accommodating for investors of all sizes and maximize the trade-related investment assistance. In the longer term, Indonesia should prudently open up to trade, improve cooperation between investment and trade functions, and build a positive public mindset for free trade.

Key words

FDI, trade war, free trade, Southeast Asia, strategy

JEL Classification

O24 Trade Policy • Factor Movement Policy • Foreign Exchange Policy

[1] London School of Economics. Research Associate at Consilience Policy Institute. 600 North Bridge Road, #10-01 Parkview Square, Singapore 188778. Email: hildayanuarjong@gmail.com. Ph.no. +62 857 9311 8843

Introduction: the US-China Trade War

The US-China trade war aims to reduce the trade flows between the two largest economies in the world. The US has been running a growing trade deficit with China since 1985 and the value reached around USD 420 billion in 2018. President Trump decided to start the trade war between the US, the world's largest importer, and China, the largest exporter, in July 2018 by imposing tariff hikes on imported goods from China.

The trade war persisted since then, and the tension between the two countries even escalated beyond trade into what experts predict as the new "cold war". (Sevastopulo, 2020) noted that as a response to the new national security laws introduced by the Chinese central government in Hong Kong, the US has revoked Hong Kong trade privileges with the country on May 2020. (McMorrow & Lockett, 2020) reported that by the end of July 2020, the global financial markets have also turned bearish as the tension extends to politics with the closure of Chinese consulate in Houston and US consulate in Chengdu. All of which are expected to reduce the trade volume between the US and China even further.

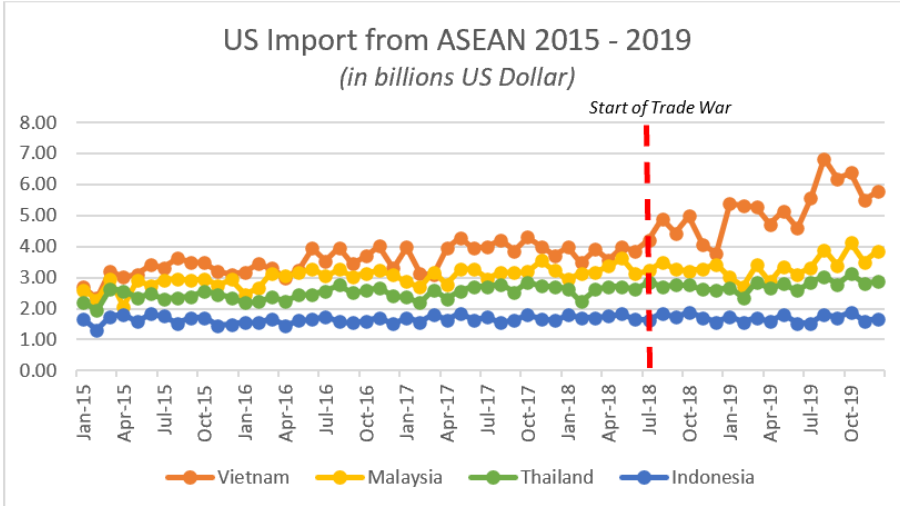
Opportunities arising from US-China Trade War for Southeast Asian Countries

Opportunity

The impact of the trade policy taken by the US is effective as demonstrated by the sharp decline of US imports from China in 2019, reaching a 6-year low (*The People's Republic of China | United States Trade Representative*, 2019). The estimate of import reduction is around USD 108 billion, a significant amount that negatively impacts the global economy. If the policy remains, the trade losses figure will have a positive trend in the next few years, and the figures could be even larger should there be further tariff hikes.

It is important to note that the reduction in trade flows between the US and China is not driven by reduction in demand side, hence it also creates significant opportunities for other emerging countries especially Southeast Asian countries. The demand of imported goods from the US remains high and producers of goods need to find other channels to trade with the US outside China. A popular option for global manufacturers is to relocate their production facilities out of China to avoid the future tariff-hikes. Southeast Asia (SEA) is one of the most viable destinations due to its lower minimum wage, availability of raw materials, and political neutrality. All these factors have resulted in the increasing trend of imports between the US and ASEAN members. ASEAN is a net exporter to the US, and the net export value has been growing steadily from 77.1 billion USD in 2015 to 99.2 billion USD in 2018(*Association of Southeast Asian Nations (ASEAN) | United States Trade Representative*, 2019). Most importantly, the goods traded between US-China and US-ASEAN are very similar. Electrical Machinery and Machinery makes up to 50% of US import from China. The percentage Electrical Machinery and Machinery is 41% for US import from ASEAN (*Association of Southeast Asian Nations (ASEAN) | United States Trade Representative*, 2019; *The People's Republic of China | United States Trade Representative*, 2019). The similarity puts SEA as a natural option for companies shifting location to trade with the US.

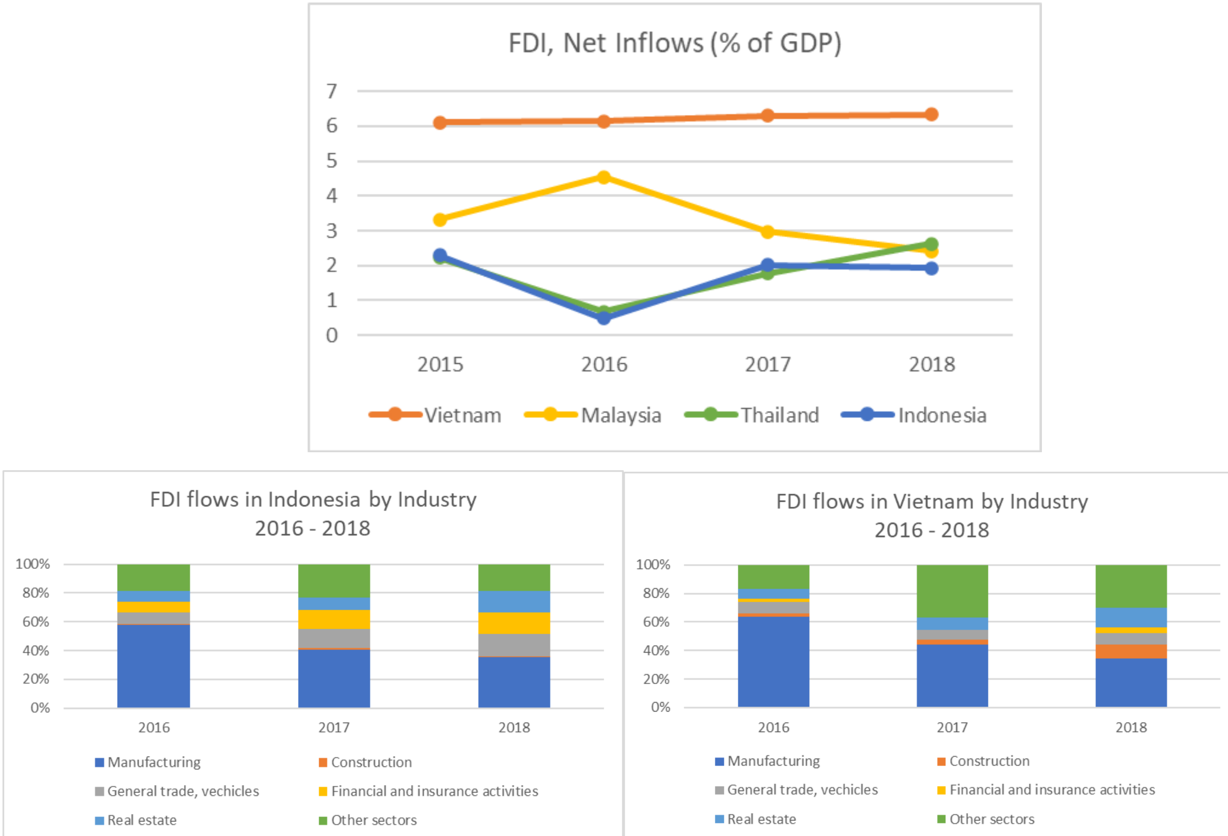
The opportunity arising from the trade war is significant in value, yet only a few countries in SEA is grasping it well. The 2019 estimated import reduction of USD 108 billion between the US and China, if shifted fully to ASEAN, could increase US export value from the region by almost 60%. Vietnam, Thailand, Malaysia and Indonesia are both the top exporters to the US and have relatively similar demography, and therefore can be used as comparable countries to study the effect of the US-China trade war in the region. Singapore is also a top exporter to the US, yet it may be plausibly excluded since it has an exceptionally different demography: a much smaller population, a service-based economy and a high GDP per capita. Figure 1 shows that Vietnam is leading in grasping the opportunities as there is substantial export growth to the US since the trade war began in July 2018. Malaysia has also experienced growth although not as sizable as Vietnam. On the other hand, Thailand's and Indonesia's exports to the US remain stable with little to no growth even after the trade war took place.



Source: (*Association of Southeast Asian Nations (ASEAN) | United States Trade Representative*, 2019)

Figure 1 US Import from ASEAN Countries 2015-2019

Indonesia has been suboptimal in seizing the opportunities in attracting FDI amidst the trade war. This phenomenon has created substantial opportunities for export-oriented FDI as the situation forces multinational companies to invest in new production facilities outside China. Aligned with the sizeable increase of Vietnamese exports to the US, many multi-national and publicly-listed Chinese companies have announced plans to set up manufacturing sites in Vietnam in anticipation of a prolonged trade war. As reported by the World Bank Group (2019), out of 33 Chinese-listed companies planning production expansion abroad, 23 selected Vietnam as a destination, the remaining 10 went to various countries around the world, yet none chose Indonesia. Figure 2 (*World Bank Open Data | Data*, n.d.) also demonstrates Indonesia's overall lagging performance since 2015 in attracting FDI, specifically compared to Vietnam. Although Vietnam leads in relative value compared to Indonesia, the sector trends of FDI inflow in both countries are somewhat similar. Between 2016 to 2018, both countries experienced significant decline in FDI in manufacturing. The decline in manufacturing, however, shifted into different sectors in Indonesia and Vietnam, which indicates that Indonesia and Vietnam are attracting foreign investors with different focus and characteristics.



Source: (*Badan Pusat Statistik*, 2020; *Indicators | ASEANStatsDataPortal*, n.d.; *World Bank Open Data | Data*, n.d.)

Figure 2 FDI inflows to ASEAN countries 2015-2018

Window of opportunity

The window of opportunity for competition for gains from the trade war is until US and China reach a new consensus on their trade balance. However, with the Covid-19 pandemic putting the global economy to a halt combined with the US being the epicenter of the virus spread, it may take some time until the trade negotiation between US and China can resume. Furthermore, the pandemic is also an unprecedented event that will change the global supply chain landscape substantially, which enlarges the subset of possible outcome post-trade war. The direction of the negotiation also relies heavily on US 2020 presidential election result, as the trade war is a political move by President Donald Trump.

The course until a new consensus is reached will be an adjustment period for the market and a momentum for any country wishing to capitalize gain from the trade war. Given the condition, it is estimated that any further negotiation will happen the earliest by 2021. The relatively short momentum requires Indonesia to act fast with a robust strategy that has the element of both short-term and the long-term reform.

Comparative analysis: Indonesia and Vietnam

Indonesia's strategy in response to US-China Trade War

Aside from the opportunities, it is important to also consider the risks that the trade war entails. The policies, or lack thereof, carried out by Indonesian government so far have been taking these risks into account (N. M. A. Marthini, personal communication, 2020).

External risks:

a. ***Dumping***. Due to the sudden sharp reduction in export to the US, manufacturers that already finished production but had no market to sell them will need to quickly find other countries to ship their goods to. There is speculation on China dumping products to India post-trade war (Rapoza, 2018). Indonesia with its sheer population size is also likely to be a market for dumping.
b. ***Certificate of Origin (CO) manipulation***. One of the easiest routes to avoid tariff from the US is to pick a country for bypassing the products to the US, which involves CO manipulation. Chau and Burdeau (2019) reported that many fake "Made-in-Vietnam" labels are found in the US.

Internal risk:

a. ***Low awareness on the close relationship between investment and trade***. There is a large body of research that shows the high correlation, if not reverse causation, between investment and trade. However, the coordination between Indonesian Investment Coordinating Board (*Badan Koordinasi Penanaman Modal* / BKPM) and Ministry of Trade (MoT) has been very minimum with both working in silos.
b. **Sentiment against free trade**. As argued by (Bunnell & Ann Miller, 2011), 'Neo-liberalism' is a political slur in the country, especially after 2008-10 global financial ?.

There is also resistance towards free trade, notably for any policy that involves increasing import, including importation of intermediate goods that may be needed for developing domestic manufacturing capacity.

c. **Sentiment against China**. Indonesia has a long history of discrimination against China that started in 1965 anti-communist movement and resurfaced in 1998 riot. (Hutton, 2018) contended that the stigma remains, causing media over-reaction on any matter related with China. As noted by (Doherty, 2019), the debate on China's "debt trap" through its Belt and Road Initiative exacerbates the already negative general public's opinion. Thus, Indonesia is relatively apathetic on the US-China trade war.

Ever since President Joko Widodo (Jokowi) took office in 2014, Indonesia has made considerable progress in economic development. Infrastructure was the priority of President Jokowi's first term in 2014-2019, resulting in tremendous growth of toll roads, deep seaports, and airports. EODB ranking of Indonesia also steadily improved during the same period, showing commitment in attracting foreign investment. Most recently in October 2020, as a response to the economic downturn caused by the COVID-19 pandemic, the Government of Indonesia just passed Job Creation Bill known as the Omnibus Law, which mainly focuses on reforming Indonesia's business landscape in an attempt to attract investment and stimulate the economy.

Indonesia is yet to be optimal in strategizing to be more competitive in attracting FDI, let alone those arising from the trade war. Overall, the liberalization effort has not resulted in considerable increase in FDI. So far, the current government relies heavily on physical infrastructure to boost the economy, but there is not enough attention for social infrastructure that makes the liberalization effort unable to tackle the root cause for lack of FDI. Combined with the persistent sentiment against China, Indonesia also has not issued any policy specific for the US-China trade war.

The reforms within the government to be a be more liberal is still nascent does not coincide well with the start of the trade war. While there have been structural reforms, the protectionist mindset is still prevalent. The tendency to be anti-liberalization can also be found in the government's willingness to provide incentives for foreign investors. At least there are two key characteristics of the Indonesian government that slowed down the capacity to incentivize FDI:

1. *Policy stability*

   Indonesia is the world's third largest democracy, and the political climate is relatively stable under Presidential system of democracy. However, as noted by Lembong (2020), the political stability does not necessarily translate well into policy stability, especially at the ministerial level. There are on average three cabinet reshuffles for each presidential five-year period since Indonesia's first election in 2004. Ministers in Indonesia are authorized to issue regulation called *Peraturan Menteri* (MR), which can be amended drastically especially when the minister is switched between technocrats and politicians. The policy instability hinders continuity of economic development in Indonesia as the incentives offered to foreign investors through MR can be short-lived.

2. *Preferential work culture*

   According to a former chairman of BKPM (T. T. Lembong, personal communication, 2020), Indonesia has the tendency of prioritizing large-scale investors, which extends to the provision of promotion and additional investment support. This can be counter-productive to the overall FDI level. Although one large investment can increase the FDI significantly, the frequency is much less than small-to-medium investments. Furthermore, most of successful FDI development in many countries were started as a relatively small with incremental investment over time. If provision of additional support is prioritized only for large-scale investors, this would deter many small-to-medium investors that could have expanded and invested more over time.

Competitive advantage of Vietnam

On top of the three systemic factors analyzed in the previous chapter, there are also situational factors taken into account by companies in deciding their relocation. Further research on reasons companies moving to Vietnam is shown in the appendix. In accordance with the export category presented in Figure 2, majority of the companies researched are in electronics and machinery sector. The most common reasons to pick Vietnam as destination, irrespective of the nationality, is supply chain accessibility. Based on the sample, Vietnam is an attractive destination for relocation for its competitive advantage in electronics and openness to trade in manufacturing sector.

Vietnam is relatively more prepared for electronics industry compared to other ASEAN countries. Since joining WTO in 2007, about a third of its FDI originated from South Korean electronics conglomerates such as Samsung and LG (The Economist, 2018). By 2018, electronics sector was already well developed with high-technology goods comprising 41 percent of its manufactured export. These development augment labor skills and supply chain capabilities in the country's electronics sector. Furthermore, Vietnam has also invested in internet connectivity, currently leading among the comparable countries in fixed broadband subscription (Table 2). These features make Vietnam more suitable for electronics company looking for new location for production. Google, Goertek and TCL can easily trail the supply chain and experienced workforce of Samsung and LG in Vietnam, making the relocation much smoother and learning curve of the new facility shorter.

Furthermore, Vietnam is also more aggressive in trade liberalization in manufacturing sector. In the last twenty years, Vietnam has entered into various trade agreements. Starting with FTA with the US in 2000, followed by joining WTO in 2007 and FTAs with Japan, Korea, EU, and the amended TPP, Vietnam focuses on multilateral FTA and bilateral FTA with major manufacturing countries. (Vanham, 2018) argued that the targeted trade liberalization resulted in constant decrease of applied tariff rate for manufactured products since 2000. The decision for firms to relocate needs to be quick to respond to the trade war. The first expected step is to move the manufacturing of the end exported product to avoid tariff. Hence, it is rational for them to pick a country where trade barrier is the lowest as they may need to import intermediate materials that are still manufactured in China or any other country that has trade agreement with China. In this case, Vietnam is preferable as they are the most open to trade and more geared to be a manufacturing hub among the four comparable countries.

Vietnam case demonstrates an interesting illustration of path dependence that resulted in a knock-on effect in FDI. Past inward FDI that grows over time have two types of positive externalities to the domestic economy:

1. Technology spillover. Most inward FDIs will result in technology and knowledge transfer to the local market, which would boost the whole industry to mature.
2. Labor skill improvement. FDIs can also enhance the domestic labor by acquiring new and specific skill set for the industry.

Both spillovers allow a country to acquire competitive edge in certain sector. It naturally attracts other players in same field, and eventually causes network effect that attracts even more companies in the future.

Furthermore, contrary to Indonesia's preference for large-scale investors, Vietnam provides investment support to various size of investors. Samsung, a conglomerate group that plays a major role in creating the knock-on effect in Vietnam's electronics landscape, started out as medium size investment. As demonstrated by (Lan, 2018), they first entered Vietnam through USD 670 million investment in 2008 and increased their investment over time, reaching almost 26 times of its initial investment value to over $17.3 billion in 2018.

Strategic positioning in attracting FDI in ASEAN

As the FDI opportunity from the trade war is substantial, it is important for countries to strategize in positioning themselves to compete with other economies. According to Oman (2000), there are two types of policy competition among governments in attracting FDI:

a. Incentives-based competition (IBC) is where countries compete through offering fiscal and financial incentives to potential investors. IBC tends to be short-term and conducted on a case-by-case basis.
b. Rules-based competition (RBC) refers to a broader government effort in becoming more investment-friendly, ranging from amending rules on labor to entering treaties with other countries. RBC is more of a medium to long-term and focused on institutional changes.

In practice the definition of each competition is not rigid, there can be IBC that requires long-term changes and RBC that can be implemented swiftly.

Both types of competition are important amid the trade war. The short momentum makes the need for a short-term IBC imperative, yet by offering too many incentives carries high risk of future fiscal revenue losses. On the other hand, long-term RBC would be a more prudent approach, but the time it takes to create any effect would bear the risk of missing the opportunities from the trade war altogether.

Incentives-based competition

Country comparison: regulation on incentives

Incentives for foreign investment are stipulated by the law, Table 1 is a brief overview of the prevailing regulation on the comparison countries.

Table 1. Investment Incentives Regulation

	Indonesia	**Vietnam**	**Thailand**	**Malaysia**
Investment Institution	Investment Coordinating Board (BKPM)	Ministry of Planning and Investment	Board of Investment (BOI)	Malaysia Investment Development Authority (MIDA)
Law	Investment Law 2007	Investment law 2015	Foreign Business Act 1999 and Investment Promotion Act 1977	Promotion of Investment Act 1986
Fiscal Incentives	Tax deduction, import duty holidays, accelerated depreciation	Tax exemption, provision of loans and infrastructure to investment made in designated areas	Exemption from: Income tax, import duties	Pioneer status or investment tax allowance
Non-fiscal Incentives	Special visa arrangements, expedited import procedures	Reduction in rent on government owned land		

Source: (Bonnitcha, 2014)

On top of the incentives mentioned above, each investment institution has the authority to provide additional investment support upon request of the potential investor. Commonly there is a minimum requirement to submit such request, yet the final decision on additional investment support is carried out on a case-by-case basis.

Rules-based competition

This section elaborates FDI rules-based competition among SEA countries from systemic and competitive advantage perspectives.

Despite having the largest population and relatively good macroeconomics outlook, Indonesia lags behind its peers in terms of trade with the US. As of 2018, Vietnam was ASEAN's biggest exporter to the US in 2018. The share of export to US even comprises 20 percent of Vietnam's GDP. On the contrary, Indonesia is ranked 5th in the region with export value of only 2 percent of GDP (Bureau, n.d.). However, this relatively low figure has made the US as Indonesia's top export destination. Furthermore, as mentioned in the previous section, US imports from ASEAN is predominantly electronic goods. Table 2 (*World Bank Open Data | Data*, n.d.) shows that while Indonesia is competitive in terms of human development and logistical infrastructure, it falls behind in high-technology exports and internet subscription.

Table 2. Overview of Selected ASEAN Members

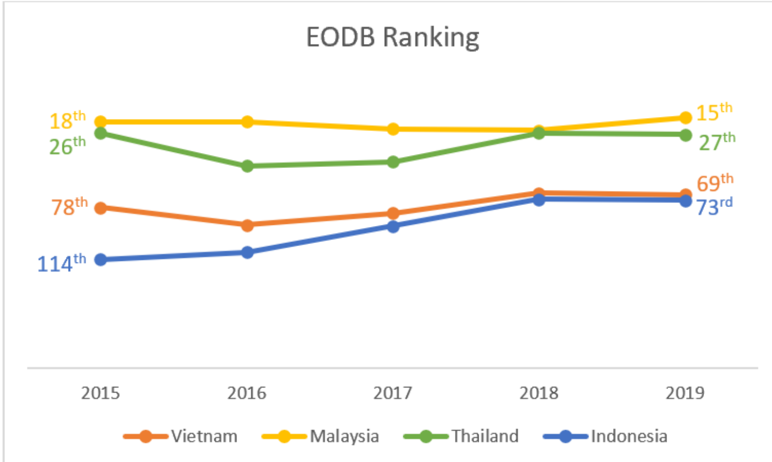
No	Aspect (2018)	Indonesia	Vietnam	Thailand	Malaysia
1	Area (in million km2)	1.9	0.3	0.5	0.3
2	Population (in millions)	256.0	92.7	65.3	31.4
3	GDP per capita (nominal, in thousand USD)	3.9	2.6	7.3	11.4
4	Human Development Index	0.7	0.7	0.8	0.8
5	Logistics Performance Index (1 worst; 7 best)	3.2	3.3	3.4	3.2
6	Fixed Broadband Subscriptions (per 100 people)	3.3	13.6	13.2	8.6
7	High-technology Exports (% of manufactured exports)	8.0	41.3	23.3	52.7

Source. (*World Bank Open Data | Data*, n.d.)

Country comparison: systemic factors

1. *Administrative complexity*

This factor refers to a country's business regulatory environment, specifically in entry regulation. As argued by Alesina, et al., (2005), the effect of regulatory reform, especially in entry liberalization, to investment in a country is substantial. OECD's EODB ranking is an appropriate indicator to measure administrative complexity. Corcoran and Gillanders (2015) contends that EODB ranking is a highly significant variable to estimate FDI. Figure 3 provides EODB ranking of four selected countries since 2015.



Source: (*Doing Business*, n.d.)

Figure 2 EODB Ranking of Selected ASEAN Countries

The data indicates that administrative complexity may have relatively low correlation in attracting FDI in SEA. Figure 3 shows that neither Malaysia and Thailand that rank highly, nor Indonesia that has improved by 41 place since 2015, has achieved significant FDI as indicated in Figure 2. On the other hand, Vietnam that improved their ranking only slightly, managed to constantly attract FDI higher relative to the other countries.

2. <u>Trade Openness</u>

Trade openness is a factor that measures a country's exposure to global supply chain, which also reflects the state's stance on free trade. Two indicators are discussed in this paper, namely number of FTAs and Trade-to-GDP.

A. FTA

As contended by Damanik et al. (2019), there is a positive perception of FTA as an effective instrument in attracting export-oriented FDI for Indonesia, Vietnam and Thailand. Table 3 shows the number of FTAs that is currently signed and in effect in the comparison countries. Indonesia has the least number of FTA both in bilateral and multilateral agreements. Furthermore, during the period of 2004-2015, there was no bilateral trade negotiations at all, which indicates that Indonesia is more reluctant than its neighboring countries in participating in the international trade through FTA. Although it is important to note that there are other factors that can also be indicators such as trade barriers in a form of export-import regulation.

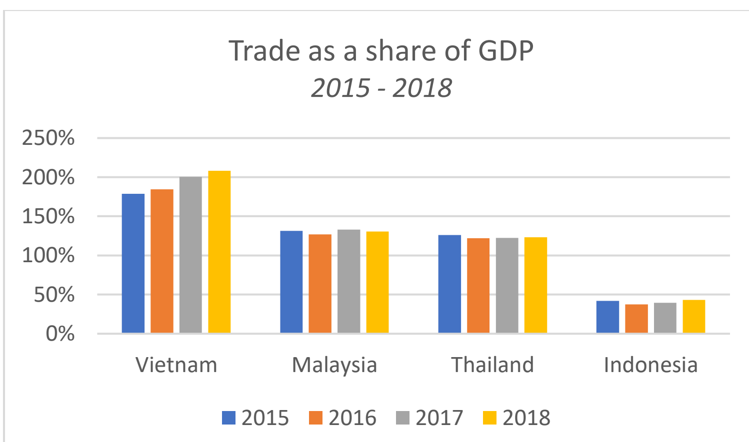
Table 3. Number of FTAs Signed and In Effect of Selected ASEAN Countries

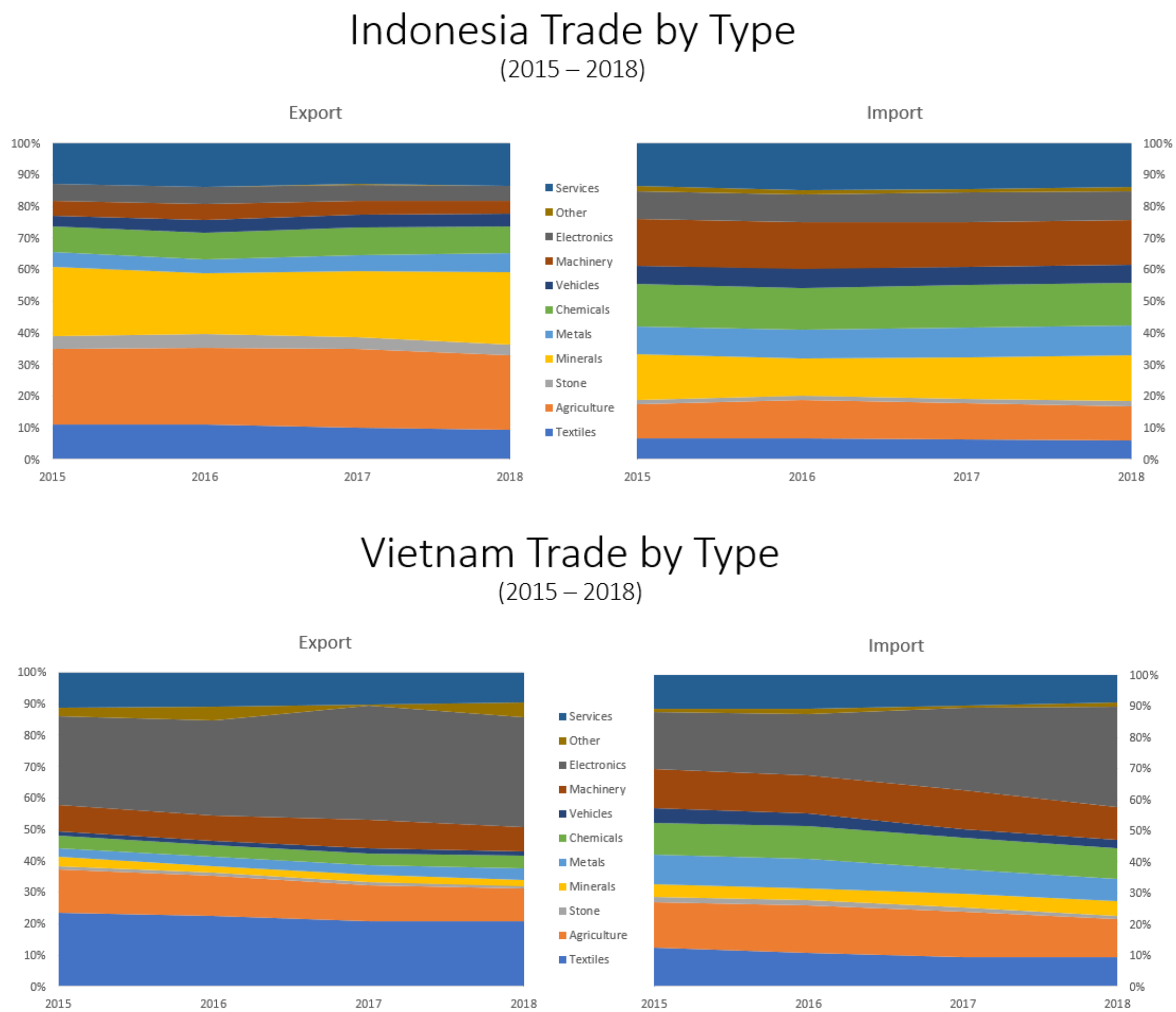
No	Country	Bilateral	Multilateral	Total
1	Malaysia	7	8	15
2	Thailand	7	7	14
3	Vietnam	3	9	12
4	Indonesia	3	8	11

Source: (ADB, n.d.)

B. *Trade-to-GDP*

The trade-to-GDP ratio is a measurement of the relative importance of international trade in the economy of a country, hence it can indicate degree of globalization of an economy. Figure 4 shows that Indonesia has the lowest Trade-to-GDP percentage since 2015. With a share of less than 50 percent , the gap between Indonesia and other countries are significant. Malaysia and Thailand have relatively stable measurement at around 125 percent while Vietnam's share has increased in the past 4 years, reaching more than 200 percent in 2018.





Source: (Growth Lab at Harvard University, n.d.; *World Bank Open Data | Data*, n.d.)

Figure 4 Trade of Selected ASEAN Countries

Figure 4 also shows that even before the trade war happened, Vietnam's export is dominated by Electronics and Machinery. Electronics and Machinery proportion to Vietnam's export grew steadily between 2015 – 2018. This makes Vietnam's export much more comparable to China. Meanwhile, Indonesia's export is predominantly Minerals and Agriculture, both are natural resources and relatively low-tech.

Indonesia's low Trade-to-GDP is caused by several reasons. Firstly, it is somewhat natural as larger the economy size, the lower Trade-to-GDP tends to be. As showed in Table 2, with GDP size of over USD 1 trillion and population of more than 260 million, Indonesia is the biggest economy in SEA and the only ASEAN country in the G-20, much larger relative to the other comparable countries. Secondly, according to (N. M. A. Marthini, personal communication, 2020), Indonesia in general has negative perception towards international free trade. Indonesia's prevailing trade regulation and inactivity in trade negotiations reflect a quiet protectionist attitude.

The data indicates that trade openness may have significant role in attracting FDI in SEA. Vietnam is leading in opening up to trade, shown by the increasing Trade-to-GDP and the number of multilateral agreements, which indicates the state's growing willingness for international trade. This finding is also supported by an theory by (Collie, 2011) that shows the positive correlation between multilateral trade to FDI

3. *Political Certainty*

Political certainty refers to the underlying state institutional quality in supporting the business environment. This factor measures whether the government can deliver economic growth-oriented policies. Table 4 (*GovData360 - Data Governance | Poverty Reduction*, n.d.) shows the political landscape of the countries based on five different indices, i.e., corruption, government effectiveness, global competitiveness, transparency in policymaking and judicial independence.

The data shows counterintuitive findings where Vietnam, the country with most success in attracting FDI, is lagging in almost all political certainty indices. Nevertheless, many literatures in developing countries also have similar findings. Kim (2010) finds that FDI inflows are higher in countries with high level public corruption and low level of democracy. Buracom (2014) also demonstrates that there is a case of well-established institutional framework increasing regional business transaction in the EU. Nevertheless, China and India that rank worse than some of the ASEAN countries in institutional quality still manage to be highly competitive economies.

Table 4. List of Political Certainty Indicators from Selected ASEAN Countries

No	Aspect	Indonesia	Vietnam	Thailand	Malaysia
1	Corruption Perception Index (2019, 0 high; 100 low)	40	37	36	53
2	Government Effectiveness Index (2018, -2.5 weak; 2.5 strong)	0.18	0	0.35	1.08
3	Global Competitiveness Index (2018, 0 worst; 7 best)	4.7	4.4	4.7	5.2
4	Transparency of Government Policymaking (2017, world ranking out of 151 countries)	51	82	83	23
5	Judicial Independence (2017, 1 low; 7 high)	4.37	3.60	4.08	4.65

Source: (ASEAN, n.d.; *GovData360 - Data Governance | Poverty Reduction*, n.d.; Transparency International, 2019)

Conclusion and policy recommendation

Indonesia is yet to be successful in capitalizing the substantial opportunity arising from the US-China trade war relative to its ASEAN peers, especially Vietnam.

Based on the analysis from IBC perspective, while the provision of investment incentives cannot be compared by country as they are carried out on a case-by-case basis, Indonesia has two main challenges in such competition. The first is policy instability, as incentives offered through MR can change drastically each time there's cabinet reshuffle. The second is counterproductive work culture that prefers large-scale investors in offering additional incentives. The current work culture does not accommodate small-to-medium potential investors equally, although cases from other countries show that such investors have significant growth potential over time.

From RBC perspective, the country comparison on three systemic factors indicates that trade openness may be the most crucial. Indonesia has been progressing in terms of administrative complexity and political certainty. Administrative complexity, measured by EODB rankings, apparently has relatively low correlation with the country's performance in attracting FDI. Analysis on political certainty also demonstrates counterintuitive findings, where Vietnam is the most attractive to foreign investors despite having relatively poor institutional quality. Trade openness is crucial in the context of quick response to the trade war. Firms' relocation plan would start with the end product, yet the complexity of global supply chain requires them to still import materials from elsewhere. Hence it is rational to pick a destination country where trade barrier is the lowest, which Vietnam offers best through growing trade-to-GDP and number of multilateral FTAs. Indonesia, on the other hand, remains relatively closed to trade as there is public sentiment against free trade, which is reflected in the government's protectionist policies.

Furthermore, there are a few implications from the interrelations between IBC and RBC of Indonesia. Firstly, the preferential work culture bears high risk of missing the path dependence and knock-on effects from small-to-medium foreign firms. Secondly, the low awareness on the correlation between investment and trade results in ineffective policies. Thirdly, the tendency to be anti-free trade causes political resistance in trade liberalization and policy instability.

To capitalize on the US-China trade war within the short window of opportunity, Indonesia needs a strategy that can be implemented swiftly with minimum wasteful fiscal losses while reforms in the systemic factors are in progress. The policy recommendation is a two-pronged approach of short-term and medium-to-long term strategies as follows:

Short Term

1. *<u>Maximize trade-related assistance by BKPM</u>*

   BKPM needs to improve the trade-related investment assistance to potential investors to counteract the relatively high trade barrier in Indonesia. Ease of trading can be a key determinant for export-oriented investment decision, which is a common investment type as a result of the trade war. While reducing a national trade barrier requires lengthy reform and needs to go through a series of political resistance, given the short time window of the trade war, BKPM can maximize its efforts in assisting potential investors in getting trade-related incentives. This would increase the attractiveness of Indonesia as a potential investment destination while trade reform is still in progress.

   There are several avenues that can be leveraged quickly by BKPM according to the prevailing regulations. BKPM currently has the authority to coordinate incentives, both fiscal and non-fiscal, as needed by any potential investors. One example of fiscal incentives is export/import duties exemption, which can be executed in a similar manner to past offering of tax holidays (BKPM, 2019). The implementation of these incentives requires close cooperation with the

Ministry of Finance. As for non-fiscal incentives, they can be in the form of a new dedicated service to help investors in following through the export-import procedures in Indonesia.

2. *Change the working culture of BKPM to capture path dependence*

BKPM needs to put more attention and effort towards smaller scale investors to increase FDI growth continuity. Path dependence of investment decision from foreign investors is an important mechanism to be capitalized. As explained previously, one relatively small inward investment today can grow significantly over time. Furthermore, small to medium investment opportunities are more ubiquitous than large-scale one-off opportunities. Lastly, the nature of the global supply chain puts more weight on this recommendation, as interrelated companies are more likely to move together and create knock-on effects.

On top of the Samsung case in Vietnam, another case can be taken from China as one of the most successful countries in attracting FDI after three decades of openness and reform. As explained by Li (2013), China began to open its market around 1980 and ever since there have been three stages of FDI inflow each characterized with different motives of investment. At first the foreign investors were resource seekers, then they changed into being market seekers and then after the global financial crisis they became strategic asset seekers. Although the history can be divided into stages, the majority of current investors belong to all three stages, which shows that major investors in the country today started their ventures decades ago. Many of them started out as small to medium investors and as they expanded their businesses, they put more investment into China over the years.

Medium-to-Long Term

1. *Reduce trade barrier while ensuring mitigation on external risk.*

Indonesia needs to reduce protectionist regulations to attract more FDI while being prudent on the external risk. Being more open to trade will not only be beneficial during the US-China trade war, but also for a longer time horizon for any FDI opportunity in the future. Trade liberalization is imperative and crucial for any country wanting to attract FDI, as discussed by (Li, 2013), a sample case from China that was very focused in reforming during the early period of openness and reform in the 1980s. However, this does not mean blindly reducing any trade barrier. Indonesia needs to set policies to ensure the goods imported by foreign investors are production materials, not final products that are intended to be sold to the local market (dumping) nor to be bypassed to other markets (CO manipulation).

There are several ways to reduce trade barriers. First, Indonesia should engage more in trade negotiations and enter more FTAs. While both bilateral and multilateral FTAs are equally as important depending on the context, multilateral FTAs may be more impactful in the medium term as they provide access to tap bigger markets. Second, Indonesia should revamp its Special Economic Zones (SEZs) program. (Wahyuni et al., 2013) noted that SEZs have been a successful strategy for China, Malaysia and Thailand to attract FDI, yet (Rothenberg & Temenggung, 2019) found that the fifteen SEZs in Indonesia have been relatively fruitless and tend to be a wasteful tax giveaway.

2. *Improve cooperation between BKPM and MoT.*

To increase the effectivity of investment promotion, BKPM needs to cooperate with MoT. The coordination can work either way, as both investment and trade are interdependent. Various empirical studies have shown the potential reverse causal link between trade and investment. Le Clus-Rossouw et al. (2015) contend that increasing FDI from the BRIC countries (Brazil Russia, India and China) to South Africa successfully resulted in an increase of export performance from Africa to the BRIC. Another empirical study by Liargovas and Skandalis (2012) also agrees with the positive correlation between trade openness to FDI inflows in 36 developing countries.

Examples how BKPM and MoT can coordinate their efforts are as follows:

1. MoT to start trade negotiations or enter multilateral FTA with countries that are deemed as having high FDI potential by BKPM.
2. BKPM to intensify investment promotion efforts in countries that can be strategic trading partner as assessed by MoT.

3. *<u>Shape the public opinion on free trade.</u>*

   As a democratic country, it is important to educate the public on the gains from prudent free trade for two reasons: to reduce political resistance and to increase policy stability. When the public has a good understanding on the benefits of free trade, any policy taken to promote liberalization of investment and trade would be received positively. Furthermore, if free trade is widely accepted as a positive thing, the policy stability can be improved. The probability of contradicting and counterproductive MR amendment each time there's cabinet reshuffle can be reduced, as anyone who is appointed as minister would support liberalization.

   An approach to achieve this would be to appoint more technocrats in the cabinet for investment and trade related ministries. In contrast to partisan politicians that commonly have vested interest, independent technocrats with solid professional background would be able to bring nonpartisan evidence-based policy making practices in advocating free trade. If the practice is sustained sufficiently, it would eventually shape public opinion to be in favor of free trade.

Data Availability Statement

The data that support the findings of this study are available from the corresponding author upon reasonable request.

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The Author(s) declare(s) that there is no conflict of interest

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Appendix

Appendix 1. Sample List of companies relocating from China to Vietnam

No	Company Name	Nationality	Category	Rationale
1	Hanwha Aero Engines	South Korea	Aerospace manufacturing	Expansion
2	Yokowo	Japan	Automotive components manufacturing	Expansion
3	Huafu	Hong Kong	Textile	Access cheaper materials, reduce labor costs and avoid tariff barriers
4	Nintendo	Japan	Gaming console	Existing outsourcing manufacturers
5	Google	U.S.	Smartphone	Acquired Nokia manufacturing system, trailing Samsung smartphone supply chain, experienced workforce
6	Goertek	China	Electronics (AirPods)	Robust supply chain
7	TCL	China	Electronics (TV)	Expansion, cheaper workforce, proximity and low import barrier
8	Jinhua Chunguang	China	Rubber products	Cheaper workforce, proximity and low import barrier
9	Zhejiang Henglin Chair Industry	China	Furniture	Cheaper workforce, proximity and low import barrier

Source: (*Goodbye China*, 2020; *Google to Shift Pixel Smartphone Production from China to Vietnam*, 2020; "Nintendo Says to Shift Part of Switch Console Production out of China," 2019; VIR, 2019)