THE 40TH ANNIVERSARY OF ECONOMIC RELATIONS BETWEEN KOREA AND INDONESIA

By Kang Dae-Chang

Abstract

Korea and Indonesia have developed an increasingly robust economic relationship over the past 40 years. Since the two states established diplomatic relationship in 1973, bilateral trade volume and Korean foreign direct investment (FDI) to Indonesia have increased tremendously. At present, Korea and Indonesia are influential trade partners for each other, while Indonesia has been an important place for Korean FDI for a long time. Korea has also enhanced efforts to help the development of the Indonesian economy by strengthening cooperation on the governmental level and providing a substantial amount of official development assistance to Indonesia. With technical assistance and knowledge sharing programs, Korea has helped to enhance the quality of Indonesian institutions. With Korean-Indonesian Comprehensive Economic Partnership Agreement (CEPA), the two countries would broaden the scope of tariff free items. If concluded, both states would get substantial benefits. However, it will be difficult to finalize the deal soon as aligning the common interests of the two countries is difficult, and the conditions of East Asian regionalism have changed recently. However, Korea and Indonesia will continue good economic relations and advance them to a higher level in the future due to the complementary nature of their economies and the development potential of Indonesia.

Changes in Economic Relations between Korea and Indonesia

Korea and Indonesia have achieved remarkable advancements in economic relations over the past 40 years. Since the two states established diplomatic relations in 1973, bilateral trade volume increased by 150 fold. Figure 1 shows the trend of trade between Korea and Indonesia from 1977 to 2012. Foreign direct investment (FDI) flows from Korea to Indonesia also increased sharply. Korean direct investment to Indonesia surged from $38 million in 1980 to $1.2 billion in 2011, multiplying nearly 33 times. Figure 2 represents the trend of Korean FDI to Indonesia from 1980 to 2012.

Korean exports to Indonesia have fluctuated greatly over the years after quickly increasing from 1977.[1] During this period, they show a steadily increasing trend, except in the mid-1980s and the three subsequent economic crises: the second oil shock (1997), Asian financial crisis (1997), and global financial crisis (2008). In 1977, Korea exported to Indonesia a mere $69 million, but during the next three years exports to Indonesia increased sharply by almost three times, and it recorded almost $200 million in 1979. Korean exports to Indonesia jumped to over $300 million in the early 1980s. However, this figure decreased to below $200 million in the mid-1980s, then increased in the late 1980s and recorded $667 million in 1989. In the 1990s, Korean exports to Indonesia kept increasing.[2] They recorded over $1 billion in 1990, and increased to $3.2 billion in 1997. However, exports were drastically reduced to $1.8 billion in 1998, due to the effect of 1997 Asian financial crisis. Then, they began increasing steadily from 1999 to 2008. In 2008, exports reached almost $8 billion , but drastically plunged to $6 billion in 2009 due to the effect of the 2008 global financial crisis. In 2010, the economic environment turned around and Korea recorded almost $14 billion in exports to Indonesia in 2012. Throughout this whole period, Korea has had a trade deficit with Indonesia.

Indonesian exports to Korea also show a similar trend to Korean exports to Indonesia, although there were more fluctuations.[3] In 1977, Indonesia exported $345 million to Korea. Exports to Korea increased to almost $1 billion in 1988, despite some ups and downs. They increased to $4.1 billion in 1997. However, Indonesia also experienced a plunge in exports to Korea, due to the effect of the 1997 Asian financial crisis. Exports were reduced to $3 billion in 1998, then increased steadily from 1999 to 2008. Indonesia recorded almost $11 billion in exports to Korea in 2008. In 2009, exports decreased to $9 billion due to the effect of the 2008 global financial crisis. In 2010, they turned around and reached almost $15.7 billion in 2012. From 1977 to now, Indonesia has recorded a trade surplus with Korea.

> "When Korean firms started investing abroad in the 1960s, the primary destination was Indonesia."

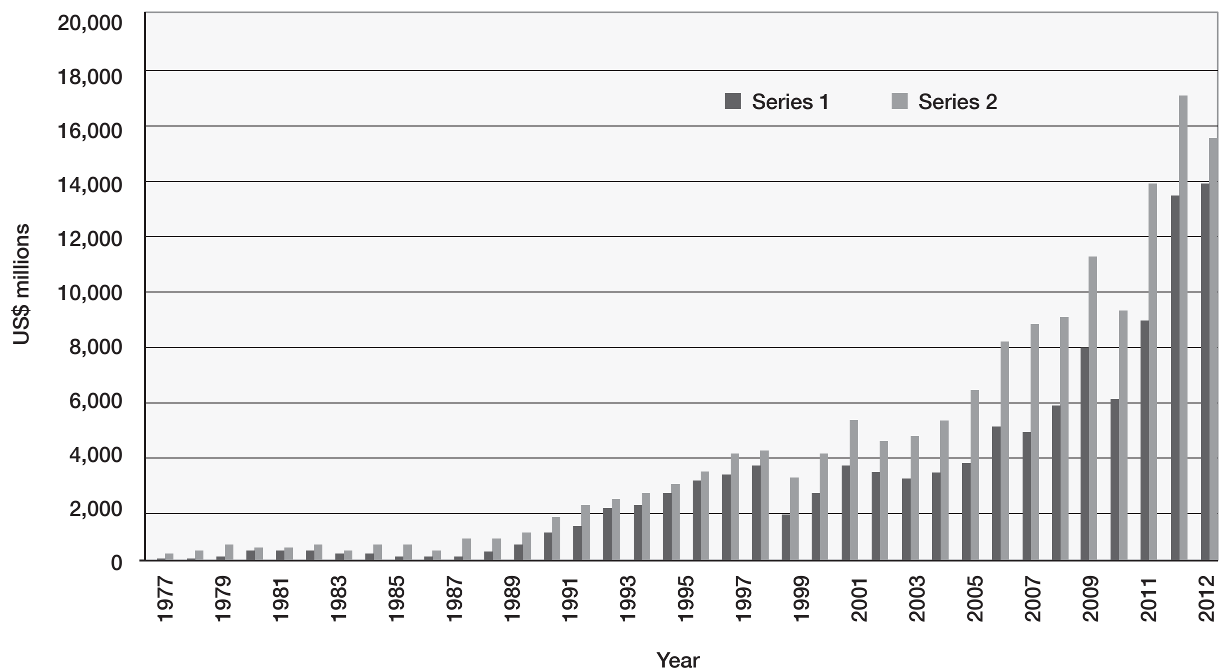
Indonesia has long been an important place for Korean FDI. When Korean firms started investing abroad in the 1960s, the primary destination was Indonesia. Of the total FDI in 1980, the percentage of Korean FDI to Indonesia was 40.6 percent. As Korean firms diversified their FDI destinations in the 1980s it decreased. By 1985, Korean FDI to Indonesia amounted to only 10.6 percent of Korea's total FDI. For a moment, though, it increased to 19 percent in 1990. Afterwards, Korean FDI to Indonesia continued to decrease from the 1990s to the 2000s, as many Korean firms diverted their FDI to China and Vietnam to take advantage of low wages. FDI fell to 6.3 percent in 1995, then falling to 1.9 percent in 2000, and 1.4 percent in 2005. However, Korean firms strengthened investment activities in Indonesia as the two countries became strategic partners in 2006. Since then, the portion of Korean FDI to Indonesia among the total Korean FDI increased to 3.6 percent in 2010, to 4.7 percent in 2011, and to 4.2 percent in 2012.

Compared to Korean direct investment to Indonesia, Indonesian direct investment to Korea has not been substantial. The highest amount is $752 million in 2010. Indonesia's investment flows directly to Korea's services sector and has reached over 99 percent.[4]

Korean firms have actively pursued business opportunities in Indonesia since the early 1960s, even before the diplomatic relationship was established. They advanced Indonesia's developing forestry industry in the 1960s. In addition, Korean companies also invested in Indonesia's condiment, garment, chemical, and pharmaceutical industries, among others, beginning in the 1960s. In the 1970s, more Korean firms entered Indonesia to expend investment in forest development and took part in Indonesian construction projects. Some Korean firms invested to develop oil fields and gas shells in Indonesia in the 1980s, but had less success in resource development.

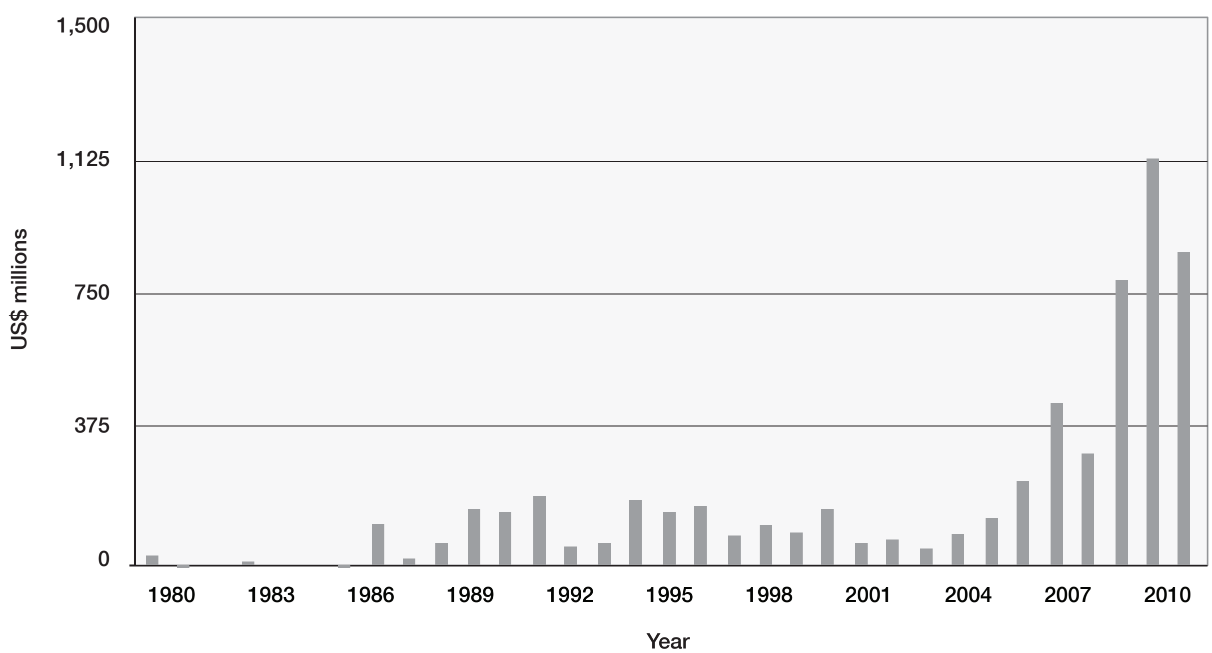
In the 1980s, Korean FDI to Indonesia concentrated in manufacturing and export-oriented industries such as food manufacturing, garment, and chemical, to take advantage of the cheap labor that Indonesia had to offer. Many Korean firms relocated their production bases to Indonesia in order to maintain international competitiveness. This trend continued in the 1990s.

Figure 1 Trade between Korea and Indonesia (1977 – 2012)



Source: Korea International Trade Association, Trade Statistics.

Figure 2 Korea's FDI to Indonesia (1980 – 2012)



Source: The Export-Import Bank of Korea, Statistics of Overseas Direct Investment.

Table 1 The Major Items of Korean Exports and Imports from Indonesia (as of 2012) (US$ million, %)

Export Items	Amount	Proportion	Import Items	Amount	Proportion
Diesel	3,827	27.4	Natural Gas	5,342	34.1
Gasoline	1,624	11.6	Bituminous Coal	3,143	20.0
Knitted Fabrics	667	4.8	Crude Petroleum	1,779	11.3
Synthetic Resin	603	4.3	Natural Rubber	481	3.1
Hot Rolled Sheet and Strip	516	3.7	Copper Ore	399	2.5
Synthetic Rubber	358	2.6	Heavy Fuel Oil	373	2.4
Cold Rolled Sheet and Strip	270	1.9	Pulp	312	2.0
Heavy Equipment for Construction	213	1.5	Lubricating Oil	201	1.3
Passenger Car	164	1.2	Other Articles of Petroleum	198	1.3
Galvanized Sheet and Strip	139	1.0	Knitted Fabrics Garments	191	1.2
Subtotal of Big 10 Items	8,380	60.0	Subtotal of Big 10 Items	12,419	79.2
Total	14,000	100.0	Total	15,676	100.0

Note: Based on MTI 4 digit classification.
Source: Korea International Trade Association, Trade Statistics.

Since the 2000s, Korean firms started to enter IT and automobile industries, considering the potential of Indonesia's vast consumer market. In the 2010s, Korean firms advanced into retail and wholesale distribution industries in Indonesia to take advantage of the opportunities presented by the Indonesian consumer market. At present, some Korean financial institutions actively do business in Indonesia.

The Current State of the Economic Relationship

At present, Korea and Indonesia are key trading partners. As of 2012, Korea is the 4th largest trading partner for Indonesia and Indonesia is the 7th largest one of Korea.[5] Since the 21st century, bilateral trade has increased significantly due mostly to the Korea-ASEAN FTA and the strategic partnership between the two states. The total trade volume between the two countries amounted to $22.9 billion in 2010, increased to $30.8 billion in 2011, and decreased to $29.5 billion in 2012. Indonesia exported $15.7 billion to Korea, and Korea exported $14 billion to Indonesia, in 2012.

The trade pattern between Korea and Indonesia shows strong complementarities. While Korea has high technologies and abundant capital, Indonesia possesses enormous natural resources. Thus, Korea exports mainly capital goods and materials and Indonesia natural resources. While Korean exports to Indonesia vary from petroleum products to passenger cars, Indonesian exports to Korea are relatively concentrated in natural resources. Table 1 illuminates the current trade pattern between Korea and Indonesia.

As of 2012, the major Korean exports to Indonesia were petroleum chemical products, fabric products, synthetic products, steel, heavy equipment, and passenger cars. These exports are worth $8,380 million, and account for 60 percent of Korea's total exports to Indonesia.

Of these exports, petroleum products account for 39 percent: diesel 27.4 percent, and gasoline 11.6 percent. Knit fabrics take up 4.8 percent. Synthetic products are 6.9 percent: synthetic resin 4.3 percent and synthetic rubber 2.6 percent. Steel takes 6.6 percent: hot rolled sheet and strip 3.7 percent, cold rolled sheet and strip 1.9 percent, and galvanized sheet and strip 1.0 percent. In addition, heavy equipment for construction accounts for 1.5 percent and passenger cars 1.2 percent.

On the other hand, the major Indonesian exports to Korea are raw fuel products, raw materials, oil products, and garments. The amount of those exports is $12,419 million, and the portion of those out of the total Indonesian exports to Korea is 79.2 percent.

Raw fuel products take up 65.4 percent: natural gas 34.1 percent, bituminous coal 20 percent, and crude petroleum 11.3 percent. Raw materials account for 7.65 percent: natural rubber 3.1 percent, copper ore 2.5 percent, and pulp 2 percent. Oil products are 6 percent: heavy fuel oil 2.4 percent, lubricating oil 1.3 percent, and other articles of petroleum. Knit fabric garments take up 1.2 percent.

Historically, Korean FDI in Indonesia concentrated on manufacturing and mining. Recently, however, this concentration has strengthened further. Of Korea's FDI into Indonesia in 2012, manufacturing and mining were 76.5 percent: manufacturing 51.1 percent, and mining 25.4 percent. Agriculture, forest, and fishery made up 7.5 percent. Electricity, gas and water were 4.3 percent. Construction was 3.4 percent. Retail and wholesale distribution accounted for 3.1 percent. Finance and insurance made up 2.3 percent and services were 1.5 percent. Korean firms also invested in Indonesia's transport, publication, real estate, and hotel industries, but the size of investment is negligible and the portion is below 1 percent.[6]

Recently, Korean FDI to Indonesia has varied in terms of the areas and the size of projects. This is because Korean firms try to tap into the huge Indonesian consumer market on one hand, while on the other hand employing Indonesia as a production base and export hub for the world as well as Southeast Asia.

Korean firms are also advancing into Indonesia's services sectors. Some have succeeded in the areas of IT, IT services, and internet games. Korean financial institutions also strengthened their business in Indonesia. Big Korean distribution firms have expanded their stores and enhanced their network of distribution in Indonesia. Indonesia provides many opportunities for public-private partnership (PPP) projects, due to the Master Plan for Acceleration and Expansion of Indonesia's Economic Development (MP3EI) of 2011. Thus, Korean construction companies are actively taking part in the construction projects in Indonesia. Some Korean companies including public enterprises do business as a PPP project developer and operator in Indonesia. Korean firms also enlarged the size of their investment in Indonesia. In 2013, a Korean steel company built a huge steel mill and began to produce steel, and a Korean tire company constructed a major factory to produce tires.

Korean Efforts to Help the Development of the Indonesian Economy

Korea enhanced efforts to help the development of the Indonesian economy by strengthening cooperation on the governmental level. At present, the Korean government supports the Indonesian government in drawing up the implementation plan for the Master Plan for Acceleration and Expansion of Indonesia's Economic Development (MP3EI). Korea also provides a substantial amount of official development assistance (ODA) for Indonesia. Currently, the Korean government is emphasizing technical assistance to Indonesia to help enhance the quality of Indonesian institutions.

As already mentioned above, the two states forged a strategic partnership in 2006 to strengthen cooperation between each other. In order to realize the strategic partnership in regards to the economic aspects, the two countries established the Korea-Indonesia Joint Task Force on Economic Cooperation (JTF-EC) in 2007, and discussed measures to implement the economic, trade and investment cooperation through the JTF-EC. In 2011, Indonesia set forth MP3EI which aims to develop the Indonesian economy as an advanced one. Since then, the two states turned the JTF-EC into the Working Level Task Force Meeting (WLTFM) to accommodate significant development in economic cooperation between the two countries. The WLTFM is held two times a year to discuss the specific cooperation agenda. Under the WLTFM, there are eight working groups which discuss future directions and projects to strengthen economic cooperation between the two countries. In order to monitor the implementation of agreements by the WLTFM, they established the Joint Secretariat of WLTFM in Jakarta on 28 February 2012. The members of the Joint Secretariat include officials from the Indonesian Coordinating Ministry for Economic Affairs and officials from the Korean Ministry of Trade, Industry and Energy[7] as the focal point of the WLTFM of each country.

The two countries launched eight major cooperative projects: the CNG Package Project, the Sumsel-6 Coal Fired Power Project, the Agro-based Multi-Industry Cluster, the establishment of a branch of Daewoo Shipbuilding and Marine Engineering (DSME) of Korea in Indonesia, the Benglulu-Muara Enim Coal Railway, the Sunda Strait Bridge, the Batam-Bintam Bridge, and the River Restoration Project in Indonesia. To perform these projects, Korean firms participate in developing the projects by providing capital and technology, and the Korean public financial institutions for policy finance provide technical assistance for the Indonesian financial institutions.

Indonesia receives official development assistance (ODA) from Korea, both by grant and credit assistance. As of 2010, Indonesia obtained a grant of $15 million from Korea and was the 6th largest grant receiving country of Korea. For credit assistance, the Economic Development Cooperation Fund (EDCF) of Korea offered $590 billion in total to Indonesia until 2010, making Indonesia the 4th largest recipient of credit assistance from Korea.

Through grants, Korea assists Indonesia in various ways. In particular, Korea allots grants for human capacity building in Indonesia.[8] Grants to Indonesia are distributed for supporting projects, providing materials and supplies, emergency aid, development and research, inviting and training Indonesian trainees, sending Korean experts, disseminating the Korean martial art of Taekwondo, dispatching World Friend Korea,[9] and assisting non-governmental organizations (NGOs). Among them, supporting projects takes the highest portion of assistance, followed by dispatching World Friend Korea and development and research. Distribution of grants for disseminating Taekwondo and sending Korean experts is sporadic.

EDCF credit is mostly allocated to infrastructure construction, health care, and institution enhancement.[10] For infrastructure construction, EDCF is credited with the first and second project of Mando detour construction, Karian Dam, Padang detour construction, and Padang detour expansion. For the second project of Mando detour construction, grant and EDCF credit were provided together. For health care, EDCF credit was distributed to East Java Local Hospital improvement, the expansion of waste water facilities for hospitals, Adam Malik Hospital improvement, general hospitals improvement, Kandou Hospital improvement, and Kalimantan Hospital improvement. For institution enhancement, EDCF credit was allocated to building the cellular network of the National Police Agency, developing the National Criminal Information Center, establishing the National Information and Communication Officials Training Institute, and building Batam e-Government. EDCF also provided credits for improving unemployment education.

The Korean government has assisted the development of Indonesian institutions. Through the knowledge-sharing program (KSP) of Korea, the Korean government provided technical assistance to Indonesia in the areas of finance. For example, Korea helped Indonesia with the development of a bond market in 2005, the development of finance supervision in 2009, the development of financial and capital markets in 2010, and the improvement of the credit assessment system in 2011. The Korean government also provided consultation for the reorganization of the Indonesian finance supervision body and trained the experts in 2012. In 2013, it assisted Indonesia with the development of the Indonesian institution and system for public-private partnership (PPP).

Background, Issues, Progress, Potential Benefits, Prospects, and Challenges of the Korea-Indonesia FTA

The Korea-ASEAN FTA took effect in the order of: agreement of trade in goods (June 2007), agreement of trade in services (May 2009), and agreement on investment (September 2009). For two years after the agreement of trade in goods came into effect, the trade volume between Korea and ASEAN increased significantly. However, the utilization rate of Korea-ASEAN FTA is substantially low. It ranges from about 10 to 30 percent, according to the reports of various institutions. It is 86 percent for Korea-Chile FTA, 78 percent for Korea-EU FTA, and 60 percent for Korea-US FTA. For ASEAN states, the utilization rate of the Korea-ASEAN FTA is low, similar to the Korean case.

> "Korea and Indonesia realized that a stronger bilateral FTA would have a positive effect on both economies and agreed to pursue a bilateral FTA to widen the scope of tariff free items and accelerate the speed of tariff abolition..."

There are two factors behind this low utilization rate. First, the liberalization scope of Korea-ASEAN FTA is narrow, compared to that of Korea-EU FTA and Korea-US FTA. The proportion of tariff free items of Korea-ASEAN FTA is about 90 percent, while those of Korea-EU FTA and Korea-US FTA are almost 99 percent. Second, the conditions for application of rules of origin (ROOs) are complex. So, the Korean government has tried to resolve these issues by extending the scope of tariff free items and alleviating the conditions for ROOs through additional negotiation at the Implementation Committee of Korea-ASEAN FTA.

However, there are some trade issues that are not dealt with by the Korea-ASEAN FTA. On electronic products, automobiles, and steel—which are core export items to the ASEAN market—Indonesia, Malaysia, Thailand, and Vietnam levy tariffs under the Korea-ASEAN FTA. To overcome this difficulty and enhance trade relations with those states, the Korean government is negotiating bilateral FTAs with Indonesia, Vietnam, Thailand, and Malaysia. Indonesia also expects to elicit benefits from a bilateral FTA with Korea, by obtaining higher technologies from Korea.

Korea and Indonesia realized that a stronger bilateral FTA would have a positive effect on both economies and agreed to pursue a bilateral FTA to widen the scope of tariff free items and accelerate the speed of tariff abolition of the bilateral parts of Korea-ASEAN FTA, when the presidential envoy of Indonesia visited Korea in February of 2011. The two countries agreed on terms of reference for the direction and to conduct a joint study. The scope of the joint study includes trade standards for commodity trade, services trade, investment, non-tariff measures, trade remedy, government procurement, intellectual property rights, customs procedures and trade facilitation, and so on. The first round of the joint study for Korea-Indonesia Comprehensive Economic

Partnership Agreement (CEPA) began in Jakarta in July of 2011, and the two countries held joint studies three times before October of 2011. On October 2011, the two countries discussed the start of negotiation of bilateral FTA at the Korean-ASEAN Summit. As of now, the two countries have held six rounds of negotiations for Korean-Indonesia CEPA.[11]

According to the joint study of Korea-Indonesia CEPA, both countries will enjoy positive growth in output and welfare. It is estimated that there will be 0.03 percent increase in GDP and $7.97 million welfare increase for Indonesia and 0.13 percent GDP increase and $1.5 billion welfare increase for Korea. However, when considering a productivity increase in major industries under a possible CEPA including trade in goods, trade in services, investment as well as economic cooperation, Indonesia will enjoy 4.37 percent of GDP increase and $10.6 billion welfare increase. With Korea-Indonesia CEPA, Korea could increase exports of IT, automobile, and steel products. On the other hand, Indonesia could get more FDI from Korea and develop industries by utilizing the higher technologies accompanying Korean FDI to Indonesia.

The two countries agreed to finalize the Korea-Indonesia CEPA by the end of 2013, when the President of Korea visited Indonesia on October 2013. It shows the strong support of the two leaders for the Korea-Indonesia CEPA, but the timeline is too tight to strike the deal in 2013. Although the final agreement will come out later, it would be struck earlier than any other bilateral FTA deals with Southeast Asian countries. This is because the two countries recognize the potential benefits of Korea-Indonesia CEPA, considering the deepened economic relations and strong complementarities between the two countries.

The Korean government wants the Indonesian markets of IT, automobiles, and steel products opened by Korea-Indonesia CEPA, but it would be difficult to loosen Indonesia's non-tariff measures. Despite a low tariff on those products, their trade would not increase substantially if non-tariff measures are not addressed appropriately. For Indonesia, obtaining higher technologies from Korea is the key interest in the Korea-Indonesia CEPA. Transfer of higher technologies to Indonesia is primarily dependent on Korean firms' interest. At present, there are not many Korean firms to transfer higher technologies to Indonesia and not many Indonesian firms to operate those technologies. These issues make aligning common interests in the bilateral FTA difficult for both countries.

The bigger challenge for the Korea-Indonesia CEPA will come from the progress of regionalism in East Asia. Korea expressed its interests in Trans-Pacific Partnership (TPP) recently, and hopes to enter the negotiation of TPP in early 2014. If Korea participates in TPP, it will divert interest from the bilateral FTA because the TPP negotiation would take a significant amount of resources and energy from Korean officials. The TPP negotiation would also take a long time to finalize because it sets high standards for a trade agreement. In the meantime, Korea's interest on the bilateral FTA would be dissipated and put aside with negotiations of other bilateral FTAs. There is a possibility that Indonesia would also turn to TPP participation. Then, the negotiation of Korea-Indonesia FTA would drift along and stop for a long while.

Future Prospects for the Relationship

Korea and Indonesia will continue to maintain strong economic relations and advance them to a higher level in the future. They need each other, due to the complementarities and the development potential of Indonesia.

Most of all, the two countries have strong complementarities in the structure of industries. Indonesia lacks technologies and capital, and Korea can provide Indonesia with capital goods and materials, while investing into various sectors. On the other hand, Korea lacks natural resources, and Indonesia is well endowed with natural resources such as coal, natural gas, tin, nickel, and timber. Thus, the two states will continue to enjoy economic cooperation in a complementary way.

Indonesia also has an enormous potential for development. According to many experts, Indonesia is expected to be the 7th largest economy in the world by around 2030. Thus, the scope for cooperation of the two countries would expand not only to trade and investment, but also to the development of the Indonesian consumer market in the future. Korea could support the development of the Indonesian economy by providing the capital and technologies for Indonesia.

Excellent economic relations between the two countries can be sustained over the long-run thanks in part to Korea's soft power. Unlike the other major economies in East Asia, Korea is seen as a country that will not overwhelm. In particular, Indonesians feel attraction to Korean pop culture. They enjoy Korean pop culture because they view it as containing values of family, warm affection, and refined image, compared to Chinese or Japanese pop culture. The attractiveness of Korean soft power is a strong foundation upon which stable economic relations between Korea and Indonesia can be built.

Kang Dae-Chang is an Associate Research Fellow at Korea Institute of International Economic Policy (KIEP).

---

1 Trade Statistics, Korea International Trade Association, http://stat.kita.net/top/state/main.jsp (accessed November 30, 2013).

2 In the period from the 1990s to 2010s, the portion of Korean exports to Indonesia takes about 2 percent of the total Korean exports on average. Author calculated by using Trade Statistics of the Korea International Trade Association.

[3] Trade Statistics, Korea International Trade Association, http://stat.kita.net/top/state/main.jsp (accessed November 30, 2013).

[4] Indonesia-Korea Joint Study Group for a Comprehensive Economic Partnership Agreement, p. 18.

[5] Trade Statistics, Korea International Trade Association, http://stat.kita.net/top/state/main.jsp (accessed November 30, 2013).

[6] ODI Statistics, The Export-Import Bank of Korea, http://211.171.208.92/odisas.html (accessed on November 30, 2013).

[7] Ministry of Knowledge Economy had been reorganized as Ministry of Trade, Industry and Energy in 2013, after the new Korean president came into office.

[8] ODA Statistics, Korea International Cooperation Agency, http://stat.koica.go.kr/ (accessed on November 30, 2013).

[9] World Friend Korea is the Korean version of the Peace Corps.

[10] Economic Development Cooperation Fund, The Export-Import Bank of Korea, http://www.edcfkorea.go.kr/edcf/job/aid/aid.jsp (accessed on November 30, 2013).

[11] Daechang Kang, et. al, *A Study for the Economic Cooperation between Korea and Indonesia from a Long Term Perspective: Focused on Regional Economic Development and Human Resources* (in Korean), Korea Institute for International Economic Policy, pp. 60-62.