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Industrial and Foreign Investment Policy in Indonesia since 1967

THEE Kian Wie*

Introduction

Indonesia's foreign investment policy since 1967 has changed directions several times in response to fluctuations in economic fortunes of the country and political pressure. The advent of the New Order government in 1966 marked a sharp reversal in the approach to the economic problems facing the country. Whereas the previous government under President Sukarno adopted an increasingly hostile attitude towards foreign investment resulting in the takeover of several foreign enterprises during the early 1960s, the New Order government put a much higher priority on solving the serious economic problems of the country. While the new government relied on foreign aid from the Western countries (including Japan) and multilateral aid agencies to provide the necessary funds for balance of payments support and the rehabilitation of the obsolete infrastructure, it realised that the development of the country's vast natural resources and the embryonic manufacturing sector would have to depend on foreign direct investment [Sadli 1972: 203]. One of the outcomes of this more pragmatic approach to economic problems was the promulgation of a new Foreign Investment Law in early 1967 which provided various favourable incentives and guarantees to foreign investors.

The Foreign Investment Law of 1967 introduced a relatively brief period of an 'open-door policy' with regard to foreign investment which lasted until early 1974. Urban riots in January 1974 directed against the perceived 'over-presence' of Japanese investment in Indonesia (the so-called 'Malari affair') led to a more restrictive policy towards foreign investment. This more restrictive foreign investment policy, however, turned out to be in line with a general increase in regulatory policies and government intervention in the economy which became more evident after the mid-1970s.

The sharp deterioration in Indonesia's balance of payments in 1982 and the protracted slowdown of the Indonesian economy as a result of the international recession and the attendant weakening of the world oil market forced the government to introduce a series of policy reforms, including a reversal of its increasingly restrictive foreign investment policy. In May 1986 the Indonesian

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government introduced a set of policy measures (the ‘Pakem’ or 6 May package) to increase the international competitiveness of Indonesia’s non-oil and gas exports and improve Indonesia’s investment climate by relaxing several restrictive measures to control foreign investment which had been in effect since the late 1970s.

Unlike the fundamental turnaround in foreign investment policy in 1967, however, shifts in foreign investment policy after 1967 did not reflect a fundamental policy change, but rather a pragmatic response to political pressures (1974) or adverse economic conditions (1982).

While recent policy measures and government efforts to promote more foreign investment mark a partial return to the ‘open-door policy’ of the late sixties and early seventies, it seems unlikely that the Indonesian government (or any Indonesian government for that matter) would ever be prepared to pursue a completely liberal policy towards foreign investment. To pursue such a course would mean a naive disregard of the potent force of economic nationalism which no Indonesian government could afford to do. In hindsight, the ‘open-door policy’ of 1967–1973 seems to have been an ‘aberration’ from a basic attitude which can only be attributed to the desperate situation of the Indonesian economy after the fall of the Old Order government. Though present economic conditions are quite serious, the Indonesian economy in the late 1980s is undoubtedly much stronger than it was two decades ago. With a favourable turnaround in economic conditions, the abiding and widespread national aspiration of ‘becoming master in one’s own house’ would undoubtedly reassert itself once again. This would imply a return to a more restrictive policy with regard to foreign investment.

In the following pages we will have a closer look at the shifts in foreign investment policy since 1967. Since the largest amount of foreign investment in the non-oil and gas sectors has taken place in the manufacturing sector, we will also see to what extent industrial development in Indonesia over the past two decades has influenced foreign investment policy. To this end we will first discuss Indonesia’s industrial policy since the late 1960s.

**Industrial Policy since 1967**

a. **Official policy**

It is not easy to glean from official documents the actual thrust of industrial policy in Indonesia. In fact, the actual pattern of industrial development since the late sixties has not always been in accordance with stated policies. Moreover, stated policies have sometimes also been rather vague, thus giving rise to different interpretations, for instance in regard to the ordering of priorities.

The general direction of Indonesia’s long-term industrial policy is outlined in the General Guidelines of State Policy (GBHN), which are set every five years by the People’s Consultative Assembly.
(MPR), the country’s highest sovereign body. The GBHN stipulated that one of the objectives of long-term development was to achieve a ‘balanced economic structure’ in which a strong progressive manufacturing sector would be supported by a strong agricultural sector. To become the backbone of the Indonesian economy, the development of the manufacturing sector would have to be carried out in successive phases, covering the two decades of the first four Five Year Development Plans (1969/70–1988/89). During the First Five-Year Development Plan (Repelita I) priority would be given to the establishment of manufacturing industries to support the agricultural sector, while during Repelita II priority would be given to resource-processing industries producing industrial raw materials. During Repelita III industries would be established which would process the industrial raw materials into manufactured goods, and during Repelita IV engineering goods industries would be established [Republik Indonesia 1978].

The Repelita I (1969/70–1973/74) document spelled out in great detail the types of industries which would be given priority, namely:

1. Industries which support the agricultural sector by making agricultural equipment or by processing agricultural produce;
2. Industries which earn foreign exchange or save foreign exchange by producing import-substituting products;
3. Industries which process more domestic than foreign raw materials;
4. Industries which employ more workers than capital;
5. Industries which through the cumulative effects of their nature promote regional development [Republik Indonesia 1969].

Based on the above five guidelines, six specific industries were designated as priority industries during the Repelita I period, namely:
1. Fertilizer, cement, and chemical industries;
2. Textile industry;
3. Paper, pulp, and printing industries;
4. Pharmaceutical industry;
5. Light and handicraft (cottage) industries;
6. Metals, machinery, equipment, and infrastructure industries [Republik Indonesia 1969].

The guidelines for industrial development during Repelita II (1974/75–1978/79) were almost the same as those for Repelita I. The main difference was that the order in which the guidelines for Repelita II was listed had been changed, apparently reflecting a slight shift in the order of priorities. Thus Repelita II listed the following industries as priority industries:

1. Industries which expand employment opportunities;
2. Industries which produce basic wage goods, such as food, clothing, and building materials for dwellings;
3. Industries which earn or save foreign exchange through manufactured exports or make import-substituting goods. Export-oriented industries
would include resource processing industries producing industrial raw materials, as well as industries producing consumer goods and intermediate goods. In promoting resource processing industries which would utilise domestic resources, development would be spurred in those regions where the resources were located [Republik Indonesia 1974].

Guidelines for industrial development set for Repelita III (1979/80–1983/84) indicated for the first time a clear shift in favour of an autarchic approach to industrial development. This shift was reflected in the emphasis given to industries which would process (domestic) raw materials into manufactured goods. It was hoped that in this way most of the country’s needs could be met by locally-made products, while the export base would also be widened.

Industrial guidelines for Repelita III for the first time also emphasized the equity aspects of development in line with the general need to achieve a more equitable distribution of the fruits of development. To this end Repelita III put an emphasis on those industries which would expand employment opportunities and produce basic needs goods at prices accessible to the populace. In addition, emphasis was put on the need for greater popular involvement in small, medium-scale, and large-scale industries as well as the expansion of educational and training opportunities [Republik Indonesia 1979].

The priority industries emphasized in Repelita IV (1984/85–1988/89) generally still included those industries already listed in the previous Repelita namely:

1. Industries producing basic needs goods at prices accessible to the population at large;
2. Industries producing machinery and equipment and industries producing industrial raw materials and ancillary goods (machinery and basic metal industries);
3. Industries utilizing natural and energy resources (basic chemical industries), effectively employing Indonesia’s comparative advantage;
4. Small and cottage industries, considered to be important for a more equitable distribution of business opportunities and the expansion of opportunities, as well as the establishment of a modern industrial society [Republik Indonesia 1984].

A novel element in the above guidelines of Repelita IV was the inclusion of small and cottage industries as one of the four priority industries. This belated recognition of the social and economic importance of these small and cottage industries, accounting for 87 percent of the total work force employed in the manufacturing sector according to the 1974/75 Industrial Census [McCawley 1979: 15], was also reflected in the emphasis laid on the need to establish a balance between large and medium industries on the one hand and small industries on the other. In fact, to an extent not found in the previous three Repelita, Repelita IV was greatly concerned with the need to establish balances (however defined): a
balance between agriculture and industry, and within the manufacturing sector itself, a balance between large and medium industries and small industries, a balance between upstream and downstream industries, a balance between industries for the domestic market and export industries, and a balance between capital-intensive and labour-intensive industries [Republik Indonesia 1984: 17–18].

The concern with the need to achieve various balances in industrial development suggests the importance of the engineers’ point of view in framing Indonesia’s industrial policy, as these balances apparently refer to ‘material balances.’ In addition, this concern with balances also underlay an autarchic approach to industrial development which was already apparent in Repelita III. Except for a passing reference to comparative advantage in regard to the basic chemicals industries, no economic or efficiency considerations seemed to have played a role in the guidelines for industrial development.

The absence of any evidence of any meaningful input by economists in determining Indonesia’s industrial policy is also evident from the fact that while ‘balances’ in industrial development have been emphasized, no mention has been made of the appropriate structure of the various industries to be set up. Given this neglect, it is therefore not surprising that economic or efficiency considerations were given so little emphasis, as industrial economists must have been aware of the close relationships between the market structures of the various industries, the market behaviour of the firms constituting an industry, and their market performance.

b. Actual policy

Although the guidelines for industrial development spelled out in the GBHN and successive Repelita do provide an insight into the general direction of industrial development, it neither reflects actual government priorities nor the policy measures taken in pursuit of these goals. Actual industrial policy over time can better be discerned from the various directives issued by the Ministry of Industry regulating the operation of various industries in pursuit of specifically defined goals and targets, by the Ministry of Trade regarding the trade regime (particularly concerning import restrictions, such as tariff duties and quantitative import restrictions), and by the Capital Investment Coordinating Board (BKPM) regarding the licencing of investment applications in various fields of activity.

Taking this approach, one can clearly observe that Indonesia’s trade regime and industrial policies since the early 1970s have, like so many other developing countries, fostered an import-substituting pattern of industrialization. Until 1970 the New Order government had pursued a relatively liberal trade regime without much reliance on tariff protection or quantitative import restrictions, as protection of domestic industries during this period was not yet an issue of prime con-
cern. It was only after the hyperinflation of the mid sixties had been brought under control and the infrastructure had been rehabilitated that the government was finally able to turn its attention to the problem of economic development, including industrial development.

1. First Phase Import Substitution

The promotion of import-substituting industries through highly protectionist policies only started in earnest since the early 1970s with the implementation of Repelita I. While several policy measures were taken to protect the nascent industries, the major forms of protection included tariff duties and import sales taxes which are collected at the same time as the tariff duties. The protective effect of the sales tax derived from the fact that its rate was often higher than the domestic sales tax on similar products [Pangestu and Boediono 1986: 11].

Since the New Order government assumed power in the mid sixties, three different tariff classifications have been used, namely the Geneva Nomenclature (1965–1973), the Brussels Tariff Nomenclature (1973–1980), and the Customs Cooperation Council Nomenclature (1980–present). Although each of these tariff classifications used different systems of commodity classification and tariff rates, the structure of tariff protection provided by all three classifications showed a 'cascading' pattern. This meant that consumer goods enjoyed the highest tariff protection (with rates ranging from 40 to 270 percent under the latest CCCN classification), followed by intermediate goods (15 to 30 percent) and raw materials and capital goods (0 to 10 percent) [Ariff and Hill 1985: 76]. The effect of this structure of differential nominal tariff rates has been that consumer goods (specifically consumer durables) and other final goods having gone through higher stages of fabrication have generally received higher effective protection (protection of value added) than intermediate goods. In turn, these latter goods enjoyed higher effective protection than industrial raw materials and capital goods [ibid.: 86]. In view of the initial emphasis on final consumer goods during the first phase of import substitution 1967–1975), this 'made-to-measure' protection seemed quite appropriate.

The particular structure of tariff protection in Indonesia (provided by import duties and import sales taxes) has resulted in an 'anti-export bias,' with import competing sectors enjoying effective protection rates of 60 percent on the average in 1980, but exports only 32 percent [ibid.: 85]. As producers' decisions are affected by effective protection rates, it is therefore not surprising that businessmen have tended to invest in import-competing activities rather than in export industries.

Despite the fact that the structure of effective tariff protection contained a clear 'anti-export bias' in 1980, estimates of the trend in effective rates of protection over the decade of the 1970s have indicated that effective protection as a whole declined over the decade due to the reduction in nominal tariffs and changes
in import sales taxes. However, these tariff reductions affected the export sector more than the import-competing sectors, so that by 1980 the import-competing sectors were still enjoying the highest levels of nominal and effective rates of protection [Pangestu and Boediono 1986: 27-28].

2. Second Phase Import Substitution

The persistence of an 'anti-export bias' in 1980 thus reflected a continued adherence to an import-substituting pattern of industrialization after the first or 'easy' phase of import substitution had been completed by 1975. Instead of shifting to an export-promoting pattern of industrialization, however, policy-makers, buoyed by vastly increased government revenues due to the two oil booms of the 1970s, chose to push the process of industrialization into the second phase of import-substituting by promoting upstream industries, including basic industries, intermediate goods industries, and engineering goods industries. However, in order to promote this process of the second phase of import-substituting industrialization, the government began to rely more and more on non-tariff barriers (NTBs) and measures, such as increased local-content programs, rather than on tariff protection. In fact, the reliance on tariff protection continued to decline, as demonstrated by a major decline in the range and level of nominal tariff rates introduced by the government in March 1985 (Table 1).

The above table shows that as a result of the most recent tariff reductions, more than 64 percent of the product categories were enjoying relatively low tariff protection with ad valorem rates of up to 20 percent. If one includes product categories with tariff protection of up to 40 percent, the percentage of product categories covered rises to more than 91 percent.

The most recent tariff reforms included not only substantial nominal tariff reductions involving more than 60 percent of the product categories, but also a substantial reduction in the dispersion of the nominal tariff rates from a range of 0 up to 225 percent to a range of 0 to 60 percent. In addition, the tariff structure was also greatly simplified as the number of tariff rates were reduced from 25 to 11 [Suhartono 1985: 16-19]. This reduction in the spread and number of tariff rates can be considered as a significant step towards a greater uniformity of the production incentives affecting the various industries.

While tariff protection in Indonesia has slowly declined over the past few years, non-tariff protection, primarily in the form of quantitative import restrictions, has proliferated in support of Indo-

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**Table 1** Distribution of Ad Valorem Import Tariff Rates, March 1985

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<tr>
<th>Tariff Rates</th>
<th>Product Categories</th>
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<td>Percentage</td>
<td>Number</td>
</tr>
<tr>
<td>0–5</td>
<td>1,408</td>
</tr>
<tr>
<td>10–20</td>
<td>1,413</td>
</tr>
<tr>
<td>30–40</td>
<td>1,209</td>
</tr>
<tr>
<td>50–60</td>
<td>357</td>
</tr>
<tr>
<td>100 and over</td>
<td>19</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>4,406</strong></td>
</tr>
</tbody>
</table>

Source: Buku Tarif 1985, as quoted by R.B. Suhartono [1985: 17].
nesia's industrial strategy of extending the process of import substitution to upstream industries.

The views on how Indonesian industrial development should further proceed, once the phase of 'easy' import substitution for several industries was completed by the mid 1970s, has been most clearly articulated by A.R. Soehoed, former Minister of Industry during the Repelita III period, who argued that progress in import-substituting industrialization during the decade of Repelita I and II had resulted "in the widening, rather than in the deepening, of the industrial structure. As the scope for further widening the structure of industry through import substitution along the past pattern was getting more limited (by the end of Repelita II), a stage had been reached where the further development of manufacturing industry would necessitate the deepening of the industrial structure" [Soehoed 1981: 6-7]. Soehoed also argued that with the completion of the 'easy' phase of import substitution, the future growth of the manufacturing sector needed to be ensured by taking a two-pronged approach. This approach required that "first, the optimum use of existing and newly-established capacities be facilitated, and second, rational industrial development be guided in such a way, that the growth of manufacturing industries would be more and more interlinked and mutually reinforcing, vertically and horizontally, and industries would become more deeply-rooted to the Indonesian economy, and thereby enhance the capacity for self-sustained industrial growth and contribute towards greater national resilience" [Soehoed 1981: 9-10].

The above quotations have been presented to indicate the considerations which were put forward by Indonesia's policymakers by the late 1970s to lay down the guidelines for the path of Indonesia's industrial development. While one can argue about the validity of the economic rationale of these views, these views were and are still held by the present top decision-makers determining industrial policy, including Hartarto, the present Minister of Industry. In fact, in a recent speech Hartarto put forward six guidelines for industrial development during Repelita IV, the first one of which involved the need "to deepen and stabilize the industrial structure and establish linkages with the other economic sectors," while the second one (also in line with Soehoed's view) emphasized the need to develop engineering goods industries, particularly those producing machinery and electronic equipment [Hartarto 1985: 18-19].

The above views on 'deepening' the industrial structure through the generation of various backward and forward linkages reflect what in Indonesia has been called a structuralist approach to industrialization [CSIS 1982: XVII–XXIX]. This structuralist approach apparently aims at a high degree of autarchy, as reflected by the argument that by creating maximum backward and forward linkages, the "deepening of the
industrial structure could be achieved,” and thus ‘lessen Indonesia’s external dependence and vulnerability by making the industrial sector more deeply rooted to the Indonesian economy’ [Soehoed 1981: 8–9]. One could perhaps describe the above view in a more simple way as the reflection of a wish to fill up the various niches in Indonesia’s input-output table as much as possible. In a more critical vein, the structuralist approach has also been described as “an inward-looking, import-substituting approach to industrialization that pays little, if any attention, to efficiency considerations.” Hence, this approach does not appear “to make any comparisons of production costs with border prices as applied to various industries with different production functions and economies of scale” [Gray 1982: 41].

While the latter view may be a little unfair to the structuralist approach, the drive to promote upstream industries in the late 1970s was buttressed by an array of various policy measures, the most important of which included the protection of the nascent upstream industries, primarily through import restrictions and import bans, local content regulations (deletion programs) and, since late 1982, through the strict regulation of imports through licensed importers. In addition, the nascent upstream industries (basic and intermediate goods industries) were also protected by a cumbersome industrial licensing system, administered by the Capital Investment Coordinating Board (BKPM), which strictly regulated, sometimes even banned, the entry of potential new entrants into an industry. The drive to develop new upstream industries, which would process raw materials into intermediate and semi-finished products, and new downstream industries, which would process primary commodities, was also being promoted by the provision of various investment incentives to various priority projects, the most important of which involved direct government participation [Soehoed 1981: 14].

3. Partial Shift to Export Promotion

However, the sharp deterioration in Indonesia’s balance of payments in 1982 as a result of the severe international recession and the attendant weakening of the international oil market required the government to take several drastic adjustment measures, including a deferral of several major industrial projects which were to be undertaken by the government itself, including an olefin, an alumina, and an aromatics project [Awanohara 1983: 51]. The protracted economic slowdown since 1982, however, has not only required the government to defer several ambitious public sector projects but, in the face of a steady decline in foreign exchange earnings from oil exports, to reassess the economic merits of continuing to pursue an inward-looking, import-substituting path of industrialization. This reassessment appeared to be particularly relevant, as one of the major arguments in support of the decision to promote upstream industries, namely the perceived need to ‘maintain the growth momentum of the manufacturing sector’
(in addition to the need to 'deepen' the industrial structure) [CSIS 1982: XX], appeared increasingly implausible in the face of the continued sluggishness of the manufacturing sector.

As a consequence of the protracted slowdown in economic and industrial growth and the severe pressures on the balance of payments, the government has put the promotion of the growth of non-oil (and natural gas) exports, particularly manufactured exports, as a top priority. To achieve this goal, however, a substantial improvement in the technical efficiency of Indonesia's largely inefficient industries is imperative to achieve the required level of international competitiveness.

Despite a rapid rise in manufactured exports since oil export earnings started declining in 1982 (from US$850 million in 1982/83 to US$4.4 billion in 1986), the prospects for a steady and rapid increase in manufactured exports, which are to form the bulk of non-oil exports, do not seem too promising at present. While rising protectionist barriers in the industrial countries and increasing competition from other developing countries do pose a real threat to Indonesia's hopes to become a significant exporter of manufactured exports, the general lack of international competitiveness of its own manufacturing sector is at present the biggest obstacle to the realization of these hopes.

While the Indonesian government since 1983 has taken a series of sensible steps to deal with the adverse effects of the steady weakening of the world oil market, such as the deferral of several large public sector projects, the introduction of tax and financial reforms, the implementation of a flexible exchange rate policy to avoid an overvaluation of the exchange rate, and the simplification of investment procedures and port procedures to reduce over-regulation and increase efficiency in customs and port operations, severe criticism is still being directed at the highly protectionist trade regime which has contributed to the establishment of many inefficient industries.

To promote the emergence of an internationally competitive manufacturing sector, critics of current industrial and commercial policy have therefore advocated a shift from the current import-substitution regimes to a more export-oriented set of policies. The arguments of these critics are primarily based on the fact that the current trade regime has produced an 'anti-export bias' that provides stronger incentives to produce for the domestic market rather than for export markets. In fact, instead of reducing this 'anti-export bias,' the government has since late 1982 increased this 'anti-export bias' by introducing a series of quantitative restrictions on the imports of several intermediate inputs needed by the manufacturing industries. While there was an initial rationale to these quantitative restrictions in late 1982, namely to reduce the looming big current account deficit to more manageable proportions, their effects have been aggravated by the fact

that the limited imports of several intermediate inputs could only be conducted through licensed importers, the number of which for each product category was limited to only two or three companies (sometimes only one), most but not all of them state-owned trading companies.

Bearing in mind Little's observation that the major lesson of the successful experience of the four East Asian NICs (newly-industrializing countries) in expanding their manufactured exports rapidly lay in their labour-intensive, export-oriented policies which provided almost free trade conditions for exporters [Little 1981], it thus appears that until the policy reforms of 6 May 1986 (the Pakem or 6 May package), it was the very absence of these almost free trade conditions for exporters that had been an important factor in accounting for Indonesia's lack-lustre performance in expanding manufactured exports.

It should be pointed, however, that Taiwan and Korea in the early 1960s were able to introduce the required policy reforms to shift from an import-substituting to an export-oriented pattern of industrialization, because at that time they had not yet gone beyond the first phase in import substitution (import substitution of finished consumer goods). India, on the other hand, had by adopting Mahalanobis' heavy industry strategy, proceeded way beyond first-phase (primary) import substitution to establish also basic and intermediate goods industries on a wide scale regardless of their economic costs. As a result, for India a switch from an import-substituting to an export-promoting policy of industrial development along the lines of the East Asian NICs became very difficult [Lal 1985: 27–28].

Indonesia faces a predicament similar in India. Although not yet as advanced or as pervasive as India in extending import substitution to basic and intermediate goods industries, a total shift from import-substituting to outward-oriented, export-promoting policies in Indonesia is rather difficult in view of the fact that quite a few upstream industries (basic and intermediate goods industries) have already been set up since the late 1970s. Under these circumstances the provision of almost free trade conditions for exporters is very difficult to implement, as such a policy measure would run counter to the interests of the infant upstream industries. To make matters worse, the proliferation of import monopolies, duopolies, and oligopolies since late 1982 with large and lucrative 'rent-seeking' opportunities has added to the already existing 'anti-export bias,' which thus far has proved to be very difficult to reduce, let alone eliminate.

Since May 1986 the Indonesian government has tried to reduce the 'anti-export bias' of its trade regime by providing almost free trade conditions to manufacturing companies which export at least 85 percent of their output. In addition, a duty drawback system applies to those companies which export less than 85 percent of their output. These companies have also been allowed to import those
intermediate inputs which are subject to import controls, if domestic suppliers are unable to provide these inputs at competitive prices.

Further reforms in the trade regime were introduced on 25 October 1986 and 16 January 1987 to remove some of the quantitative import restrictions, and to replace these non-tariff barriers (NTBs) by an easier-to-administer tariff protection. While these policy reforms do constitute an important step towards reducing the 'anti-export bias,' several observers have pointed out that these policy reforms still cover only a relatively small number of items, with many important items still being regulated under the 'approved importers systems' (Tata Niaga Impor) [Pangestu 1987]. However, in view of the rather limited scope of the policy reforms thus far, it still remains to be seen whether these three policy reforms can in hindsight be considered important steps toward the elimination of the 'anti-export bias' in Indonesia's trade regime or only promising steps in an aborted shift from an import-substituting to an export-promoting policy.

**Foreign Investment Policy since 1967**

The thrust in Indonesia's industrial policy has been closely mirrored in its investment policy, including its policy towards foreign investment. As a result of the import-substituting policy of industrialization, it is not surprising that, aside from resource-oriented foreign investment, the bulk of foreign investment in Indonesia has been of the type oriented towards the domestic market. This orientation is understandable, as protection will raise profits in the protected domestic industry, but will reduce profits of those foreign firms the exports of which are being excluded or restricted by protection. These foreign firms will then resort to "defensive investment" in the protecting country to maintain their market in this country and thereby restore their profits [Corden 1978: 331–332].

Although no comprehensive data are available about the market orientation of all the foreign firms operating in Indonesia's manufacturing sector, survey findings of Japanese-affiliated companies do seem to confirm that the overwhelming majority of these investments are indeed "defensive investments," largely oriented towards the protected domestic market. For instance, a survey, conducted by the Japanese Ministry of Trade and Industry (MITI) in 1974, disclosed that Japanese-affiliated companies in Indonesia sold only 16 percent of their output in the export market. While some of the exported goods were labour-intensive products, most of the manufactured exports of these companies were actually processed primary resources [Yoshihara 1978: 48–49]. A more recent survey by Kinoshita revealed that of the 113 Japanese-affiliated manufacturing companies in Indonesia, not less than 105 were import-substitution oriented, while only 3 were export-oriented, and the remaining 5 were both import-substitution and export-oriented [Kinoshita 1985: 21]. As Japan
is the largest investor in Indonesia's manufacturing sector, the domestic market orientation of these Japanese-affiliated companies is an important indicator of the market orientation of foreign-affiliated companies in Indonesia.

a. More Restrictive Policy

As the first phase of import-substituting industrialization came to a close by the late 1970s, and the Indonesian government began to promote import substitution in the upstream industries, foreign investment policy with regard to the downstream, consumer goods industries became increasingly restrictive. This is evident from the rising number of fields of activity which were closed to foreign investment, particularly in those fields where domestic (i.e. national) investors were considered capable enough to take over the dominant role hitherto played by foreign investors. As a result, by the early 1980s the prevailing view among many foreign investors in Indonesia was that 'the party is over,' at least for the majority who were engaged in the production of consumer goods [Astbury 1982: 18]. Instead of more foreign investment in the downstream, consumer goods industries, the government intended to steer more foreign (as well as private domestic) investment into the upstream industries, such as basic metals industries, which would form the basis for further industrialization during Repelita IV. In addition, more foreign (and domestic) investment was to be promoted in those downstream operations which would process Indonesia's abundant natural resources and agricultural products [Soehartoyo 1982: 192-193].

b. Less Restrictive Policy

With the move towards a more export-oriented trade and industrial policy since the mid 1980s, foreign investment policy has shifted to attract more export-oriented foreign investment. As Indonesia has over the past decade become less attractive to foreign investment as a result of the increasingly restrictive conditions introduced since January 1974, several steps have been taken to simplify and reduce the regulatory framework of foreign investment which had been in effect since the mid-1970s. An important step in that direction was the policy package of 6 May 1986 which contained several provisions to attract more foreign investment, particularly for export-oriented activities, including the opening up of several sectors which hitherto had been closed to foreign investment.

Although foreign businessmen have welcomed the latest policy measures with regard to foreign investment, their actual response has thus far been lukewarm. Aside from some restrictive conditions which still bother foreign investors, for instance with regard to the dilution requirement of foreign equity participation to 49 percent or less within a period of 10 years after the start of commercial production, it appears that a substantial increase in foreign investment will only be forthcoming with further improvements in the investment climate and a
steady upturn in the Indonesian economy. Even then, however, a greater inflow of foreign investment into export-oriented industries will only take place with the elimination of the remaining “anti-export bias” in the trade regime, and with further improvements in the country’s infrastructure and an increase in the skill and productivity levels of the Indonesian workers. In this respect responses of foreign investors are hardly different from those of domestic investors.

References


