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The Indonesia-Australia Comprehensive Economic Partnership Agreement: Implications for Western Australia

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About this report

This report was prepared by members of the Western Australian Department of Treasury's Economic and Revenue Forecasting Division.

The report considers the implications for Western Australia from the Indonesia-Australia Comprehensive Economic Partnership Agreement.

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The Indonesia-Australia Comprehensive Economic Partnership Agreement: Implications for Western Australia

On 4 March 2019, Australia and Indonesia formally signed the *Indonesia-Australia Comprehensive Economic Partnership Agreement* (IA-CEPA), a bilateral trade agreement that will result in approximately 99% of Australian exports to Indonesia and 100% of Indonesian exports to Australia being tariff free or receiving preferential arrangements. The IA-CEPA has yet to be ratified by either country's Parliament.

This paper considers the implications for Western Australia of the IA-CEPA. Key observations made in the paper include:

- Indonesia offers a huge economic opportunity for the nation and the State:
  - Indonesia currently has a population of 271 million people and the United Nations anticipates that this will grow to 331 million people (equivalent to the current population of the US) by 2050;
  - the growth outlook for Indonesia is positive over the long-term. For example, PwC has forecast that Indonesia will become the fourth largest economy in the world (up from 16th now) by 2050; and
  - Indonesia is very close to Australia, and proximity matters for trade.
- The sectors likely to benefit from the agreement include the livestock, grain, horticulture and services industries.
- Australia's current trade relationship with Indonesia is not very deep. Reasons for the relatively low trade intensity between Australia and Indonesia likely include: competing rather than complementary export products; lack of cultural understanding and people-to-people links; and tariff and non-tariff barriers to trade.
- It is likely that Australia and Indonesia will produce more complementary products over time, and the IA-CEPA has provisions to address the other two barriers to trade. In particular:
  - the IA-CEPA will remove virtually all tariffs between Indonesia and Australia; and
  - greater cultural understanding and people-to-people links will be facilitated by an increase in Indonesian working holiday visas and reduced barriers to Australian service providers in Indonesia, such as universities, health care, and professional and technical services.
- To illustrate the growth potential, if Australian exports to Indonesia in 2018 were the same GDP intensity as Thailand or Malaysia, they would be $11.1 billion or $29.0 billion higher respectively. If Australia was to receive the same number of students or tourists, relative to population, from Indonesia as it receives from Malaysia, services exports could increase $11 billion or $6.5 billion, respectively.

Background

Australia and Indonesia share a common maritime border and, at their respective closest points, are only about 200km apart (Cape York in Queensland to Papua). With a population of about 271 million people that the United Nations (World Population Prospects 2019) is projecting to grow to 331 million people by 2050, Indonesia will play an increasingly important role for Australia.

Fortunately, for trade, being close matters: there is significant evidence suggesting that bilateral trade flows are related to the size of two respective economies and the distance between them (Chaney, 2018). In terms of Australia, the Commonwealth Treasury (2005) claimed that Australia's remoteness from the world's largest economies was a significant factor explaining the nation's low trade intensity. It estimated that had Australia been located as close to major markets as the UK then, on average, trade would have been about 50% greater.

In line with that theory, Australia's trade intensity with its geographical neighbours is relatively high, for example[1]:

- New Zealand, 14.4%;
- Malaysia, 6.8%;
- Thailand, 5.3%; and
- Papua New Guinea, 31.5%.

An exception is Indonesia, a country with which, despite its proximity, Australia has a relatively low bilateral trade intensity of 1.7% (i.e. the value of trade between Australia and Indonesia constitutes 1.7% of Indonesia's GDP).

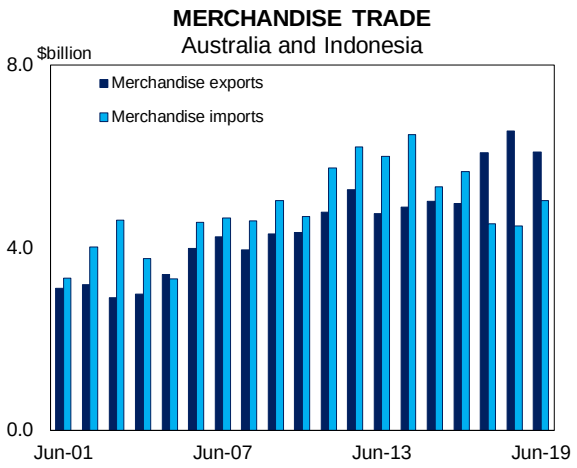
Current trading relationship

Despite its proximity, Indonesia's share of Australian merchandise trade has declined over time. In 2017-18, Indonesia was Australia's 13th largest trade partner with total trade worth $16.8 billion (DFAT, 2019b). In recent years, Australia has been a net merchandise exporter (although this has not always been the case) to Indonesia but is a net services importer from Indonesia (see charts on the next page).

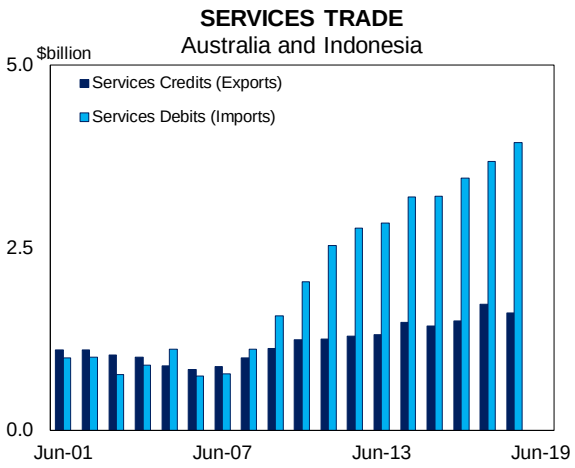
For merchandise trade, key exports to Indonesia include wheat and live animals, while key imports are crude petroleum and manufactured goods (DFAT, 2019b). Services traded are dominated by 'travel': Australia exports education-related travel, and imports tourism travel.

In 2018-19, Indonesia was the second most popular destination for Australians traveling overseas (1,311,300 trips), making up 11.7% of total short-term resident trips. Less short-term visitors arrived in Australia from Indonesia (211,000), making up 2.3% of total visitors.

[1] Bilateral trade as a percentage of destination nation GDP (DFAT, 2019a).

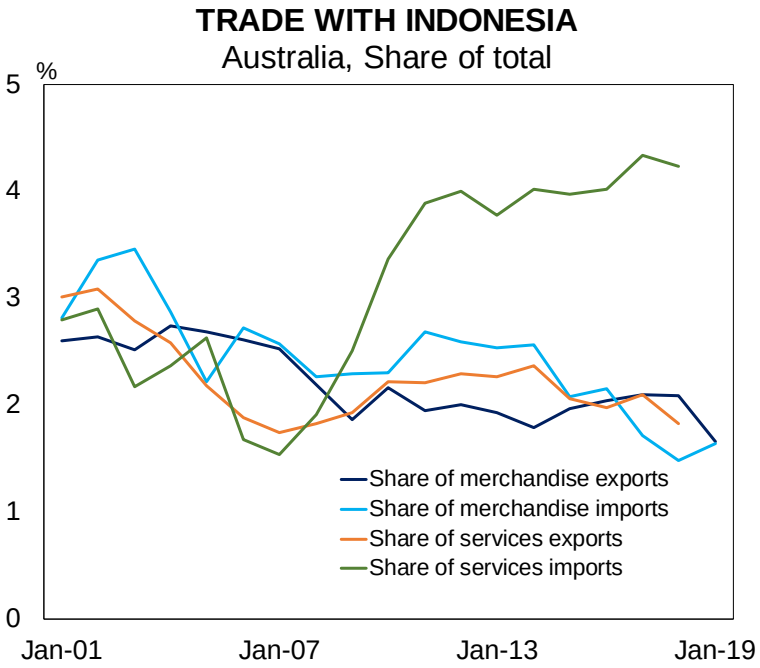


Source: ABS (2018; 2019a)



Source: ABS (2018; 2019a)

Indonesia is an increasingly important source of services imports for Australia, although its share of merchandise trade has declined over time (see chart below)[2]. In 2017-18, Indonesia received 2.1% of Australia's merchandise exports and 1.8% of Australia's services exports. In the same year, Indonesia was the origin of 1.5% of Australia's merchandise imports and 4.2% of Australia's services imports.



Source: ABS (2018; 2019a)

Australia is a net investor in Indonesia. In 2018, two-way investment was valued at $6.7 billion (DFAT, 2019c), with Australian investment in Indonesia valued at $5.6 billion and Indonesian investment in Australia at $1.1 billion. Australian investment in Indonesia declined from the year before: two-way investment was valued at $11.8 billion in 2017, with Australian investment in Indonesia at $10.7 billion (DFAT, 2019b).

[2] The rapid growth in the importance of China as a trading partner has led to falling shares of merchandise trade for most other countries.

Barriers to Trade

In 2017, a Commonwealth Government Parliamentary Paper, *Leveraging our advantages – The trade relationship between Australia and Indonesia*, noted that Australia's trade relationship with Indonesia was not particularly deep, despite the proximity between the two nations (Commonwealth of Australia, 2017). Two reasons were cited: a similar set of key export products; and cultural differences between the two nations. Moreover, several academic studies suggest that Indonesia has significant tariff and non-tariff barriers to trade, which may be limiting Indonesia's trade intensity (Vanzetti, McGuire, & Prabowo, 2005; Ing, de Cordoba, & Cadot, 2016; Marks, 2015; Ahamat & Manaf, 2018; Rigod, 2019).

However, it is possible that over time the economic output of Australia and Indonesia will naturally become more complementary and therefore conducive to trade. Moreover, if implemented, the IA-CEPA will help reduce trade barriers and increase people-to-people links and cultural understanding.

Australian and Indonesian exports likely to become more complementary

As Indonesia becomes richer, major exports from Australia and Indonesia may become more complementary and conducive to trade. This is primarily because Indonesia is much more populous than Australia and will therefore likely become a significant importer of mineral and agricultural commodities (Australia's most important exports by value) and a major exporter of manufactured goods (Australia's most important imports by value). This transition will likely also provide opportunities for Australian manufacturers to provide specialised component parts for the Indonesian manufacturing sector.

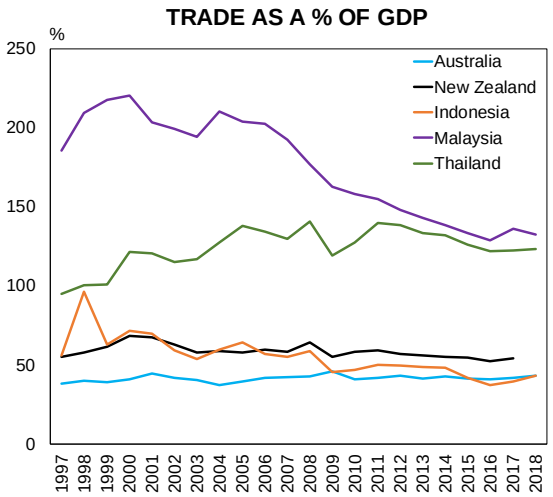
Tariff and non-tariff barriers

Australia's relatively low trade intensity with Indonesia is likely partly due to Indonesia's trade policy and institutions, with Indonesia historically far less open to trade than other developing economies in the region, such as Thailand and Malaysia[3] (see chart next page, left-hand side panel). Indonesia has historically pursued a policy objective of food self-sufficiency (Rigod, 2019).

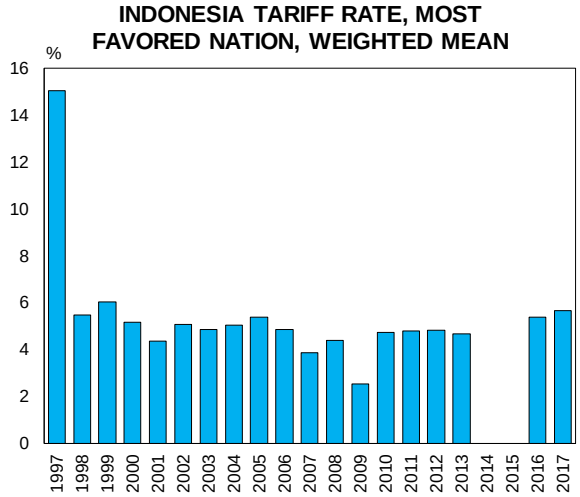
Since joining the World Trade Organisation in 1998, Indonesia's tariff level has remained relatively stable (see chart next page, right-hand panel). However, it has significant non-tariff barriers in place. The United Nations Conference on Trade and Investment reported that in 2015, 70-75% of all imports into Indonesia were covered by non-tariff measures (NTMs), which it noted "may be the 'missing factor' explaining the slow rise of intra-ASEAN trade" (Ing, de Cordoba, & Cadot, 2016, p. 21).

While it is by no means the most protectionist in ASEAN, Indonesia is particularly heavy-handed with NTMs, with a paper by Nikmanesh and Nor (2016) noting that by comparison, the Malaysian economy is more than three times as open to trade as the Indonesian economy.

[3] While counties with larger populations tend to have lower trade intensity, institutions still matter. For example, an economist at the IMF found "that institutional differences are in fact a significant determinant of trade flows" (Levchenko, 2007, p. 4).



Source: World Bank (2018)



Source: World Bank (2017)[4]

Similarly, a study by Marks (2015, p. 10) found that NTMs in Indonesia have "proliferated" since 2011, with the total coverage of non-tariff measures in 2015 sitting at 8.1% on the import side and 32.6% on the export side, figures the author states might be underestimated due to their negative impacts on overall trade levels.

These NTMs tend to be "highly distortionary and opaque", and might partially explain why Indonesia has failed to increase its trade intensity along with other nations in the region (Vanzetti, McGuire, & Prabowo, 2005, p. 8).

A report published by the Lowy Institute provides a list of NTMs imposed by Indonesia since 2009, which included "measures such as licence and permit requirements, pre-shipment inspections, and new labelling requirements" (Patunru, 2015, p. 7). The report also includes an appendix on recently passed trade related laws, most of which "and their accompanying regulations are intended to restrict export or import, stabilise domestic prices, and foster linkages in the domestic economy" (Patunru, 2015, p. 6). These laws require Ministers to restrict imports of agricultural commodities where domestic supply is sufficient.

The IA-CEPA will help to reduce some of the tariff and non-tariff barriers to trade. In particular, it will remove virtually all tariffs between Indonesia and Australia, benefiting the livestock, grain and horticulture industries. There will also be a significant reduction in non-tariff barriers facing Australian services industries seeking to operate in Indonesia, such as education, health care, tourism and professional services. However, many non-tariff barriers will remain, imposing a limit on the benefits that can accrue from the tariff reductions.

[4] The weighted mean most favored nations tariff rate is the average of most favored nation rates weighted by the product import shares corresponding to each partner country. The World Bank does not have data available for 2014 or 2015.

Cultural and people-to-people links

Deepening cultural and people-to-people links with Indonesia presents a significant opportunity to increase flows of trade and investment to the advantage of both countries. This was a key theme of the *Leveraging our advantages* Parliamentary Paper, which cited many submissions including from the Australia Indonesia Business Council and Trade and Investment Queensland, which noted that better cultural understanding would improve trade and investment (Commonwealth of Australia, 2017, pp. 13-14).

Some of the features of the IA-CEPA seek to address those issues. In particular, increases in the temporary migration visas for Indonesian citizens seeking to work in Australia and a reduction in the barriers faced by Australian service providers (e.g. universities, health care providers and professional and technical services) are likely to increase the people-to-people links, helping to foster the development of productive networks.

There exists some evidence among the academic literature to support the notion that increased people-to-people and cultural links between nations facilitates increased trade. For example, a meta-analysis of 48 studies on the impact of migration on trade, found evidence to suggest that on average a 10 per cent increase in immigration would result in an increase in trade of 1.5 percent (Genc, Gheasi, Nijkamp, & Poot, 2011). Similarly, a common language has been positively correlated with trade volumes between countries (Egger & Lassmann, 2011).

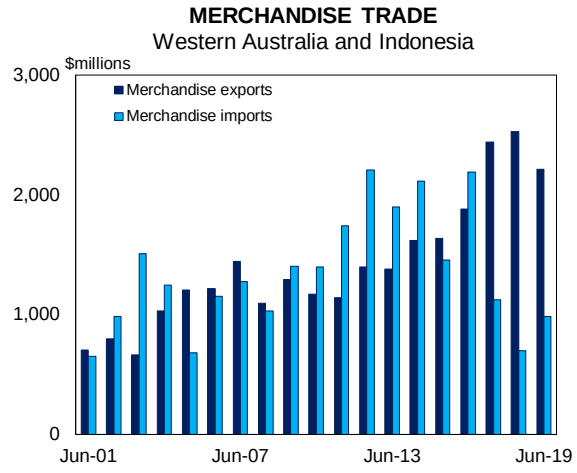
Given the relative importance of proximity to trade (outlined previously), it is reasonable to assume that an increase in migration and cultural exchange from nations which are closer to each other will have a larger impact on trade flows than nations that are more remote from each other.

Implications for Western Australia

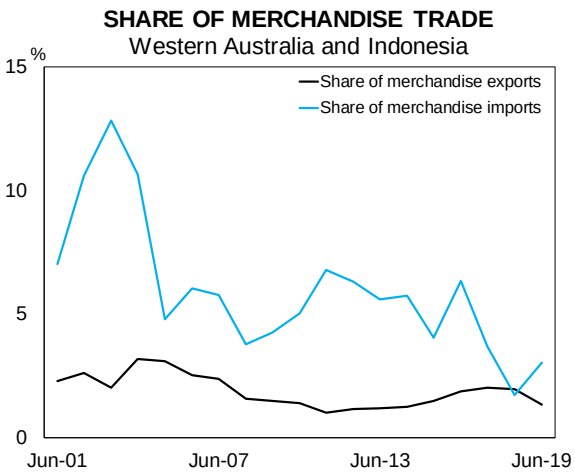
Reflecting its proximity – Perth is closer to Jakarta than it is to Sydney or Brisbane – Indonesia is more important to Western Australia than it is to the Eastern States.

Indonesia is consistently one of Western Australia's major trading partners for merchandise trade. Since 2000-01, Indonesia has on average ranked as Western Australia's 10th largest export trading partner, and 7th largest import trading partner. However, Indonesia's ranking as a merchandise export or import trading partner has fluctuated, and in 2018-19 was Western Australia's 12th largest export partner and 9th largest import partner.

Indonesia is an increasingly significant market for Western Australian products. Since 2000-01, the value of total merchandise exports has trended upwards, although merchandise imports have been less stable (see charts below). In recent years, Western Australia has been a net exporter to Indonesia, although this has not always been the case. Despite this, Indonesia represents a larger share of Western Australian imports (origin) than exports (destination). In 2018-19, Indonesia accounted for 3.0% of its merchandise imports ($984 million) and 1.4% of Western Australia's merchandise exports ($2.2 billion).



Source: ABS (2019a)



Source: ABS (2019a)

Western Australian exports to Indonesia are broadly consistent with its general export profile, although agricultural products play a relatively more important role in the case of Indonesia. In 2018-19, Western Australia's largest exports (by value) were 'combined confidential items',[5] crude petroleum, wheat and iron ore (note these items are already largely tariff free), while Indonesia was the largest recipient of Western Australian exports of rails/railway construction material, machine-tools, and plastic waste (Table 1). Notably, Indonesia was the recipient of 32% of Western Australia's live animal exports and 13% of Western Australia's wheat exports. This made it the largest export market for these products.

Table 1: Western Australian merchandise exports to Indonesia, 2018-19

	Largest exports by value				Exports for which Indonesia is the largest recipient		
Rank	**%**	**$m**	**t('000)**	**Item**	**%**	**$m**	**Item**
1	1	637	1,604	Combined confidential items	72	0.05	Iron or steel rail/railway construction material
2	9	457	525	Crude petroleum	66	1.2	Machine-tools for metal work
3	13	362	1,021	Wheat	64	2.8	Waste, parings and scrap, of plastics
4	0.4	302	3,561	Iron ore and concentrates	56	4.4	Stone, sand and gravel
5	32	145	45	Live animals (excluding seafood)	46	0.3	Margarine and shortening
TOTAL	1.4	2,217					

Source: Customised data from the ABS

Note: Percentage refers to share of Western Australia's total exports from that item – for example, 9% of the State's crude petroleum exports went to Indonesia in 2018-19.

Indonesia is a key supplier of refined petroleum, tobacco and cement. The largest merchandise imports by value are crude and refined petroleum oils, and non-monetary gold, while Western Australia imports almost all of its tobacco from Indonesia (Table 2).

[5] Various merchandise exports are, or have been, confidentialised (Australian Bureau of Statistics, 2019b). Of particular note for Western Australia is liquified natural gas and aluminium oxide. Other items include the following at various points in time: some fish, nuts, bagged wheat, barley, oats, rice, lupins, cane sugar, beer, salt, rutile ores, ilmenite and zirconium ores, crude petroleum, beef products, woodchips, footwear, iron products including ferrous turnings and iron coils, nickel products including nickel powders and mattes, and others.

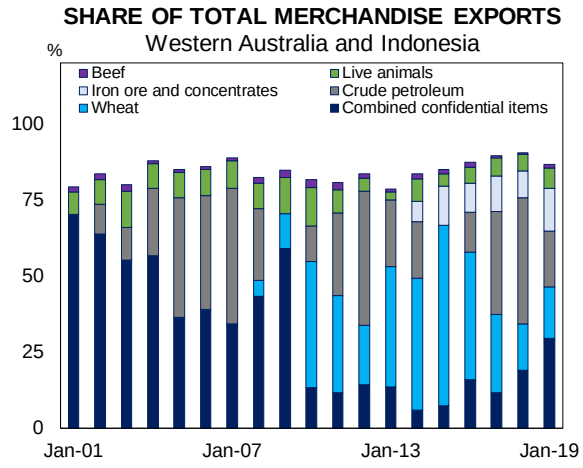
Table 2: Western Australian merchandise imports from Indonesia, 2018-19

Largest imports by value				Imports for which Indonesia is the largest origin		
Rank	**%**	**$m**	**Item**	**%**	**$m**	**Item**
1	14	433	Refined petroleum oils	93	4	Manufactured tobacco
2	2	105	Gold, non-monetary	52	0.5	Fuel wood (excl. wood waste) and wood charcoal
3	2	92	Crude petroleum	25	26	Lime, cement and other construction materials
4	5	28	Specialised machinery and equipvment	24	18	Footwear
5	25	26	Lime, cement and other construction materials	20	0.3	Synthetic fibres suitable for spinning
TOTAL	3.0	984				

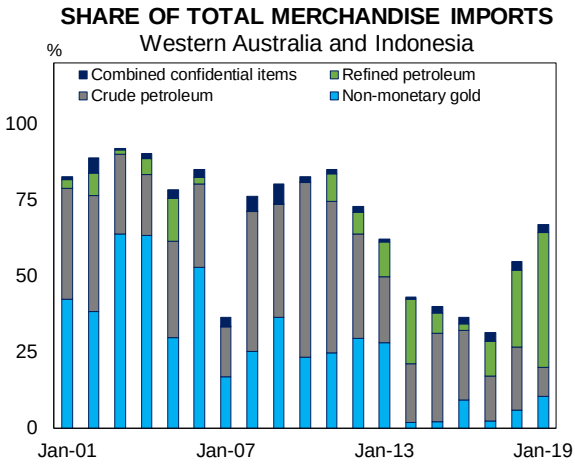
Source: Customised data from the ABS

Note: Percentage refers to share of Western Australia's total imports from that item – for example, 14% of the State's refined petroleum oils imports came from Indonesia in 2018-19.

Western Australia's trade mix with Indonesia has changed over time, with wheat exports and refined petroleum imports increasing (see charts below). The proportion of 'combined confidential items' of Western Australia's total merchandise exports to Indonesia fell significantly in 2009-10.[6] Since that time, wheat exports have played an increasingly significant role, while crude petroleum has remained a significant export. While non-monetary gold remains a significant import by value, it has contributed proportionally less of Western Australia's total merchandise imports from Indonesia. Refined petroleum imports have increased significantly since 2010-11.



Source: Customised data from the ABS



Source: Customised data from the ABS

Services trade

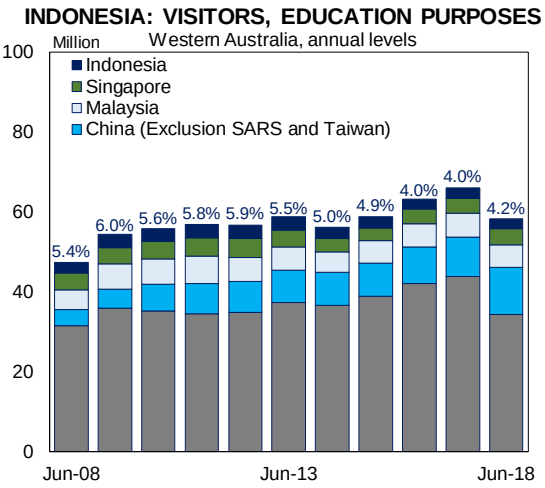
In 2017-18, approximately 4.2% of international visitors arriving in Western Australia for educational purposes were from Indonesia (2,400 people), while 3.3% of tourism arrivals to Western Australia were from Indonesia (31,800 people). For Western Australian tourists, Indonesia is the most popular overseas destination, with 330,000 visitors in 2017-18.

As shown in the charts on the following page, Indonesia's share of visitors arriving in Western Australia for education purposes has declined over the last decade and the overall visitor spend by Indonesian visitors has declined over the last four years. This is a key

[6] Note that as various products become and cease to be confidentialised over time, it is not possible to accurately track which items in 'combined confidential items' have changed over time.

opportunity for the State to pursue, given the Government's focus on attracting international students.

Source: Tourism WA (2019)



Source: Department of Home Affairs (2019)

While services trade data are not readily available by State and trading partner country, we can make broad assumptions about the services trade relationship between Western Australia and Indonesia. If the assumption that Western Australia has the same trading relationship with Indonesia as the nation as a whole holds (i.e. Indonesia is the destination of 2.7% of Australian exported education-related travel, and is the origin of 7.9% of Australian imported tourism travel)[7] then in 2017-18, Western Australia would have exported education-related travel services of approximately $50 million, and imported tourism travel services of approximately $455 million.

Key features of the IA-CEPA

The IA-CEPA builds on the liberalising effects of the ASEAN-Australia-New Zealand Free Trade Agreement (AANZFTA) – which removed tariffs on 85% of Australia's bilateral trade with Indonesia by value – by eliminating 100% of tariffs on Indonesia's exports to Australia and resulting in around 99% of Australia's exports to Indonesia being either tariff free or subject to preferential arrangements. While both Indonesia and Australia were already relatively low-tariff nations[8], the IA-CEPA will still benefit certain sectors of the Western Australian economy. However, the impact of tariff reductions will be curtailed by the continuation of various NTMs. The most tangible benefits in the short term are likely from tariff free quotas, as this suggests that Indonesia seeks to import more of these particular goods.

Examples of sectors which may benefit are highlighted below.

Livestock

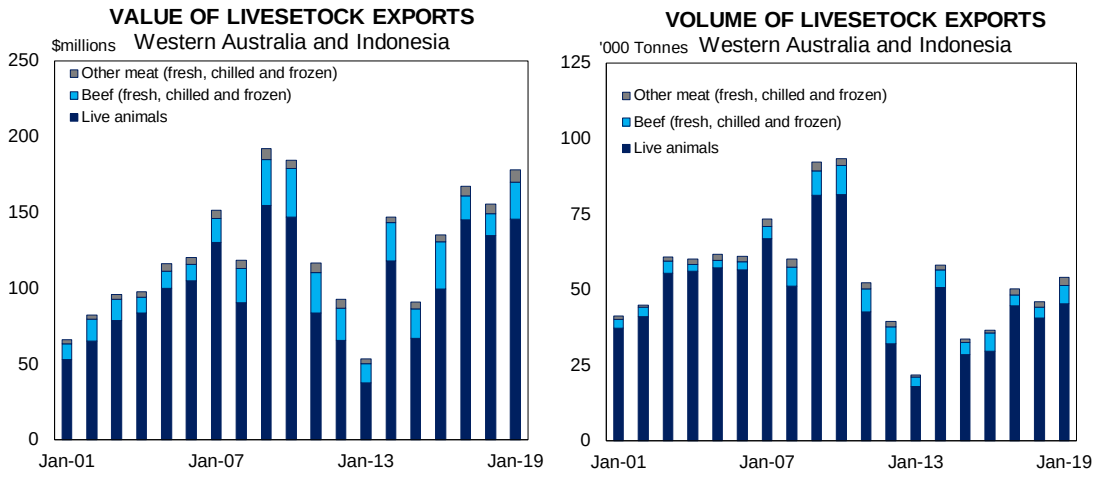
- The first 575,000 cattle exports will be duty free, growing by 4% per annum to a maximum of 700,000 (beyond these quotas the tariff will be cut from 5.0% to 2.5%).

[7] This simplifying assumption is regarded as reasonable given Western Australia's relative proximity.

[8] According to the World Bank (2017), in 2017 the weighted mean tariff rate for Indonesia was 5.7% and for Australia, 2.9%.

- The frozen beef and sheep meat tariff will be cut from 5% to 2.5% and eliminated entirely within 5 years.

In 2017-18, Indonesia received 45,000 tonnes of live animal exports worth $145 million (see chart below, left-hand panel). Since a decline in 2010-11, exports have not returned to their peak levels from around 2008-10 (see chart below, right-hand panel).[9] This may suggest that there is capacity to increase exports in response to the tariff changes.



Source: Customised data from the Australian Bureau of Statistics.

The IA-CEPA will assist in Australia retaining its position as the dominant supplier of imported beef to Indonesia. Live cattle import data from Indonesia shows that between 2012 and 2017 Australia was the sole overseas supplier (Mecardo, 2018). Western Australia provides around 25% of Australia's live cattle exports, and around half of Australia's live cattle exports are sent to Indonesia (around ½ million animals each year). Under the IA-CEPA, it is expected that these exports will rise to at least the tariff free quota of 0.7 million animals per year.

Furthermore, as Indonesia's population expands and per capita incomes rise, it is unlikely that it will be able to increase its own production sufficiently to meet rising demand. Imports from Australia of live cattle and frozen beef products are likely to meet a significant amount of the rising demand.

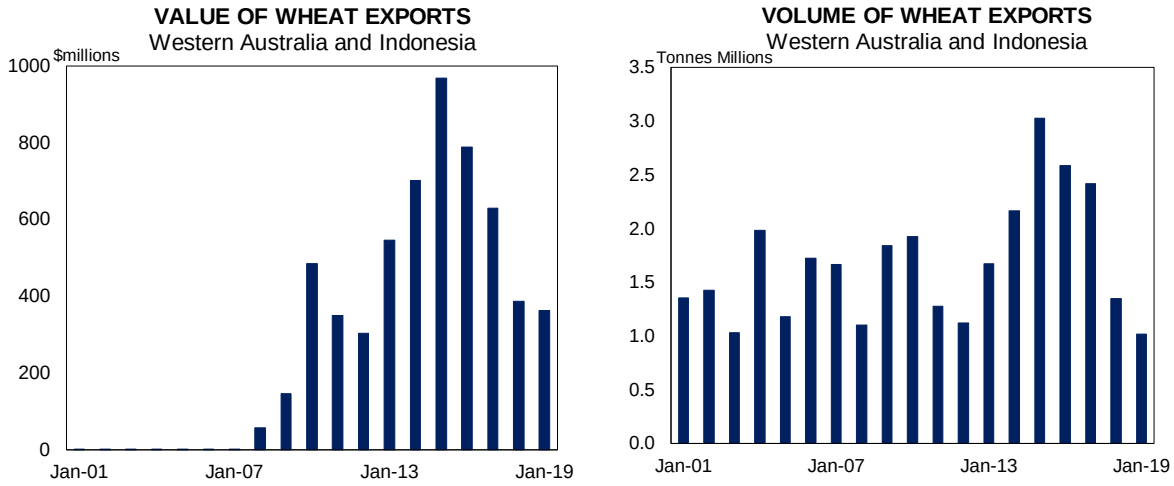
Agriculture

- Feed grains will be duty free for the first 500,000 tonnes (beyond this quota a 5.0% tariff continues to apply), growing by 5% per annum.
- A number of tariffs will be reduced/removed on various dairy exports.
- Mandarins, oranges and lemons will have increased duty-free quotas and tariff reductions, with mandarins becoming completely duty free over 20 years.
- Potatoes and carrots will have duty free quotas implemented along with reductions in tariff rates, with the latter to be completely duty free over 15 years.

[9] Australian exports of cattle to Indonesia, especially in 2011-12 and 2012-13, were impacted by the Australian Government suspension of live exports to Indonesia in June 2011.

Many grain exports to Indonesia are already tariff free and most remaining tariffs will be removed under the IA-CEPA. Under the agreement, Australia will become the only country with approved access to the Indonesian feed grain market. The Australian Export Grain Innovation Centre (2019) estimates that the 500,000 tonnes duty-free quota for feed grains could add $125 million to Australian exports (other Australian grain exports do not have tariff rate quotas).

In 2018-19, Western Australia accounted for 1.0 million tonnes (valued at $362 million) of Australia's wheat exports to Indonesia (see charts below). Note that other agricultural exports (such as barley, rice and maize) have been confidentialised.



Source: Customised data from the Australian Bureau of Statistics

Other sectors

In addition, Australian companies will be provided with additional access to Indonesia's services sector.

- Australian universities, which according to Universities Australia (2007) already have more than 118 formal agreements with Indonesian universities, will be allowed to open campuses in Indonesia.
- Ownership of up to a 67% stake in companies in the health (e.g. large hospitals, aged care), telecommunications, technical and vocational training, architectural, engineering and surveying, construction, wastewater and mining services sectors.
- Ownership of up to a 100% stake in 3-5 star hotels and a 67% stake in most other hospitality services.
- Various levels of ownership, from 51% to 95%, of Indonesian power plants and related infrastructure (including transport).
- Tariff rates on a range of mineral ores and concentrates will be reduced from 5% to 0% in the first year of the IA-CEPA, and although Western Australia does not currently export many of these to Indonesia, it may create opportunities in the future.[10]

[10] Note that Indonesia already has a 0% tariff rate on iron ore, Western Australia's largest commodity export.

The agreement increases ownership limits in many sectors from 49% to 67%, essentially permitting majority Australian ownership. This is expected to benefit sectors important to Western Australia, like mining services.

Perceived Issues with the IA-CEPA raised in Submissions to Parliamentary Committee

Concerns have been raised[11] about the IA-CEPA's increase in the number of Work and Holiday visas issued to Indonesian citizens from the present 1,000 per annum to 4,100, scaling up to 5,000 by the 6th year (AFTINET, 2019, p. 10). Any negative impact on unemployment and wage levels caused by the additional Work and Holiday visas is expected to be minor.

According to the most recent Department of Home Affairs (2018) working holiday visa report, as at 31 December 2018 there were 127,688 working holiday visa holders (subclass 417) in Australia (down 2.9% y/y), and 17,791 holders of the more restrictive work and holiday subclass 462 (up 19.6% y/y), the visa category within which Indonesia falls. The key differences between the two visas are that Work and Holiday visa arrangements generally have a cap on the number of visas granted annually and additional eligibility requirements such as the successful completion of at least two years of undergraduate university study.

Visa holders are able to apply for a second visa if they complete three months of specified work in regional Australia. The table below shows the number of work and holiday (subclass 462) visa holders in Australia by key country (it includes those with visa extensions).

Table 3: Top 10 subclass 462 visa holders by citizenship country

COUNTRY	31/12/2017	31/12/2018	% OF TOTAL
CHINA	**4,759**	**4,936**	**27.7**
USA	**4,097**	**4,217**	**23.7**
CHILE	**1,543**	**1,914**	**10.8**
SPAIN	**821**	**1,347**	**7.6**
ARGENTINA	**757**	**1,224**	**6.9**
INDONESIA	1,110	1,173	6.6
THAILAND	**353**	**532**	**3.0**
POLAND	**156**	**389**	**2.2**
ISRAEL	**396**	**366**	**2.1**
SINGAPORE	**42**	**252**	**1.4**

Source: Department of Home Affairs (2018)[12]

The IA-CEPA will increase the number of temporary workers from Indonesia by 3,100 in the first year and by 4,000 from year 6 onwards, providing it with a similar cap to China.

[11] A number of submissions to the Joint Standing Committee on Treaties raise these concerns.

[12] Note that these numbers include those on second visas so Indonesia exceeds the 1,000 people cap.

While issues concerning the subclass 462 visa have been raised in the past[13], an additional 4,000 workers into an existing pool of nearly 150,000 (i.e. an increase of less than 3%) is unlikely to have a material effect on the labour market[14].

Some organisations have also raised concerns with the investor-state dispute settlement clauses included in Chapter 14 of the IA-CEPA, as investor-state dispute settlement clauses in the Australia-Hong Kong Free Trade Agreement were used by tobacco giant Philip Morris in 2011 to challenge Australia's plain packaging laws (Ranald, 2019). The legal implications (both benefits and costs) of the Chapter 14 clauses are beyond the scope of this paper.

Potential distributional impacts

It is widely accepted that trade liberalisation nearly always leads to increased economic activity in aggregate (Department of Treasury Western Australia, 2019). However, it is also well established that changes in trade policy can have a significant impact on the distribution of incomes within a nation. A research paper commissioned by the Department of Foreign Affairs and Trade in 2017 claimed that trade liberalisation in Australia over the period 1986-2016 likely increased real GDP by 5.4% and real wages by 7.4% compared to what they otherwise would have been (Centre for International Economics, 2017, pp. 13-16). However, the textile and car industries suffered declines in output.

The distributional and adjustment impacts associated with the IA-CEPA are not likely to be significant, as the impacts are expected to be relatively small at first due to the limited trade integration between the two countries and the similar range of key export goods. However, the benefits of the IA-CEPA are likely to accumulate over time. This will allow businesses and households to adjust without the significant distributional and adjustment costs associated with some other trade agreements.

Long-term benefits of trade with Indonesia

The IA-CEPA should be viewed as a stepping-stone towards a further liberalisation of the Indonesian economy. As the experience of China's emergence has shown, a strong Indonesian economy moving in the direction of liberalisation will likely bring benefits to Western Australia far beyond that of a single trade agreement.

Indonesia is a nation of enormous economic potential. This potential is largely driven by demographic trends, which are very favourable toward economic growth, and low per capita incomes, which provide substantial opportunities for "catch-up growth". The positive long-term economic outlook for Indonesia offers significant trade and investment opportunities for Australia and Western Australia given it is one of the nation's closest neighbours.

[13] For instance, Howe et al (2019, p. 93) noted that high wage differentials between Australia and many countries included in the subclass 462 visa scheme, including Indonesia, "substantially increases the risk that these visa holders will be exploited, which in turn damages the reputation of the industry and attraction of workers into it".

[14] An additional 4,000 workers equates to 0.03% of the national labour force.

To illustrate the potential of greater economic integration with Indonesia:

- in 2018, Australia received more students from Malaysia than Indonesia, despite Indonesia's population being nearly 10 times larger. If Australia was to receive the same proportion of students (relative to population) from Indonesia as Malaysia, this would add around 150,000 additional students. This would equate to approximately an additional $11 billion in exports for the nation;
- if Australia was to receive the same proportion of tourists (relative to population) from Indonesia as it did from Malaysia in 2018, then (holding all else constant) Australia's tourism exports would increase by around $6.5 billion;
- if Australian exports to Indonesia were the same GDP intensity (i.e. percentage of destination nation GDP) as Malaysia, exports would increase by $29 billion; and
- if Australian exports to Indonesia were the same GDP intensity as Thailand, exports would increase by $11.1 billion.

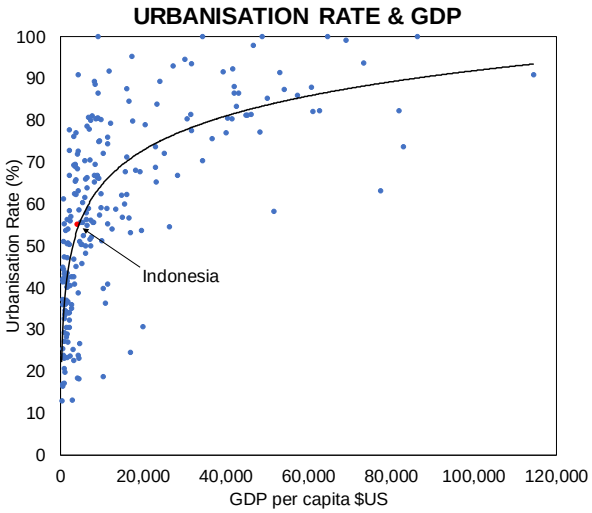
In addition, Indonesia is expected to grow significantly faster than the global average, which would magnify these opportunities over time. If Indonesia continues to grow rapidly, it will likely develop a significant manufacturing industry, which may allow Western Australia to manufacture and export high-value specialised component parts.

Demographics

Indonesia's demographics are favourable for aggregate economic growth for two key reasons. First, the aggregate population is expected to grow significantly, and second, the urban population is expected to grow even faster.

Indonesia is the fourth most populous nation in the world and its population is expected to continue to grow, with the United Nations projecting its population to increase by around 60 million people (equivalent to the entire population of Italy) to a total of 331 million people by 2050, approximately the same size as the current population of the US – the world's largest economy (United Nations, 2019). Holding all else equal, a larger population will result in greater economic activity.

Urbanisation is strongly correlated with higher per capita incomes (see chart to the right). Nearly every nation that has experienced a period of sustained and rapid growth in incomes has also experienced significant urbanisation (Spence, Clarke, & Buckley, 2009). This is likely because urban centres offer increased access to productive networks which facilitates specialisation. Migration from rural to urban centres has also been correlated with increased demand for commodities, like construction raw materials. For example, the very rapid increase in commodities demand in China over recent decades has correlated with both strong growth in incomes and rapid urbanisation.



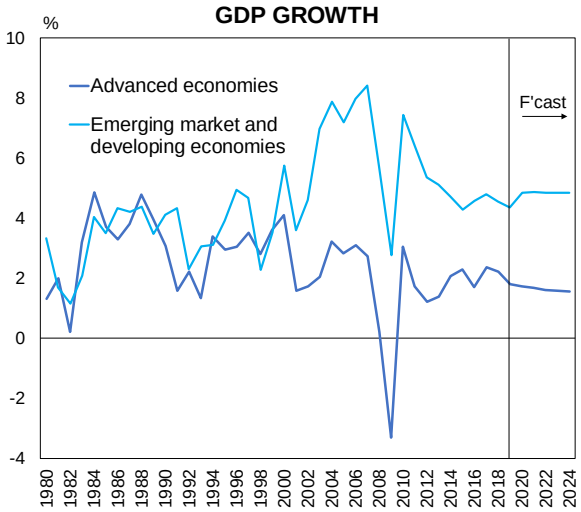
Source: World Bank (2018a; 2018b)

Indonesia's urbanisation rate of around 55% offers considerable scope for growth and is significantly lower than the high-income[15] average of around 81% (World Bank, 2018a). Reflecting this, the United Nations (2019) forecasts that Indonesia's urban population will increase from around 151 million persons in 2019 to around 234 million persons by 2050, an increase of around 83 million, which is equivalent to the entire population of Germany in 2019. Growth in Indonesia's urban population is likely to be positive for growth overall and lead to an increase in demand for the primary products that Western Australia exports.

Catch-up growth

Countries with low per capita incomes have a greater potential for growth than those with very high per capita incomes, as they are able to grow by adopting the technology and the public institutions (e.g. rule of law and regulations) used in richer countries. They also often have a greater capacity to grow through deepening their stocks of physical and human (i.e. through education and training) capital.

Conversely, economies which have relatively deep stocks of human and physical capital, operate at the technological frontier and have relatively well functioning public institutions (such as Japan, the US and Singapore)



Source: IMF (2019)

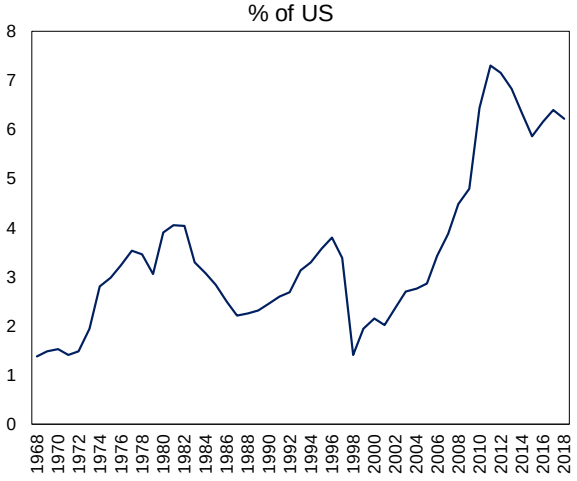
[15] Defined by the World Bank (2018a) as economies with gross national income per capita of $12,376 or more.

generally have a lower rate of growth potential, as they are largely constrained by the expansion of the technological frontier. Reflecting this, as illustrated in the chart on previous page, emerging market economies have generally grown significantly faster than advanced economies since around 2000, a trend that the IMF (2019) is forecasting to continue over the coming years[16].

Indonesia's per capita income is low at around $US4,123 per annum in 2019. According to the IMF (2019), this ranks Indonesia as 118th in the world. Low per capita incomes mean that, despite being the fourth most populous nation in the world, Indonesia ranks 16th in terms of total GDP at around $US1.1 trillion. That means that despite its much larger population, Indonesia has a smaller economy than Australia, which has a total of GDP of $US1.4 trillion.

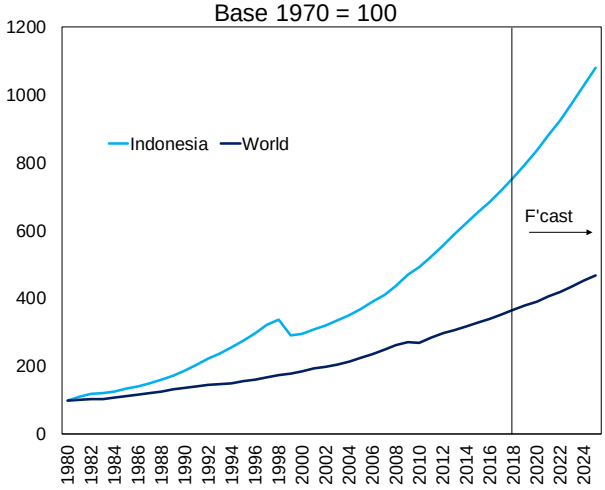
Indonesia's low per capita incomes therefore offer significant potential for catch-up growth. The following chart (left-hand panel) illustrates a substantial (but volatile) upward trend in Indonesian GDP per capita (relative to that in the US) over recent decades, particularly since the Asian Financial Crisis[17].

INDONESIA PER CAPITA GDP
% of US



Source: IMF (2019)

GDP (INDEX POINTS)
Base 1970 = 100



Source: IMF (2019)

[16] Noting that prior to 2000, there was a period where emerging markets did not grow faster than the advanced economies as they were negatively impacted by a number of financial crises, such as the Latin American Debt crisis and Asian Financial Crisis.

[17] The chart is particularly volatile because it is measured in $US and therefore incorporates exchange rate movements. However, this is a better approximation of the nation's import purchasing power than measures such as purchasing power parity, which exclude the direct impact of exchange rate movements.

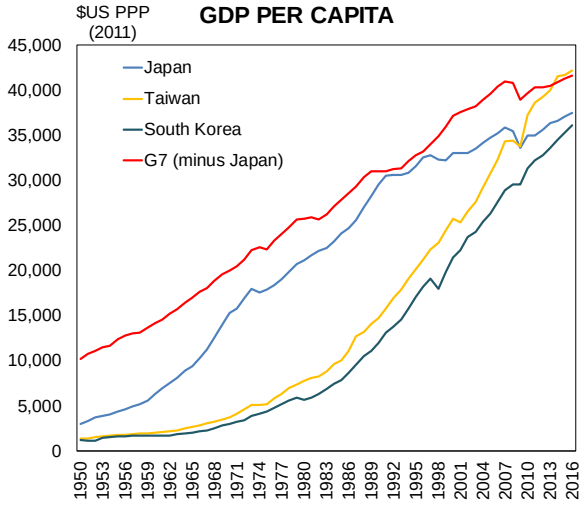
Most economic forecasters are predicting that the combined impact of demographic trends and catch-up growth will cause the Indonesian economy to continue to grow significantly faster than the global average. For example, according to the IMF (2019), the Indonesian economy has expanded by an average of 5.6% per annum since 1979, which compares to a global average of 3.6%. It is forecasting this trend to continue, with growth averaging 5.3% over the period to 2024, which compares to 3.6% for the global average. A 1.7 percentage point increase in the annual growth rate may not seem significant; however, if sustained over the course of 20 years, such an increase would result in Indonesia's economy growing by an additional $US1 trillion. Similarly, since 1979, Indonesia's faster economic growth rate resulted in the size of its economy multiplying by around 11 times, compared to around 4.5 times for the world (see chart above, right-hand panel).

Longer-term projections tell a similar story. For example, PwC (2017, p. 68) recently projected that Indonesia would jump from having the 16th largest economy in 2016 to the 4th largest by 2050, behind only China, the US and India. PwC (2019) also forecasts Indonesia's GDP per capita to rise from around $US3,400 in 2016 to $US22,000 by 2050.

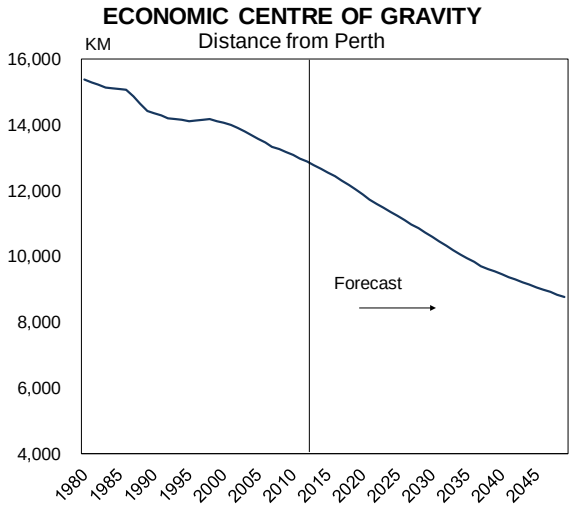
It is therefore clear that if Indonesia continues its path of economic convergence it will likely have a substantial impact on the Western Australian and national economies, given its proximity and very large population.

Past Episodes of Convergence

The economic convergence of Japan, Korea and Taiwan with the per capita incomes of the major advanced economies (see following chart, left-hand panel) offers some insight into the potential benefits a similar process from Indonesia may offer. These economies were located much closer to Western Australia than the major advanced economies in Europe and America, meaning that the State was well placed to gain significant benefits from trading with these jurisdictions. Western Australia's share of exports to these destinations peaked at around 44% in the mid-1990s and now stands at about 23%. These economies underpinned the development of the two largest industries in Western Australia, iron ore and LNG, through offtake agreements and direct investments.



Source: Maddison Project Database (Bolt, 2018)



Source: Quah (2011); Treasury WA

It is unlikely that Indonesia will converge as rapidly as these economies and history has taught us that the path to convergence can easily be derailed or interrupted for significant periods of time. However, this example serves as a useful illustration of the potential benefits of rapid economic growth from our neighbours.

Economic growth in Indonesia is a key part of the broader shift in the economic centre of gravity from the north Atlantic toward Western Australia's region. Quah (2011) attempted to calculate how the world's economic centre of gravity has moved over time as a means of quantifying and visualising the impact of the increasing relative importance of emerging markets. The chart above (right-hand panel) illustrates how the economic centre of gravity has moved toward Perth as a result of faster relative economic growth in parts of east and south Asia. The author predicts that this trend will continue for many decades as per capita incomes in the most populous nations in the region, such as China, India and Indonesia, converge with those in advanced economies. If global economic growth follows this path, the opportunities for Western Australia over coming decades will be substantial.

A report earlier this year by the Western Australian Treasury (Department of Treasury Western Australia, 2019) outlines in greater detail the growing trade potential in the Asia Pacific region.

Concluding Remarks

Indonesia, a country that some predict may become the fourth largest economy by 2050, presents considerable opportunities for both Western Australia and Australia. However, it is widely recognised that the current trade and investment relationship between the two nations is relatively limited. Reflecting this, the IA-CEPA represents one way in which Australia and Indonesia may increase their bilateral trade and investment flows, in particular in agriculture and services, and increased mutual cultural understanding through greater movement of people between the two nations. But perhaps more importantly, it sends a signal that the relationship between the two nations is important. Conversely, failing to ratify the agreement may send the signal that greater economic integration is not a priority, potentially limiting future economic opportunities.

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