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# RSIS COMMENTARIES

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## **Indonesia's New Offset Policy: Time for Broader Defence Industrial Strategy**

By Ron Matthews, Curie Maharani and Fitriani

### **Synopsis**

*Indonesia is preparing to launch its first national offset policy. The challenge is how to craft it to reflect the country's unique economic and security environment, and weaved into a broader defence-industrial strategy.*

### **Commentary**

INDONESIA IS one of the few countries without a formal offset policy, but its Defence Ministry has a mandate to quickly put this right. The imminence of Jakarta's first formal offset policy has aroused much debate and expectancy. Nearly all arms importing countries have an offset policy aimed at extracting reciprocal benefits from the overseas vendor. But the reality of offset is that most countries struggle to realise its potential.

### **Asian offset policy experiences**

Indonesia has been looking at the offset policy experiences of Australia and India. However it should consider crafting an offset policy appropriate to its own unique conditions. Jakarta would also do well to reflect on Singapore's considerable success in fostering indigenous defence industrial and technological capability. A major ingredient for this success has been the island state's flexible approach to offset management, pursuing partnerships with foreign vendors rather than contractual rigidity and the imposition of penalties when times get tough.

While it has proved invaluable, such flexibility on its own would have been insufficient in generating both the breadth and depth of Singapore's technological expertise. Technology transfer through offset has not been an isolated process, but was just one element within a broader integrated defence industrial strategy, implemented with governmental vision, resources and commitment.

### **Ad hoc offset policy and its impact**

Indonesia, by contrast, has pursued an informal, largely ineffectual, ad hoc offset policy since the 1960s. Too often, Indonesian acquisition has been detached from defence policy, driven by cost considerations rather than operational capability, and invariably delinked from reciprocal transfer of technology and/or substantive work packages.

Long-term paucity of acquisition funding has starved local defence industry of essential investment required to modernise process technologies, promote indigenous R&D capacity, upgrade worker skills, and, most importantly, generate sufficient output scale to reduce acquisition cost. Of equal concern is the absence of local

specialist subcontractor industries, which suppresses competitiveness and the emergence of an international 'brand' to market Indonesian weapon systems.

Two years ago, PT PAL, the Surabaya shipbuilder, pleaded for bail-out funds to stay afloat, and recently it was revealed that PT Dirgantara, the Bandung-based aerospace operation, is on the verge of bankruptcy. The two companies are amongst those designated as strategic industries by the Indonesian government, but it is unclear what this means in practice. If the Indonesian government wants a robust indigenous defence industry, then this state of recurring crisis cannot be allowed to persist.

While offset has the potential to contribute to defence industrial aspirations, it needs to be set within a broader overarching defence industrial strategy. The formulation of this strategy should encompass several significant and interrelated policy issues. To begin with, Indonesia's huge defence commitments require a hefty hike in the military expenditure to national income ratio. Indonesia spends a meagre 0.9% of its GDP to defend an archipelagic territory comprising over 17,000 islands and a population exceeding 242 million. It needs to increase its defence commitment up to, perhaps, a non-contentious target of 2% Military Expenditure to Gross National Product (national income), conventionally referred to as MILEX/GDP, which is the ASEAN average for 2010.

### **Agenda for Action**

Indonesia has to move quickly to implement policies to secure sufficient demand to enable research and production efficiencies to be realised for its defence industrial base. For this to happen, acquisition spending has to rise, enabling military capability requirements to be met in a cost-effective way. Indonesia's average procurement volumes struggle to reach double figures (the 2003-08 procurement of SU-27/30 fighters was just 10 aircraft). In comparison India's defence budget for 2010 was US\$36 billion, which allowed simultaneous acquisition of 126 European medium combat aircraft and 250-300 Indo-Russian fifth generation fighter aircraft. Moreover, Indonesia's low-scale procurement affords overseas contractors the opportunity to circumvent Indonesian offset requirements, because for such short production runs offset is commercially unviable.

Jakarta's policymakers should consider redefining the country's defence industrial boundaries. It needs to broaden the offset policy-envelope to encourage local development of 'dual-use' industries, especially those producing information technologies, computerised equipment, microelectronics, avionics and telecommunications systems, representing around 70-80 per cent of the value of modern weapon systems.

Indonesia needs to reinforce its defence-related R&D capacity. Offset can act as a necessary policy vehicle to transfer technologies on the back of expensive arms acquisition, but it is likely to be insufficient to construct a robust and durable indigenous Indonesian defence industrial capability. For this to happen, funds must be made available to create a strong domestic defence R&D infrastructure, going beyond the present miniscule commitment of less than 0.5% of GDP.

Development of a viable Indonesian defence industry will require parallel complementary 'absorptive technology' pillars to be constructed, aside from the creation of local R&D capacity. Policies must be implemented to aggressively foster innovation through domestic industrial and technological clusters, such as Singapore's fledgling aerospace cluster at Seletar airfield and Malaysia's maritime clusters in Selangor, Trengganu, Sarawak and Sabah.

### **Policy Implications**

Indonesian Defence Minister Purnomo Yusgiantoro's commitment to launch an offset policy is an important first step forward. However on its own, it will be inadequate to revive the bankrupt strategic industries, and, more broadly, the ailing Indonesian defence economy. The urgent imperative now is the implementation of a broader civil-military industrial strategy alongside a determination by the government to provide the required resources to make it work. If the Indonesian government wants a strong indigenous defence industry it must be prepared to pay the price, bearing in mind that the alternative of foreign dependence may be more expensive in the long-run.

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