

RSIS presents the following Policy Report, *Indonesia's Emerging Defence Economy: The Defence Industry Law and Its Implications*, by the RSIS Indonesia Programme. It is also available online at this link. (Please click on the link for printable version).

Indonesia's Emerging Defence Economy: The Defence Industry Law and Its Implications

Executive Summary

This paper examines the impact of the Defence Industry Law (UU No.16 2012 on Defence Industry) and its implications on the development of Indonesia's Defence Industry. Currently the 16th largest economy in the world and capitalizing on its growing economy, Indonesia is ready to reinvigorate and modernize its defence industry. In this regard, the Defence Industry law is vital primarily because it functions as a guideline in steering the direction and setting the goals that Indonesia wants to achieve in developing its own defence industrial base. Several steps are required to ensure the smooth implementation of the law: first, the establishment of a strong and clear implementation mechanism that cover clear goals with definite timelines allowing for accountability and full adherence of the law; second, a commitment to reducing the gap between proposed and actual budgets; third, the need to take steps to ensure policy complementarity as a supportive and operational gesture; fourth, the assurance of policy harmonization between stakeholders; and fifth, the need to exercise greater openness and flexibility with regard to international opportunities in the arena of defence industry cooperation. This paper concludes that a healthy development of local industry, technological vibrancy and absorptive capability in Indonesia has to be supported by a more practical, robust, and flexible policy, along with promoting transparency and eradicating corruption.

A New Beginning

New waves of reform emerged within Indonesia's Defence Industry when the government passed the Defence Industry Law - UU No 16 – 2012 on 2 October 2012, affirming a legal-political commitment to develop Indonesia's local defence industrial capacity. This policy is vital as it pledges to change the course of Indonesia's approach in

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dealing with its defence industry – one heavily dependent on foreign suppliers. The current state of the domestic defence industry is further exacerbated by the lack of a formal offset or countertrade mechanism that often excludes technology transfers. Although some defence procurement procedures may include an element of offset, without a formal policy, such offsets can be misdirected. For example in 2004, offset procurement for Su-27SKs and Su-30MKs were directed primarily to non-defence related sectors such as rubber, palm oil, coffee and bauxite. Such ad hoc based offset policy inevitably undermined the development of a local defence industry. Current policy now intends to incrementally shift the trajectory of Indonesia's defence equipment requirements from its foreign-centric orientation to a strategy that emphasizes greater dependence on local content.

The impetus for developing Indonesia's domestic capacity has always been present since the early 1990s. Under the leadership of B.J. Habibie, Indonesia started to invest heavily in developing its indigenous defence capacity in order to reach its stated goals in 2015. Unfortunately these earlier efforts proved futile as negative externalities generated by International Monetary Fund (IMF) loan conditionalities in the aftermath of the 1997 Asian financial crisis undermined defence development. Indonesia was obliged to follow IMF procedures to remove economic distortions including subsidies that undermined market competitiveness, including those that were directed to its fledgling defence industries sustained by government funding. Only a few local industries managed to survive by conducting their own research and development. For example, even though PT Dirgantara (Indonesia Aerospace Industry) managed to sell twenty-eight CN-235s while enjoying growth in the area of composite fabrication export sales to Europe's Airbus Company, further development was contingent upon state funding for the company. PT Dirgantara's competitiveness was further exacerbated by corruption and arms brokerage practices that created comparative disadvantages and inefficiencies. For instance, favoritism toward

manufacturers from the West was usually accompanied by bribery and one-upmanship. According to a *Jakarta Post* report on *the defence industry and arms procurement initiatives* (“Lengthy costly arms deals put TNI firepower at risk”, October 06 2011), the leakage of close to 40 percent of the total procurement budget is due to the malpractice of paying out commission money to a few TNI officials, high-ranking civil servants and dealers. This practice had eventually led to an overall budget deficit.

Slowly but steadily, Indonesia managed to recoup its losses from such malpractices with the steady performance of its economy. Making up for lost time when domestic priorities ranked above taking a high profile foreign policy stance, Indonesia now intends to re-brand herself as a key player in regional affairs, primarily within the context of ASEAN. Complementing such a strategy will be a defence policy in dire need of internal re-balancing. By 2007, Indonesia reached a milestone by maintaining a stable 6.3 percent economic growth and in the process settling debt commitments to the IMF earlier than required (payment in full was required by 2010). Within the country, a new found confidence is now evident, buoyed by economic performance and with it a concomitant prioritization that revitalizing Indonesia’s defence sector is now one of Indonesia’s top three priorities after education and infrastructure. Notwithstanding the capacity of Indonesia’s economy to weather domestic economic challenges (like the inequality gap), confidence abounds that as Indonesia’s economic profile rises on the world stage, confidence in her abilities as a rising economic power will assuage its many anxieties. Indonesia is now the 16th largest economy in the world and is slated by McKinsey Global Institute to become the 7th largest by 2030. The Boston Consulting Group report also portrayed Indonesia as ‘Asia’s next big opportunity’, emphasizing the importance of changing demographic trends in the country and its potential. Currently, Indonesia has a population working-age that is two times larger than Vietnam, and nearly three times the entire South Korean population. With this new-found confidence, Indonesia aims to commit greater financial resources to revitalize its defence industries. The new defence industry law functions as basic guidelines on how to rejuvenate the indigenous defence industry.

Current Indonesia's Defence Industry and the Surge of Defence Cooperation

To rejuvenate its defence industries, Indonesia faces two key challenges: first, the promotion of cooperation between related government institutions as it will integrate six related ministry under one framework of called The Committee of the Defence Industry (KKIP, *Komite Kebijakan Industri Pertahanan*). The committee will be chaired by the President. This policy is aimed at changing the approach to national planning particularly how each ministry conducts its business, with the primary aim of championing the development of the local defence industry. These include changes in the direction of R&D policy, foreign policy approaches, and other related policies such as the Industrial policy and University-based research.

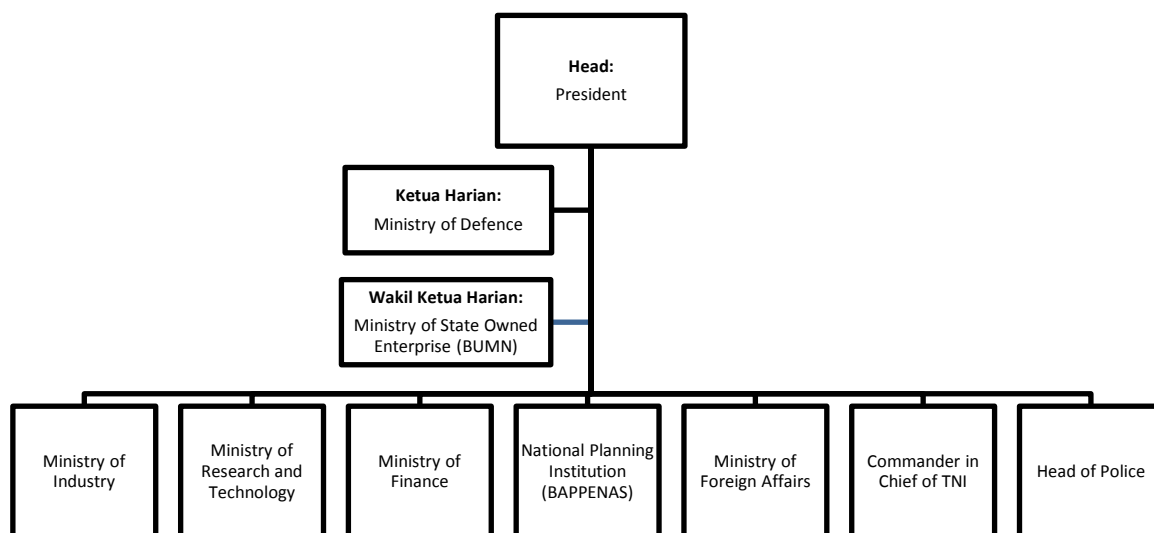


Figure 1, Committee for Defence Industry (KKIP)

Second, the policy situates the indigenous defence industry within the ambit of other prominent industries and ministries, as it requires the state to be main source of funding by providing safety nets through necessary means such as loan provisions and credit guarantees to banks and other financial institutions. The government will opt for market intervention only when necessary, for example by providing preferential tariffs for products and fiscal incentives such as free imports and taxes. However, local bias will be evident through obligatory requirements for all stakeholders (government defence and security institutions) within Indonesia to buy and use domestic-made weapon systems – notwithstanding the rigid obligation for local strategic industry engagement in the form of a minimum 85 per cent of

countertrade and 35 percent of offset that periodically will be increased by 10 percent every 5 years. According to *Business Monitor International* (BMI), “Indonesia Defence & Security Report Q1 2013”, confidence in the local defence industry is growing, for instance PT PAL (*Penataran Angkatan Laut*, Indonesian Naval Industry) has announced in June 2012 that it plans to expand its businesses, and aims to hire 1,000 new workers. PT Dirgantara also plans to take on 1,500 new workers. The expansion of several defence industries in Indonesia indicates growing confidence.

The government also aims to introduce a concept of Minimum Essential Forces that will divide the defence development in Indonesia into four stages. Within each step, the allocation of defence GDP will be gradually increased. Correspondingly, the allocation of the defence budget for non-military infrastructure (supporting and reserve components) such as logistics and human capital will also be increased. R&D has become a main concern specifically as the new defence law stipulates a minimum budget allocation of 5 percent from total profit. Following this, the defence industry will come under the limelight, especially in emphasizing its third stage of development (2020-2024). During the first (2010-2014) and second stages (2015-2019) of development, the Indonesian government focused on creating a set of regulations while simultaneously pioneering the development of absorptive capability (in the form of reliable manpower or human capacity and the basic capacity to manufacture). This would be achieved vis-à-vis various R&D collaborations. Having achieved that, the third stage of MEF will be one that will work towards consolidating the credibility of the defence industry.

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intelligence and market research company, external defence collaboration done in tandem with a variety of newly initiated military revitalization programmes will boost Indonesia’s defence market, making it one of the fastest-growing in the world. Recently, Indonesia deepened its defence ties with many prospective countries like the United Kingdom (UK), France, Germany, the European Union, Australia, South Korea, China, India, Brazil, Japan,

Russia, Turkey, Vietnam, and the United States. Most recently, Indonesia and UK have signed a MoU in 2012 to bolster future working relations. During the signing ceremony, Prime Minister David Cameron justified the presence of UK defence companies in Indonesia such as the BAE Systems whilst expressing UK's willingness to deepen relations with his Indonesian counterparts. In 2011 and early 2012, Daewoo Shipbuilding and Marine Engineering (DSME), a South Korea company, confirmed its supply to the Indonesian Navy of three type 209/1200 diesel-electric attack submarines by 2020 – a contract worth US\$1.07 billion. The two submarine boats will be built in Busan, and the third will be built in Indonesia by local shipbuilder, PT PAL. There is also an on-going deal between the two countries over the recent development of the KF-X fighter, highlighting viable technology transfers.

Such fostering and the deepening of ties amongst cooperating countries bodes well for the local defence industry since this is not a one-way transaction of foreign suppliers to Indonesia, but Indonesia also concurrently derives export production contracts from them. As reported in *Business Monitor International* (BMI), South Korea has agreed to procure four CN-235s from PT Dirgantara, as a countertrade mechanism for the 16 T-50 advanced jet fighters ordered by Indonesia. In October 2011, Indonesia's Ministry of Defence announced the procurement of nine CN-295 medium transports for US\$325 million, which will be jointly produced by Airbus Military together with local company, PT Dirgantara. With this cooperation, PT Dirgantara expects to be able to build 200-250 CN-295s in the near future. This initiative aims to fulfill a growing demand in the Asian region for affordable medium-sized early warning systems, air defence, and battlefield management that are suited for non-conventional missions such as border protection, counter-terrorism, and homeland security. Companies like PT Pindad (*Perindustrian Angkatan Darat/Indonesia Arms Manufacturer*) have since signed four Joint Ventures with various international companies such as PT Siemens Indonesia to produce machinery and switchgears with the German multinational company. PT Fanuc GE Automation Indonesia will produce factory automation systems in cooperation with Japanese firm Fanuc. PT Lucas-Pindad Aerospace of Indonesia is lined up to assemble, manufacture and produce aircraft components with PT GHH Borscig.

Current State of Anxiety

The Defence Industry Law has another facet that unconsciously limiting or inhibiting closer cooperation with potential partner countries – clauses that carry strong nationalistic and

protectionist overtones. Preference for local ownership rather than foreign ownership is an example. Another example is the Indonesian government’s control over the ownership of assets in the overall process of the value chain within the main weapon industry category. Until today, the government is still asserting full control over these assets and intends to retain the majority ownership over the industry.

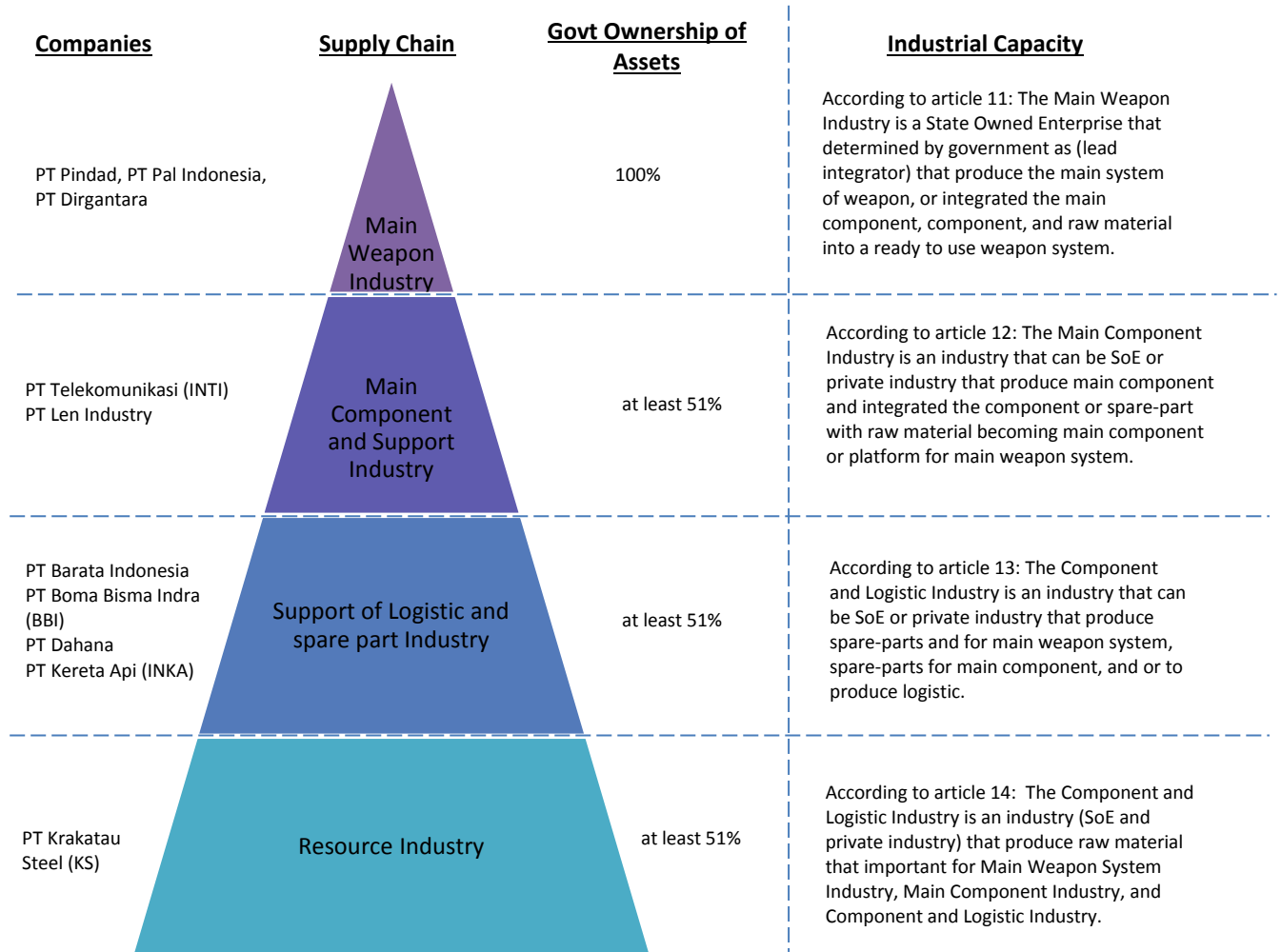


Figure 2, Indonesia Defence Value Chain

Such protectionist attitudes are derived from an irrational fear of the recurrence of embargoes and foreign intervention. It may also eventually shape the mindset of policy-makers especially on the strategic aspects of the development of the defence industry. Indonesia has in the past experienced arms embargos by the U.S. in 1991 and 1999 and by the EU in 1999 over allegations of human rights abuses in Timor-Leste. Although relations with the US and the EU have since normalized, there still remains a residual fear. However, phobias over embargoes will continue, visible in article 43 (3) of Indonesia’s Defence Industry Law. The article intends to close any legal loopholes and provides a legal assurance to prevent

situations arising where embargos or political conditionality would be placed upon Indonesia. Such sensitiveness however may result in some wariness or reluctance to cooperate with prospective countries. For example in 2012, several legislators opposed the U.S. offer of a discount on its offer of two squadrons of F-16 fighter jets, due primarily to suspicions over a possible future embargo. Such fears have also been exacerbated by the fact that Indonesia possesses a high concentration of weapons from the EU and U.S. - countries that have consistently used embargoes on military equipment as a punitive option for human rights violations.

The over emphasis on self-reliance is also founded on anxieties over a possible external intervention or intrusion. This is evident in Indonesia's defence posture and outlook particularly in relation to counterterrorism. Here Indonesia is concerned over threats of a preemptive strike against terrorism targets within Indonesia and by that extension over foreign intervention on Indonesia's sovereign territory. Such thinking parallels worries over the growing regional arms build-up and the challenges posed by the increased military capabilities of neighboring countries in the region. Although actual inter-state conflict is almost non-existent, the changing regional strategic equation particularly with new security challenges on the horizon will mean that the Suharto era logic of prioritizing development over defence will no longer be viable. Increasingly, defence planners in Indonesia want to prioritise and plan against worst-case scenarios.

The Way Forward

The Defence Industry Law is arguably a bold move signaling the need for a long-awaited rejuvenation of Indonesia's local defence industry. The law demands significant commitment from the government towards the development of its defence industry. Nevertheless, amidst these opportunities, going forward, Indonesia still needs to overcome several challenges.

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First, government needs to establish a firm and clear legal enforcement mechanism in order for the initiative to be effective. Furthermore, the following requirements are necessary: 1) The creation of a clear roadmap that embraces reachable goals and definite timelines; 2) A reward and punishment system to ensure enforcement and adherence to the law, considering the possibility that stakeholders may exploit current loopholes in article 43 of the law,

allowing stakeholders to disregard the offset mechanism or allow them to buy from foreign countries instead of local industries). 3) The discrepancy between proposed and actual budget being allocated for defence can and should be minimized (for instance, in 2011 the budget proposed was US\$13.68 million, yet the approved actual budget turned out to be only \$5.75 million As a result, the Ministry of Defence was forced to postpone further modernization efforts).

Secondly, as this law covers a broad spectrum, there has to be complementary policy with regard to its implementation. Such subsidiary policies can cover aspects of coordinated research at the national level between universities and think-tanks and other related policies of critical importance to various Defence-affiliated stakeholders. Synchronization of policies across stakeholders is also important, particularly among the defence research and academic community where a division of research between universities is also needed to ensure its effectiveness. With the creation of KKIP as a platform for integration between affiliated governmental institutions, a synchronized master plan for national policy on defence can then be achieved.

Third, there has to be policy harmonization between various stakeholders. The adoption of the multi-stakeholder approach will undoubtedly create its own complications particularly when it comes to harmonizing its approaches and SOPs (Standard Operating Procedures). Possible challenges faced by the KKIP will be in the area of unnecessary overlaps of policies between stakeholders. For example, there is a real possibility of an overlapping mandate between the KKIP with the Ministry of Defence. The UU No.3/2002 on Defence has mandated that strategic planning relating to the defence industry, weapon acquisitions and funding fall under the authority of the Ministry of Defence. However, KKIP has shifted responsibility to involve a broader group of related ministries in its decision making process. Confusion may also arise amongst overlapping authorities within related ministries. This can be problematic as there could be a perception of interference and disruption to other ministries presenting a challenge to the authority of certain stakeholders due to the lack of clarity on the division and management of labour. Hence in order to prevent potential misunderstanding occurring between stakeholders, the boundaries of collaboration have to be clearly defined and harmonized across sectors.

Finally, Indonesia needs to exercise more openness and flexibility regarding international opportunities found within the ambit of defence cooperation. There is a tendency amongst

policy-makers to over-emphasize self-reliance and this can lead to poor policy implementation. The Indonesian government needs to reassess its strong emphasis on self-sufficiency and autarky and its implications for policy rigidity. While current existential threats can be contained, the cost of weapons acquisition is rising rapidly. Emphasizing self-reliance may not be the most viable solution. Hence, the government needs to be flexible by placing emphasis on cooperative endeavour rather than championing the notion of autarky. Furthermore, the Indonesian government should be more open towards opportunities that may arise amidst such conditions like the internationalization of defence, joint ventures or even mergers with overseas counterparts. The internationalization of defence is also viable strategy to increase purchases and enjoy economies of scale. Doing so will open up more opportunities and advantages to Indonesia. This would include the economic diversification of R&D incorporating the sharing of costs and risks and through technology transfer better develop local industries vis-à-vis collaborative engagements.

A more practical and flexible policy would ensure the healthy development of local industries, technological vibrancy and absorptive capabilities in Indonesia, along with promoting transparency and eradicating corruption.

About RSIS and Indonesia Programme

The *S. Rajaratnam School of International Studies (RSIS)* was officially inaugurated on 1 January 2007. Before that, it was known as the Institute of Defence and Strategic Studies (IDSS), which was established ten years earlier on 30 July 1996. Like its predecessor, RSIS was established as an autonomous entity within Nanyang Technological University (NTU). RSIS' aim is to be a leading research institution and professional graduate school in the Asia-Pacific. To accomplish this mission, RSIS provides a rigorous professional graduate education in international affairs with a strong practical and area emphasis; conducts policy relevant research in national security, defence and strategic studies, international political economy, diplomacy and international relations; and collaborates with like-minded schools of international affairs to form a global network of excellence.

The *Indonesia Programme* is one of nine active research programmes under the umbrella of IDSS. The Programme studies current developments and a wide range of key issues in the archipelago, including political Islam, military and security affairs, foreign policy and regional relations, as well as national and local politics – especially in the Riau region. Through various research, networking, and teaching activities, the Programme has not only provided a platform for networking between the Singapore policy community and the emerging political elites in Indonesia, but it has also tried to further deepen mutual understanding and closer friendship between the two neighbours.