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The Importance of Services in Indonesian Trade

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Canada

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KEMENTERIAN PERDAGANGAN REPUBLIK INDONESIA

MINISTRY OF TRADE

The Importance of Services in Indonesian Trade

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About the TPSA Project

TPSA is a five-year C$12-million project funded by the Government of Canada through Global Affairs Canada. The project is executed by The Conference Board of Canada, and the primary implementation partner is the Directorate General for National Export Development, Ministry of Trade.

TPSA is designed to provide training, research, and technical assistance to Indonesian government agencies, the private sector—particularly small and medium-sized enterprises (SMEs)—academics, and civil society organizations on trade-related information, trade policy analysis, regulatory reforms, and trade and investment promotion by Canadian, Indonesian, and other experts from public and private organizations.

The overall objective of TPSA is to support higher sustainable economic growth and reduce poverty in Indonesia through increased trade and trade-enabling investment between Indonesia and Canada. TPSA is intended to increase sustainable and gender-responsive trade and investment opportunities, particularly for Indonesian SMEs, and to increase the use of trade and investment analysis by Indonesian stakeholders for expanded trade and investment partnerships between Indonesia and Canada.

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Executive Summary

The important role of services in a country's trade performance has largely been overlooked. This is partly because countries have historically focused on the exports of goods. Compared with goods, services are "intangible"—they are often difficult to observe as they cross borders and add value to trade. This is also due to the fact that, until recently, national statistical systems have struggled to capture and quantify the value of services in trade. A new dataset developed jointly by the Organisation for Economic Co-operation and Development (OECD) and the World Trade Organization (WTO) has filled that gap and reveals that, while goods exports still dominate Indonesia's trade picture, services play a much more important role in Indonesia's exports than conventional statistics suggest. The share of services in Indonesia's exports more than doubles when value-added measures of trade are used.

In addition, the value of services embodied in goods exports is substantial and has largely been ignored. Unfortunately, Indonesia's goods exports embody a below-average share of services compared with exports of selected peer countries. This finding is true for all of Indonesia's major goods exports. Indonesia has not kept up with its peers in taking advantage of the benefits from services exports.

One reason for this relatively poor performance may be due to a high level of restrictions on investment and trade in the services sector. The data show that key Indonesian service sectors are more restrictive to foreign direct investment than average, which can impair the international competitiveness of these sectors.

This is a concern, given the increased attention worldwide on the services sector as a likely source of growth, the contribution of the services sector to the competitiveness of other sectors, and the opportunities available for capturing the gains from innovation from services trade.

Chapter 1: Services' Contribution to Indonesia's Economy

The important role of services in a country's trade performance has largely been overlooked. This is partly because countries have historically focused on the exports of goods. Compared with goods, services are "intangible"—they are often difficult to observe as they cross borders and add value to trade. This is also due to the fact that, until recently, national statistical systems have struggled to capture and quantify the value of services in trade. A new dataset developed jointly by the Organisation for Economic Co-operation and Development (OECD) and the World Trade Organization (WTO) has filled that gap and reveals that services play a bigger role than traditionally thought, particularly with the rise of global value chains. Unfortunately, however, Indonesia has not kept up with its peers in taking advantage of the benefits from services exports. This is a concern, given the increased attention worldwide on the services sector as a likely source of growth, the contribution of the services sector to the competitiveness of other sectors, and the opportunities available for capturing the gains from innovation from services trade.

How Important Are Services to Indonesia's Economy?

Most modern economies are, in fact, service economies. According to data reported by the World Bank, service-producing industries account for over 70 per cent of the world's gross domestic product (GDP).[1] Modern economies rely on the direct role that services play in creating jobs and economic value, but also on their role behind the scenes, adding value to almost every segment of goods production. For example, business services—such as design, legal, and engineering—play an important role in the production chain of activities both at the upstream and downstream ends. And distribution services enable the efficient movement of goods, enhancing the country's global competitiveness.

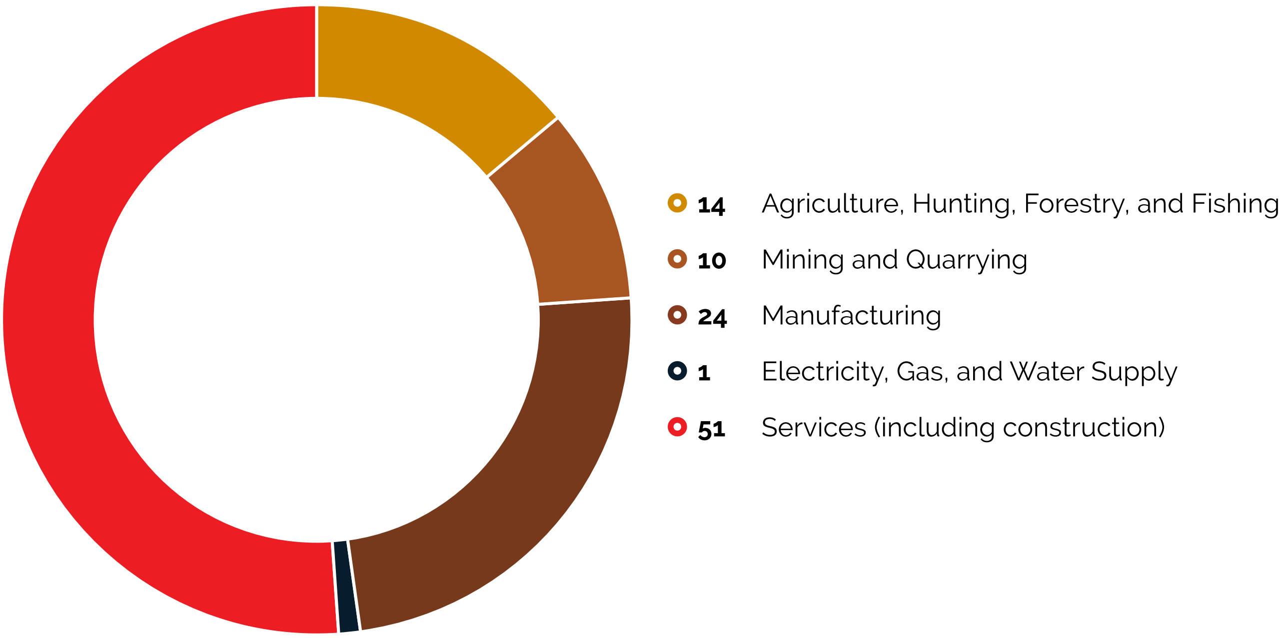
According to Indonesia's national statistics agency, Badan Pusat Statistik, services accounted for 51 per cent of Indonesia's GDP in 2015.[2] (See Chart 1.) By contrast, manufacturing contributed only 24 per cent; agriculture, mining, forestry, and fishing contributed 14 per cent; mining and quarrying accounted for 10 per cent; and electricity, gas, and water made up the remaining 1 per cent.

1 World Bank Group, *World Development Indicators.*

2 Indonesia's national statistics agency includes construction in the definition of services. The World Bank does not include construction in services data.

CHART 1: SERVICES ACCOUNTED FOR MORE THAN HALF OF INDONESIA'S GDP IN 2015

(per cent)

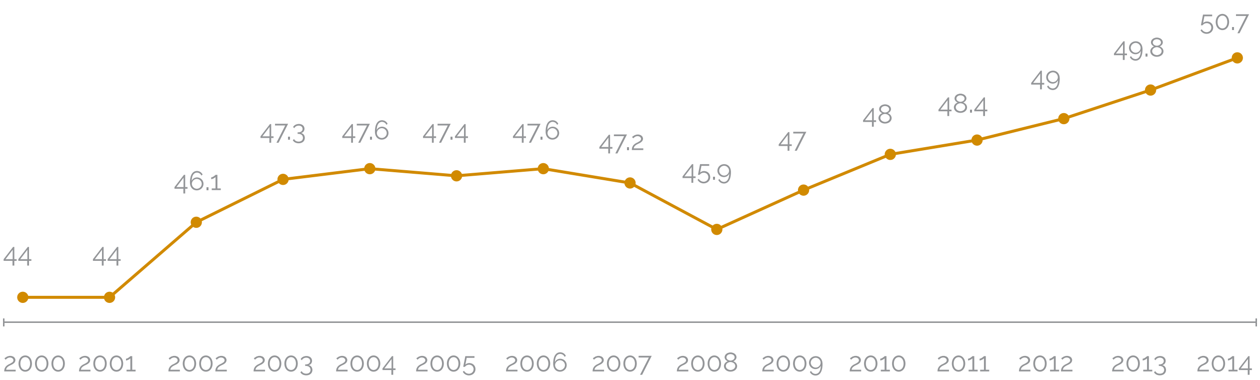


Source: Badan Pusat Statistik.

Services have increased in importance in Indonesia's economy. In 2000, services accounted for 44 per cent of GDP. Despite a small drop due to the 2008–09 financial crisis, services as a share of GDP grew to 50.7 per cent in 2014. (See Chart 2.) This means that services have become more integrated into Indonesia's economy. The growth in services is a good sign for Indonesia's economy, as a services-dominated economy is a characteristic of developed countries, while less-developed countries rely more on primary industries.

CHART 2: SERVICES ARE GROWING IN IMPORTANCE

(share of Indonesia's GDP, per cent)

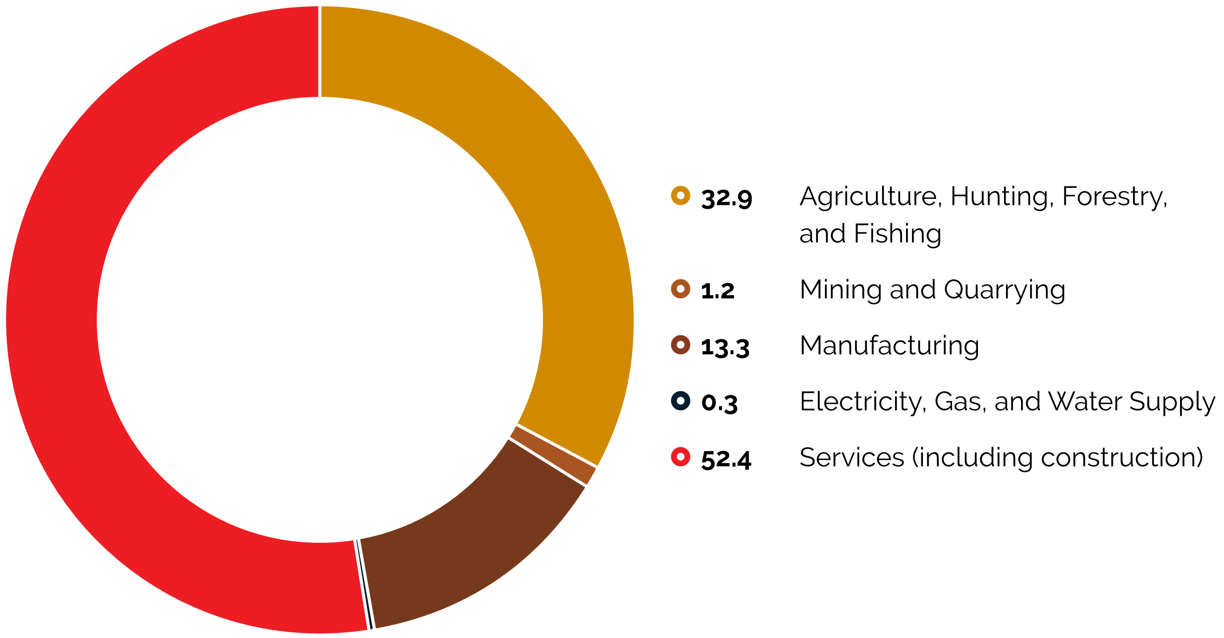


Source: Badan Pusat Statistik.

Over half the people employed in Indonesia worked in services industries. (See Chart 3.) The second largest portion—32.9 per cent—was made up of workers in the agriculture, mining, forestry, and fishing sector. Employees in manufacturing industries accounted for 13.3 per cent of employment, while mining and quarrying jobs accounted for 1.2 per cent. The smallest share of employment was made up of jobs in electricity, gas, and water industries—0.03 per cent of employment (not shown on this chart).

CHART 3: OVER HALF OF INDONESIA'S WORKERS IN 2015 WERE EMPLOYED IN THE SERVICE SECTOR

(per cent)

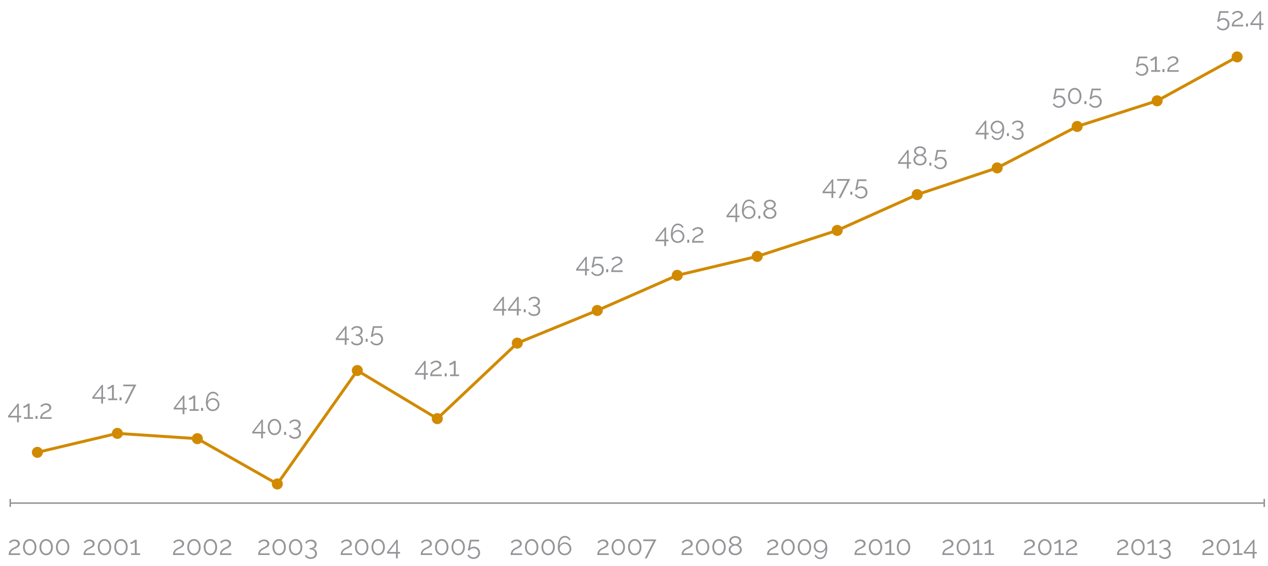


Source: Badan Pusat Statistik.

The growth of services employment in Indonesia's total employment has been quite promising over the past decade. Chart 4 shows that, between 2000 and 2005, services' share of employment remained fairly stable around 43 per cent. After 2005, the share increased steadily to 52.4 per cent in 2015.

CHART 4: INDONESIA'S SERVICE SECTOR EMPLOYMENT SHARE IS INCREASING

(per cent)

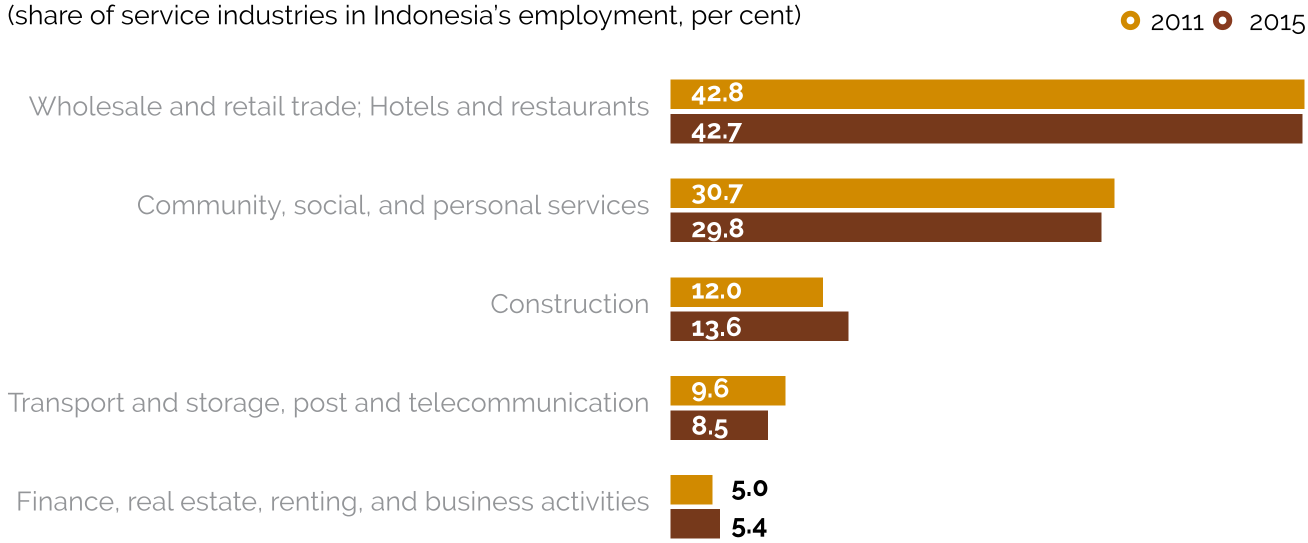


Source: Badan Pusat Statistik.

According to statistics from Badan Pusat Statistik, the employment share is largest in the wholesale and retail trade/hotels and restaurants grouping. (See Chart 5.) These jobs account for more than 40 per cent of services employment. The second largest contribution to services employment comes from the community, social, and personal services grouping, with approximately 30 per cent of services jobs. The shares in both of these groupings have been fairly stable over time. Construction's share increased from 12 per cent to almost 14 per cent, while transport and storage's share declined somewhat. The finance, real estate, renting, and business grouping accounted for the smallest share of services employment—5.4 per cent—although that share increased slightly over time.

CHART 5: WHOLESALE AND RETAIL TRADE/HOTELS AND RESTAURANTS IS THE LARGEST SERVICE EMPLOYER

(share of service industries in Indonesia's employment, per cent)



Source: Badan Pusat Statistik.

How Important Are Services to Indonesia's Exports?

The answer to this question varies depending on how services exports are measured. Conventional trade statistics underestimate services exports relative to goods exports. There are two reasons for this undervaluation:

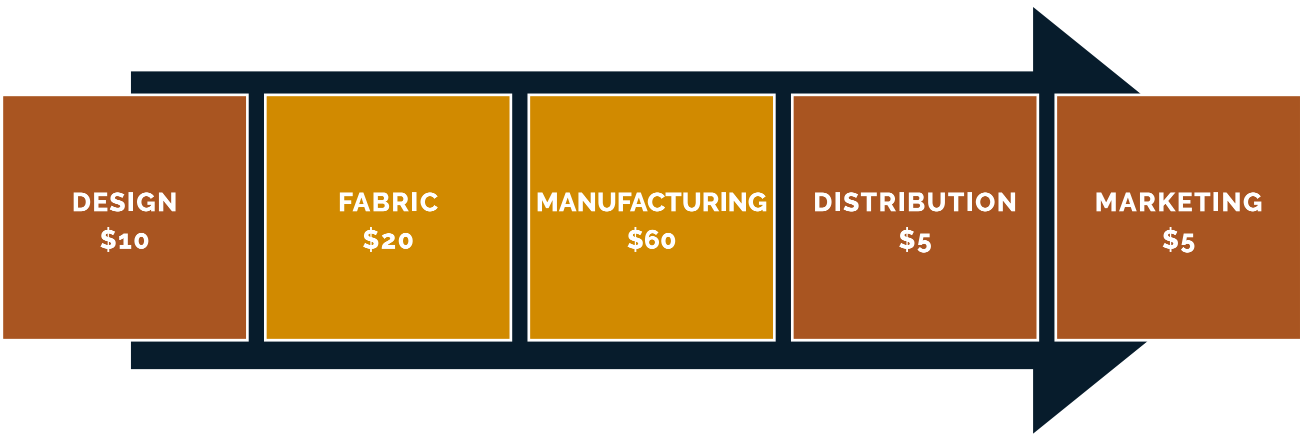
1. Goods exports are counted each time they cross the border, even if only a small amount of value was added as it crossed that border. Because of the fragmentation of global value chains, goods cross borders more often than services. (See box "What Are Global Value Chains?")
2. The value of behind-the-scenes services in goods production is not attributed as a services export, but rather as a goods exports. For example, the value of design, engineering, or distribution activities are included in the price of the good—and the full value is counted as a goods export.

WHAT ARE GLOBAL VALUE CHAINS?

International production, trade, and investments are increasingly organized within so-called global value chains (GVCs), where the different stages of the production process are located across different countries. The rise of global value chains has challenged our conventional wisdom of how we look at and interpret trade statistics, as well as the policies that we develop based on those statistics. Today, a single finished product often results from manufacturing and assembly in multiple countries, with each step in the process adding value to the end product.

A better way to get a more accurate picture of the true value of services exports is to use value-added statistics. Value-added measures only the additional value a country makes to an exported good. It takes into account and separates the value of the full range of activities that occur along the production process rather than attributing all the value to the final product. For example, consider a simple example of a batik dress exported by a manufacturer for US$100. Conventional trade data would attribute the total value to goods exports. However, the value-added approach breaks down the $100 into the value actually added at each step of the production chain. (See Exhibit 1.) Using a value-added approach would attribute US$20 to services exports (design, distribution, and marketing) and US$80 to goods exports (fabric and manufacturing).

EXHIBIT 1: SERVICES PLAY AN IMPORTANT ROLE IN PRODUCTION CHAINS

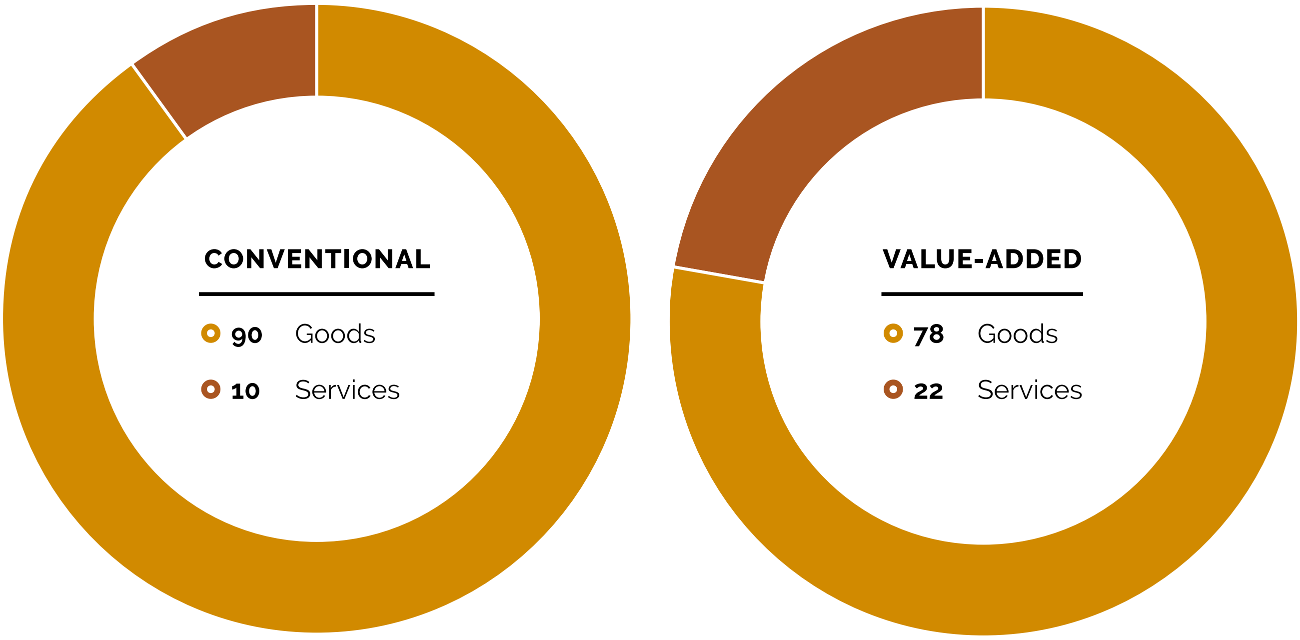


Source: Canada–Indonesia Trade and Private Sector Assistance Project.

Chart 6 compares the share of goods and services in Indonesia's exports using conventional statistics and the trade-in-value-added approach. Conventional data published by Indonesia's Ministry of Trade reveal that services made up 10 per cent of the value of Indonesia's total exports in 2011, while goods made up the remaining 90 per cent.[3]

CHART 6: SERVICES ARE MORE IMPORTANT THAN CONVENTIONAL MEASURES SUGGEST

(share of Indonesia's exports, 2011, per cent)



Sources: Indonesia Ministry of Trade; OECD-WTO TiVA Database.

Services' share of exports more than doubles—22 per cent—using the value-added measure of trade published in the trade in value-added (TiVA) database. This method more accurately describes the contribution of services to Indonesia's exports, reflecting the role of Indonesian services in global value chains. The analysis that follows in this chapter and the next will be done by means of the TiVA database.

What Ways Are Services Exported?

Services can be exported directly, embodied in other services, or embodied in goods. The TiVA database not only gives us a truer picture of the contribution of services exports, it allows researchers to separate the services data into these three types so that we can better understand the different ways that services can be exported.

1. **Direct:** Direct services are traded as a stand-alone commodity and not as an intermediate input in either goods or other services. An example of a direct service is an Indonesian computer consultant who sells his or her services to a firm in Germany.
2. **Embodied in other services:** Some services are embodied in other services and are therefore consumed indirectly in a foreign market. An example of a service embodied in another service export is an Indonesian computer consultant who sells his or her services to an Indonesian design company, which in turn sells its design services to a firm in Germany.

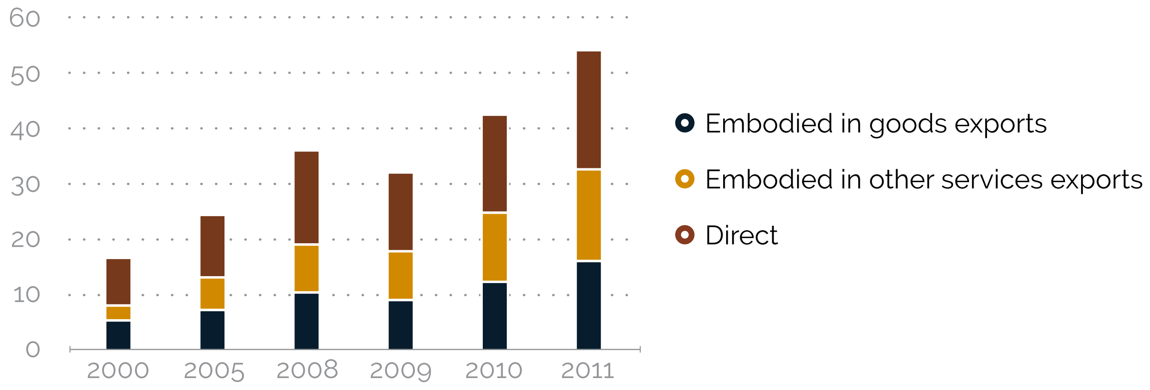
[3] The year 2011 was used because it was the most recent year published in the TiVA database.

3. **Embodied in goods:** Some services play a role in the production process of a good being produced and are therefore embodied in that good. An example is an Indonesian design firm that sells its batik designs to an Indonesian textile manufacturer who in turn exports that fabric to Germany.

Between 2000 and 2011, Indonesia's total gross exports of services more than tripled in value. (See Chart 7.) As a proportion of total gross services exports, direct services account for the largest share.

CHART 7: INDONESIA'S SERVICES EXPORTS TRIPLED IN VALUE

(gross value-added exports of services, US$ billions)



Source: OECD-WTO TiVA Database.

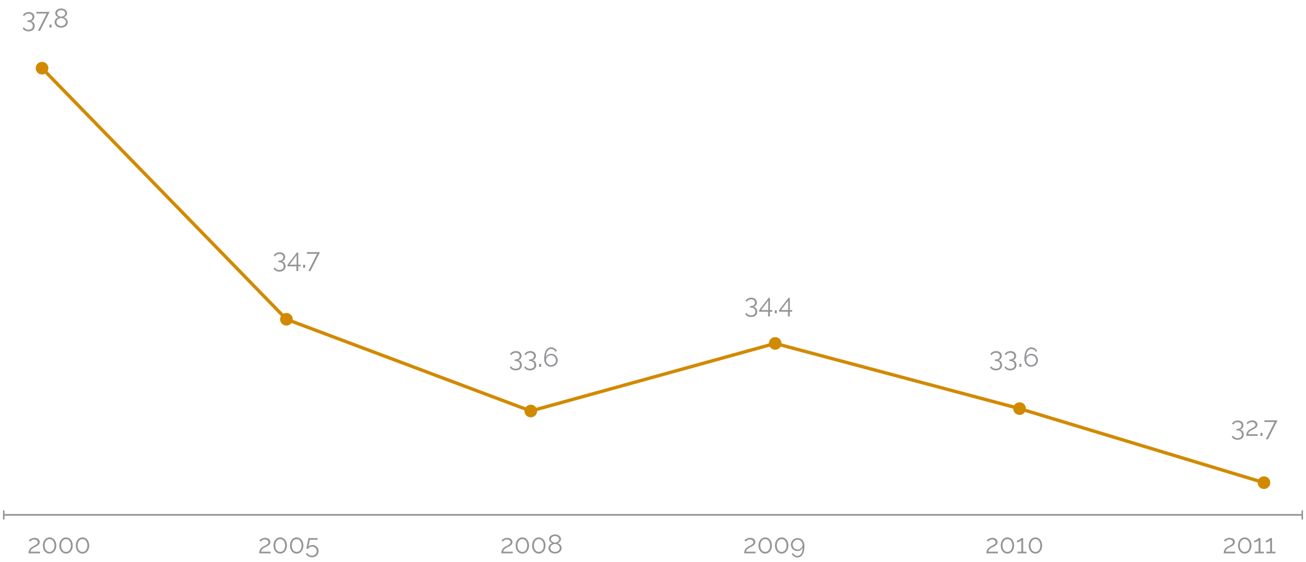
This chapter will focus on the role that direct services play in Indonesia's exports. The role of services embodied in goods exports is discussed in Chapter 2.

How Important Are Direct Services in Indonesia's Exports?

The value of direct services exports increased from US$8.6 billion in 2000 to US$21.4 billion in 2011. Despite this increase, direct services exports accounted for a smaller share of Indonesia's total exports in 2011 compared with 2000. In 2000, 37.8 per cent of the value of total exports came from direct services exports. This share fell to 32.7 per cent in 2011. (See Chart 8.) It is important to remember that Indonesia's direct services exports did not decrease in value—in fact, they increased by 8.7 per cent per year—but they did represent a smaller share of the total value of exports over the decade.

CHART 8: DIRECT SERVICES EXPORTS ACCOUNT FOR A DECLINING SHARE OF VALUE-ADDED EXPORTS

(per cent)

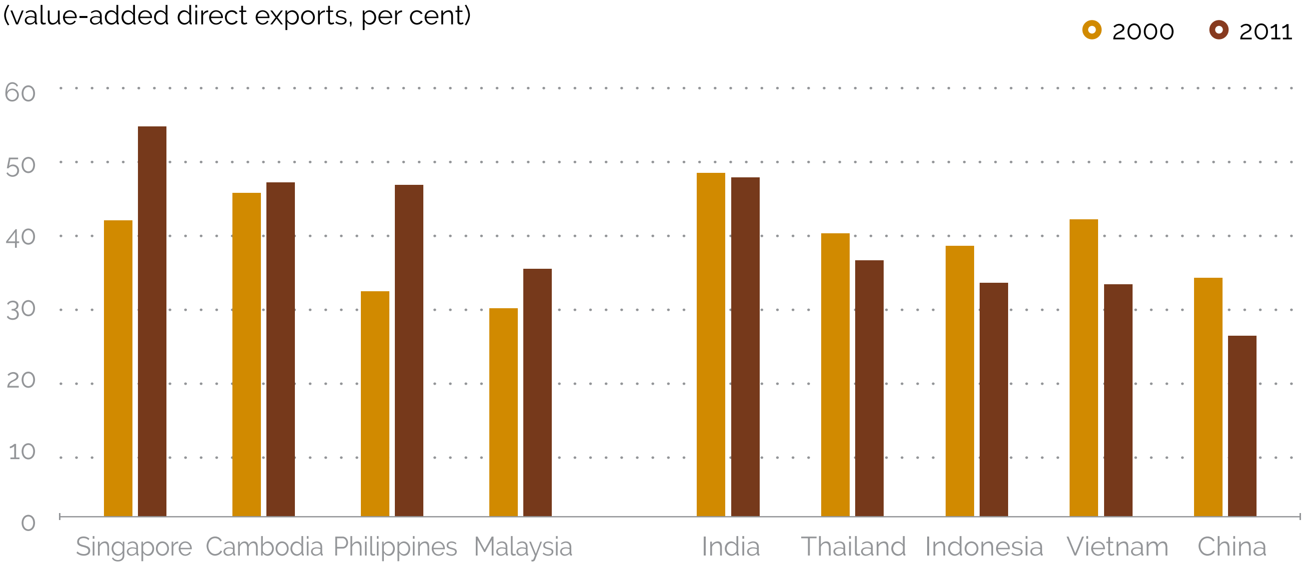


Source: OECD-WTO TiVA Database.

Several of Indonesia's peer countries also experienced a decline in direct services exports' share of total exports.[4] Chart 9 reveals that China and India had declining shares, as did Thailand and Vietnam. In the remaining four peer countries, direct services took on a more important role in overall exports. In the case of the Philippines, the share increased by nearly 15 percentage points between 2000 and 2015.

CHART 9: SERVICES' SHARE OF EXPORTS FALLING IN SOME PEER COUNTRIES

(value-added direct exports, per cent)



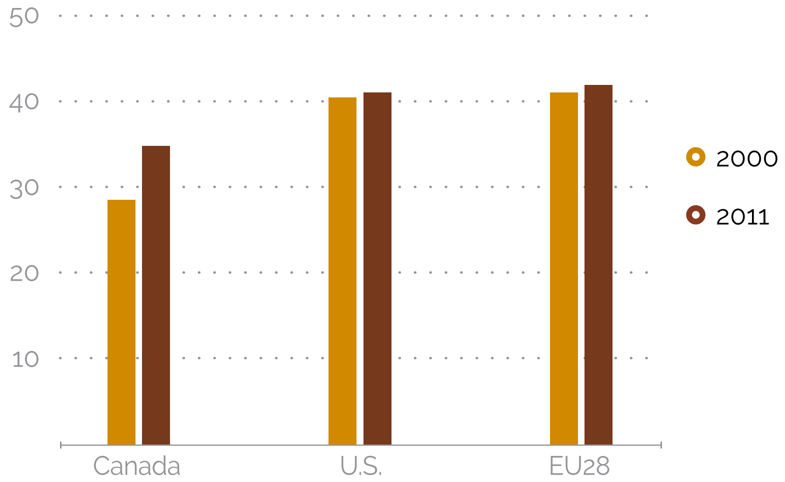
Source: OECD-WTO TiVA Database.

4 The TiVA database does not include data for all ASEAN countries. Therefore, this report has chosen eight countries in the database as Indonesia's peer countries: Cambodia, China, India, Malaysia, Philippines, Singapore, Thailand, and Vietnam.

In most high-income countries, the share of direct services in overall exports increased over the past decade. (See Chart 10.)

CHART 10: SHARE OF SERVICES IN EXPORTS OF HIGH-INCOME COUNTRIES IS INCREASING

(value-added direct exports, per cent)



Source: OECD-WTO TiVA Database.

What Are Indonesia's Most Important Direct Services Exports?

Using the TiVA list of Indonesia's services industries (see box "How Are Service Exports Defined?"), we have identified three service groupings as being important to the future of Indonesia's export performance:

1. High-demand services:
   a) enabling services—those services that play a significant role in enabling the efficient distribution and movement of goods exports (wholesale and retail trade, and transport services)
   b) tourism-related services—hotels and restaurant services
2. High-value services:
   a) research and development (R&D) and other related services
   b) computer and related services
3. High-growth services (the potentials):
   a) education services
   b) health and social work

HOW ARE SERVICE EXPORTS DEFINED?

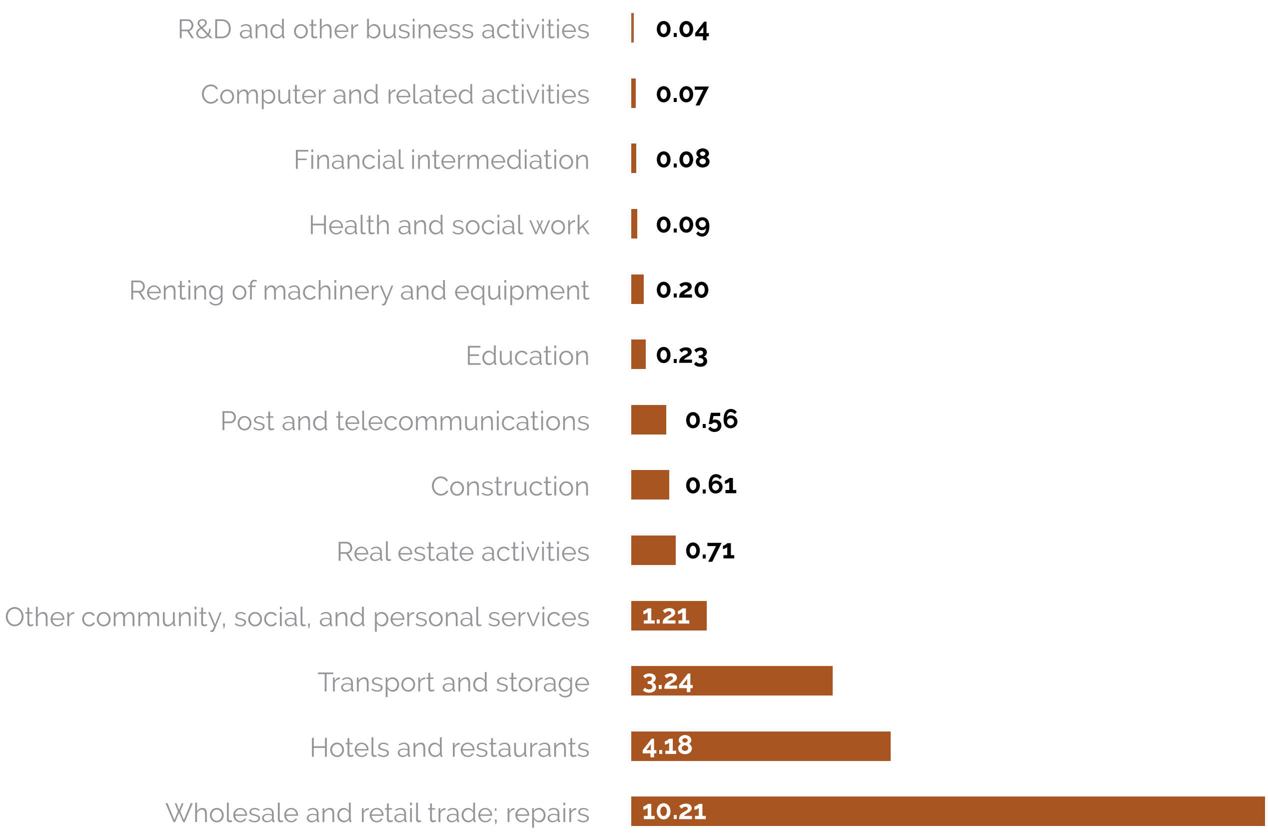
There are differences between services data published in the TiVA database and data published by the WTO. The TiVA database classifies services into 15 major groups according to the International Standard Industrial Classification (ISIC) Rev. 3, divisions 45 to 95. There are 12 services sectors in WTO's Services Sectoral Classification List. A concordance between the two lists can be developed using the UN classification registry.

WTO CLASSIFICATION	***TIVA CLASSIFICATION***
Business services	Construction
Communication services	Wholesale and retail trade; repairs
Construction and related engineering services	Hotels and restaurants
Distribution services	Transport and storage
Educational services	Post and telecommunications
Environmental services	Finance and insurance
Financial services	Real estate activities
Health-related and social services	Renting of machinery and equipment
Tourism and travel-related services	Computer and related activities
Recreational, cultural, and sporting services	R&D and other business activities
Transport services	Public administration and defence; compulsory social security
Other services not included elsewhere	Education
	Health and social work
	Other community, social, and personal services
	Private households with employed persons

As can be seen in Chart 11, wholesale and retail trade—an "enabling service"—was the largest of the 15 services sectors reported in the TiVA database, with over US$10 billion in export value in 2011. Another enabling service—transport—ranked third. Tourist-related services were in second place. This was followed by hotels and restaurants, with US$4.2 billion in export value, and transport and storage, with US$3.2 billion. While high-value services do not currently represent a significant portion of Indonesia's services exports, they are critical to moving up the services value chain for both developed and developing countries. The final grouping—services such as education—is not large, but has exhibited stronger-than-average growth and can be expected to play a more important role in Indonesia's future export picture.

CHART 11: ENABLING SERVICES ARE THE LARGEST SERVICES EXPORTS IN INDONESIA

(value-added direct exports, 2011, US$ billions)



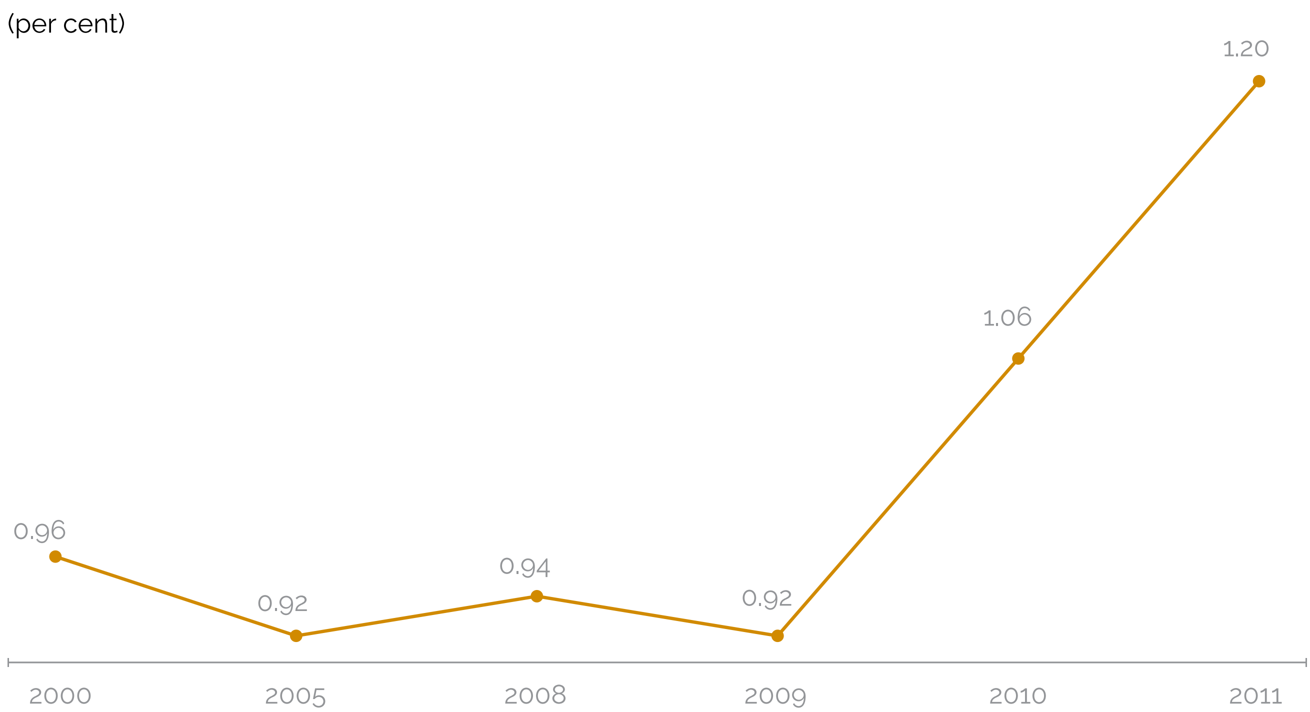
Source: OECD-WTO TiVA Database.

High-Demand Services

Enabling Services

Wholesale and retail trade (WRT) services account for the largest share of Indonesia's direct services exports and comprise one of the most important industries in enabling the efficient movement of goods exports. Indonesia's WRT services industry has captured a slightly larger share of world WRT exports, increasing from 0.96 per cent in 2000 to 1.2 per cent in 2011. (See Chart 12.)

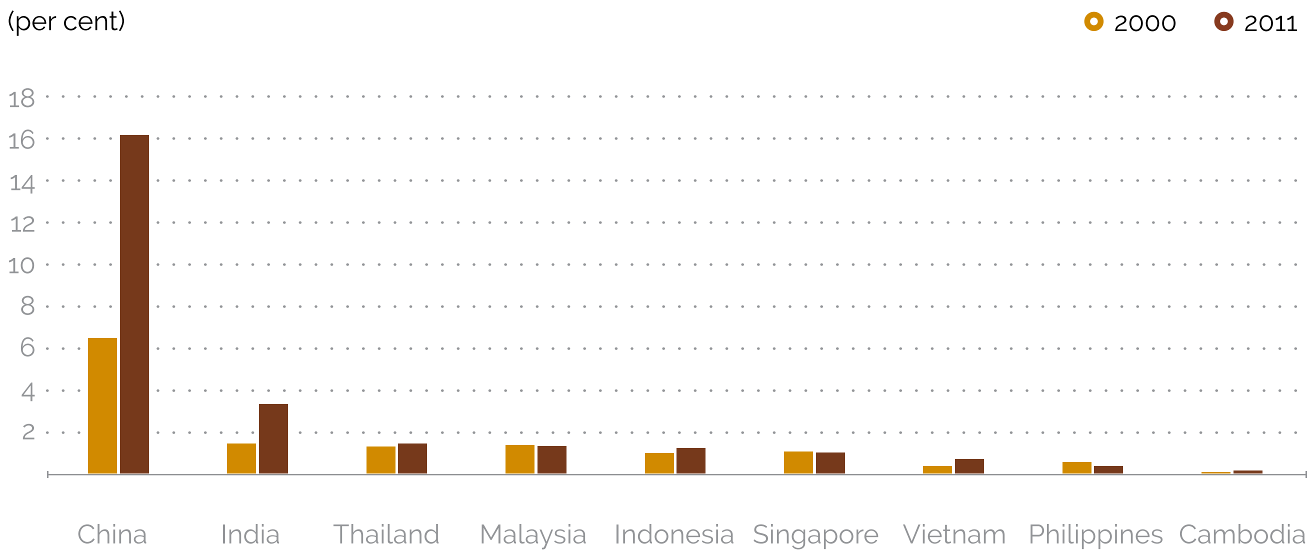
CHART 12: INDONESIA'S WHOLESALE AND RETAIL TRADE IS CAPTURING A LARGER SHARE OF WORLD EXPORTS OF WHOLESALE AND RETAIL TRADE



Source: OECD-WTO TiVA Database.

Among its peer countries, however, Indonesia's increased share of world WRT exports is much smaller than that of China, which increased from 6.4 per cent in 2000 to 16 per cent in 2011. (See Chart 13.) This is mostly due to China's performance in goods exports to the world, as WRT is closely related to goods exports. Indonesia ranked fifth among its peers, behind Thailand and Malaysia, whose world export shares reached 1.4 per cent and just over 1.2 per cent respectively, but higher than Singapore, Vietnam, Philippines, and Cambodia.

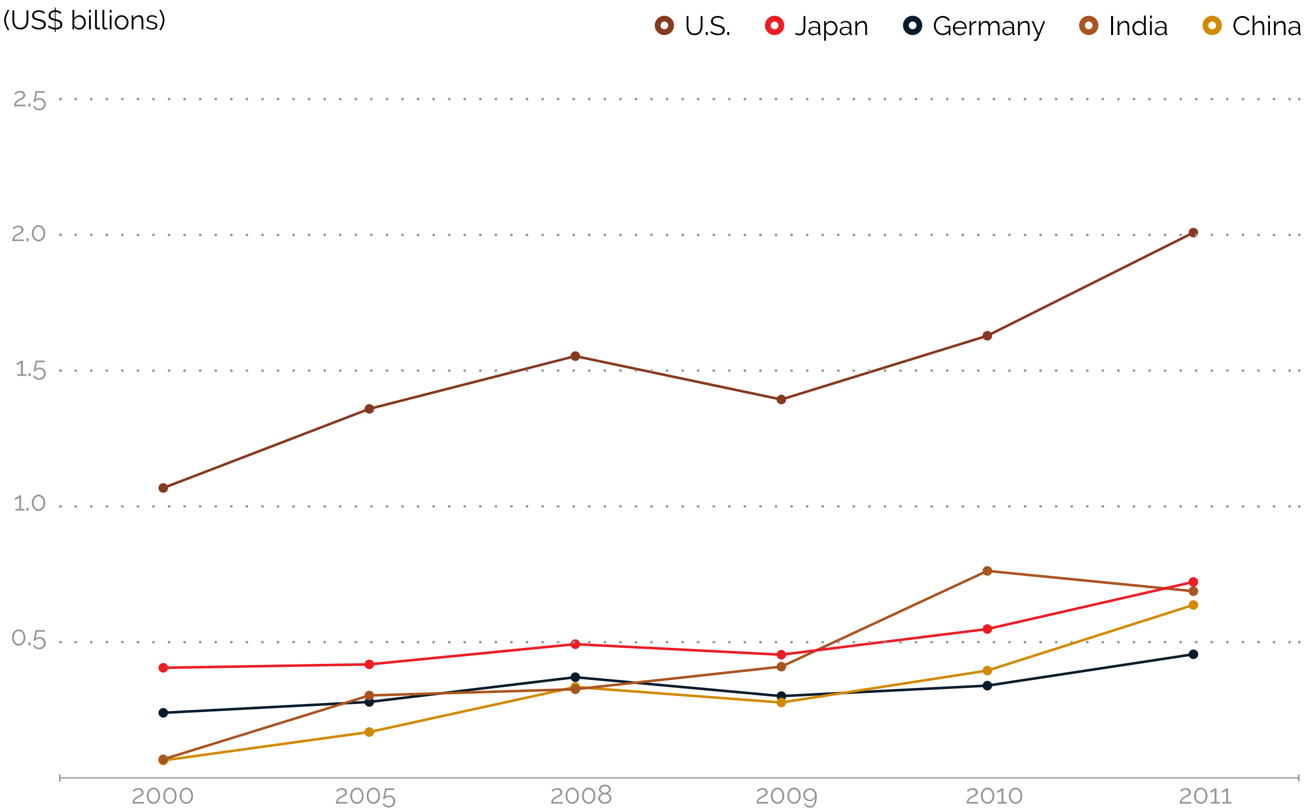
CHART 13: CHINA DOMINATES AMONG PEER COUNTRIES ON WORLD SHARE OF WRT EXPORTS



Source: OECD-WTO TiVA Database.

In 2011, the United States imported just over US$2 billion of Indonesia's WRT services, which was nearly double the value from 2000. (See Chart 14.) This represented 20 per cent of Indonesia's total WRT exports, making the United States the largest importer of Indonesia's WRT services. The other top five destinations for Indonesia's WRT services are Japan, India, China, and Germany, with values ranging from US$455 million to US$700 million in 2011.

CHART 14: THE U.S. IS INDONESIA'S BIGGEST MARKET FOR WRT EXPORTS

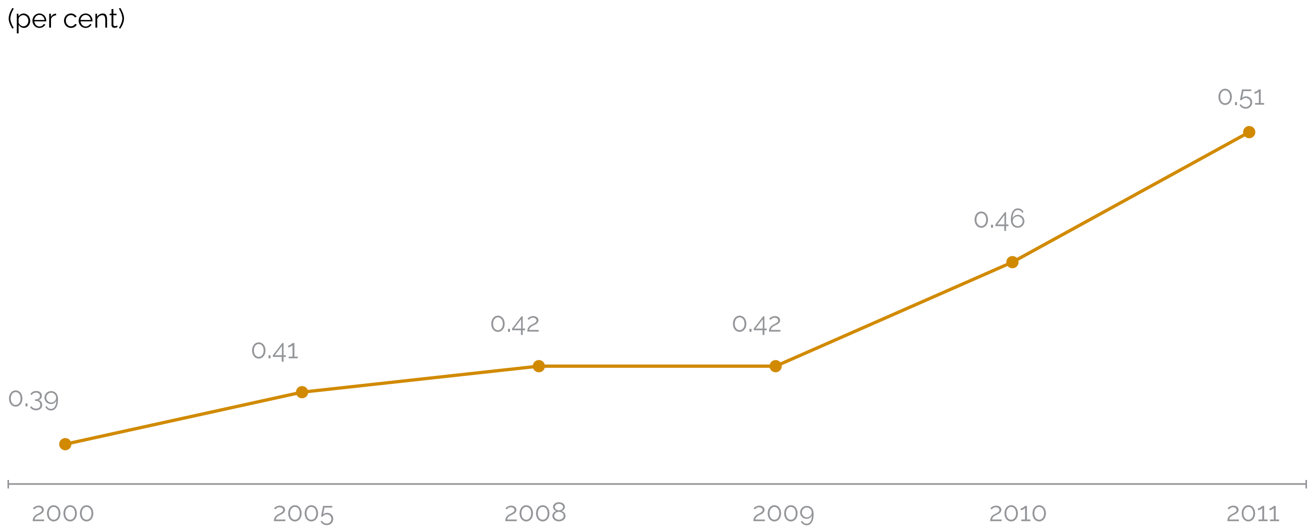


Source: OECD-WTO TiVA Database.

Transport services also play an important role in Indonesia's goods exports. Transportation plays a crucial role in the efficient distribution of goods exports. Improvements in techniques and management principles can improve traffic congestion, delivery speed, service quality, operation costs, and energy savings.[5] Indonesia's share of transport services exports to the world increased from just under 0.4 per cent in 2000 to just over 0.51 per cent in 2011. (See Chart 15.)

5 Tseng, Wen, and Taylor, "The Role of Transportation."

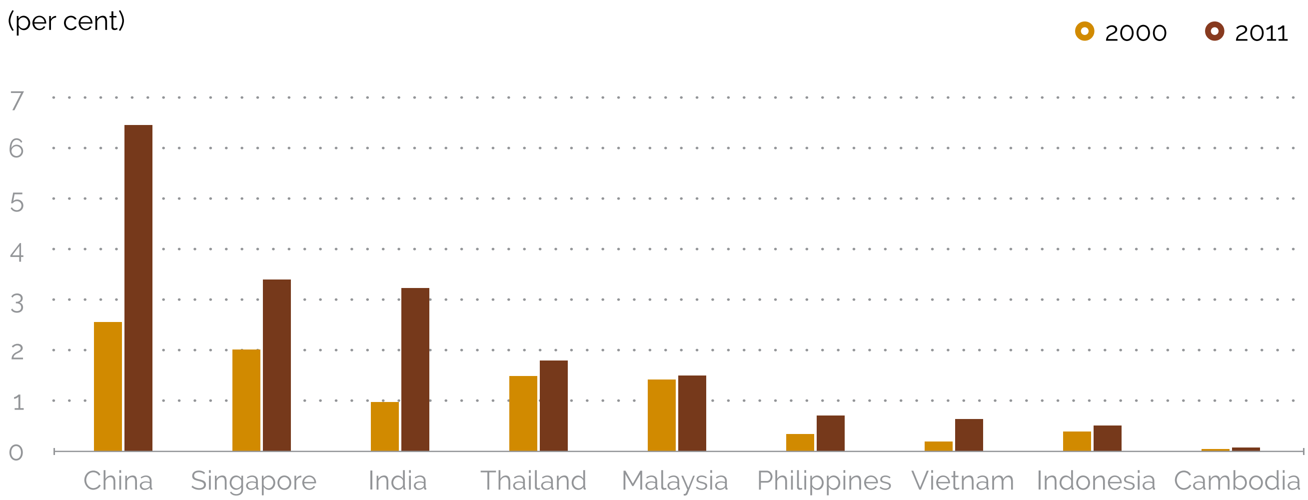
CHART 15: INDONESIA CAPTURES A SMALL BUT GROWING SHARE OF WORLD TRANSPORT AND STORAGE EXPORTS



Source: OECD-WTO TiVA Database.

Compared with its peer countries, Indonesia's transport services exports are low. (See Chart 16.) Cambodia was the only country with a lower share than that of Indonesia. While the Philippines and Vietnam were close, with around a 0.2 per cent difference, Singapore, Thailand, and Malaysia were far ahead. Singapore's share was even higher than that of India. China has been the biggest player throughout; its share rose from 2.5 per cent in 2000 to 6.4 per cent in 2011.

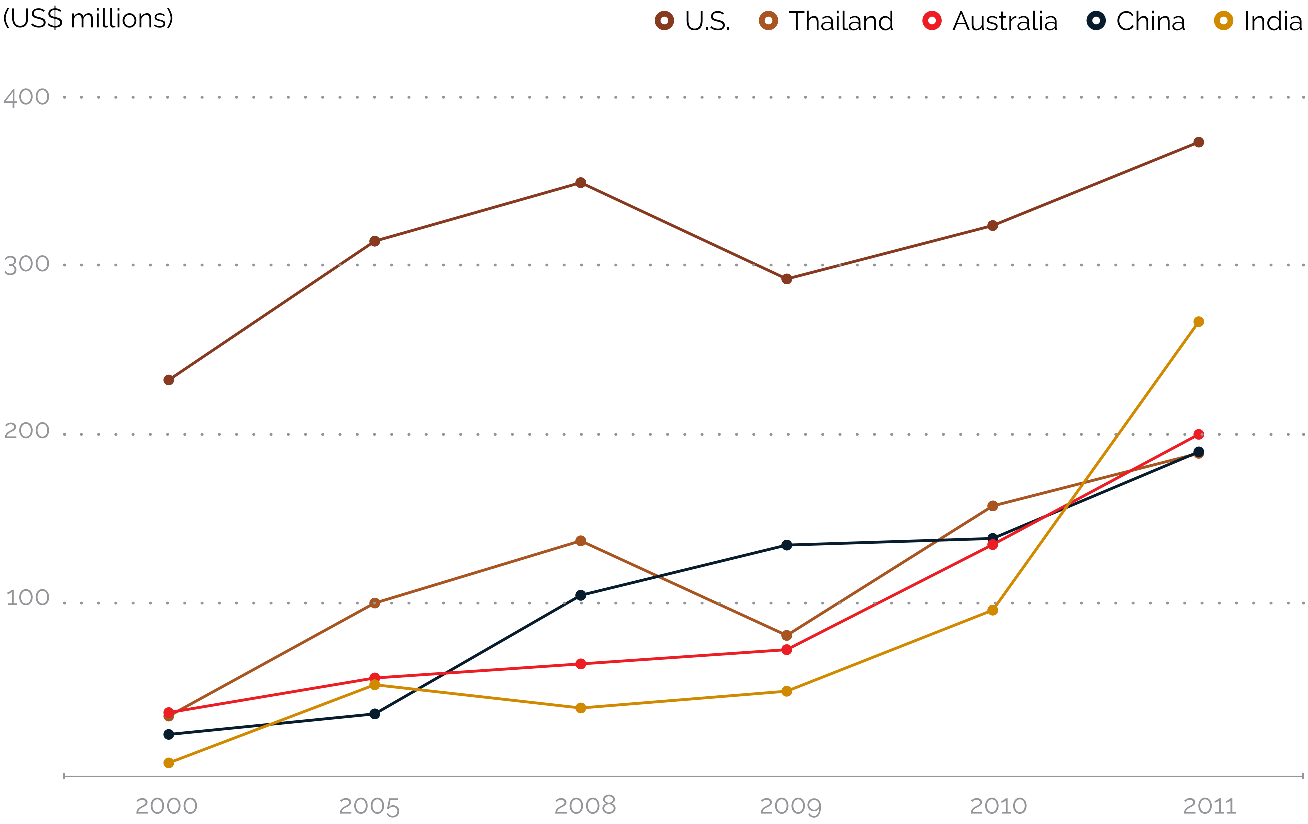
CHART 16: INDONESIA RANKS LOW ON WORLD SHARE OF TRANSPORT AND STORAGE EXPORTS



Source: OECD-WTO TiVA Database.

As was the case for WRT services, the U.S. was the largest of the top five importers of Indonesia's transport and storage services. The value of U.S. imports increased from US$233 million in 2000 to US$374 million in 2011. (See Chart 17.) A sharp increase in imports of Indonesian transport services moved India from ranking in 10th place in 2000 to second place in 2011.

CHART 17: THE U.S. IS INDONESIA'S BIGGEST MARKET FOR TRANSPORT AND STORAGE SERVICES EXPORTS



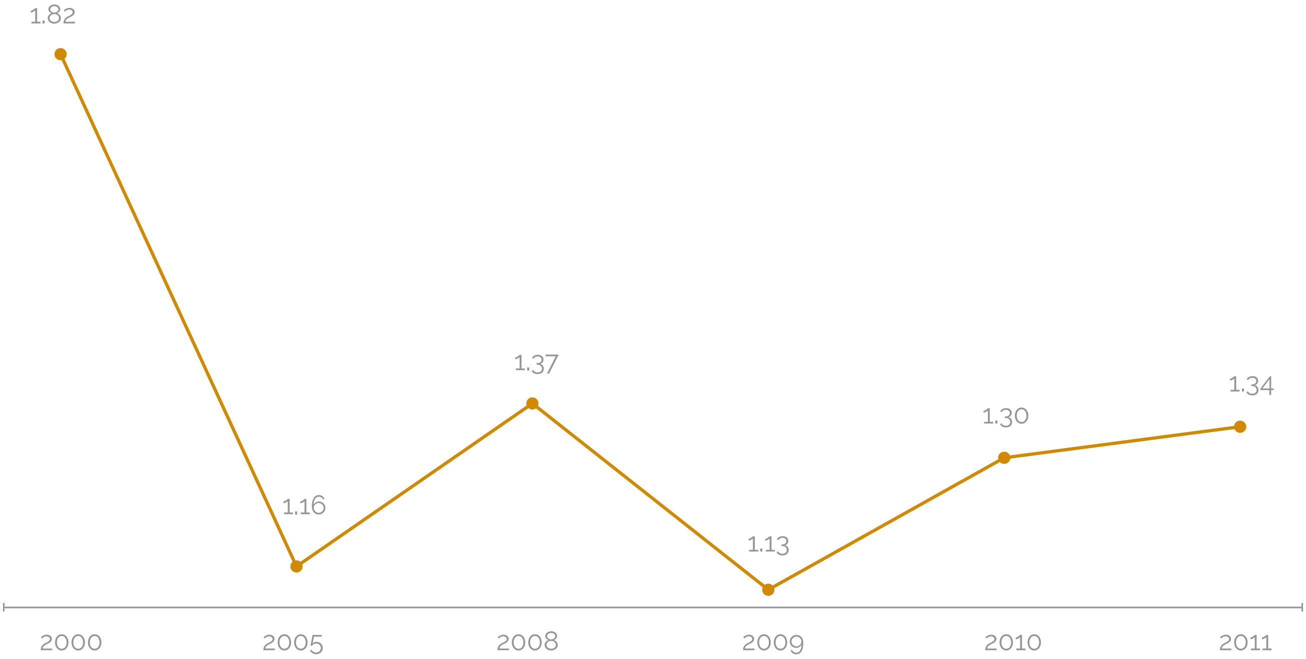
Source: OECD-WTO TiVA Database.

Tourism-Related Services

Hotel and restaurant (HR) services is the main category related to tourism in the TiVA database. This is Indonesia's second largest services export. Indonesia's share of HR services world exports declined between 2000 and 2005, but has been relatively stable since 2008. (See Chart 18.)

CHART 18: INDONESIA HAS LOST MARKET SHARE OF WORLD HOTEL AND RESTAURANT SERVICES EXPORTS

(per cent)

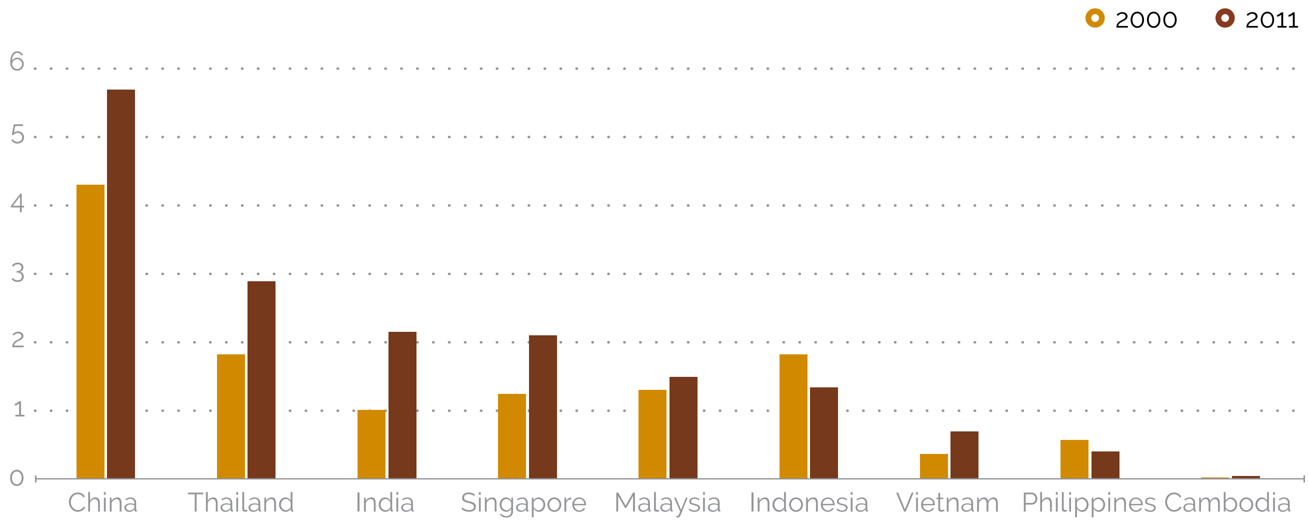


Source: OECD-WTO TiVA Database.

Among their peers, Indonesia and the Philippines are the only countries that experienced a decrease in world export shares over 2000 to 2011. (See Chart 19.) While China has remained in first place over the decade, Indonesia's position has deteriorated. In 2000, Indonesia was ranked second after China. By 2011, Thailand had taken over second position, and Indonesia had moved down to sixth position.

CHART 19: INDONESIA TRAILING PEER COUNTRIES ON SHARE OF WORLD HOTEL AND RESTAURANT SERVICES EXPORTS

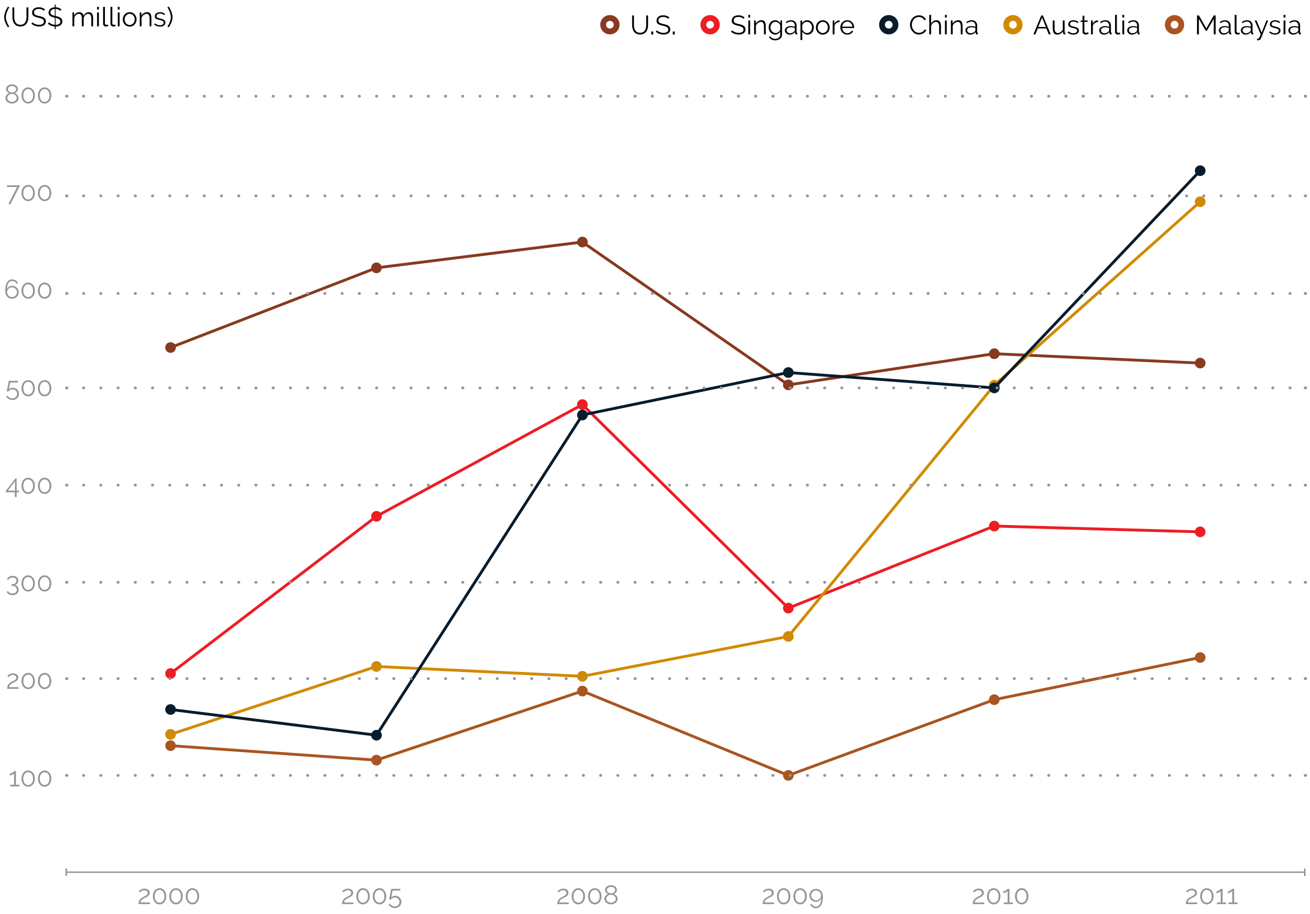
(per cent)



Source: OECD-WTO TiVA Database.

China and Australia are now the top importers of Indonesia's hotel and restaurant exports, with each country importing around US$700 million. (See Chart 20.) The U.S. dropped from being the largest importer of Indonesian HR services in 2000 to third position in 2011. Over the same period, Singapore fell from second to fourth position and Thailand dropped from fourth to 10th spot.

CHART 20: CHINA AND AUSTRALIA JUMP AHEAD OF U.S. AS TOP IMPORTERS OF INDONESIAN HOTEL AND RESTAURANT SERVICES



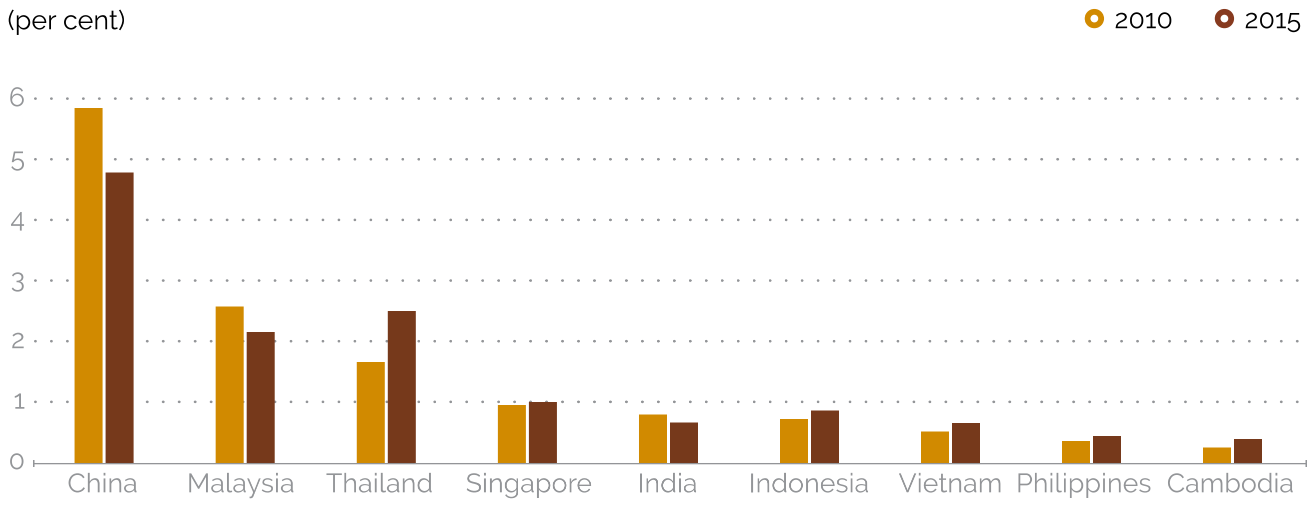
Source: OECD-WTO TiVA Database.

Tourism is an important sector of the Indonesian economy, as well as a significant source of its foreign exchange revenues. Indonesia's tourism sector, defined in TiVA as hotels and restaurants, ranked second largest among all direct services exports. According to data from the United Nations World Tourism Organization (UNWTO), Indonesia's international tourism receipts reached US$9.8 billion in 2014 and accounted for 0.79 per cent of world tourism receipts.[6]

The UNWTO also published data on tourist arrivals that reveal that Indonesia accounted for 0.88 per cent of world tourist arrivals in 2015. (See Chart 21.) Among peer countries, China attracted the most tourists, followed by Malaysia and Thailand. Thailand had a significant rise of nearly 1 percentage point between 2010 and 2015. While China is far ahead of peer countries, it has experienced a decrease in world tourist arrivals.

[6] United Nations World Tourism Organization, *Tourism Highlights*, 9.

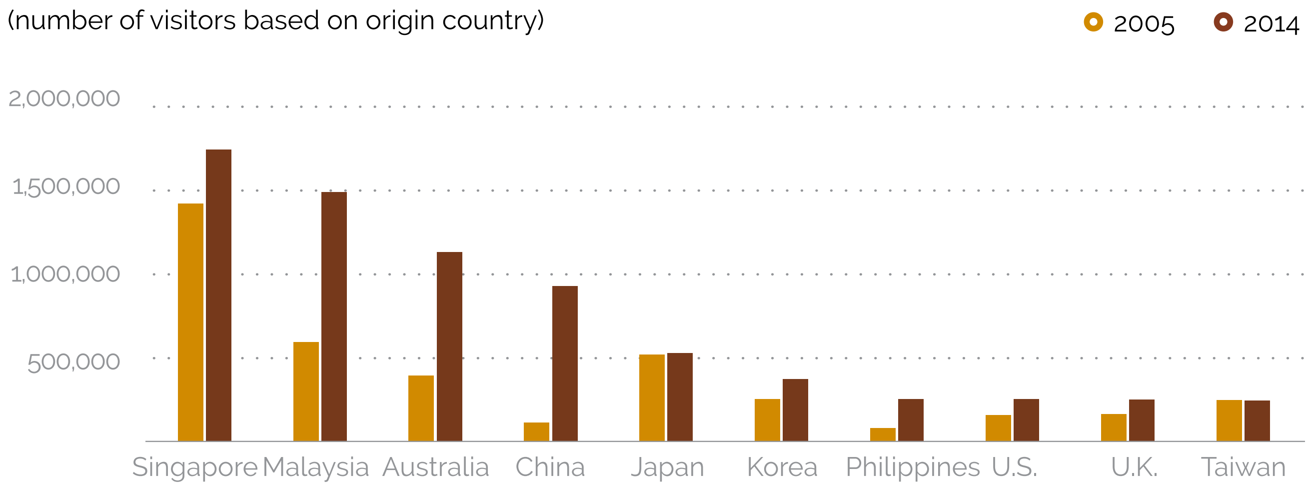
CHART 21: INDONESIA RANKS SIXTH AMONG PEER COUNTRIES IN ATTRACTING TOURISTS



Source: United Nations World Tourism Organization.

According to data from Badan Badan Pusat Statistik, most foreign travelers to Indonesia originate from the Asia/Oceania region, with only two countries from outside that region making up the top 10—the United States and Great Britain. (See Chart 22.) Over 2005 to 2014, the number of visitors from all top-ten countries, with the exception of Taiwan, increased. The largest increases came from Malaysia, China, and Australia.

CHART 22: MOST VISITORS TO INDONESIA CAME FROM ASIA/OCEANIA

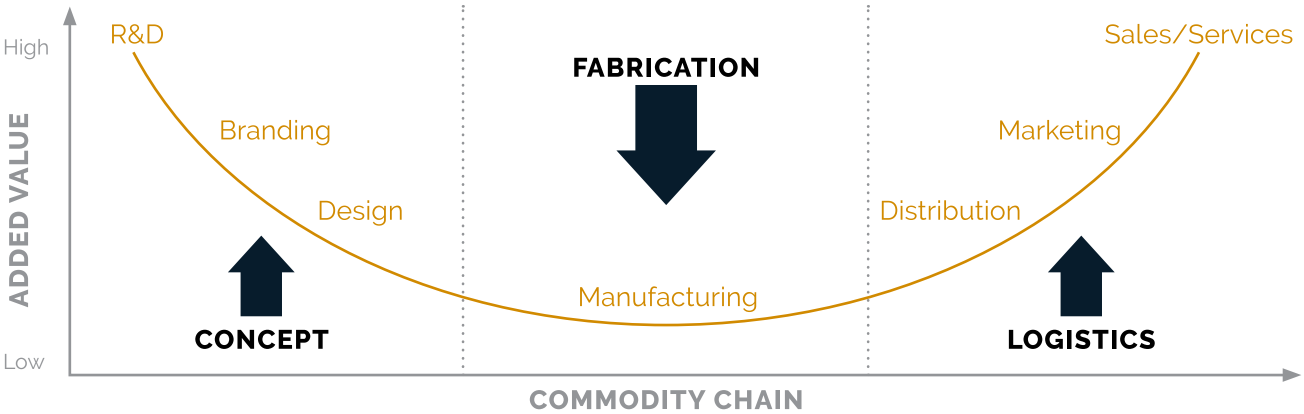


Source: Badan Pusat Statistik.

High-Value Services

Not all services are alike. The well-known "smile curve" proposes that higher-value activities happen at both the beginning and end of the value chain, while lower-value activities occur in the middle. (See Exhibit 2.) At the beginning of the production chain, R&D, intellectual property, and design are high-value activities. Service activities in the middle of the production chain related to distribution are lower-value activities, only slightly higher value-added than the manufacturing of the product itself. At the very end of the chain are the high-value services related to marketing, after-sales servicing, training, and support.

EXHIBIT 2: VALUE-ADDED ACTIVITIES THROUGH THE VALUE CHAIN

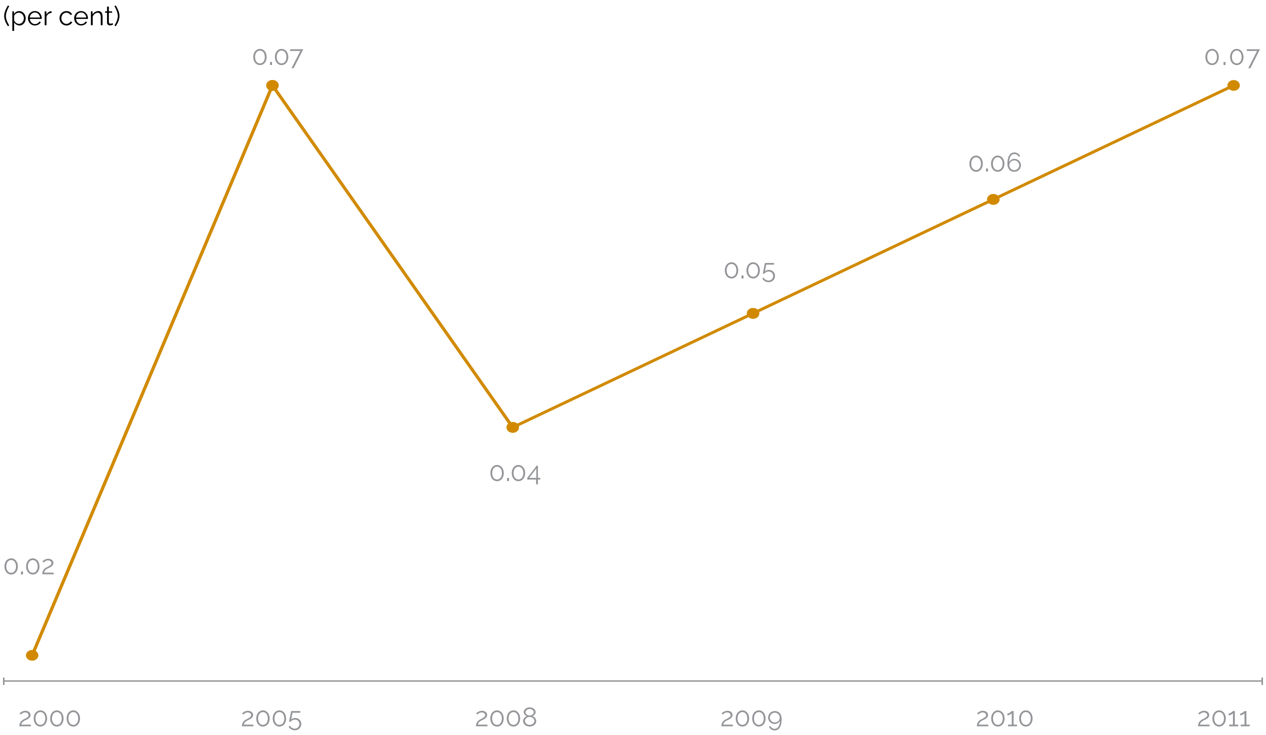


Source: Adapted from the Stan Shih concept.

In the TiVA database, high-value services are captured in two categories: 1) research and development and other business services, and 2) computer and related services. These two categories support innovation and are associated with increased competitiveness and higher profits.

Research and development and other services (R&D) exports do not represent a significant share of overall exports in Indonesia. After falling in 2008 during the global financial crisis, the share has, however, regained its pre-2008 level. (See Chart 23.) In Indonesia, as in many other developing countries, R&D has not been a high priority. This is because most developing countries compete more on a cost basis rather than using innovation to move up the value chain to capture market share. However, as countries develop, innovation becomes more important. This can be seen in the case of China, which finds itself focusing more on innovation as it becomes wealthier and no longer competes solely on cost.

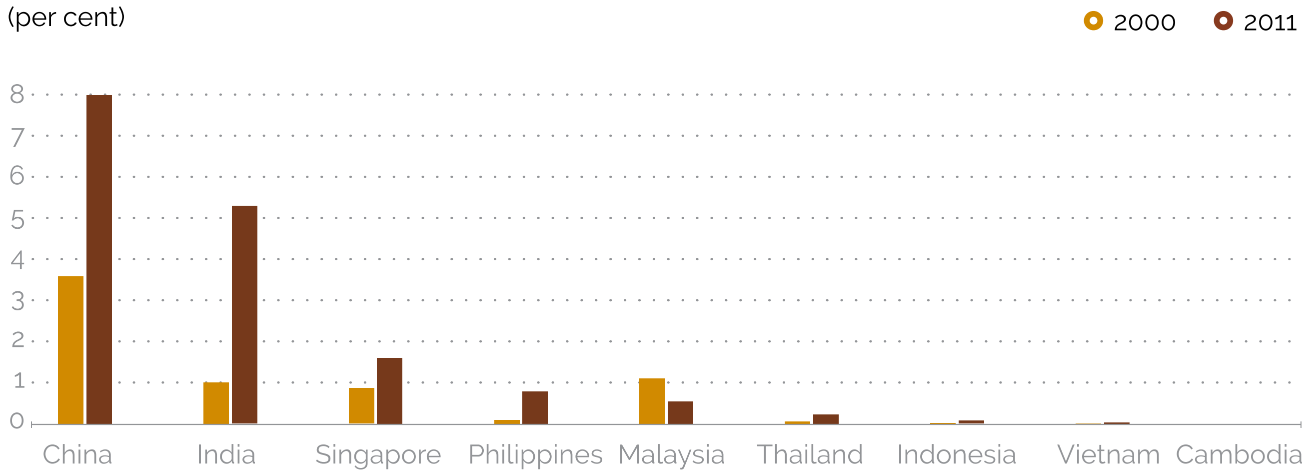
CHART 23: INDONESIA CAPTURES A SMALL SHARE OF WORLD R&D SERVICES EXPORTS



Source: OECD-WTO TiVA Database.

Among its peer countries, Indonesia lies in seventh position, ahead of only Vietnam and Cambodia. (See Chart 24.) China and India lead the pack. Thailand is one rank above Indonesia, but its world share was three times that of Indonesia. Malaysia saw a decrease in market share, from just over 1 per cent in 2000 to only 0.5 per cent in 2011, while Singapore and the Philippines experienced large increases in their shares. India made a leap from just 1 per cent of the world share in 2000 to over 5 per cent in 2011. Not surprising, China is in first place among the peer countries and, in fact, ranks fourth among all countries.

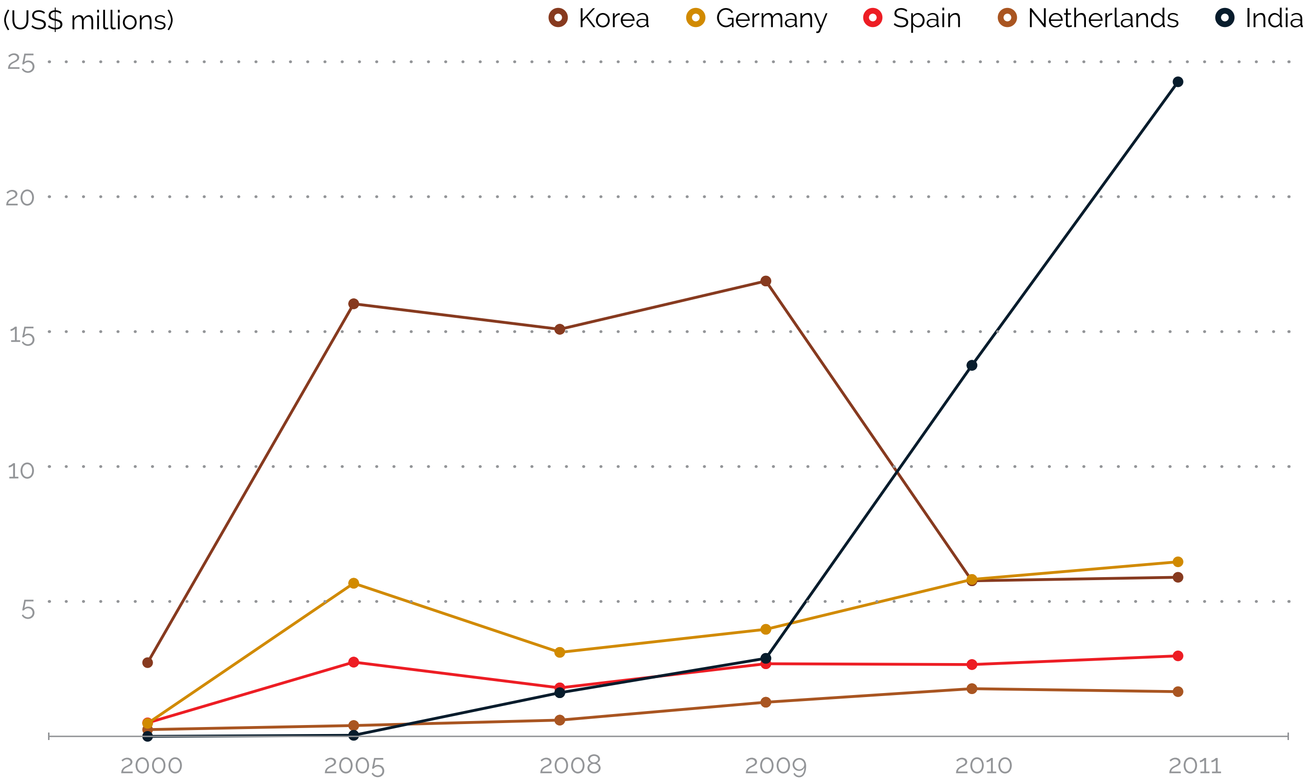
CHART 24: INDONESIA FAR BEHIND MOST PEER COUNTRIES ON SHARE OF WORLD R&D SERVICES EXPORTS



Source: OECD-WTO TiVA Database.

In terms of export destinations, India has been Indonesia's top importer of R&D services with a significant increase in export value from US$3 million in 2009 to nearly US$25 million in 2011. (See Chart 25.) Korea lost its place as Indonesia's top export destination in 2010 due to a sharp decline in export value to that country—from US$16 million in 2009 to less than US$6 million in 2011. Germany inched ahead of Korea to claim second place in 2011.

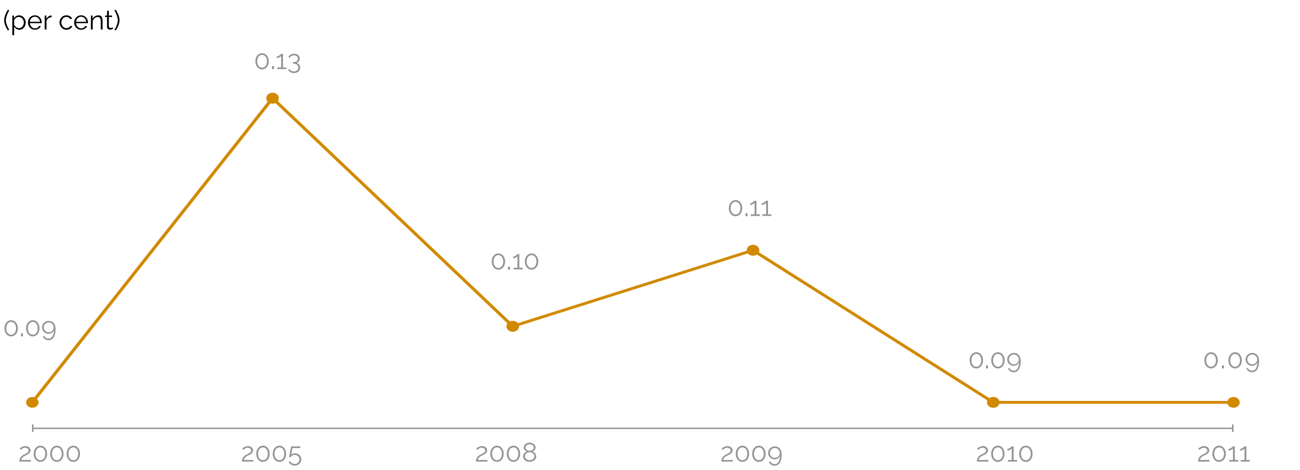
CHART 25: INDIA IS TOP IMPORTER OF INDONESIAN R&D SERVICES



Source: OECD-WTO TiVA Database.

Computer and related services include such services as hardware and software consultancy, data processing, database activities, and maintenance and repair. A 2015 report by Euromonitor on Indonesia's computer-related services stated that this service industry was experiencing strong growth domestically due to expanding demand in e-commerce, cloud computing, and business process outsourcing.[7] Unfortunately, however, exports of computer and related activities have not experienced similar growth. Indonesia's computer and related services accounted for just 0.09 per cent of world exports of these services, which is what it was in 2005. (See Chart 26.)

CHART 26: INDONESIA'S SHARE OF WORLD COMPUTER AND RELATED SERVICES EXPORTS HAS DECLINED

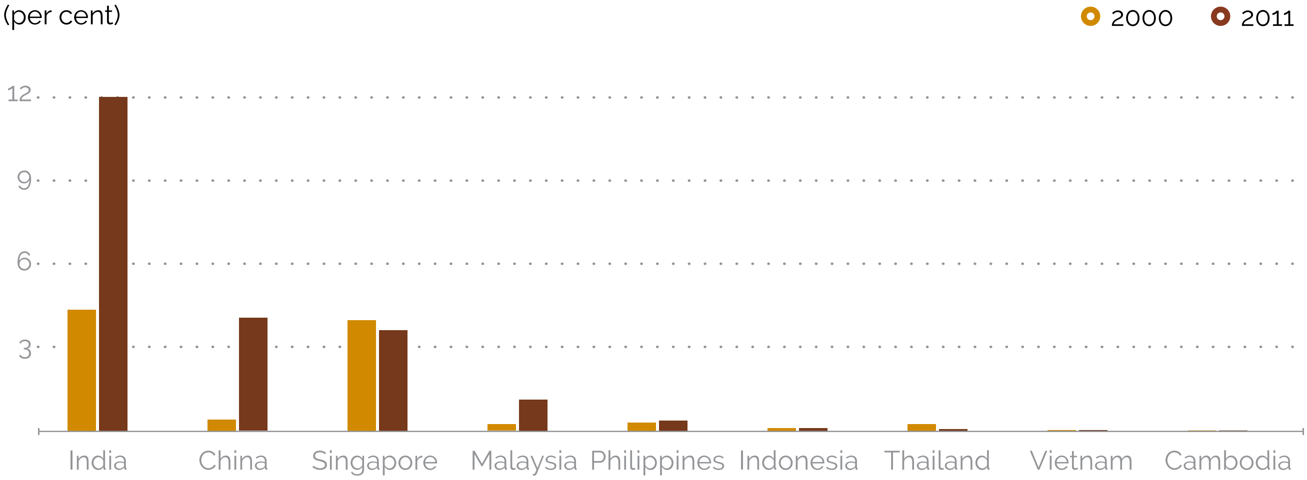


Source: OECD-WTO TiVA Database.

7 Euromonitor International, *Computer and Related Services*.

Among Indonesia's peer countries shown in Chart 27, China, India, and Singapore are doing well, while the remaining six countries, including Indonesia, have a low share of world exports. India has been very successful in exporting computer and related services. Between 2000 and 2011, its world market share nearly tripled. China also experienced an improvement—from 0.4 per cent in 2000 to 4.1 per cent in 2011.

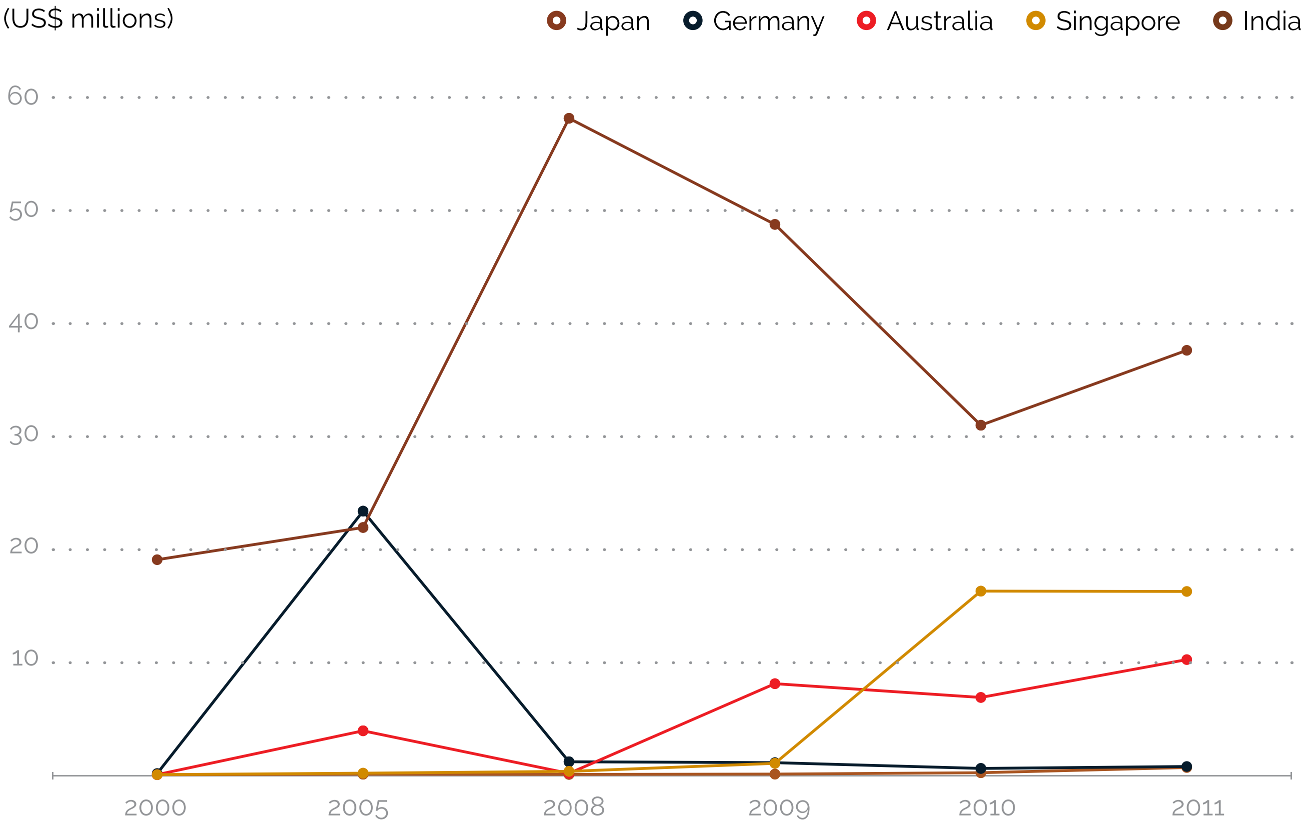
CHART 27: INDIA CAPTURES LARGEST SHARE OF WORLD COMPUTER AND RELATED SERVICES EXPORTS AMONG PEER COUNTRIES



Source: OECD-WTO TiVA Database.

Japan has been the main export destination for Indonesia's computer and related services, with more than US$37 million of export value. (See Chart 28.) The only other significant destinations are Singapore with US$16 million and Australia with US$10 million. Germany and India each accounted for less than US$1 million.

CHART 28: JAPAN IS INDONESIA'S MAIN EXPORT DESTINATION FOR COMPUTER AND RELATED SERVICES



Source: OECD-WTO TiVA Database.

Potential Services

This section examines two of Indonesia's service sectors that potentially could become important exports in the future: 1) education and 2) health and social work. Both services had strong average growth over the 2000 to 2011 period.[8] While still small in value, education services exports grew by a compound annual growth rate (CAGR) of 14.2 per cent, and health and social work exports grew by 11.6 per cent per year.

More than 4 million students were enrolled in post-secondary education outside their country of citizenship in 2013.[9] The U.S. was by far the most popular destination, accounting for 19 per cent of students in 2013. The United Kingdom ranked second, with 10 per cent of international students, and Australia came in third place, with 6 per cent.

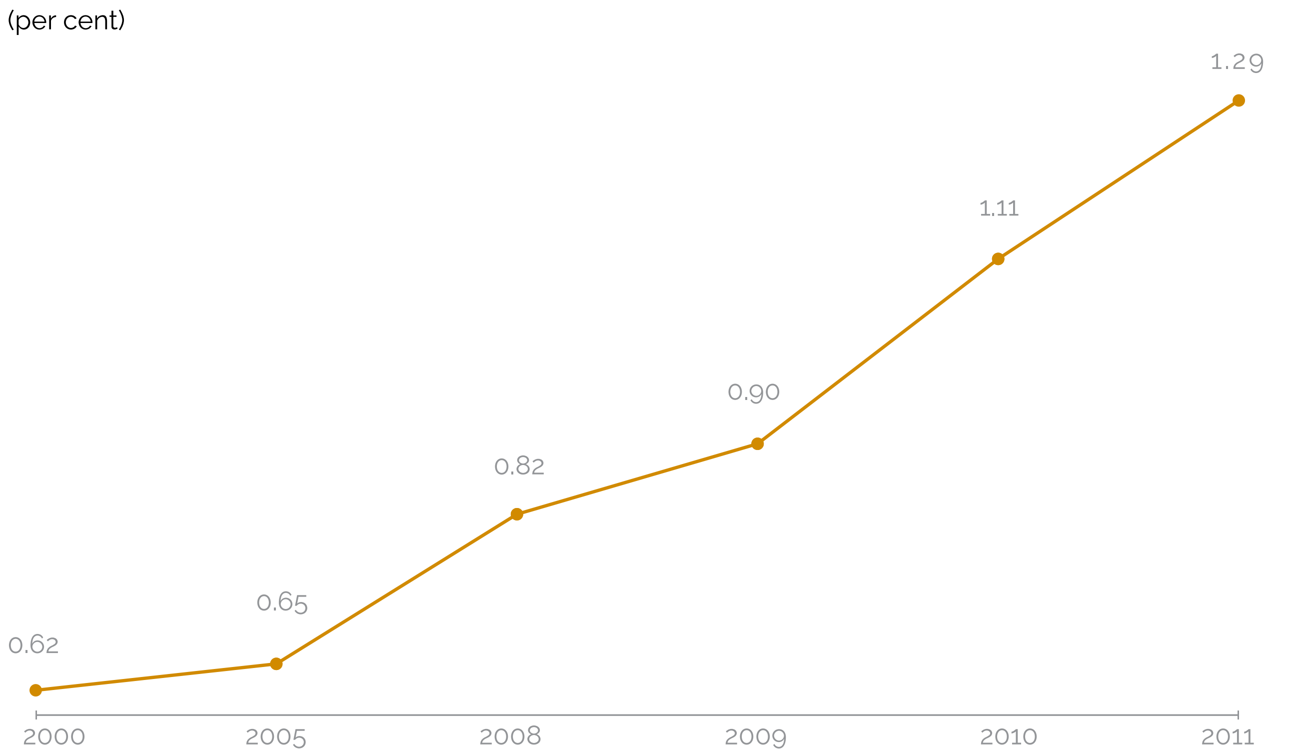
Students from Asia formed the largest group of international students, accounting for 53 per cent in 2013.[10] China alone accounted for 22 per cent of all international post-secondary students, with most going to the United States.

Indonesia has been a net importer of **education** services. Around 39,000 Indonesian students went abroad for their education in 2013 while only 7,235 foreign students came to Indonesia to study.[11] However,

8 The CAGR is the geometric average of the annual growth rates.
9 OECD, *Education at a Glance*, 352.
10 OECD, *Education at a Glance*, 359.
11 UNESCO UIS, *Global Flow*.

Indonesia's education services exports increased steadily from 0.62 per cent of world education exports in 2000 to 1.29 per cent in 2011. (See Chart 29.)

CHART 29: INDONESIA'S SHARE OF WORLD EDUCATION SERVICES EXPORTS IS INCREASING



Source: OECD-WTO TiVA Database.

Nowadays, almost every aspect of our life is affected by globalization. **Health care** is also a service sector being influenced by international trade and globalization. Attracting a lot of media attention recently is the practice of "medical tourism"—travelling to other countries to get medical services.

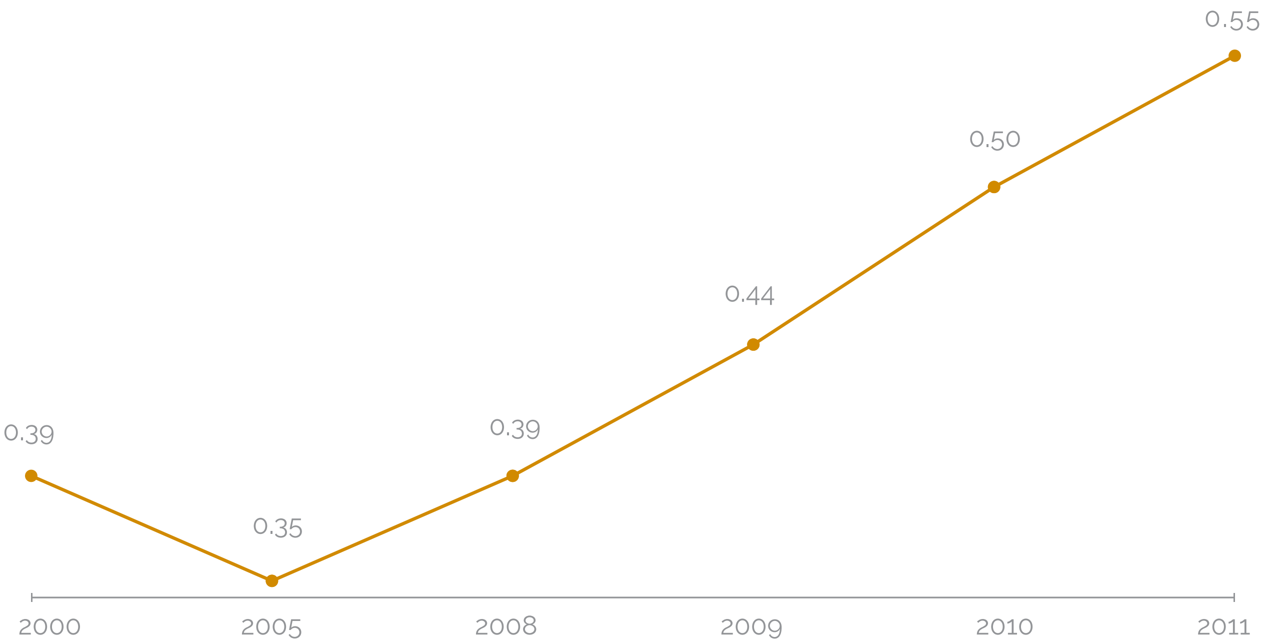
While most trade in health services occurs in the physical movement of a person from their home country to another country to seek treatment, other ways that health services are traded are through pharmaceutical exports/imports, as well as health advice and diagnostic services being delivered via the Internet. Technological advances in information communication systems allow patients or third-party purchasers of health care the possibility to seek out quality treatment at lower cost and/or more immediately from health care providers in other countries.[12]

Indonesia's share of world health and social work exports has increased—from a world share of 0.39 per cent in 2005 to 0.55 per cent in 2011. (See Chart 30.)

[12] OECD, "Trade in Health Services."

CHART 30: INDONESIA'S SHARE OF WORLD HEALTH AND SOCIAL WORK EXPORTS IS GROWING

(per cent)



Source: OECD-WTO TiVA Database.

What Are the Implications of the Findings?

Services are more important than you think

Service-producing industries account for over 70 per cent of the world's gross domestic product. In Indonesia, more than 50 per cent of GDP and employment in 2014 were in service-producing industries. Traditionally, international trade measures have focused on the export of goods. Compared with goods, services are "intangible"—it is often difficult to observe services as they cross borders and add value to trade. But a new database using value-added statistics shows that, in Indonesia, services' share of exports is more than double what traditional trade statistics show. This increase reflects the role of Indonesian services in global value chains.

Indonesia's share of direct services exports has fallen and lags some of its peers

While the value of Indonesia's direct services exports increased from 2000 to 2011, these exports accounted for a smaller share of Indonesia's total exports over that period. While some peer countries also experienced a decline, others did not. More importantly, the share of high-income countries grew.

Indonesia exports mostly "enabling" services

Enabling services—wholesale and retail trade, transport—represent a large share of domestic production and employment. Because they play a significant role in enabling the movement and distribution of goods exports, efficiency is critical to ensuring that consumers have access to a wide variety of goods at competitive prices. Failure of the distribution sector to perform its role well—which can arise if government policies restrict competition—can lead to a significant misallocation of resources and economic costs. Indonesia needs to increase its efficiency in these sectors in order to better compete globally.

Indonesia needs to once again become a top tourist destination
Indonesia's tourism industry has experienced a decline in recent years, with its share of world hotel and restaurant services exports falling. While Indonesia has managed to attract more visitors between 2010 and 2015, it still trails far behind peer countries like China, Malaysia, and Thailand, even though it has been increasing in export value and number of visitors.

Indonesia is not a strong exporter of high-value services
High-valued service activities—such as R&D and computer-related services—happen at the beginning and end of the supply chain. Countries around the world are competing to dominate the market in these kinds of service exports because they bring higher-than-average value to the country that exports. Emerging countries view these service exports as an exciting opportunity to move up the value chain in global markets. They also may, one analyst argues, reinforce inclusive growth.[13] Indonesia needs to focus on improving its competitiveness in high-valued service activities.

Small contribution now, but potentially promising
Education and health care services have the potential to be important exports in the future. While they do not currently account for a large share of Indonesia's exports, they have exhibited strong growth and can potentially contribute more to Indonesia's total services export in the future.

13 Jagannathan, "Tapping Into the Potential."

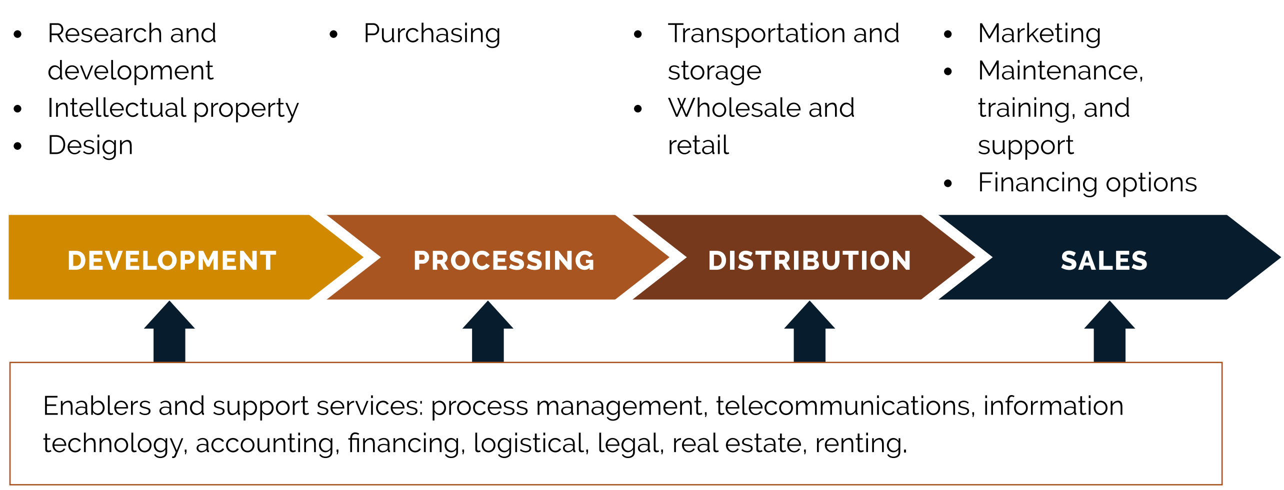
Chapter 2: Services' Contribution to Indonesian Goods Exports

The rise of global value chains has transformed the way we think and talk about international trade. As Chapter 1 revealed, while goods exports still dominate Indonesia's trade picture, services play a much more important role in Indonesia's exports than conventional statistics suggest. The share of services in Indonesia's exports more than doubles when value-added measures of trade are used. This chapter takes that analysis one step further and analyzes the contribution that services make to Indonesia's goods exports, arguing that the value of services embodied in goods exports is substantial and has largely been ignored. Unfortunately, Indonesia's goods exports embody a below-average share of services compared with exports of selected peer countries. This finding is true for all of Indonesia's major goods exports.

How Are Services Embodied in Goods Exports?

Services play a role in creating and supporting goods along the production process at every stage: development, processing, distribution, and sales/after sales. (See Exhibit 3.) Most goods exports could not take place if they were not supported by service activities. For example, in dress manufacturing in the Indonesian garment industry, we can see that service activities are involved from the beginning to the end of the production chain. In the early stage, research is done on consumer preferences and the design is then developed. In later stages, purchasing services may be used to buy fabrics and other inputs, and activities such as sewing and tailoring may be outsourced. In the distribution stage, services involved include warehousing and transportation from the production site to the outlet. Services involved in the final stages include marketing and customer service.

EXHIBIT 3: SOME OF THE WAYS SERVICES ARE EMBODIED IN GOODS



Source: The Conference Board of Canada, adapted from National Board of Trade, Servicification of Swedish Manufacturing.

It is not surprising, therefore, that services are often called the "glue" that holds global value chains together and allow them to operate efficiently. Services can make goods more competitive and the firms that produce those goods more profitable in several ways. (See Exhibit 4.) For example, a coffee producer in Sumatra that creates a unique branding package is differentiating and enhancing its coffee from that of competing countries. Another example is an Indonesian parts manufacturer that includes after-sales services—maintenance and repair—in the price of its good. This added feature not only allows the firm to keep in contact with its customers, it also puts the firm first in line when the part needs to be replaced or upgraded. A report by Deloitte Research noted that, for many of the world's largest manufacturers, after-sales services are more profitable than the good itself.[14]

EXHIBIT 4: HOW SERVICES CAN MAKE GOODS MORE COMPETITIVE AND PROFITABLE

SERVICES CAN ADD VALUE TO GOODS BY...

Differentiating and enhancing	Lowering costs	Building customer relations
Examples	Examples	Examples
Research and development	Information and communications	Training and education
Branding	Efficient logistics and transport	Maintenance and repair
Design	Process management	Financing options

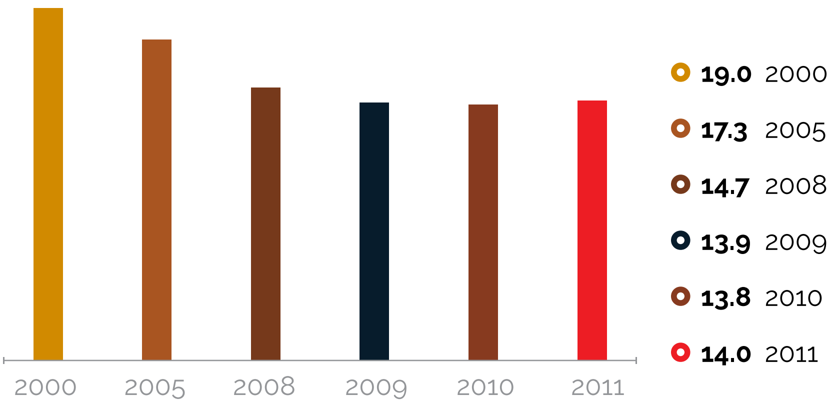
Source: Palladini.

In 2011, the most recent year of TiVA data, services embodied in goods accounted for 14 per cent of Indonesia's goods exports. (See Chart 31.) This is lower than the share in 2000 and mainly attributable to slow growth in the services embodied in three manufacturing sectors: chemicals and chemical products; computer, electronic, and optical equipment; and coke, refined petroleum products, and nuclear fuel.

14 Koudal, *The Service Revolution*, 5.

CHART 31: INDONESIA'S SHARE OF SERVICES EMBODIED IN GOODS EXPORTS HAS FALLEN

(value-added services, per cent)

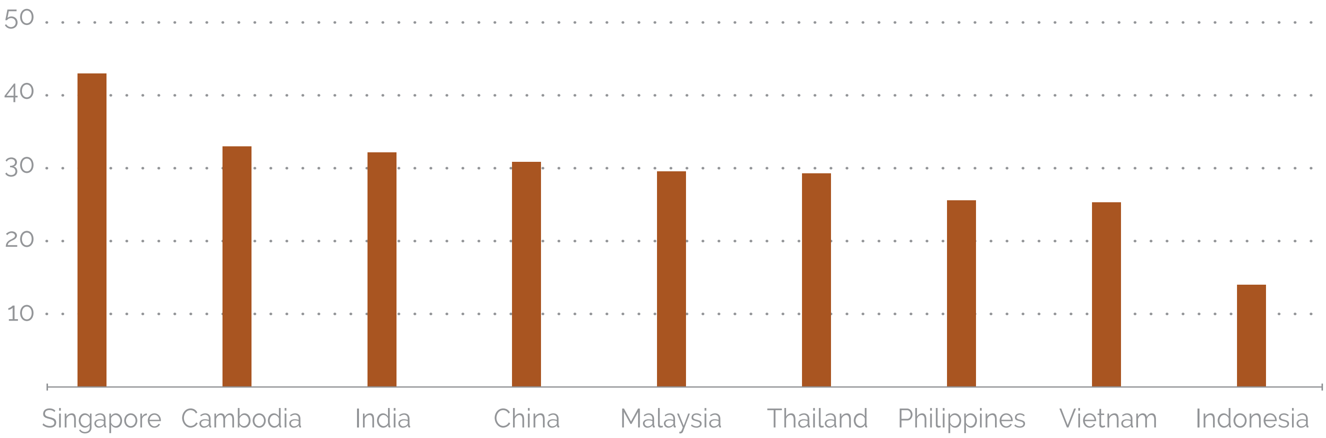


Source: OECD-WTO TiVA database.

While the contribution of services to Indonesian goods exports inched up slightly in 2011, this share is much lower than those of peer countries. (See Chart 32.) Singapore, at 43 per cent, has the highest share, followed by Cambodia and India. The closest peer country to Indonesia is Vietnam, but its share of services embodied in goods exports is almost double that of Indonesia.

CHART 32: INDONESIA'S SHARE OF SERVICES EMBODIED IN GOODS EXPORTS IS LOWER THAN ITS PEERS

(value-added services embodied in gross exports by origin, 2011, per cent)



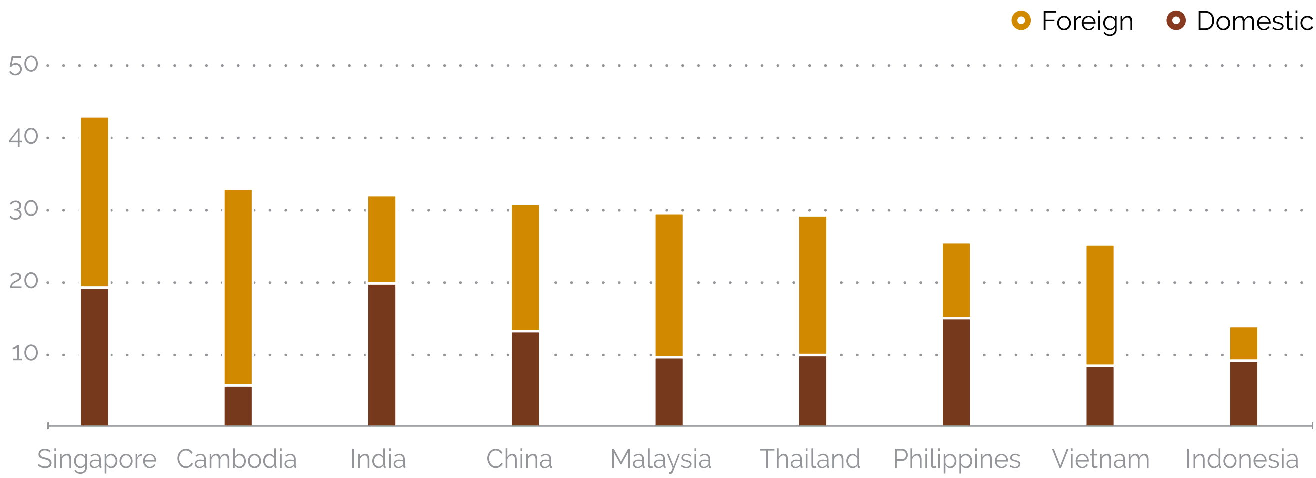
Source: OECD-WTO TiVA database.

Does Indonesia Take Advantage of Global Supply Chains in Services?

To better understand Indonesia's performance compared with its peers, the share of services embodied in goods exports shown in Chart 32 is broken down into two components in Chart 33. The first component is the share of domestic services embodied in goods exports. An example is an Indonesian textile producer buying fabric designs from an Indonesian design company. The second component is the share of foreign services embodied in goods exports along global supply chains. An example is an Indonesian textile producer buying fabric designs from a German design company. These simple examples illustrate the fact that service providers in every country face competition from foreign firms that can also supply those services.

CHART 33: INDONESIA'S GOODS EXPORTS EMBODY BOTH DOMESTIC AND FOREIGN SERVICES

(share of domestic and foreign value-added services embodied in goods exports, 2011, per cent)



Source: OECD-WTO TiVA database.

Viewing the foreign share embodied in goods exports as "bad" and the domestic share as "good" has been shown to be outdated. Imported services can help improve a country's export competitiveness. This conclusion is based on the theory of global supply chains where countries import those goods or services for which it does not have a comparative advantage. Taking advantage of the most efficient and cost-effective services inputs, no matter where they are located, makes good business sense. A recent joint study by the OECD, WTO, and World Bank states that global value chains (GVCs) are critical to improving the competitiveness of developing countries:

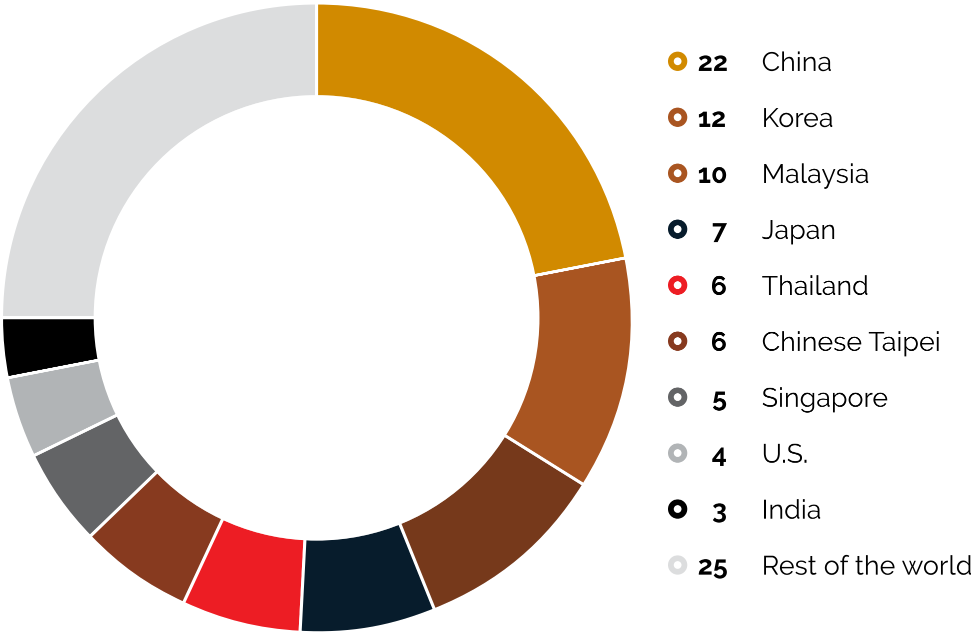
> GVCs are especially important for developing countries, for which the best metaphor would not be a chain but a ladder. The disaggregation of production into separate stages allows their firms not only to find their place on the ladder, but to move up the rungs as their capabilities improve. GVCs encourage that upward movement by rewarding skills, learning, and innovation. Overcoming obstacles to GVC participation can pay big dividends; developing economies with the fastest growing GVC participation have GDP per capita growth rates 2 per cent above average.[15]

Also, being open to foreign service providers is necessary for Indonesia to be able to embody services in other countries' goods exports. In 2011, goods exported from other countries embodied US$13 billion of Indonesian value-added services. China was the biggest user of Indonesian services, followed by Korea and Malaysia. (See Chart 34.) Twenty-two per cent of Indonesia's total embodied services in foreign goods exports are found in Chinese exports, 12 per cent are embodied in Korean exports, and 10 per cent in Malaysian exports.

[15] OECD, WTO, and World Bank Group, *Global Value Chains*, 18.

CHART 34: OTHER COUNTRIES EMBODY INDONESIAN SERVICES IN THEIR GOODS EXPORTS

(share of Indonesian services embodied in foreign goods exports, 2011, per cent)



Source: OECD-WTO TiVA database.

Compared with its peers, Indonesia's share of domestic services embodied in its goods exports is lower than all countries except Cambodia and Vietnam. The largest share is in India, where nearly 20 per cent of the value-added of goods exports is supplied by domestic service providers. By contrast, only 9 per cent of the value-added of Indonesia's goods exports is supplied by Indonesia's service providers.

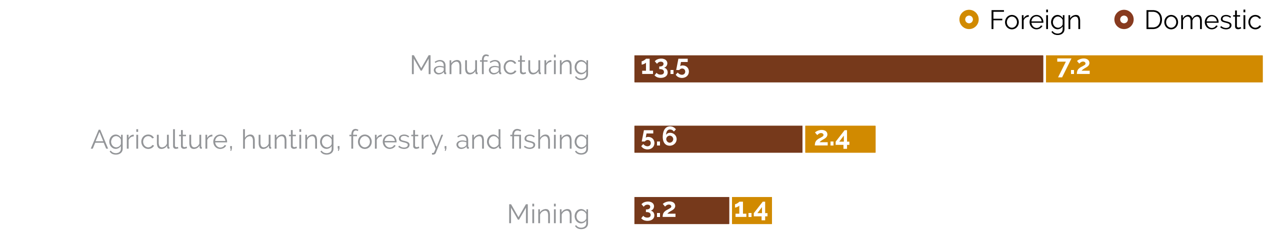
Among its peers, Indonesia has by far the smallest share of foreign services embodied in goods exports—only 4.8 per cent. Cambodia, with 27 per cent of foreign services embodied in its goods exports, has the largest share. A high share of foreign services reflects a high share of integration in global or regional value chains. The share of foreign services in goods exports is typically larger in high-income countries. In six of the peer countries, the share of foreign services in goods exports is larger than the share of domestic services. Indonesia, India, and the Philippines are the three peer countries where the share of foreign services in goods exports is smaller than the share of domestic services.

One explanation for the low share of foreign services in Indonesian goods exports is that countries with large shares of primary commodity exports tend to have a lower foreign services content in their exports. With 44 per cent of its exports coming from the mining sector and 28 per cent from agriculture, hunting, forestry, and fishing,[16] Indonesia's exports are largely resource-based. Only 1.4 per cent of foreign services are embodied in exports from the Indonesian mining sector and 2.4 per cent from the Indonesian agriculture sector. (See Chart 35.)

[16] The agriculture, hunting, forestry, and fishing sector will be referred to as agriculture for short.

CHART 35: INDONESIA'S SHARE OF EMBODIED SERVICES IN EXPORTS IS LOWEST IN MINING

(value-added services embodied in sector exports, 2011, per cent)

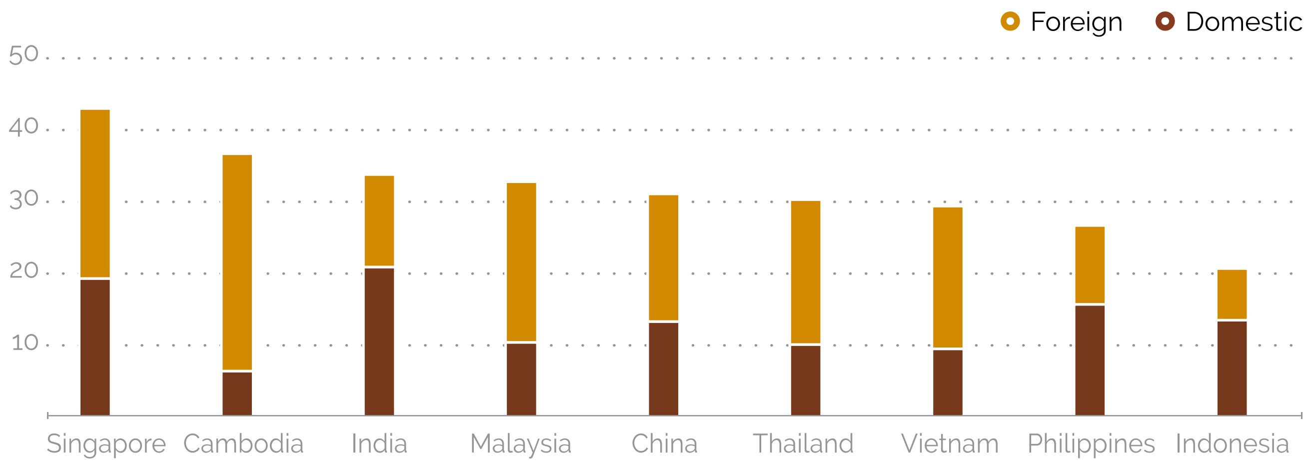


Source: OECD-WTO TiVA database.

While the share of services embodied in Indonesia's manufacturing exports (20.7 per cent) is larger than the shares in agriculture (8 per cent) and mining (4.6 per cent), it is smaller than the share of every one of its peer countries. (See Chart 36.)

CHART 36: INDONESIA'S SHARE OF EMBODIED SERVICES IN MANUFACTURING EXPORTS IS LOWEST AMONG PEERS

(value-added services embodied in manufacturing exports, 2011, per cent)



Source: OECD-WTO TiVA database.

In addition, compared with high-income countries, the share of services in most peer countries is low. A recent study by Lanz and Maurer for the WTO reached similar conclusions—services value-added accounted for nearly 33 per cent of manufacturing exports in developed countries but only 26 per cent in developing countries. In addition, the shares increased over time in developed countries, but remained stable or declined in developing countries.[17] One reason may be that, in Indonesia and other developing countries, the manufacturing sector has been dominated by labour-intensive industries with relatively short supply chains. As a result, the creation of added value is also relatively small and does not rely as much on services.

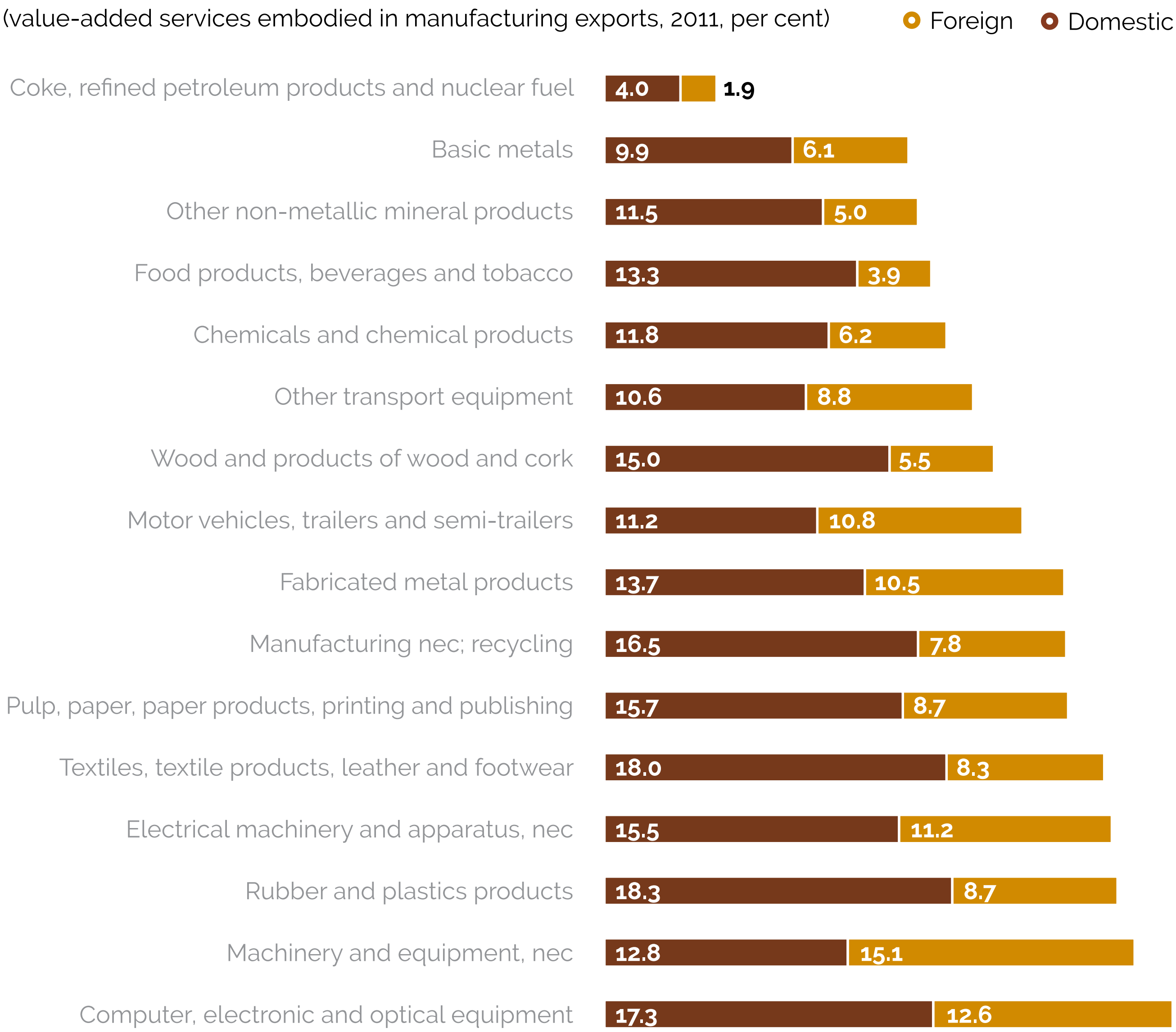
Which Indonesian Manufacturing Sub-industries Embody the Most Services?

Breaking down the overall manufacturing data into 16 manufacturing sub-industries reveals that the share of embodied services in exports varies widely. (See Chart 37.) The share is highest in computer and

[17] Lanz and Maurer, *Services and Global Value Chains*, 9.

electronics and lowest in the coke, refined petroleum, and nuclear fuel. Not surprisingly, the manufacturing sub-industries associated with mining have a low share of embodied services in their exports. The foreign share of services in exports is highest in the machinery and equipment (not elsewhere classified) sub-industry, followed by the computer and electronic sub-industry.

CHART 37: INDONESIA'S SHARE OF EMBODIED SERVICES VARIES BY MANUFACTURING SUB-INDUSTRY



Source: OECD-WTO TiVA database.

Is Indonesia Keeping Up With Its Peers in Key Manufacturing Export Sectors?

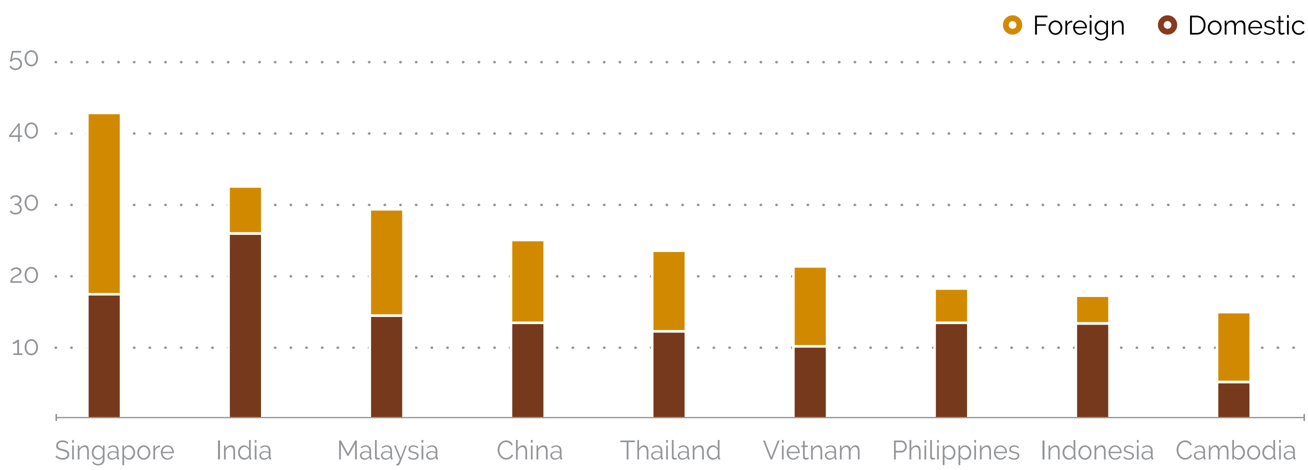
Not all of the 16 Indonesian manufacturing sub-industries shown in Chart 37 are large exporters. In order to evaluate how Indonesia compares with its peers in key manufacturing export sub-industries, value-added data from the TiVA database were used to rank the sub-industries. Indonesia's top five manufacturing export sub-industries in 2011 were:

1. food products, beverages, and tobacco;
2. basic metals;
3. chemicals and chemical products;
4. textiles, textile products, leather, and footwear;
5. computer, electronic, and optical equipment.

In four of the five sub-industries, the share of Indonesia's services embodied in exports was either the lowest or second lowest, compared with peer countries. In the case of the computer and electronics sub-industry, Indonesia was third lowest. (See charts 38 to 42.) In terms of the contribution of foreign services, Indonesia also had the lowest or second lowest share across the five sub-industries. This finding shows that, compared with peer countries, Indonesia's largest manufacturing export industries are relatively isolated from global services supply chains.

CHART 38: INDONESIA'S SHARE OF EMBODIED FOREIGN SERVICES IN FOOD INDUSTRY EXPORTS IS LOW

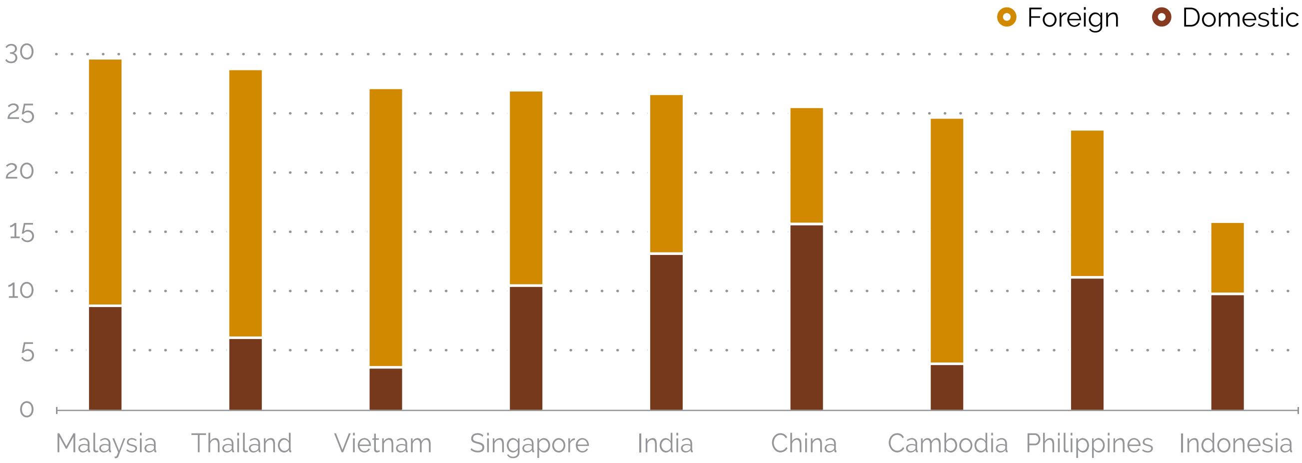
(share of value-added services embodied in food industry exports, 2011, per cent)



Source: OECD-WTO TiVA database.

CHART 39: INDONESIA'S SHARE OF EMBODIED SERVICES IN BASIC METALS INDUSTRY EXPORTS IS LOWEST AMONG PEERS

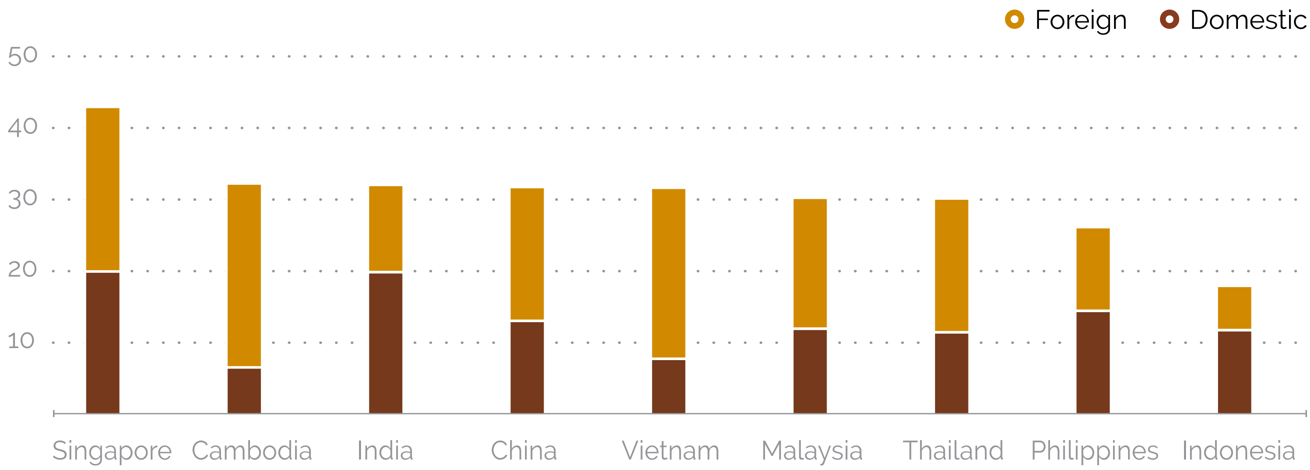
(value-added services embodied in basic metals industry exports, 2011, per cent)



Source: OECD-WTO TiVA database.

CHART 40: INDONESIA'S SHARE OF EMBODIED SERVICES IN CHEMICALS INDUSTRY EXPORTS IS LOWEST AMONG PEERS

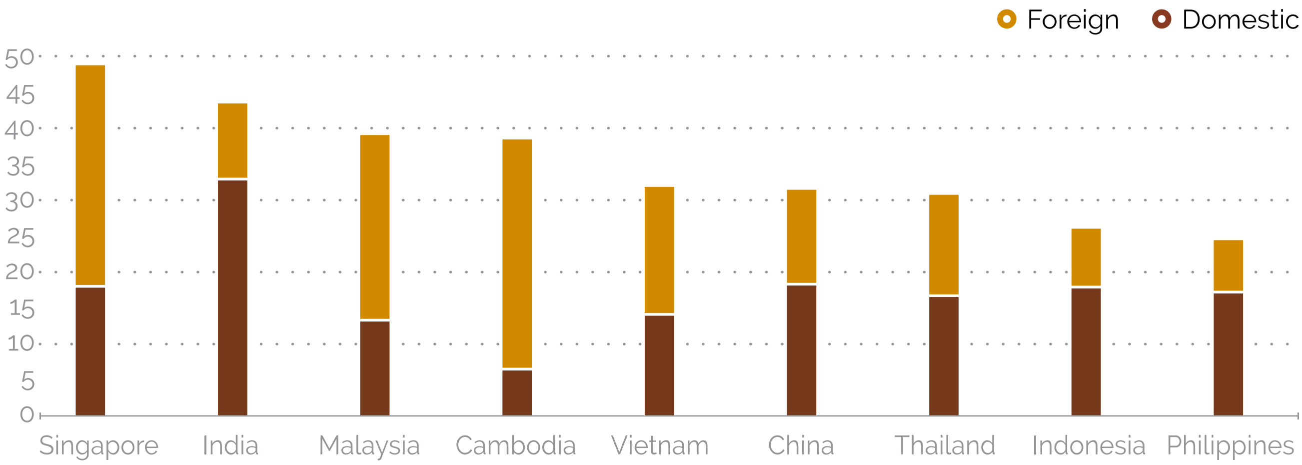
(value-added services embodied in chemicals industry exports, 2011, per cent)



Source: OECD-WTO TiVA database.

CHART 41: INDONESIA'S SHARE OF EMBODIED SERVICES IN TEXTILE AND FOOTWEAR INDUSTRY EXPORTS IS LOW

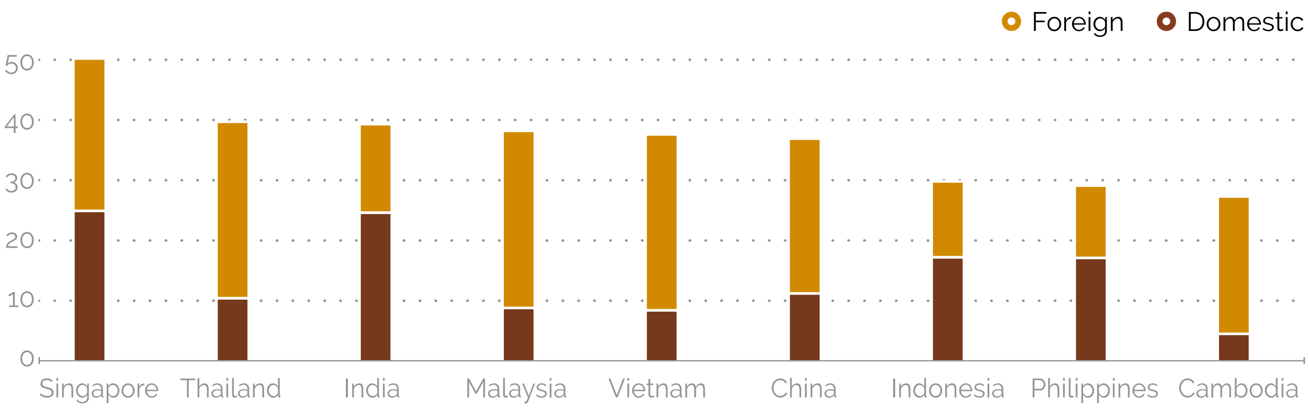
(share of value-added services embodied in textiles and footwear industry exports, 2011, per cent)



Source: OECD-WTO TiVA database.

CHART 42: INDONESIA'S SHARE OF EMBODIED SERVICES IN COMPUTER AND ELECTRONICS INDUSTRY EXPORTS IS LOW

(share of value-added services embodied in computer and electronics industry exports, 2011, per cent)



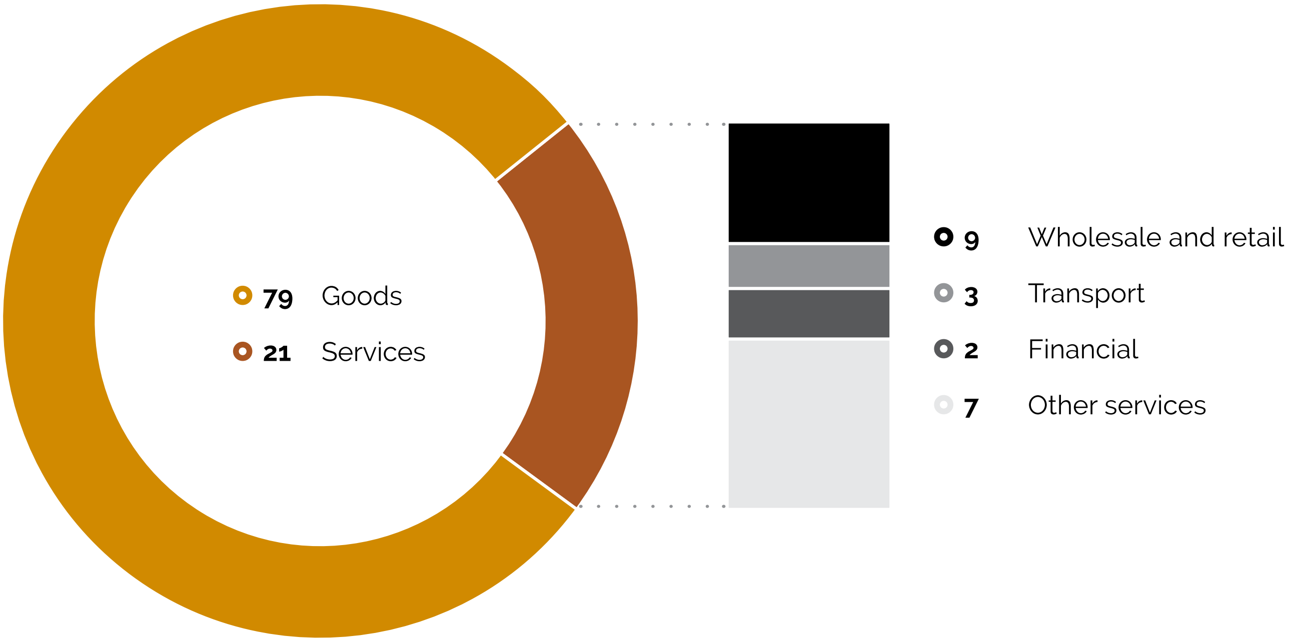
Source: OECD-WTO TiVA database.

What Are the Largest Service Sectors Embodied in Manufacturing Exports?

Chart 35 reveals that nearly 21 per cent of the value of Indonesia's manufacturing exports can be attributed to the services embodied in those manufactured goods. Many types of services make up that 21 per cent. The largest two services embodied in manufacturing exports are related to distribution: wholesale and retail (9 per cent) and transportation and storage (3 per cent). (See Chart 43.) Financial services accounted for 2 per cent and the remaining 12 services together accounted for 7 per cent of the total value of manufactured goods exports.

CHART 43: MANY TYPES OF SERVICES ARE EMBODIED IN MANUFACTURING EXPORTS

(share of value-added services embodied in the exports of manufactured goods, 2011, per cent)



Source: OECD-WTO TiVA database.

The importance of distribution services is not surprising, given the geographic size of the country. Indonesia is an archipelagic country of over 13,000 islands, extending 5,120 kilometres from east to west and 1,760 kilometres from north to south.

While distribution services are generally lower value-added activities compared with other activities along the production chain (see the "smile curve" in chapter 1), these services are still important for Indonesia's export competitiveness. When performed efficiently, wholesale and transport services can lower the overall costs for Indonesian exporters and make Indonesia's goods exports more desirable and competitive to foreign buyers.

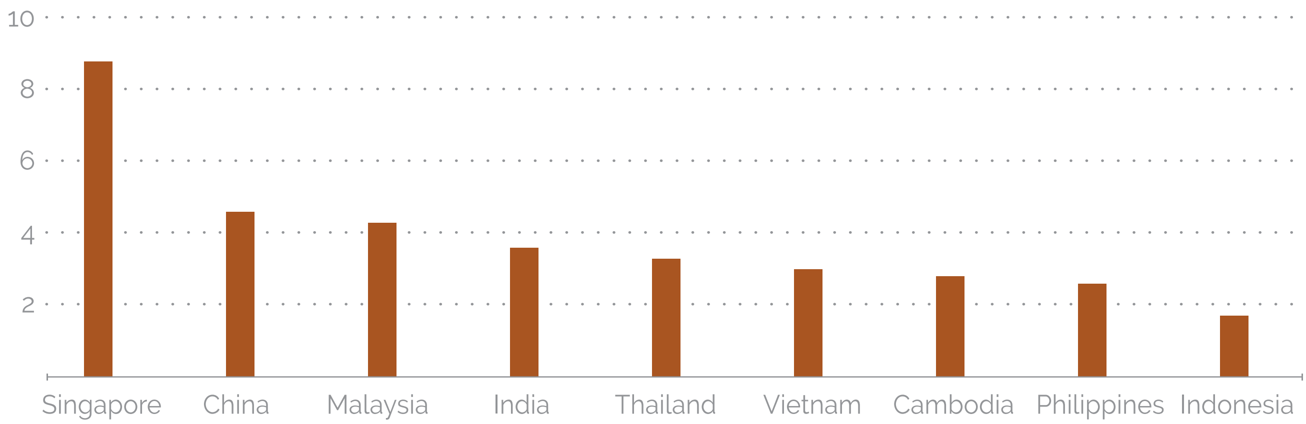
How Does Indonesia Compare With its Peers on High-Value Services?

High-value services are important to the competitiveness of countries.[18] Unfortunately, Indonesian manufacturing exports embody a smaller share of high-value services compared with exports from peer countries. (See Chart 44.) High-value services represent less than 2 per cent of Indonesian value-added in manufacturing exports.

[18] Using the TiVA database, high-value services have been defined as: 1) computer and related activities, and 2) R&D and other business activities.

CHART 44: INDONESIA HAS THE LOWEST SHARE OF HIGH-VALUE SERVICES EMBODIED IN MANUFACTURING EXPORTS AMONG ITS PEERS

(2011, per cent)



Source: OECD-WTO TiVA database.

Indonesia has the lowest share of high-value services embodied in manufacturing exports across all manufacturing sub-industries. Indonesian firms were farthest from the peer average in the pulp, paper, paper products, printing, and publishing sub-industry and closest to the peer average in the fabricated metal products sub-industry. (See Table 1.)

TABLE 1: INDONESIA'S SHARE OF HIGH-VALUE SERVICES EMBODIED IN MANUFACTURING EXPORTS

(Indonesia vs. weighted peer average, 2011, per cent)

	MANUFACTURING SUB INDUSTRY	INDONESIA	PEER AVERAGE	DIFFERENCE
Closest to Peer Average	Fabricated metal products	2.8	3.9	-1.1
	Wood and products of wood and cork	1.3	2.6	-1.2
	Computer, electronic, and optical equipment	4.3	5.7	-1.5
	Electrical machinery and apparatus, nec	3.7	5.3	-1.6
	Food products, beverages and tobacco	0.9	2.6	-1.7
	Textiles, textile products, leather, and footwear	1.6	3.3	-1.7
	Other non-metallic mineral products	1.2	3.0	-1.8
	Manufacturing nec; recycling	1.7	3.6	-1.9
	Other transport equipment	3.0	4.9	-1.9
	Machinery and equipment, nec	3.2	5.2	-2.0
	Basic metals	1.2	3.2	-2.1
	Motor vehicles, trailers, and semi-trailers	2.6	4.7	-2.1
	Coke, refined petroleum products, and nuclear fuel	0.3	2.4	-2.1
	Rubber and plastics products	1.6	4.0	-2.4
	Chemicals and chemical products	1.3	4.4	-3.2
Farthest from Peer Average	Pulp, paper, paper products, printing, and publishing	1.9	5.6	-3.7

Source: OECD-WTO TiVA database.

Most peer countries also have relatively low shares of high-value services compared with high-income countries. For example, the average share of high-value services in manufacturing in EU15 countries was 11.5 per cent. A 2013 study by the OECD explained that a country's level of development will affect the size of its share of high-value services embodied in exports.[19] Countries with large high-technology industries tend to have larger shares. However, high-value services can play a role in helping countries move up the value chain by differentiating their products from those of their competitors and allowing them to charge a higher price.

What Are the Implications of the Findings?

Goods and services are integrally linked

Conventional statistics view services as being distinct from goods. The analysis in this chapter has shown, however, that a range of services are integrated into Indonesia's goods exports. Services accounted for 14 per cent of the value-added of goods exports in 2011. Indonesian firms and government departments must integrate this new reality into their thinking.

Indonesia lags its peers on embodied services

Compared with its peers, Indonesia generally has a lower share of embodied services in its goods exports, and this finding holds across most goods sub-industries. Further study is needed to determine why this is the case.

Lower-value services account for the largest share of embodied services

The largest two services embodied in manufacturing exports are related to distribution: wholesale and retail, and transportation and storage. While not high-value, making these services more efficient and effective will enhance Indonesia's export competitiveness.

Reducing restrictions on services trade will improve the competitiveness of Indonesia's goods exports

Because of the way that services are embodied in goods exports, the OECD argues that "policy distortions in services markets spill over to manufacturing export markets."[20] The OECD study puts forward the following recommendation:

> Tariff reductions, FDI [foreign direct investment] liberalisation, better contract enforcement and reduced time for exports and imports are the low-hanging fruits for low and lower-middle income countries. Such reforms do not require investments or taxing government capacity and scarce resources very much, and would make a relatively large impact as a first step up the value chain.[21]

The joint OECD, WTO, and World Bank study agrees with this recommendation, stating that the institutional context in which firms operate plays a critical role in the success of those firms. In particular, governments can ensure that policies promote the capacity of firms to enhance their competitiveness, attract investment, and insert themselves into global value chains.[22]

Foreign services embodied in Indonesian goods is a good thing

Indonesia's low share of foreign services content in its manufacturing exports may be an indicator of below-average participation in global value chains compared with peer countries. High barriers to FDI in the services sector (as will be discussed in Chapter 3) may be one reason. Other possible reasons for fewer links include the large size of Indonesia's domestic market (potentially allowing it to rely on domestic suppliers instead) and its geographic location (the larger the distance to key manufacturing hubs, the lower the foreign engagement).[23]

[19] Nordås and Kim, *The Role of Services,* 22.
[20] Nordås and Kim, *The Role of Services,* 35.
[21] Nordås and Kim, *The Role of Services,* 35–36.
[22] OECD, WTO, and World Bank Group, *Global Value Chains,* 23.
[23] OECD, WTO, and World Bank Group, *Global Value Chains,* 19.

Chapter 3: The Impact of Investment and Trade Restrictiveness on Indonesia's Services Exports

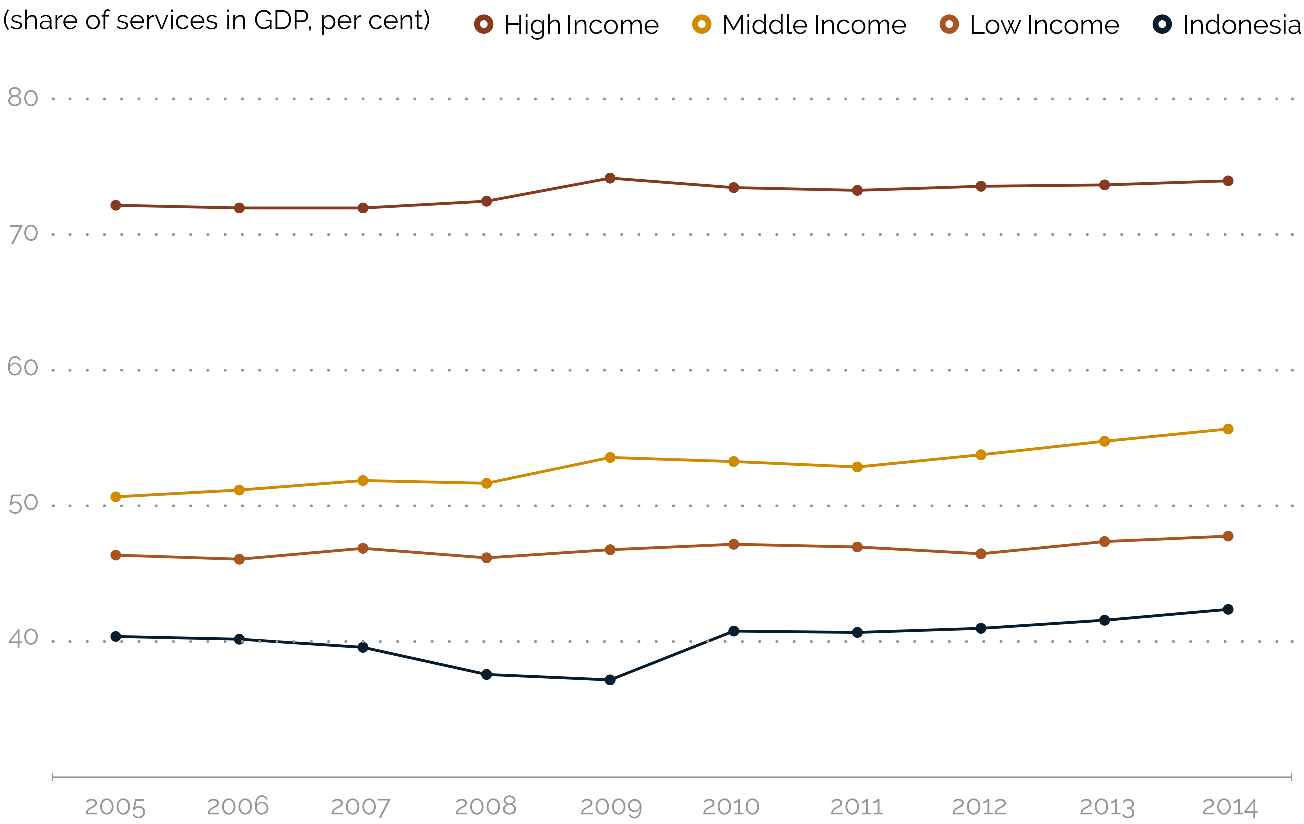
Services play a major role in most economies, particularly in high-income countries. Economic development relies more and more on the expansion of the services sector. However, the contribution of services to Indonesia's economy is small, lagging even that of many low-income countries. One reason for this relatively poor performance may be due to a high level of restrictions on investment and trade in the services sector. The data show that key Indonesian service sectors are more restrictive to foreign direct investment than average, which can impair the international competitiveness of these sectors.

How Important Is the Service Sector?

As demonstrated in chapters 1 and 2, services have increased in importance in Indonesia's economy, accounting for a growing share of GDP, employment, and exports. Despite this, Indonesia still ranks below most countries on these indicators. For example, data from the World Bank's World Development Indicators (WDI) show that 74 per cent of high-income countries' GDP came from services.[24] Middle-income countries averaged 56 per cent. (See Chart 45.) Meanwhile, services in Indonesia only contributed 42 per cent to GDP, below the average of low-income countries, which was around 48 per cent.

[24] The WDI calculates services based on the International Standard Industrial Classification (ISIC) divisions 50–99 and does not include "construction" in its definition. This differs from the BPS data as presented in Chapter 1.

CHART 45: INDONESIA'S SERVICES CONTRIBUTION TO GDP IS BELOW AVERAGE



Source: World Bank, World Development Indicators.

Why Is Indonesia's Services Contribution to GDP so Low?

While it is to be expected that services account for a larger share of GDP in higher-income countries, it does not explain why the contribution of services to Indonesia's economy is below the average for low-income countries. One factor may be Indonesia's high level of restrictions on foreign direct investment in the service sector. Chart 3.2 shows that there is a clear relationship between the share of services in a country and the level of foreign direct investment (FDI) restrictiveness. (See box "How Is FDI Regulatory Restrictiveness Measured?")

HOW IS FDI REGULATORY RESTRICTIVENESS MEASURED?

The FDI Regulatory Restrictiveness Index published by the OECD measures statutory restrictions on foreign direct investment in 59 countries, including all 20 OECD and G20 countries, and covers 22 goods and services sectors. Restrictions are evaluated on a 0 (open) to 1 (closed) scale.

It gauges the restrictiveness of a country in four types of measures:

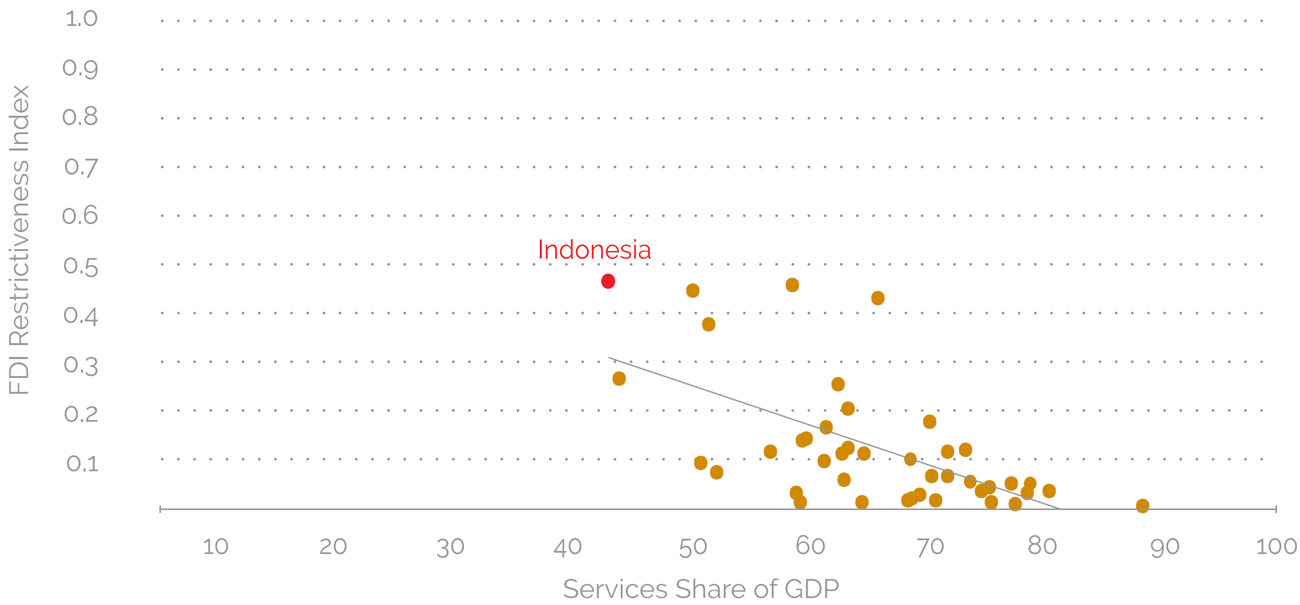
1. foreign equity restrictions
2. screening or prior approval requirements
3. restrictions on the employment of foreigners as key personnel
4. other restrictions on the operation of foreign enterprises (such as limits on the purchase of land or on repatriation of profits and capital)

There are eight services sectors covered, as well as 16 services sub-sectors.

1. distribution
   a) wholesale trade
   b) retail trade
2. transport
   a) land
   b) maritime
   c) air
3. hotels and restaurants
4. media
   a) radio and TV broadcasting
   b) other media
5. telecommunications
   a) fixed telecoms
   b) mobile telecoms
6. financial services
   a) banking
   b) insurance
   c) other finance (including securities and commodities brokerage, fund management, and custodial services)
7. business services
   a) legal
   b) accounting and audit
   c) architectural
   d) engineering
8. real estate

CHART 46: INDONESIA'S HIGH LEVEL OF FDI RESTRICTIVENESS IN SERVICES MAY BE AFFECTING ITS SERVICES CONTRIBUTION

(FDI restrictiveness index, 0 (open) to 1 (closed) scale; services share of GDP, per cent)



Sources: World Bank, World Development Indicators; OECD, FDI Regulatory Restrictiveness Index online database.

Chart 46 maps WDI data on services' share of GDP (horizontal axis) against OECD data on the FDI Regulatory Restrictiveness Index for services industries (vertical axis). Countries that are less restrictive in their policies around tertiary industry FDI tend to have an economy in which services contribute a higher share to GDP. While Chart 3.2 does not prove a causal relationship, the scattered dots show a strong inverse correlation between FDI restrictiveness and services' share of GDP. What is even more interesting to note is that, among the 58 countries for which FDI index data are available, Indonesia has the lowest share of services contributing to GDP and the highest FDI restrictiveness index on services.

In 2015, Indonesia's FDI Regulatory Restrictiveness Index in services overall was 0.466—the most restrictive among all the countries for which data are available. Indonesia is even less open than the Philippines (0.459), China (0.445), Myanmar (0.408), and Malaysia (0.265). The countries most open to FDI in services are Luxembourg (0.007), followed by Netherlands (0.008).

Why Is FDI in Services Important?

Traditional international trade theory views FDI as a way to avoid tariff barriers—a substitute for international trade. The new international trade paradigm—integrative trade—recognizes that inward FDI enhances the ability of firms and countries to improve competitiveness by expanding production, which results in increased economic activity, increased employment, and higher income. Countries now compete to attract FDI because this foreign investment allows the transfer of technology and knowledge and encourages more efficient resource allocation, which help improve productivity. In addition, not only does FDI in the services sector improve the productivity of the targeted industry, it also fosters productivity growth in the rest of the economy, particularly in the manufacturing sector. As such, recent studies looking at the experience of countries such as the Czech Republic, Ukraine, Chile, and Indonesia have confirmed the positive relationship between FDI in the services sector and the productivity of manufacturing firms.[25]

[25] Arnold, Javorcik, and Mattoo, "Does Services Liberalization"; Fernandes and Paunov, "Foreign Direct Investment"; Shepotylo and Vakhitov, "Services Liberalization"; Duggan, Rahardja, and Varela, *Revealing the Impact.*

Is Indonesia's Services Sector More Restrictive Than Other Countries?

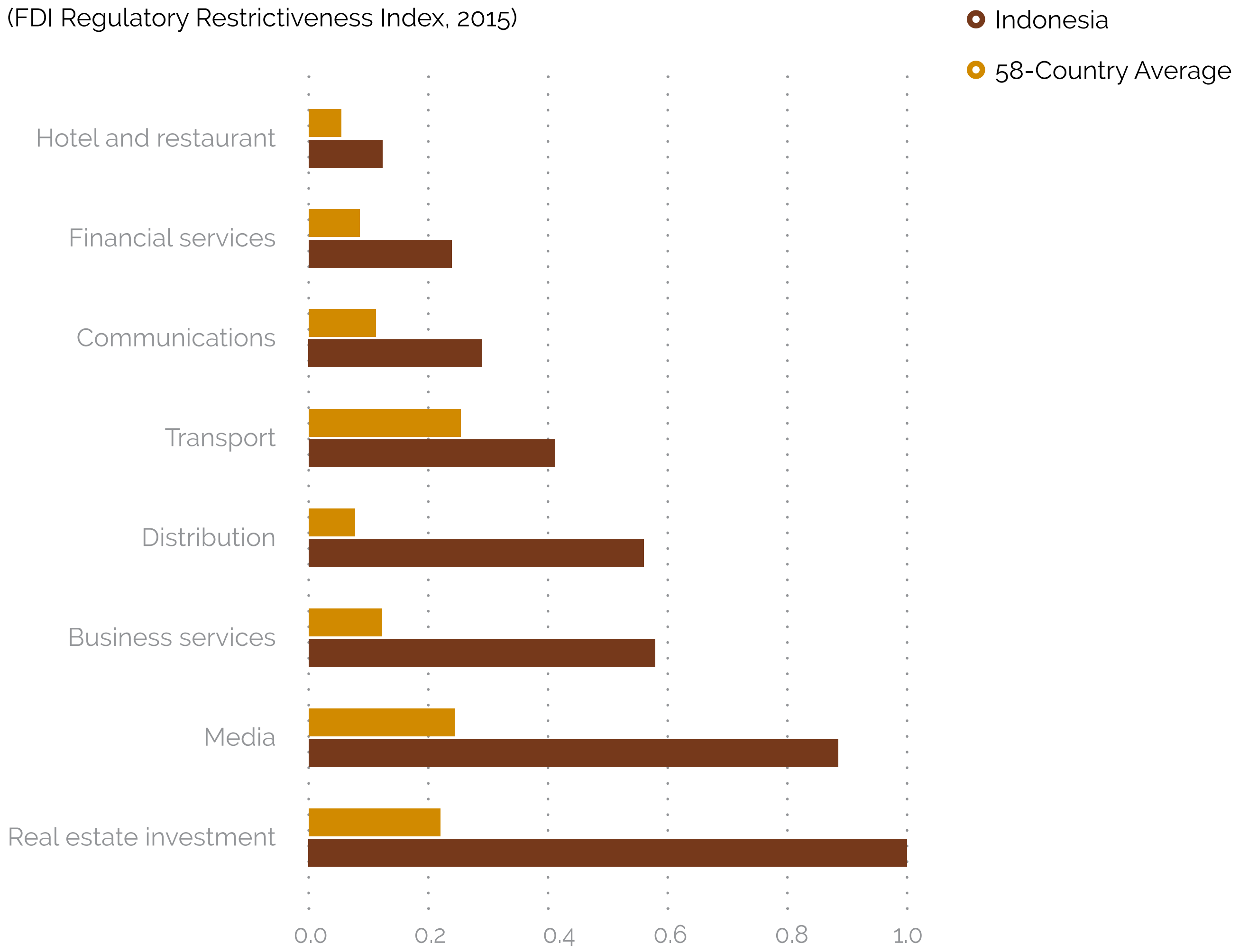
FDI Regulatory Restrictiveness Index

In each of the eight services sectors included in the FDI Regulatory Restrictiveness Index, Indonesia is more restrictive than the average index of the 58 other countries. (See Chart 47.) In fact, Indonesia's FDI Restrictiveness Index for the real estate sector is 1, which means that it is totally closed to foreign direct investment. The most open sector is hotel and restaurant services (0.123).

Chart 47 also shows that there is a wide gap between Indonesia's index and the average. This means that every services sector in Indonesia is more restrictive to foreign direct investment compared with the average. Indonesia's index ranges from 1.6 to 8 times more restrictive than the average. The narrowest gap is in hotel and restaurant services, and the widest is in real estate services.

CHART 47: INDONESIA'S FDI RESTRICTIVENESS IS HIGHER THAN AVERAGE IN EVERY SERVICE SECTOR

(FDI Regulatory Restrictiveness Index, 2015)

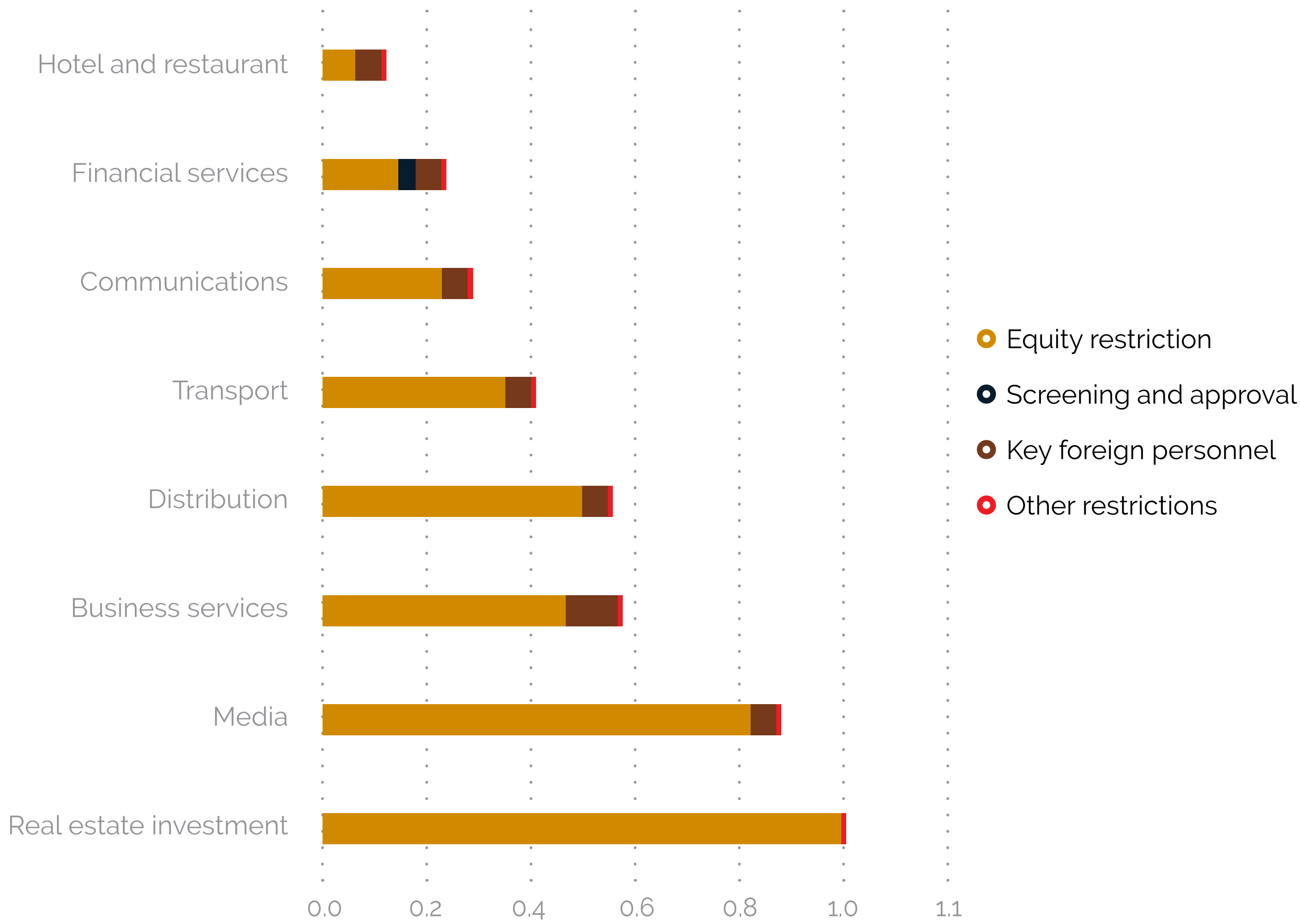


Source: OECD, FDI Regulatory Restrictiveness Index online database.

Chart 48 reveals that, of the four types of restrictions, equity restrictions are the most important in each of the eight Indonesian services industries.[26] These restrictions generally specify the proportion of a company's equity in a given industry that can be foreign owned, ranging from a complete ban on foreign ownership to allowing 100 per cent foreign participation.

CHART 48: EQUITY RESTRICTIONS ARE SIGNIFICANT IN ALL SERVICE SECTORS

(FDI Regulatory Restrictiveness Index, 2015)



Source: OECD, FDI Regulatory Restrictiveness Index online database.

In seven out of eight industries, restrictions on key foreign personnel are the second most important, but much lower than foreign equity restrictions. Restrictions on key personnel usually take the form of economic criteria for the employment of foreign managers, limits on how long the foreign manager can be employed, and nationality requirements for members of the board of directors.

Chart 48 also reveals that screening and prior approval restrictions are only applied to Indonesia's financial services sector. Screening and approval is a process whereby a proposed foreign direct investment is reviewed to determine whether it serves the national interest and whether there are national security implications in cases where products or industries are of strategic importance. The "other restrictions"

[26] If no foreign equity is permitted in the country, the sector is considered closed and the FDI index score for this type of restriction is 1. If foreign equity is permitted, but majority foreign control is not allowed the score is 0.5. If foreign equity is permitted but a domestic minority holding is required, the score is 0.25. If no restrictions exist, the score is 0.

category contributes in every sector's restriction, but not significantly. These are mostly restrictions on ownership, the establishment of branches, and profit or capital repatriation.

Services Trade Restrictiveness Index

A new composite index released by the OECD provides further information on country restrictiveness in service sectors. The Services Trade Restrictiveness Index (STRI) gives a comprehensive snapshot of trade restrictions on services in 42 countries across 22 sectors and five policy areas. (See box "How Is Services Trade Restrictiveness Measured?")

HOW IS SERVICES TRADE RESTRICTIVENESS MEASURED?

The STRI, published by the OECD, measures the legal and regulatory impediments faced by foreign service providers in 42 countries (34 OECD member countries plus Brazil, China, Colombia, India, Indonesia, Latvia, Russia, and South Africa).[27] The index takes a value between zero and one, zero representing an open market and one a market completely closed to foreign services providers.

It gauges the restrictiveness of a country in five policy areas:

1. restrictions on foreign entry
2. restrictions on the movement of people
3. other discriminatory measures
4. barriers to competition
5. regulatory transparency

There are 22 service sectors covered:

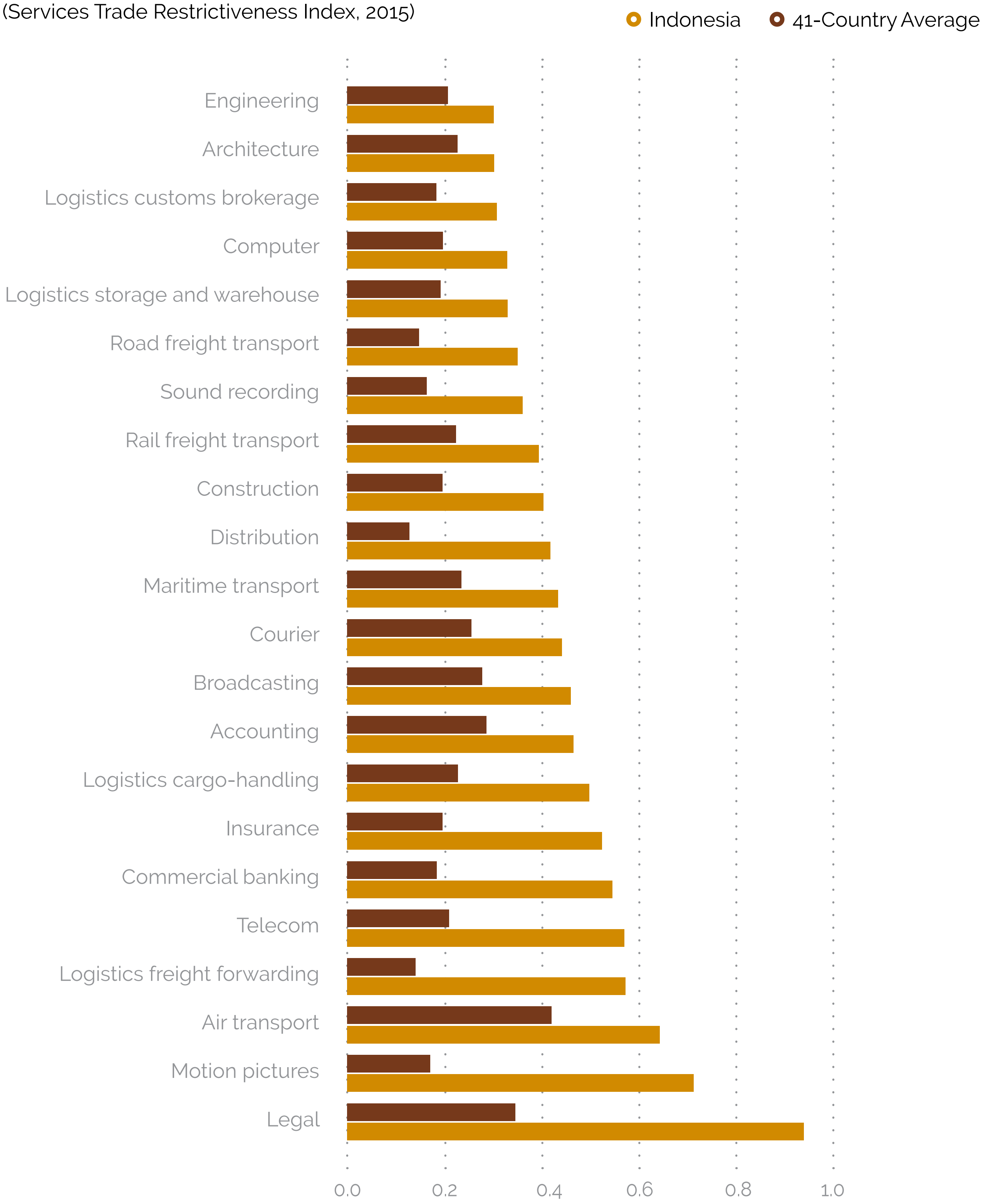
1. computer services
2. construction
3. distribution
4. commercial banking
5. insurance
6. accounting
7. architecture
8. engineering
9. legal services
10. telecommunications
11. air
12. maritime
13. rail
14. road
15. courier
16. motion pictures
17. broadcasting
18. sound recording
19. logistics; customs brokerage
20. logistics; storage and warehouse
21. logistics; cargo handling
22. logistics; freight forwarding

Chart 49 shows Indonesia's STRI compared with the average STRI of the 41 other countries for which data are available. Indonesia is more restrictive in all sectors. Legal services are the most restrictive (0.94) and almost three times higher than the 41-country average (0.34). Engineering services have the lowest STRI (0.3).

[27] Geloso Grosso and others, "Services Trade Restrictiveness Index."

CHART 49: INDONESIA'S SERVICES TRADE RESTRICTIVENESS INDEX IS HIGHER THAN AVERAGE IN EVERY SERVICE SECTOR

(Services Trade Restrictiveness Index, 2015)



Source: OECD, Services Trade Restrictiveness Index online database.

What Restrictions Are Hindering Indonesia's Service Sectors?

The following sections take a more in-depth look at the types of restrictions most hampering key service sectors in Indonesia. As noted in chapters 1 and 2, several service sectors are important to the future of Indonesia's export performance. Unfortunately, the classification of service sectors in the TiVA database used in chapters 1 and 2 does not match the classifications used in the databases for the FDI Regulatory Restrictiveness Index and the Services Trade Restrictiveness Index. As a result, not all service sectors discussed in the previous chapters could be examined in this chapter. However, three service sectors that have high restrictiveness were added to the analysis: business services, telecommunications services, and financial services.

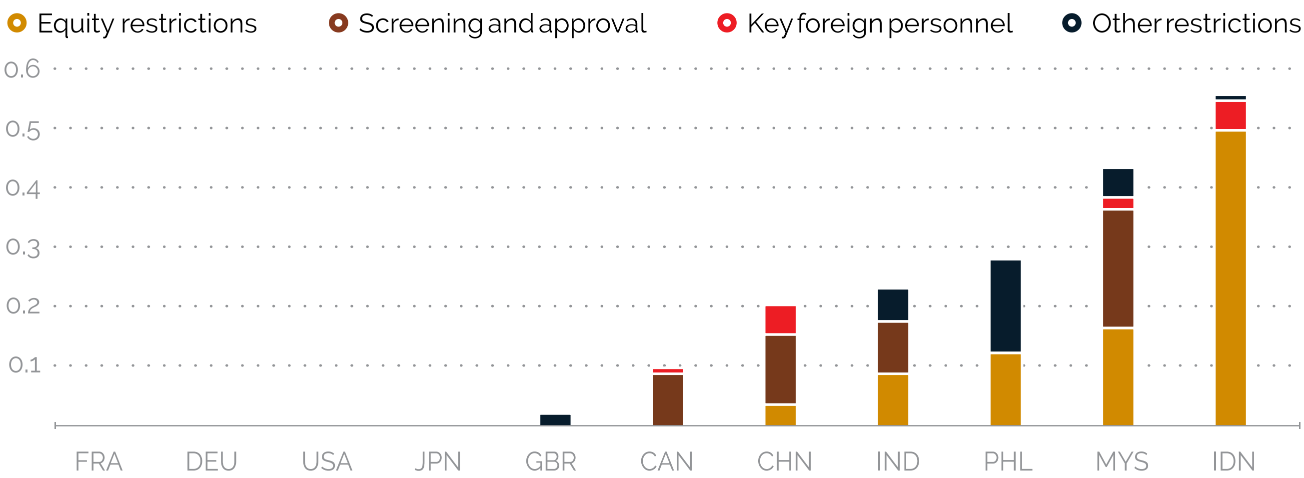
Comparator countries were chosen by using the list of peer countries in Chapter 1, as well as Canada and the top five non-peer countries in terms of value of services exports (United States, Germany, United Kingdom, France, and Japan). Data on the FDI Restrictiveness Index and the STRI were not available for all peer countries. Cambodia, Singapore, Thailand, and Vietnam were not included in the analysis due to data unavailability. This left 14 countries in the analysis.

Distribution Services

The FDI Regulatory Restrictiveness Index for distribution services covers both wholesale and retail trade. Indonesia's index is the highest among the comparator countries. (See Chart 50.) (See box "Country 3-Digit Codes" to understand the country codes in the following charts.) Most non-Asian comparator countries do not have any restrictions. Equity restrictions contribute the most to Indonesia's restrictiveness. In Indonesia, wholesale and retail services are reserved for local ownership. There is some openness to FDI in select distribution-related services, such as direct selling (which allows up to 95 per cent foreign ownership), distribution and warehousing (up to 33 per cent foreign ownership), and cold storage (up to 33 per cent foreign ownership for businesses in Sumatra, Java, and Bali, or 65 per cent if established in Kalimantan, Sulawesi, Nusa Tenggara, Maluku, or Papua).

CHART 50: INDONESIA HAS THE HIGHEST FDI RESTRICTIVENESS IN DISTRIBUTION SERVICES

(FDI Regulatory Restrictiveness Index, 2015)



Source: OECD, FDI Regulatory Restrictiveness Index online database.

COUNTRY 3-DIGIT CODES

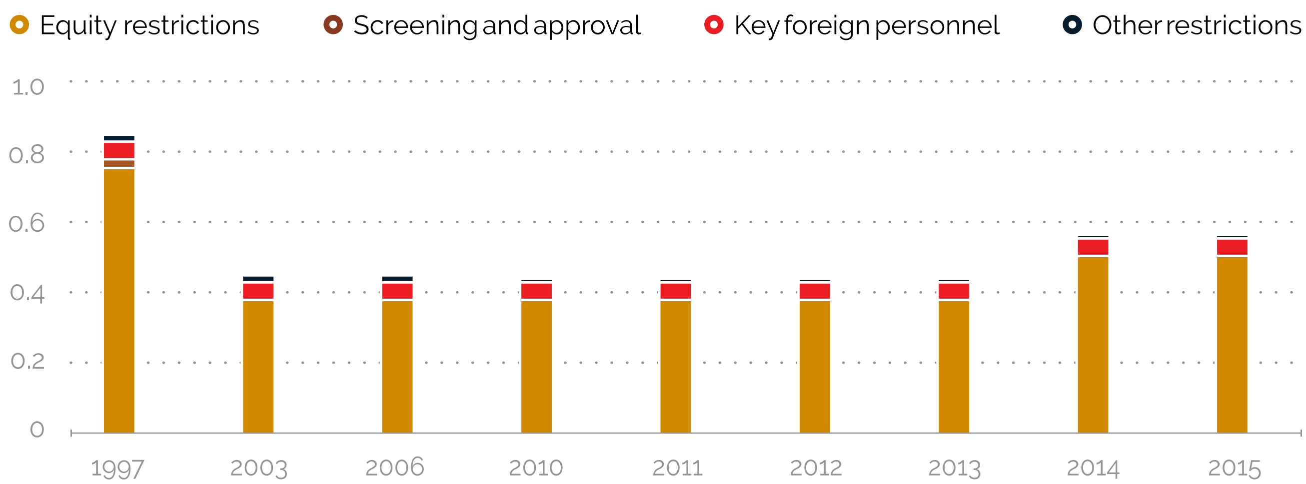
Canada	CAN
People's Republic of China	CHN
France	FRA
Germany	DEU
India	IND
Indonesia	IDN
Japan	JPN
Malaysia	MYS
Philippines	PHL
United Kingdom	GBR
United States	USA

Source: International Organization for Standardization.

Indonesia's overall index for distribution services fell between 1997 and 2013, but increased in 2014 due to an increase in equity restrictions. (See Chart 51.)

CHART 51: INDONESIA'S FDI RESTRICTIVENESS IN DISTRIBUTION SERVICES RECENTLY INCREASED

(FDI Regulatory Restrictiveness Index)

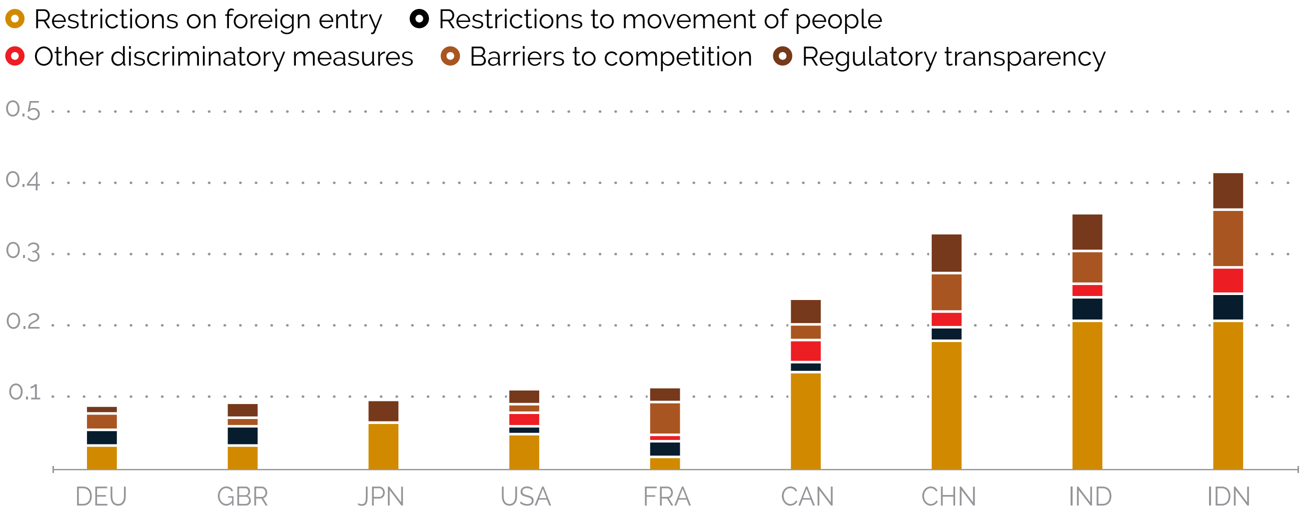


Source: OECD, FDI Regulatory Restrictiveness Index online database.

The STRI reveals more information on how distribution service are regulated. Compared with other countries, Indonesia's STRI on distribution services is relatively high. (See Chart 52.) Unsurprisingly, foreign entry restrictions contribute the most to the index. The second most important type of restrictions are the "barriers to competition," including the fact that the government controls at least one major firm, regulations on prices of certain products, and regulations on shop hours.

CHART 52: INDONESIA HAS THE HIGHEST STRI IN DISTRIBUTION SERVICES

(Services Trade Restrictiveness Index, 2015)



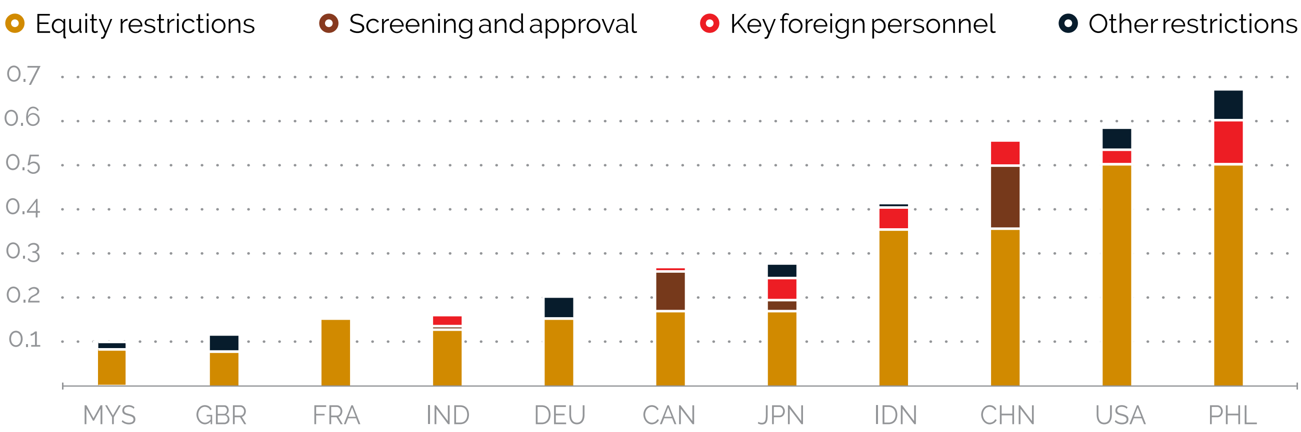
Source: OECD, Services Trade Restrictiveness Index online database.

Transport Services

In transport services, Indonesia is the fourth most restrictive among comparator countries on the FDI Regulatory Restrictiveness Index. (See Chart 53.) The fact that transport services appear to be restrictive in many countries, including the U.S., suggests that these restrictions may relate to national security issues. Equity restrictions are the largest component in all countries. Indonesia's FDI Regulatory Restrictiveness Index has fallen from 0.45 in 1997 to 0.41 in 2015, revealing that this sector has become less restrictive over time. Transport services are open to 49 per cent foreign capital for every mode of transport—large enough for foreign enterprises to take part in domestic industries yet not be able to assume majority control.

CHART 53: PHILIPPINES HAS THE HIGHEST FDI RESTRICTIVENESS IN TRANSPORT SERVICES

(FDI Regulatory Restrictiveness Index, 2015)

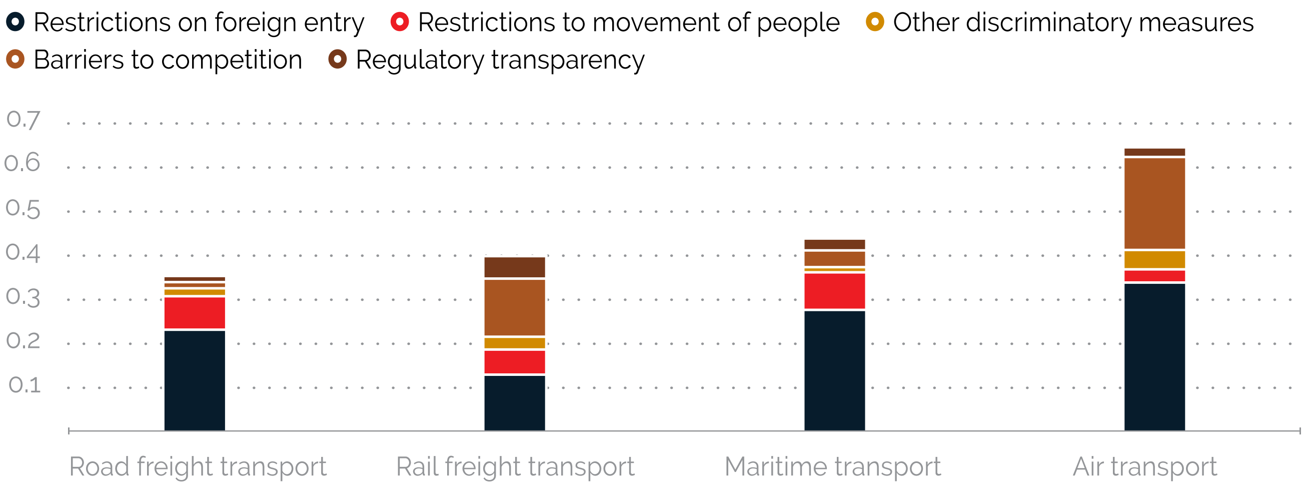


Source: OECD, FDI Regulatory Restrictiveness Index online database.

Data in the Services Trade Restrictiveness Index are available by detailed transport sector and reveal that air transport is the most restrictive sub-sector in Indonesia. (See Chart 54.) Foreign equity in air transport is limited to 49 per cent in both domestic and international traffic. Barriers to competition exist in the allocation of takeoff and landing slots, as well as provisions regulating prices for domestic routes. In addition, the government controls a major airline—Garuda Indonesia—and exempts it from competition law. Indonesia does not include rail transport in the Negative Investment List, thus the STRI assessed it as 100 per cent open to investment. The barriers shown in Chart 54 reflect some horizontal provisions and also regulations on pricing. A state-owned enterprise—Kereta Api—is a major firm in the rail sector. In maritime transport, the government also controls a major enterprise—Pelayaran Nasional Indonesia.

CHART 54: AIR IS THE MOST RESTRICTED TRANSPORT SERVICE IN INDONESIA

(Services Trade Restrictiveness Index, 2015)



Source: OECD, Services Trade Restrictiveness Index online database.

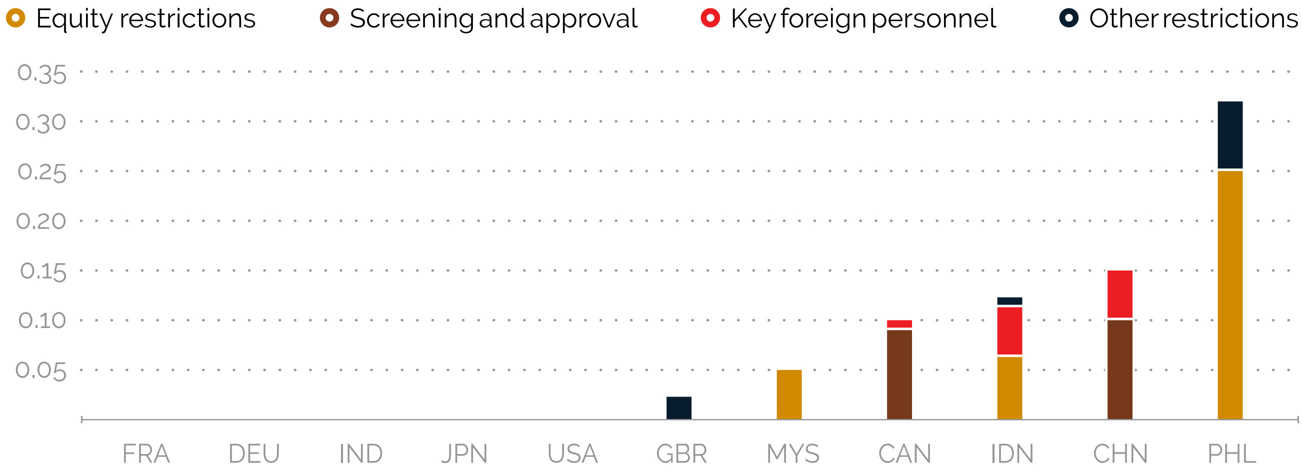
Tourism Services

Indonesia's tourism sector is more open to FDI than other service industries, although overall restrictions remain relatively high compared with peer countries. (See Chart 55.) It is the third most restrictive (0.123) after the Philippines and China. Five of Indonesia's peer countries do not have any restrictions. The FDI Regulatory Restrictiveness Index only covers hotels and restaurants, and Indonesia allows up to 51 per cent foreign investment in these two industries. Other industries not included in the index have varying maximum thresholds:

- non-government museums, natural tourism management, conventions and exhibitions, and spas (51 per cent)
- travel agent/operator (49 per cent or 51 per cent in cooperation with an SME)
- art galleries and art theaters (67 per cent)
- sporting recreations (49 per cent or 51 per cent in cooperation with an SME)

CHART 55: PHILIPPINES HAS THE HIGHEST FDI RESTRICTIVENESS INDEX IN HOTEL AND RESTAURANT SERVICES

(FDI Regulatory Restrictiveness Index, 2015)



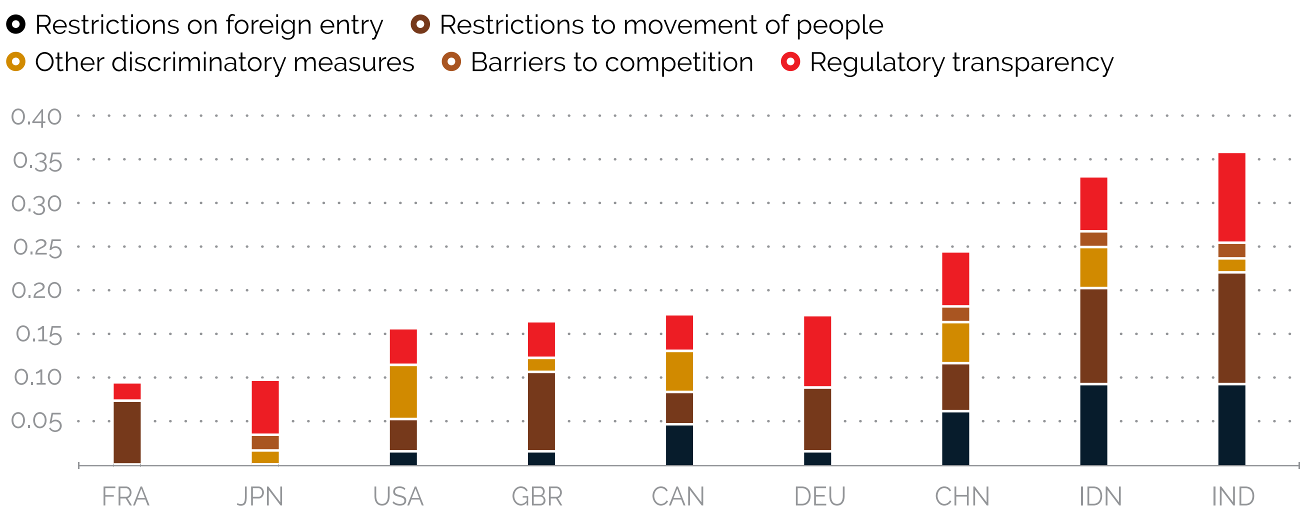
Source: OECD, FDI Regulatory Restrictiveness Index online database.

Computer and Related Services

While computer and related services have relatively low levels of FDI restrictions compared with other Indonesian service sectors (see Chart 49), Indonesia still lags behind all comparator countries apart from India. (See Chart 56.) The largest type of restriction is on the movement of people. Restrictions on the movement of people can act as a significant barrier to trade in computer and related services. The OECD notes that, for example, limiting the number of foreign software engineers or the duration of their stays exerts a dampening effect on trade.[28]

CHART 56: INDIA HAS THE HIGHEST FDI RESTRICTIVENESS INDEX IN COMPUTER AND RELATED SERVICES

(Services Trade Restrictiveness Index, 2015)



Source: OECD, Services Trade Restrictiveness Index online database.

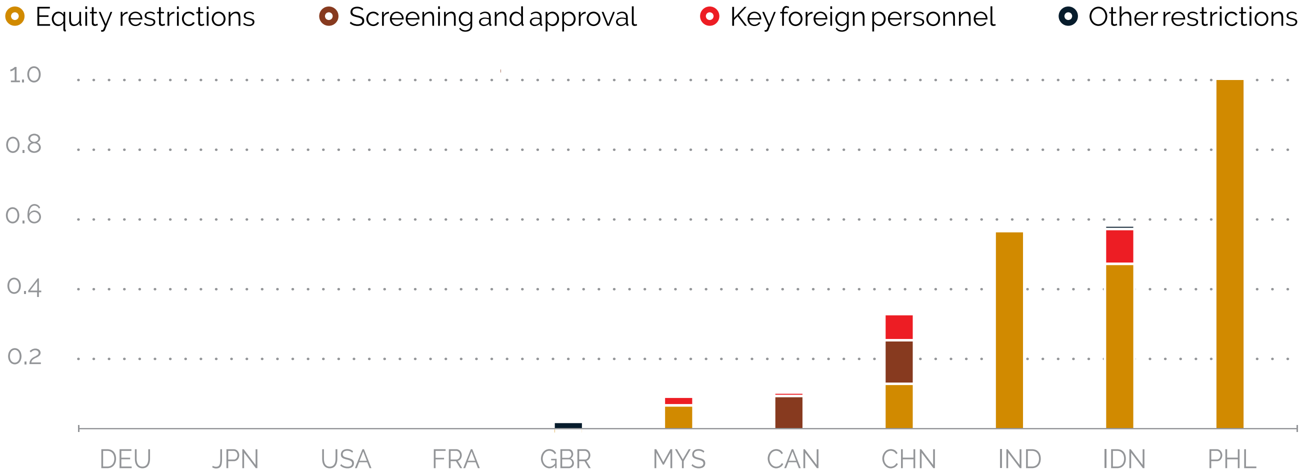
[28] Geloso Grosso and others, "Services Trade Restrictiveness Index," 9.

Business Services

The OECD FDI Regulatory Restrictiveness Index in business services covers accounting and audit, architecture, engineering, and legal services. Indonesia's index is the second highest among comparator countries. (See Chart 57.) Philippines has an index of 1 due to a complete restriction on foreign equity. However, the Philippine government has recently relaxed restrictions in this sector, so its index for 2016 will likely fall substantially.

CHART 57: PHILIPPINES HAS THE HIGHEST FDI RESTRICTIVENESS IN BUSINESS SERVICES

(FDI Regulatory Restrictiveness Index, 2015)

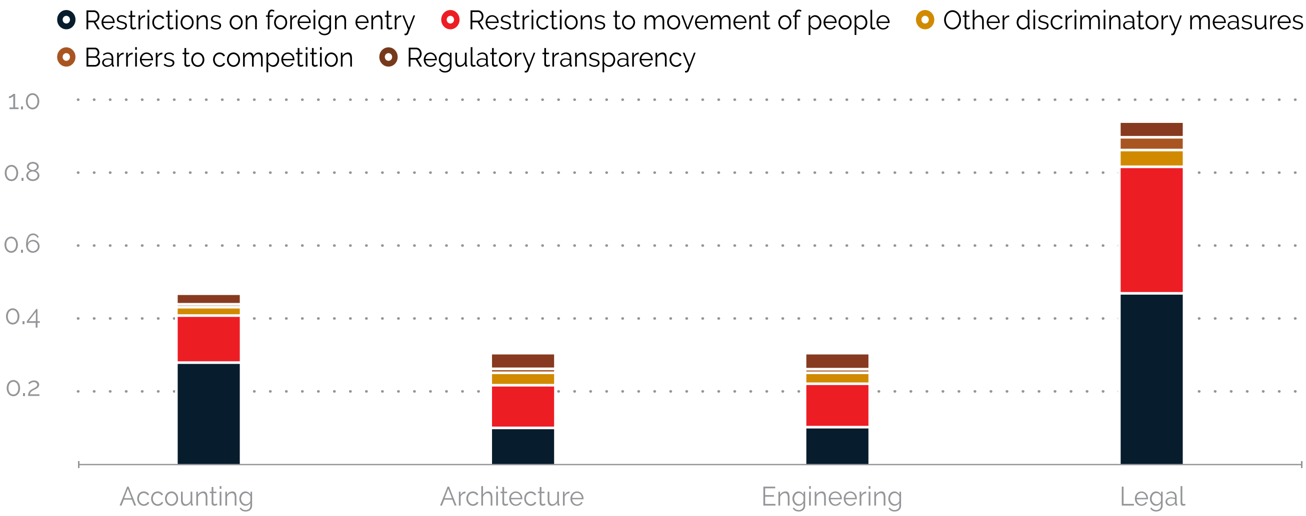


Source: OECD, FDI Regulatory Restrictiveness Index online database.

The STRI data reveal that legal services are the most restrictive among the four business services sub-sectors, followed by accounting, architecture, and engineering in Indonesia. (See Chart 58.) Foreigners are not allowed to establish law firms or practice law in the country. Foreign lawyers are permitted only as consultants. The second highest business services sub-sector is accounting, where foreign equity is capped at 51 per cent and the firm must be owned by an Indonesian national.

CHART 58: LEGAL SERVICES ARE THE MOST RESTRICTED BUSINESS SERVICES IN INDONESIA

(Services Trade Restrictiveness Index, 2015)



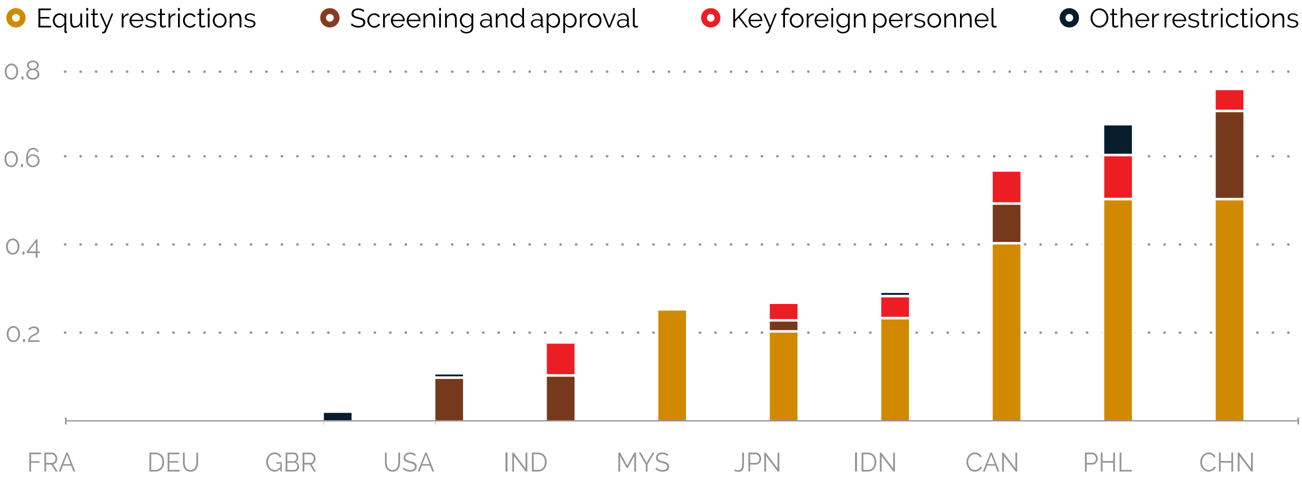
Source: OECD, Services Trade Restrictiveness Index online database.

Telecommunications Services

In telecommunications services, Indonesia's FDI Regulatory Restrictiveness Index is much lower than those of China, the Philippines, and Canada. (See Chart 59.) Two countries—France and Germany—have no FDI restrictions in this sector.

CHART 59: CHINA HAS THE HIGHEST FDI RESTRICTIVENESS IN COMMUNICATIONS SERVICES

(FDI Regulatory Restrictiveness Index, 2015)

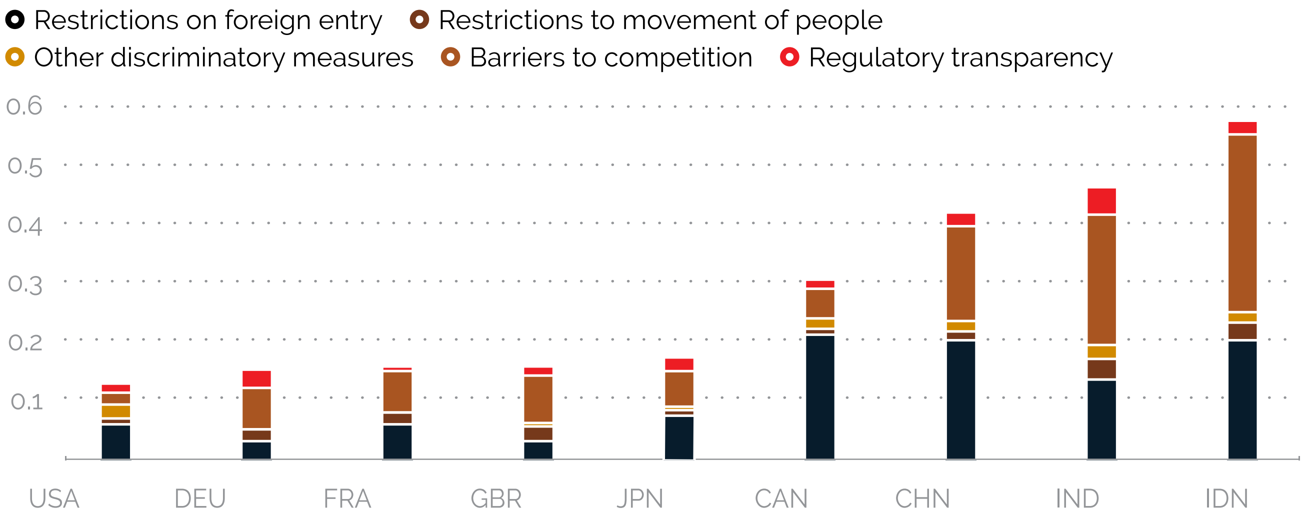


Source: OECD, FDI Regulatory Restrictiveness Index online database.

There are major barriers to competition in Indonesia's telecommunications sector, which is the main reason Indonesia's STRI is the most restrictive among comparator countries. (See Chart 60.) In addition to horizontal regulations—general regulations that apply to all sectors in the economy—there are other provisions inhibiting competition. For example, the government ownership of one Dwiwarna (golden) share at Telkom Indonesia means the government has effective control through special voting and veto rights. In addition, the independence of Indonesia's telecommunications regulatory body—Badan Regulasi Telekomunikasi Indonesia (BRTI)—is questionable, as BRTI does not have executing authority. The regulatory body is also chaired by government officials from the Ministry of Communication and Information. Regarding restrictions on foreign entry, Indonesia's Negative Investment List states that foreign ownership can be up to 67 per cent for fixed and mobile services, and for internet providers.

CHART 60: INDONESIA HAS THE HIGHEST STRI IN TELECOM SERVICES

(Services Trade Restrictiveness Index, 2015)



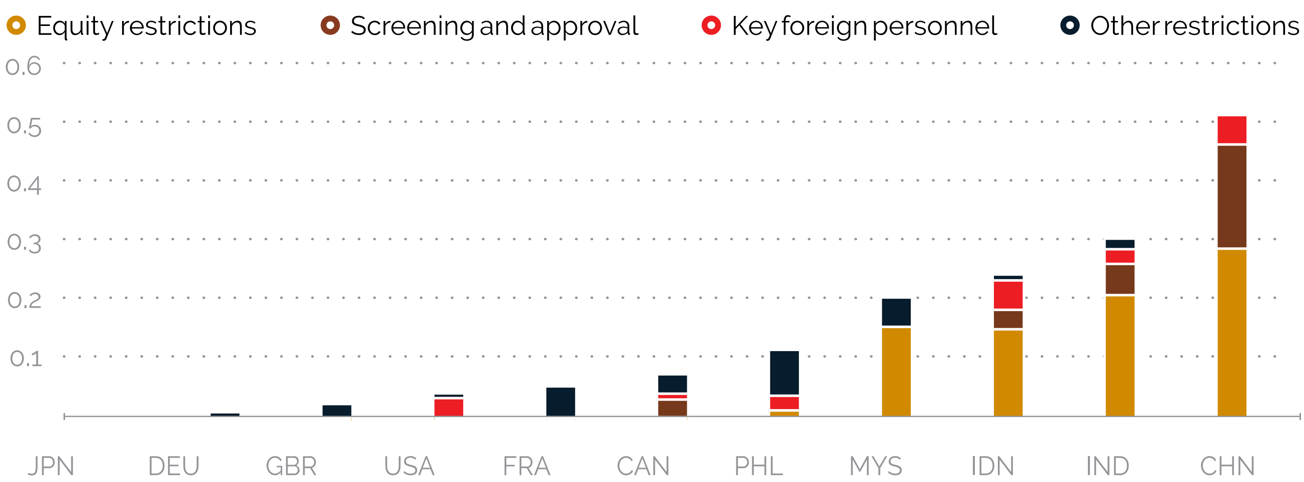
Source: OECD, Services Trade Restrictiveness Index online database.

Financial Services

As seen in Chart 49, the financial services sector is one of the least restricted service sectors in Indonesia. However, it still ranks third most restrictive among comparator countries. (See Chart 61.) The FDI Regulatory Restrictiveness Index on financial services covers banking, insurance, and other financial services (including securities and commodities brokerage and fund management). The financial services sector is relatively open regarding equity restrictions. For example, foreign shareholders can own up to an 80 per cent stake in insurance firms. The financial services sector is the only Indonesian service sector with screening and approval restrictions. Investments in this sector need to be approved by the Otoritas Jasa Keuangan (OJK, or Financial Services Authority).

CHART 61: CHINA HAS THE HIGHEST FDI RESTRICTIVENESS INDEX IN FINANCIAL SERVICES

(FDI Regulatory Restrictiveness Index, 2015)

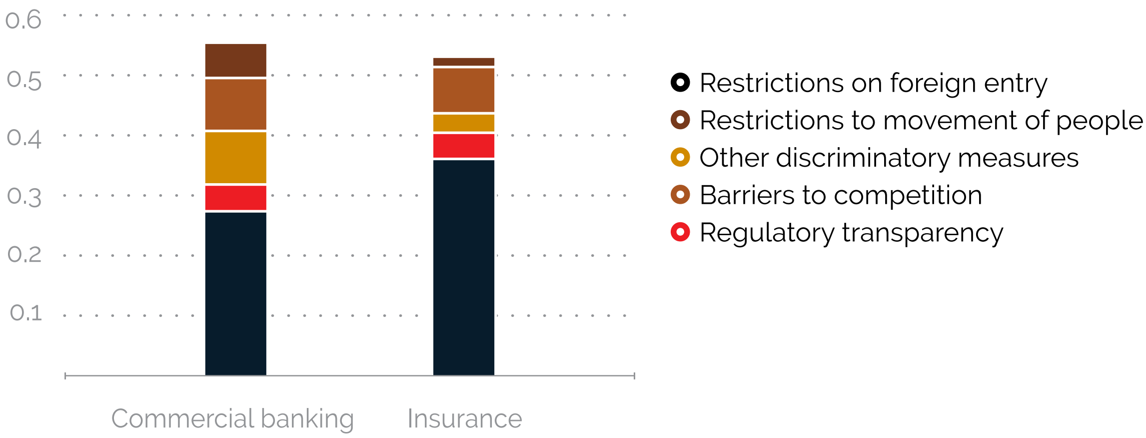


Source: OECD, FDI Regulatory Restrictiveness Index online database.

The STRI provides more details on other restrictions. (See Chart 62.) Indonesia's commercial banking and insurance industries restrict foreign entry: foreign capital must be established via a joint venture with an Indonesian national/entity; branches are only permitted for global top-200 banks and are limited by number. There are limitations on the number of ATMs and prohibitions on foreign commercial banks engaging in banking services, such as rural banking.

CHART 62: FOREIGN ENTRY RESTRICTIONS ARE HIGH IN INDONESIA'S FINANCIAL SECTOR

(Services Trade Restrictiveness Index, 2015)



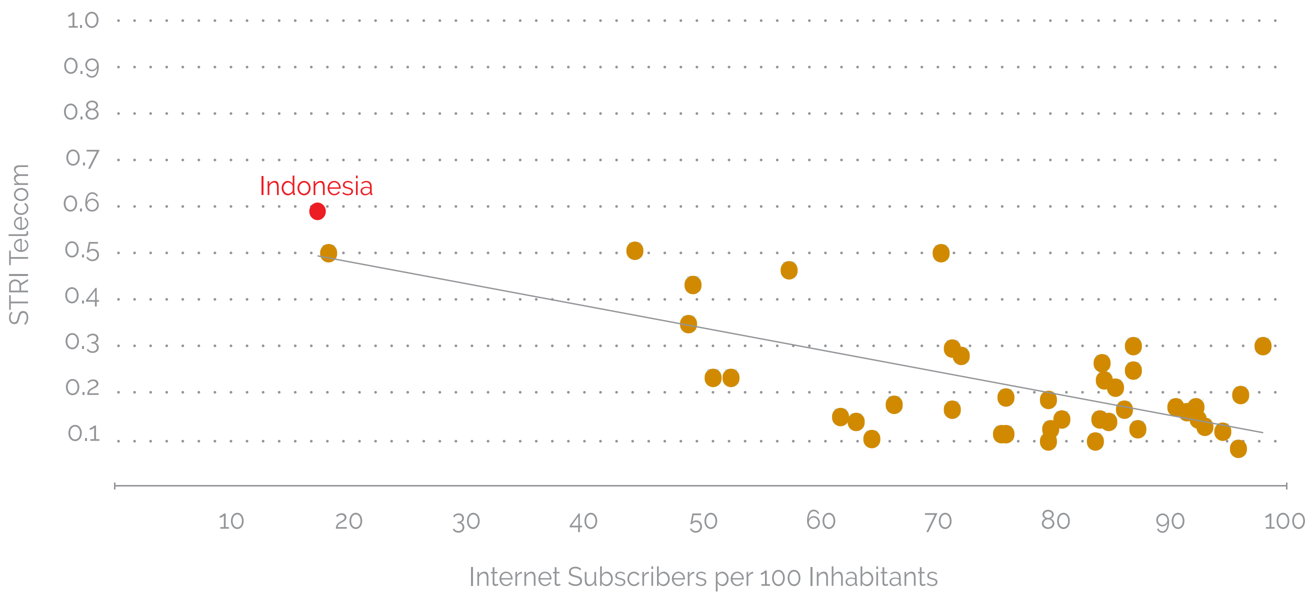
Source: OECD, Services Trade Restrictiveness Index online database.

How Does Restrictiveness Affect the Competitiveness of the Services Sector?

Restrictiveness can impair the competitiveness of the services sector. Using data from the World Bank's World Development Indicators database and the STRI, it is clear that there is an inverse correlation between trade restriction and services performance in telecommunications and financial services. (See Chart 63.)

CHART 63: HIGH RESTRICTIVENESS MAY IMPEDE TELECOM PERFORMANCE

(Services Trade Restrictiveness Index; number of internet provider per 100 inhabitants, 2015)

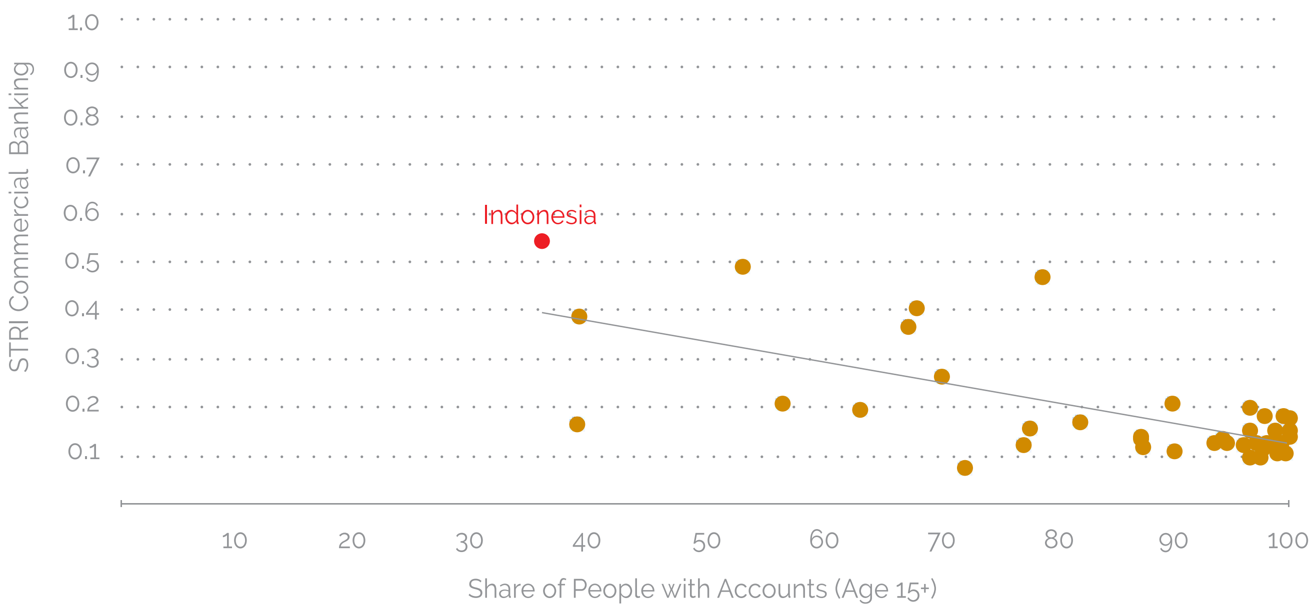


Sources: World Bank, World Development Indicators; OECD, Services Trade Restrictiveness Index online database.

A similar pattern is seen in financial services. Chart 64 plots the STRIs for the commercial banking sector on the vertical axis and the percentage of people (aged 15+) who reported having an account at a bank or other type of financial institution for the 42 countries covered by the STRI on the horizontal axis.

CHART 64: HIGH RESTRICTIVENESS MAY IMPEDE COMMERCIAL BANKING PERFORMANCE

(Services Trade Restrictiveness Index; share of people with bank accounts, per cent; 2015)



Sources: World Bank, World Development Indicators; OECD, Services Trade Restrictiveness Index online database.

What Are the Implications of the Findings?

Indonesia is relatively restrictive to FDI in services sector compared with other countries

Indonesia has higher restrictions than average in all service sectors covered by the FDI Regulatory Restrictiveness Index and the Services Trade Restrictiveness Index. This can be explained in large part by general regulations that apply to all sectors in the economy. For example, certain management positions in Indonesian corporations are reserved for nationals, investments in all sectors are subject to screening, and price preferences are given to local providers in the context of public procurement. In addition, the state plays a prominent role in the economy. There is at least one major state-owned enterprise in air transport, banking, distribution, insurance, maritime, logistics, and telecommunications services. Indonesia applies restrictions to trade through the movement of natural persons. In particular, it maintains labour market tests on all categories of service providers covered in the STRI (i.e., intracorporate transferees and contractual services suppliers). The duration of stay for these categories is limited to 24 months on their first entry permit.

Indonesia is the most restrictive country on FDI in distribution services

Most non-Asian comparator countries do not have any restrictions. Equity restrictions contribute the most to Indonesia's restrictiveness. In Indonesia, wholesale and retail services are reserved for local ownership.

Equity restrictions are the most common form of restrictions to FDI in services in Indonesia

Equity restrictions are the most important type of restrictions in every one of the eight Indonesian services sectors included in the FDI Regulatory Restrictiveness Index.

Trade barriers are detrimental and decrease overall economic efficiency

Economists generally agree that trade barriers are detrimental and decrease overall economic efficiency. From the studies reviewed here, increased FDI in services has been linked to improved productivity in manufacturing firms, suggesting the same impact in other industries. No country in modern history has developed successfully without harnessing economic openness to aid national development. Relaxing restrictions on competition and foreign investment helps encourage new market entrants. New entrants may be in a position to provide services that had not been available and that may impact other sectors' performance. Competition may also lead to a reduction in the cost of services or an improvement in their quality. New entrants can also provide capital for infrastructure investment, thus improving the quality and reliability of service provision. Clearly, such improvements not only improve service sector performance, but can benefit downstream manufacturers, creating dynamic, economy-wide gains that boost national competitiveness.[29]

High restrictiveness may be affecting Indonesia's ability to benefit from global value chains

Services are key inputs in global value chains. When a manufacturer enters a contract with a foreign supplier, legal services are needed for setting up the contract. Cross-border financial services are needed for payment and supplier credit. Computer and communication services are needed for product development and supply chain management, and transport and distribution services are needed to move products between processing stages and to the final consumers. The restrictions in services indeed generate consequences for downstream users of these services.[30] As noted in Chapter 2, Indonesia's low share of foreign services content in its exports may be an indicator of below-average participation levels in global value chains compared with peer countries. The OECD, WTO, UNCTAD, and World Bank all argue that participation in GVCs is critical to improve the competitiveness of developing countries. The fact that Indonesia may not be fully exploiting or benefiting from GVCs may be related to its relatively high restrictiveness.

[29] Varela, "Openness, Growth, and Productivity."

[30] OECD, *Services Trade Restrictiveness Index Policy Brief*, 8.

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