Non-Equity Modes of Trade in ASEAN

Promoting new forms of trade between Japan and ASEAN

PAPER 3

MARCH 2021

A
S
E
A
N

ASEAN-JAPAN CENTRE

国際機関 日本アセアンセンター

For inquiries, contact ASEAN-Japan Centre
(ASEAN Promotion Centre on Trade, Investment and Tourism)

1F, Shin Onarimon Bldg., 6-17-19, Shimbashi,
Minato-ku, Tokyo 105-0004 Japan
Phone/Fax: +81-3-5402-8002/8003 (Office of the Secretary General)
+81-3-5402-8004/8005 (Research and Policy Analysis (RPA) Cluster)
+81-3-5402-8116/8005 (Capacity Building (CB) Cluster)
+81-3-5402-8006/8007 (Trade and Investment (TI) Cluster)
+81-3-5402-8008/8009 (Tourism and Exchange (TE) Cluster)
+81-3-5402-8118/8003 (PR)
e-mail address: info_rpa@asean.or.jp
https://www.asean.or.jp

Paper 3 / March 2021 / Non-Equity Modes of Trade in ASEAN: Indonesia
Promoting new forms of trade between Japan and ASEAN

Non-Equity Modes of Trade in ASEAN

Promoting new forms of trade between Japan and ASEAN

PAPER 3

MARCH 2021

ASEAN-JAPAN CENTRE

国際機関 日本アセアンセンター

NOTES

The terms "country" and "economy" as used in this study also refer, as appropriate, to territories or areas. The designations employed and the presentation of the material do not express any opinion whatsoever on the part of the ASEAN-Japan Centre concerning the legal status of any country, territory, city or area, or of the authorities or delimitations of frontiers or boundaries.

The tables use the following symbols:

- Two dots (..) indicate that data are not available or are not separately reported.
- A dash (-) indicates that the item equals zero or its value is negligible.
- Use of an en dash (–) between dates representing years, e.g., 2015–2016, signifies the full period involved, including the beginning and end years.
- Reference to "dollars" ($) means United States dollars, unless otherwise indicated.

This series comprises 10 papers in total. Six (Cambodia, Lao People's Democratic Republic, Myanmar, the Philippines, Thailand and Viet Nam) have been published. The other papers will be produced subsequently.

Paper 1. Brunei Darussalam
Paper 2. Cambodia (published in August 2019)
Paper 3. Indonesia
Paper 4. Lao People's Democratic Republic (published in March 2020)
Paper 5. Malaysia
Paper 6. Myanmar (published in March 2020)
Paper 7. Philippines (published in March 2018)
Paper 8. Singapore
Paper 9. Thailand (published in April 2020)
Paper 10. Viet Nam (published in December 2018)

Prepared by Fithra Faisal Hastiadi (Universitas Indonesia) under the direction of Masataka Fujita (ASEAN-Japan Centre). The author wishes to thank Askar Muhammad, Jordan Brahmansyah and Fitri Nurjanah for their research assistance. The manuscript was edited by Tora Estep and typeset by Laurence Duchemin. Errors and omissions are solely those of the authors and should not be attributed to their organizations.

CONTENTS

KEY MESSAGES

- Investment provides a sizeable contribution to the economy. Investment contributed as much as 34 per cent of Indonesia's gross domestic product in 2019. The size of this contribution has prompted the government to pass the Job Creation Law, which aims to facilitate investment entry into Indonesia.
- The services sector largely supports the Indonesian economy (approximately 45 per cent), and this figure has not changed significantly in the last 3 years despite the COVID-19 pandemic hit in 2020.
- Indonesia is facing the problem of premature de-industrialization. The entry of foreign investment, including non-equity modes (NEMs), is expected to encourage the industrial sector to progress more rapidly.
- NEMs in Indonesia appears to be growing quite rapidly. In the primary sector is natural rubber, in the secondary sector is footwear and in the tertiary sector we see the growth of restaurants, retail and hotels.
- Contract farming is common in the natural rubber industry to meet demand from the international tire industry. Because the international price fluctuates, the government needs to develop agreement guidance to stabilize the price of rubber in NEM agreements.
- Indonesia has an important global presence in all types of footwear and is especially prominent in athletic footwear. In Indonesian global footwear production, outsourcing has given rise to subcontracting NEMs.
- International hotels operate in Indonesia either through management contracts or franchise agreements, or on long-term leased land on which hotels are built with equity investments. Due to the restrictiveness of foreign direct investment (FDI) inward regulation in Indonesia, NEMs can be an attractive choice for international brand owners considering their flexibility in entering the Indonesian market.
- According to analytical hierarchy process analysis, FDI is still considered a better investment mode than NEMs because FDI is superior in terms of driving business growth and sustainability; expanding market access and acquiring technology, skills and knowledge.
- As transnational corporations (TNCs) can easily terminate contracts, a long-term relationship is not guaranteed, particularly when the quality of services or goods does not meet TNCs' standards and local firms in other countries are more competitive.
- NEMs may play a role in alleviating the potential risks of the externally dependent economic characteristics of Indonesia and are critical for inclusive economic development.
- The government should consider implementing and strengthening the regulatory working environment to maximize the capacity of NEMs in expanding employment, upgrading technology and contributing in global value chains.

1. INTRODUCTION

Economic relations among countries are a consequence of comparative and competitive advantage and specialization. Close economic cooperation can help to overcome scarcity of a resource at a lower cost. Such economic cooperation can take various forms, such as trade and investment. When the economic cooperation is strengthened by investment, it is generally a foreign direct investment (FDI) made by a foreign transnational corporation (TNC) into a particular country. As FDIs develop, the investment relations between and among countries do not always have to take the form of equity. Contractual relationships or other similar forms of relationship—non-equity modes (NEMs)—can also present an option in developing economic cooperation between and among countries. Aside from developing economic cooperation between and among countries, trade and investment—including NEMs—can also play a part in building global value chains (GVCs). Unfortunately, studies on NEMs remain exceptionally scarce. Moreover, the existing official statistics only provide general and vague data without showing specifically the form of ownership or the mode of investment relationship.

NEMs of economic cooperation are also practiced in ASEAN, including in Indonesia. NEMs found in Indonesia include the contract farming scheme in the agricultural sector; franchising in retail-sector education, fast-food and convenience stores and licensing and contract management in the hotel sector. This study examines the case of Indonesia within the overall framework of the ASEAN-Japan Centre (AJC) NEM project (box 1), with a particular focus on selected industries.

Box 1. **The NEM project of the ASEAN-Japan Centre: The case of Indonesia**

Equity-holding is not the only means of exerting control over the international value chain. Companies also enter into contractual relationships with other independent firms. This form of trade is gaining importance as global production and value chains become more integrated. However, a lacuna exists in the knowledge of and research undertaken on this form of trade in ASEAN. Also required is the formulation of an overall analytical framework to assess development impacts to propose generic policies for dealing with this kind of transaction. The fundamental difference between equity and non-equity forms of operation concerns who holds the equity: for NEMs, local parties, especially private interests, completely share it. Typically, the role of the state in this partnership is limited to setting up the framework conditions within which local parties can freely negotiate the terms of their operations and cooperation with buyers and suppliers. By understanding this phenomenon better, including the scale and scope of NEM operations, and filling in a policy analysis gap, AJC seeks to provide ASEAN country governments with the advisory support needed to benefit fully from these new forms of trade and related investments.

To explain the scale and scope of non-equity involvement in major industrial sectors, this study uses a case study methodology. The reasons for taking this approach are twofold: (1) balance of payments and supplementary statistics do not provide the details necessary to measure cross-border NEMs of participation accurately and (2) the relevant microdata are fragmented and disconnected. Nevertheless, as much as possible, each case study builds on existing research and statistics.

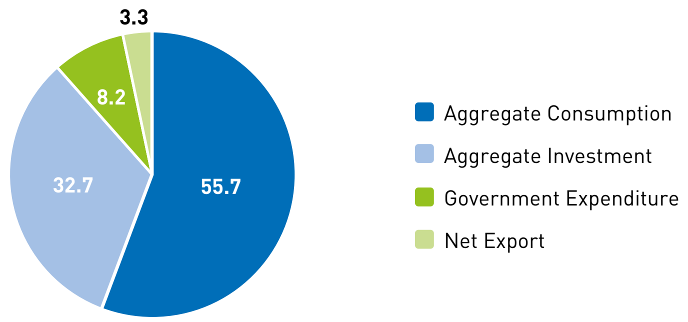
Furthermore, as a special case for this issue (the case of Indonesia), AJC presents a new approach using the analytical hierarchy process (AHP) to uncover the main benefits the host country experiences from NEMs. AHP is a structured technique for organizing and analyzing complex decisions. Individual expert experience is used to estimate the relative magnitude of factors through pairwise comparisons. Each respondent must compare the relative importance of the two items in the pair through a specially designed questionnaire with a scale of 1–9. Section 2 will present a more detailed explanation of the AHP method used in this study.

.../

Box 1. **The NEM project of the ASEAN-Japan Centre: The case of Indonesia** (Concluded)

New opportunities are opening up for ASEAN countries owing to changes in the conduct of TNCs and to international innovation networks. While attracting FDI inflows and encouraging foreign TNCs to establish affiliates (including branch offices, subsidiaries and joint ventures) remain important options for ASEAN countries, governments need to review their current regulatory regimes in the context of new corporate strategies. A key objective of this study is to offer policy recommendations (investment and industrial policies) that the governments can consider to benefit fully from these emerging opportunities.

Figure 1. **Gross domestic product by expenditures, 2020** (Per cent)



Source: Statistics Indonesia.

Indonesia is the world's seventh largest economy and the largest in ASEAN. Figure 1 shows that, although consumption supports the largest part of the economy, investment contributes at least one third of the economy.[1] This makes investment the second largest contributor to the economy after domestic consumption. Aside from contributing to gross domestic product (GDP), investment has played an important role in creating jobs.

Considering such a large economic contribution from foreign investment, the Government of Indonesia in 2020 passed Law number 11 of 2020 on Job Creation, an omnibus law that aims to improve ease of doing business and boost investment. This ambitious law covers 11 clusters, from employment, ease of doing business, to micro-, small- and medium-sized enterprises (MSMEs). This law addresses one of the main obstacles to investing in Indonesia, namely bureaucratic inefficiency relating to ease of doing business, overlapping laws, lack of coordination between central and local governments, etc. The law is expected to cut the bureaucratic red tape that has long deterred investment. Efforts to attract investment, both FDI and NEMs, can take several forms. Box 2 further details such efforts. Many of the determinants for TNCs to undertake FDI or NEMs, or both, are common, but some work more for FDI, while others work more for NEMs (table 1). Understanding how these determinants work by mode is important for formulating policies for NEMs that maximize benefits and minimize costs associated with promoting NEMs.

[1] Represented by gross fixed capital formation and inventory changes, both foreign and domestic.

Box 2. **Factors that make countries attractive NEM locations**

When examining the factors that make national, regional and global locations attractive and conducive to NEMs, identifying overlapping factors that also stimulate FDI inflows is important. As with FDI, determinants of location choice for NEMs include, among others, political and social stability, a literate labour force, good infrastructure, sufficiently efficient and competitive policies, financial incentives, smooth trade procedures and conducive macroeconomic policies.

In addition to policy-related determinants that stimulate FDI, many factors can also support NEM development in host countries. First, NEMs also depend on forms of contract-based TNC linkages in host economies, such as stable and enforceable commercial contract laws and business and industry-related laws and regulations.

Second, as with FDI, facilitation measures for promoting businesses are critical for attracting NEMs. For example, promotion activities and financial incentives must be applied over a wide variety of NEMs (e.g., franchising, licensing, contract-manufacturing, outsourcing, etc.), such as when investment promotion institutions facilitate partnership between foreign NEM providers (e.g., franchisers) and local companies. Moreover, access to capital procurement is an important factor for regional enterprises with strong potential for promoting NEM expansion.

TNCs may establish footholds through equity investment from where they can support the growth and expansion of NEM businesses. These footholds can be a minimal commercial presence, such as purchasing and quality management organizations that enable outsourced manufacturing or logistics support operations that provide materials to franchise locations, as in the case of retail and quick service restaurant franchises. Foreign companies may also directly control NEM recipients through contractual arrangements without establishing footholds (e.g., management contracts in the hotel business).

The existence of reliable and capable regional enterprises, and the ability to network with them, are an essential component of promoting NEM operations. Most NEMs require local partners that are powerful, efficient and capable of taking on risks in complementary but dissimilar operations on behalf of TNCs. For example, if TNCs do not find it economical to produce their own machinery and equipment in integrated circuit assembly operations, their operations in particular locations become more deeply rooted when NEMs emerge to provide such services (Rasiah, 1994). Furthermore, when TNCs do not enter contracts directly with individual farms, agricultural cooperatives can act as intermediaries to reduce business risk and provide reliability (Barrett, 2010).

Third, the degree of economic development and its association with social capital within a country are important in promoting NEMs. For example, consumer market scale and growth and access to regional markets are as important to such NEMs as franchises and out-licensing as they are to FDI. Basic infrastructure provision and transport and energy and communication costs are all major areas of interest for local and foreign companies.

Fourth, technological capabilities and the capacity to improve the quality and productivity of local enterprises are critical to both TNC and NEM operations. Government policies targeted at improving such capabilities in national firms, and regulations to stimulate strong corporate social responsibility practices and minimum labour conditions, are also important to stimulate upgrading in TNCs and NEMs. Furthermore, such initiatives help expand the pool of NEMs available to network with TNCs. For example, the Government of Malaysia has introduced a law specifically concerning franchises and has implemented other measures to promote TNC participation in local economies. For service outsourcing, the Government of the Philippines has contributed to promoting the information technology and business process outsourcing industry.

Factors such as these have contributed to increasing the attractiveness of ASEAN countries as sites for various types of NEMs. Table 1 summarizes the major locational determinants of each mode.

Table 1. **Locational determinants for FDI and NEMs**

Relevant for FDI and NEMs	More relevant for FDI	More relevant for NEMs
	Policy framework	
• Economic, political and social stability • Competition policy • Trade policy • Tax policy	• Rules regarding entry and operations • Standards of treatment of foreign affiliates • International investment agreements • Privatization policy	• Stable general commercial and contract law • Specific laws governing NEM contractual forms (e.g., recognizing licensing, franchising contracts) • Intellectual property protection
	Business facilitation	
• Reduction of hassle costs (e.g. cost of doing business)	• Investment promotion • Investment incentives • Provision of after-care • Provision of social amenities (e.g. quality of life)	• Facilitation efforts aimed at - Upgrading of technological quality, productivity standards of local firms - Enterprise development, increasing local entrepreneurial drive, business facilitation - Subsidies, fiscal incentives for start-ups - Information provision, awareness-building on NEM opportunities with local groups - Support for minimum standards of working conditions and corporate social responsibility in local firms
	Economic determinants	
• Infrastructure • Market size and per capita income • Market growth • Access to regional and global markets • Country-specific consumer preferences • Access to raw materials • Access to low-cost labour • Access to skilled labour • Relative cost and productivity of resources and assets • Other input costs (e.g., transportation, communication, energy)	• Access to strategic assets • Created assets (e.g., technology, intellectual property) • Strategic infrastructure	• Presence of credible local entrepreneurs and business partners • Access to local capital

Source: AJC.

Table 2. **Major Indonesian commodity exports and imports, 2019**

Major Indonesian commodity exports, 2019			Major Indonesian commodity imports, 2019		
Commodity	**Value (million USD)**	**Share of non-oil and gas exports (%)**	**Commodity**	**Value (million USD)**	**Share of non-oil and gas imports (%)**
Mineral fuels, mineral oils and products of their distillation	22.3	14.3	Nuclear reactors, boilers, machinery and mechanical appliances	26.8	18.0
Animal or vegetable fats and oils and their cleavage products	17.6	11.3	Electrical machinery and equipment and parts thereof	20.1	13.4
Electrical machinery and equipment and parts thereof	9.0	5.8	Iron and steel	10.4	7.0
Vehicles other than railway/tramway rolling stock and parts and accessories thereof	8.2	5.3	Plastics and articles thereof	8.8	5.9
Iron and steel	7.4	4.7	Vehicles other than railway/tramway rolling stock and parts and accessories thereof	7.2	4.8
Natural and cultured pearls, precious/ semi-precious stones, precious metal and articles thereof and imitation jewelry	6.6	4.2	Organic chemicals	5.8	3.9
Rubber and articles thereof	6.0	3.9	Articles of iron and steel	3.7	2.4
Nuclear reactors, boilers, machinery and mechanical appliances	5.5	3.6	Cereals	3.2	2.2
Articles of apparel and clothing accessories, not knitted or crocheted	4.5	2.9	Optical, photographic, cinematographic, measuring, checking, precision, medical or surgical instruments and apparatus	2.9	1.9
Footwear, gaiters and the like	4.4	2.8	Residues and waste from food industries	2.6	1.8
Others	64.3	41.2	Others	57.9	38.8
Total	**155.9**	**100**	**Total**	**149.4**	**100**

Source: Ministry of Trade of the Republic of Indonesia.

Box 3. **COVID-19 and the Indonesian economy**

The COVID-19 pandemic swept across the world, hitting the entire world economy hard, including the Indonesian economy. In two consecutive quarters, the GDP of Indonesia recorded negative year-on-year growth. This officially characterizes the country's 2020 economy as a recession. In the same consecutive periods, investment fell. Unlike consumption and GDP in general, which improved from the second quarter to the third quarter of 2020, investment has slumped in the second quarter and further in the third quarter.

Some of the main sectors with which NEMs are closely linked, such as accommodation, restaurants and retail and trade have been among the hardest hit. Even though these sectors started to recover in the third quarter, their growth in the second quarter was among the worst. In the second quarter, the trade sector suffered negative year-on-year growth of -7.6 per cent, the restaurant sector fell -16.8 per cent, while the accommodation supply sector plunged -44.2 per cent. This situation certainly complicates NEM development in Indonesia.

According to our projection for 2021, Indonesia could face three possible growth scenarios, ranging from 3.8 per cent (pessimistic) to 4.4 per cent (moderate) and 6.2 per cent (optimistic). These seemingly high estimates are very much in line with those given by several international bodies such as the International Monetary Fund (4.8 to 6 per cent), World Bank (4.4 per cent) and Fitch Rating (6.6 per cent). These scenarios clearly work only in the case of mass vaccination, because the economy in 2020 lost steam due to COVID-19. That said, the future course of the economy remains uncertain depending on possibly prolonged COVID-19.

Despite the 2020 recession caused by the pandemic, figure 2 indicates no significant changes in the structure of the economy. In general, the service sector provides the largest contribution to the Indonesian economy. NEMs in these sectors, such as restaurants, retail and accommodation, have mushroomed in Indonesia and contributed significantly to the economy, but the pandemic has affected them the most (box 3).

In the industrial sector, exports of electrical machinery and equipment and parts make up 6 per cent, the third largest of the leading export commodities in Indonesia (table 2). The agricultural sector, in this case, exports of animal or vegetable fats and oils and their cleavage products, constituted 11 per cent of all Indonesian exports in 2019 or the second largest.

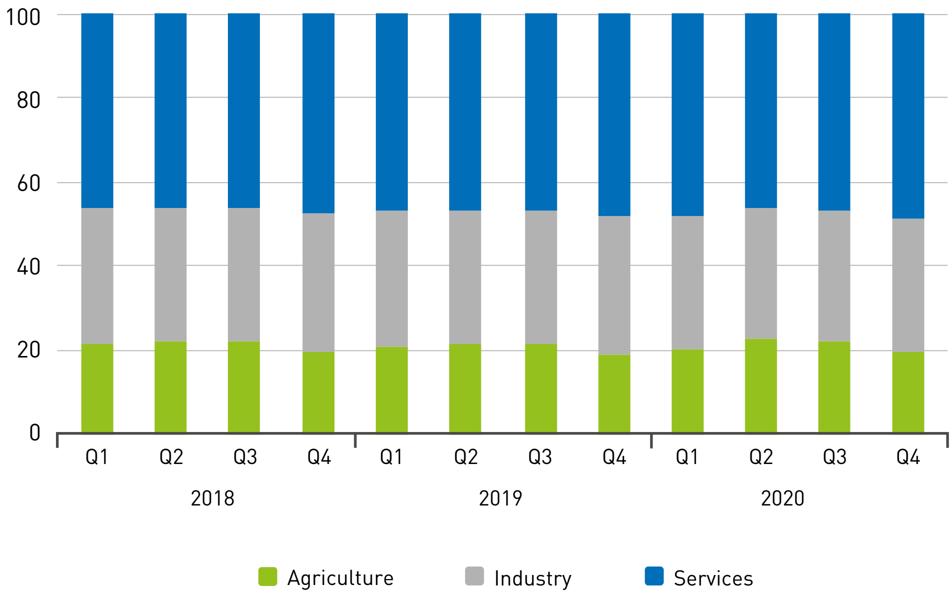
In terms of the structure of the economy, no significant changes have occurred in the last three years; however, over a longer span of almost four decades, the structure of the economy has changed significantly. Figure 3 exhibits that Indonesia has long been experiencing premature de-industrialization.[2] It is important to see the impact of NEMs on industrial development in Indonesia. FDI and NEMs can expand the business market in the host country; the hope is that the manufacturing industry can develop better. However, in the past, FDI has not helped industrialization much, nor has it increased value added in the industrial sector of Indonesia (figure 3).

Section 2 describes the characteristics and scope of NEMs by types and introduces certain types of Indonesian NEMs with distinguishing characteristics. Section 3 provides an overview of the

2 Premature de-industrialization occurs when a country transforms into a service-based economy before achieving an established industrialized economy. Such a country has lower income than developed countries when the developed countries are in the industrialization process.

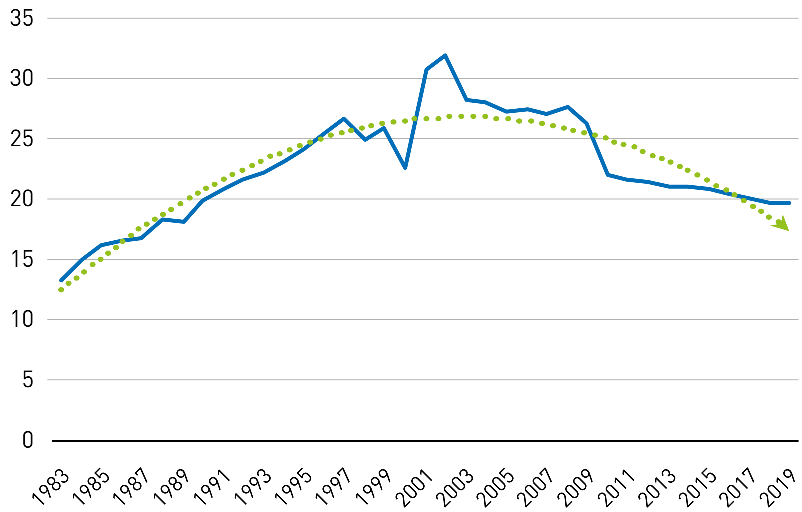
opportunities and challenges in the selected industry and analyzes the implications of NEMs for the economy. Finally, section 4 discusses policy recommendations and implications for NEM industries in Indonesia.

Figure 2. **GDP by sector** (Per cent)



Source: Statistics Indonesia.

Figure 3. **Manufacturing sector value added** (Per cent of GDP)



Source: Statistics Indonesia and World Bank.

2. CHARACTERISTICS OF NON-EQUITY MODES IN INDONESIA

The characteristics and scope of the different modalities vary. Hence, discussing them is important so that efforts to promote them recognize the unique elements associated with each. Because most NEMs have already emerged in Indonesia, this section provides a systematic discussion.

2.1 Scale and Scope

In 2010, the United Nations Conference on Trade and Development (UNCTAD) estimated global NEM production at more than $2 trillion of sales (UNCTAD, 2011). However, it noted that the analysis of NEMs was complex as "the web of directly owned, partially owned, contract-based and arm's-length forms of international operation of TNCs is tangled, and some of the distinctions between the different modes are blurred" (p. 130). Thus, the analysis is limited to industries in which NEMs are particularly important. The characteristics and scope of the different NEM modalities vary. Hence, discussing each modality separately is important to ensure that promotion efforts recognize the unique elements associated with each. As most NEM modalities have already emerged in Indonesia (table 2), the following provides a systematic discussion.

[1] Agriculture: Contract Farming

Contract farming implementation has become widespread internationally. TNCs use this NEM in more than 110 developing countries, and it involves a diverse range of agricultural products (UNCTAD, 2011). It is a tool for efficient procurement of agricultural commodities because it enables TNCs to secure the required quantity and quality. Additionally, farmers can secure stable sales and income levels. TNCs expect high-quality products from farmers as farmers attempt to fulfill TNC demands because they can sell their products at higher prices than market prices. In return, contract farming offers farmers the opportunity to acquire new knowledge, technology and sanitation procedures, which can raise the quality of their farm products.

Contract farming contributes broadly to employment because it is primarily performed by large numbers of small-scale farmers. Eventually, employment secures income and thus has a positive impact on decreasing poverty. Although the total number of contract farms is difficult to identify, a typical individual project has several tens of thousands of participating farms.

[2] Manufacture: Subcontracting

Since the 1980s, subcontracting has developed significantly in the electronics, machine tool and automotive sector in the Asian region. Competition has pushed firms to search for cheaper options and take advantage of opportunities arising from NEMs in rapidly industrializing countries, such as China, Indonesia, Malaysia, the Philippines, Thailand and Viet Nam. Major automotive and electronics companies have committed to research and development, product design and brand management using electronics manufacturing services and cellular manufacturing to outsource manufacturing of certain components. According to the *Fortune* Global 500 ranking in 2020, of the top 10 electronics manufacturing companies in the world, eight are from East Asia and five companies locate their manufacturing in Indonesia (table 3).

Table 3. **Top electronics manufacturers in the World**

Company	Headquarters	Revenues (million $)	Manufacturing located in Indonesia
Apple	USA	260,174	-
Samsung Electronics	Republic of Korea	197,705	✓
Honhai Precision Industry (Foxconn)	Taiwan Province of China	172,869	✓
Amer International Group	China	89,347	-
Hitachi	Japan	80,863	✓
Sony	Japan	75,972	-
Panasonic	Japan	68,897	✓
LG Electronics	Republic of Korea	53,464	✓
Mitsubishi Electric	Japan	41,045	-
Honeywell International	USA	36,709	-

Source: *Fortune* Global 500 in 2020.

Subcontracting also broadens into other labour-intensive industries, such as garment, footwear and toy industries. Clothing value chains have expanded to include not only simple cut, make and trim manufacturing processes, but also the intermediary process that manages much of the value chain, such as manufacturing and logistics throughout Africa, Asia and Latin America. In Indonesia, this chain extends into the footwear industry where NEMs play a role.

[3] Retail, Hotels, etc.: Franchising or Management Contracts

Franchising is a popular business mode in which franchise holders contract out their brand, including the technology, for a fee. In addition, they manage the marketing of the brand. In return, franchisees match the conditions imposed by the franchiser. Using this modality, franchisers not only expand operations tremendously and efficiently, but they also procure capital. This contract mode is commonly used in the retail industry, such as apparel stores, restaurants, hotels and convenience stores.

The need to penetrate markets motivates the use of franchising. In franchise contracts, franchisers typically provide franchisees with various types of services related to business operations, which consist of initial and ongoing support, training, management guidance, marketing, administration and human resources management advice. Franchisees pay royalties to franchisers to use these services.

Hotels frequently operate as franchises, with the franchisee taking on the style and brand reputation of a leading chain under license. The ownership and operation of a hotel can take many forms. The structure chosen depends on the scale of investment by the investor or hotel owner; land ownership is also an important factor.

If the hotel owner prefers to minimize the obligations and responsibilities that are associated with land ownership, then a management contract is another choice. International hotel chains such as Marriott and Ibis are doing business in Indonesia through management contracts with local companies. Normally, management contracts last 10 to 20 years. In return for operating duties specified in the contract, the operator charges a management fee, which is calculated from a percentage of the hotel's gross operating income and revenue and an incentive management fee related to operating profit.

According to the World Travel & Tourism Council Report 2020, the total contribution (direct and indirect) of travel and tourism to global GDP in 2019 was $8.9 trillion or 10.3 per cent of global GDP and 1 per cent of total employment or 330 million jobs in 2019. Meanwhile, travel and tourism in Indonesia contributed $63.6 billion to the economy or 5.7 per cent of Indonesian GDP and 9.7 per cent of total employment or 12.5 million jobs in 2019. The travel industry includes international hotel chains through the contract management mode. Table 4 summarizes NEM operations in Indonesia in the three aforementioned sectors.

Table 4. **NEM operations in three sectors, 2020**

Sector	Primary		Secondary	Tertiary	
Industry (representative example)	Pineapple	Rubber	Footwear	Convenience store	Hotel
Product or services	Fresh or canned fruit	Semi-finished natural rubber product	Athletic shoes, formal shoes and sandals	Small retail groceries, snack foods, confectionery, soft drinks and tobacco	Roomstay; restaurant and meeting, incentive, conference and event
Number of companies (NEM-related estimation)	356	75 companies (60 companies) (2020)	39 companies (27 companies) (2020)	34,023 stores (624 stores) (2019)	18,829 hotels (13,180 hotels) (2016)
Major companies (TNC partners)	PT. Nusantara Tropical Fruit, PT. Alamanda Sejati Utama and PT. Great Giant Pineapple	PT. Kirana Megatara, Tbk; PT. Bakrie Sumatera Plantations, Tbk and PT. PP London Sumatera Indonesia, Tbk	Adis Dimension Footwear, Panarub Industry and KMK Global Sports	Lawson (Japan), Family Mart (Japan) and Circle K (USA)	Marriott International (USA), Accor Hotel (France) and Hyatt Hotels Corp (USA)
Estimated export volume (estimated exports by NEM)	$700 million (2019)	$2.9 billion ($2.3 billion) (2017)	$4.4 billion ($3 billion) (2019)	$12 billion ($165.5 million) (2019)*	$4.5 billion ($3.1 billion) (2019)
NEM mode	Contract farming	Contract farming	Subcontracting	Franchising	Management contract
Estimated employment	30.7 million	2.5 million	643,000	31,900	610,000
Annual average export growth	3.1% (2015–2019)	4% (2009–2019)	11% (2010–2019)	12% for convenience stores from 2017–2019*	9.9% (2010–2019)
Market export destination	Viet Nam (27%) China (21.,2%) Malaysia (16.9%) Hong Kong, China (10.8%) India (8.68%) (As of January 2019 for annual fruit and vegetable)	China (40%); India (8%); USA (7%); Japan (5%); (2019)	Western Europe (32%); North America (29%); East Asia (22%); (2016)	Lawson (0.12%) Family Mart (0.43%) Circle K (0.82%) Local (Alfamart and Indomart) (84.26%) (2019)	Westin (Marriott International Inc) (1.2%) Mercure (AccorHotels Group) (1.0%) Grand Hyatt (Hyatt Hotel Corp) (0.6%) (2020)
Product or services scope	Further improvement of fruit and vegetable production to meet increasing global demand during the pandemic	2nd largest natural rubber producer in the world	3rd largest footwear exporter in Asia	More convenient stores open	Asian country with thousands of natural landscape destinations and cultural heritage

Source: AJC based on Euromonitor, Statistics Indonesia and Bank Indonesia.
*Using retail value retail selling price estimation (exclude sales tax).

2.1 NEM Case Studies

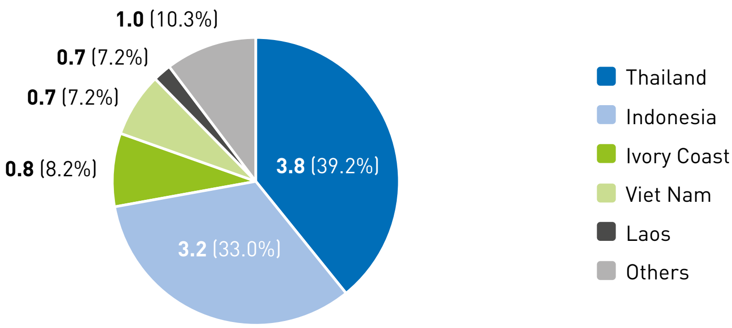
Many foreign firms and TNCs do business with local partners through NEMs in various industries. Their type of involvement in NEMs and their contribution to the Indonesian economy vary by modality and industry. In this section, modalities such as contract farming, subcontracting, management contract and franchise are examined by highlighting specific industries that rely on them.

[1] Contract Farming: Natural Rubber

As a predominantly agricultural economy, Indonesia is the second largest natural rubber producer in the world (box 4), contributing 32 per cent of global production (figure 4). In 2019, total natural rubber production in Indonesia was an estimated 3.4 million tons with a total plantation area of 3.2 million hectares (ha).

Natural rubber is the second largest agricultural commodity export by value after palm oil. Approximately 80 per cent of total natural rubber production in Indonesia is spent in the export market, which generated $2.9 billion in revenue in 2020. The top four export destinations for Indonesian natural rubber are China, India, the United States and Japan, which are by far the world's largest natural rubber consumers.

Figure 4. **Top global producers of natural rubber, 2019** (Million tons)



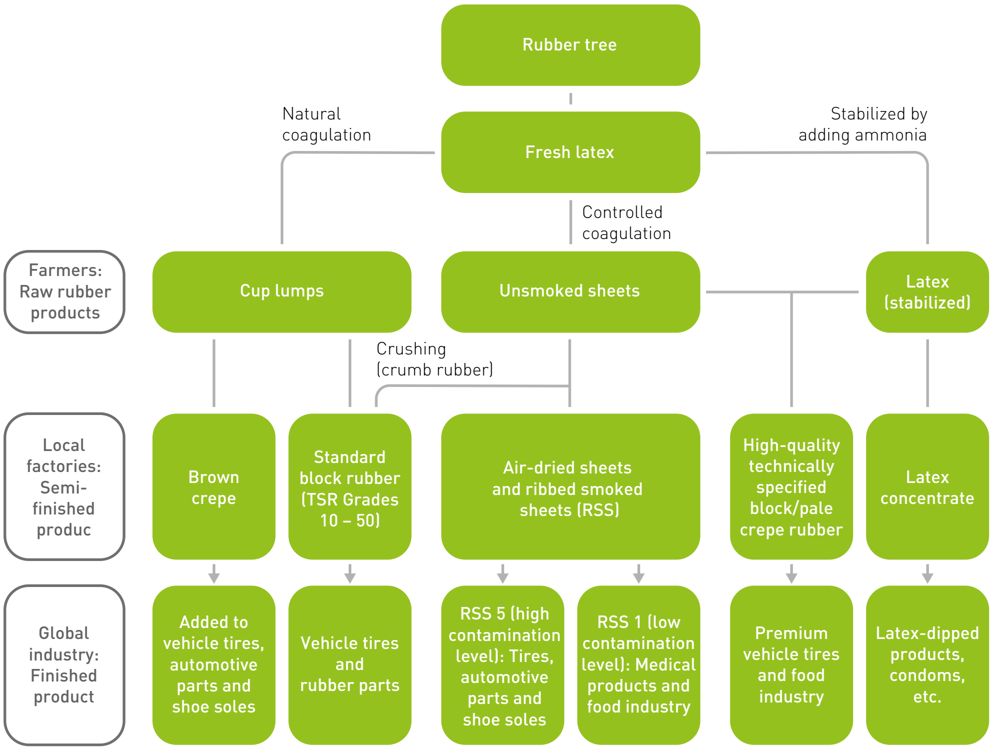
Source: UN Comtrade Database.

Box 4. **Types of rubber and product stages in the natural rubber industry**

Rubber can be divided into two categories: natural rubber and synthetic rubber. Natural rubber is a renewable natural resource and mostly produced by small farmers in the developing countries of Asia. Synthetic rubber is an artificial polymer made from petrochemical feedstock. The characteristics of natural rubber, which is more robust (durable), are required to manufacture tires for medium/heavy commercial vehicles and for high-quality tires, making natural rubber irreplaceable by synthetic rubber.

Natural rubber is used widely in many applications and products, either alone or with another material. It can be used for more than 50,000 different products, including gloves, mattresses, condoms, shoe soles and tires. Generally, the three stages of products are raw product, semi-finished product and finished product. Box figure 4.1 summarizes the stages of products in the natural rubber industry.

Box figure 4.1. **Product stages in the natural rubber industry**



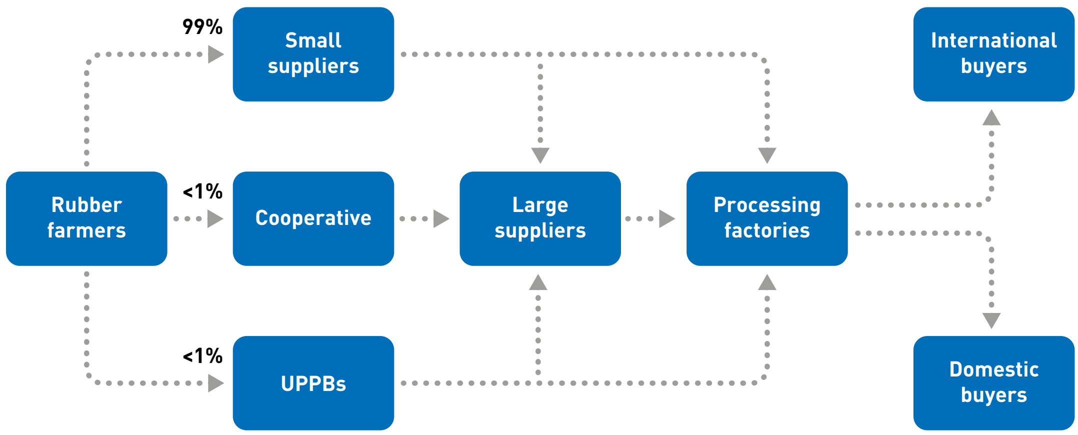
Source: AJC based on Haustermann and Knoke (2019), Chanchaichujit and Saavendra-Rosas (2018) and Röthemeyer and Sommer (2013).

Indonesian areas for rubber plantation can be classified into three types of ownership. Smallholder farmers own around 85 per cent, private companies own about 9 per cent and state-owned companies own about 6 per cent. More than 2.25 million farmers and 255,000 farm workers are involved in the rubber sector. Sumatra and Kalimantan are the dominant production areas, accounting for 96 per cent of Indonesian plantation areas and total rubber production (Grow Asia, 2020).

The supply chain starts with the producer, which is the owner of the rubber land. These small-scale rubber producers share similar characteristics: they mostly cultivate rubber as a monoculture crop with an average plantation area of 1 ha, tree density of 600 trees/ha and tree age of 10–20 years. Farmers sell their products to three types of buyers: local suppliers, UPPBs (*unit pengolahan dan pemasaran bokar*, collective rubber processing and marketing units) and cooperatives (*koperasi*) (figure 5). UPPBs are institutions established by each district's agriculture office following guidelines from the Ministry of Agriculture to increase farmers' rubber quality and selling price.

Most smallholder plantations are in remote and dispersed locations, typically a one to two hour motorcycle ride from a main road and a two to three hour ride from the nearest processing factory. Farmers who live in remote areas prefer selling, mostly once a week, to small suppliers who come and collect their produce. Consequently, selling to small local suppliers becomes the predominant market channel as few farmers are organized into farmer groups, cooperatives or UPPBs. Box 5 explains the natural rubber supply chain case with its NEM application in an Indonesian company.

Figure 5. **The Indonesian natural rubber supply chain**



Source: AJC based on Grow Asia (2018).

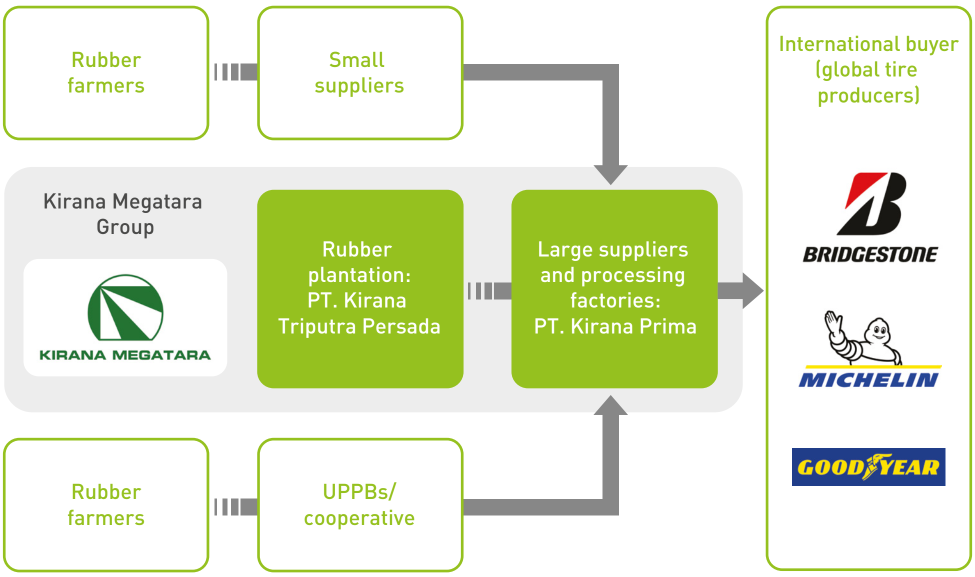
Box 5. **NEM case study: Kirana Megatara Group's rubber export to the tire industry**

Kirana Megatara Group (KMG) is the largest producer of crumb rubber in Indonesia, capturing more than 18 per cent of the Indonesian market share. The holding company was established under the name PT Kirana Megatara in 1991, and the group now has 16 subsidiary processing companies. KMG was listed as a public company on the Indonesia Stock Exchange on 19 June 2017.

From the total sales volume of KMG standing at 467.05 thousand tons in 2019, 96 per cent was distributed for export and the remaining 4 per cent was distributed for local market consumption. KMG's top three largest export destinations are the United States, Japan and the European region. Around 60 per cent of KMG rubber production is absorbed by the global tire industry, including Bridgestone, Michelin, GoodYear, Pirelli, Continental, Sumitomo, Toyo Tires, Yokohama, Hankook, Kumho, Nexen, Cooper and Apollo.

Based on the natural rubber supply chain, KMG simultaneously positions itself as a large supplier and as a processing factory. KMG collects raw products from small suppliers that are then processed into semi-finished products. With a total annual capacity of 720,000 metric tons, KMG produces technically determined rubber of the SIR-10, SIR-20 and SIR-20 CV types.[3] The global tire industry imports these products for processing into tires as end products. Box figure 5.1 shows the supply chain of KMG's natural rubber in the tire industry.

Box figure 5.1. **KMG's natural rubber supply chain in the tire industry: Kalimantan case**



Source: Grow Asia (2018) and KMG website.

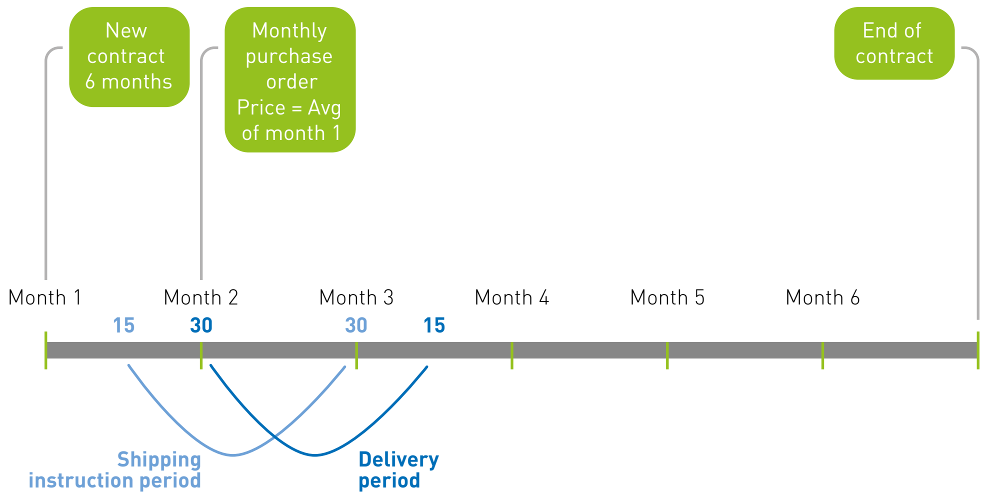
.../

[3] SIR stands for Standard Indonesian Rubber. It is a codification for natural rubber that meets the quality requirements of the Indonesian National Standard. CV stands for constant viscosity.

Box 5. **NEM case study: Kirana Megatara Group's rubber export to the tire industry** (Concluded)

In the context of NEMs, KMG plays a role as integrator, starting from cultivating rubber plantations to gathering crumb rubber to producing semi-finished products. While the former sources of natural rubber come completely from smallholder farmers, the latter sources are from KMG's own rubber plantations. In Bangka, there are two processing factories, PT Karini Utama (monthly capacity 1,000 tons), owned by PT Kirana Megatara Tbk, and PT Fajar Berseri, owned by local entrepreneurs.

Box figure 5.2. **KMG's long-term contract scheme**



Source: Kirana Megatara (2019).

In general, such a large supplier as KMG has annual contract farming with monthly supply obligations that operate at the provincial level, with a supply capacity exceeding a thousand tons per month. Large suppliers have long-term partnerships with small suppliers and rubber farmers in the same location. They provide advance payments and in-kind loans (foodstuffs such as rice, sugar and salt) to secure farmer loyalty.

The international natural rubber market trade commonly consists of two types of transactions:

1. Spot sales are the volume and market price negotiations between buyers and sellers at the time of transaction. Spot sales still dominate trading transactions of the international natural rubber market.

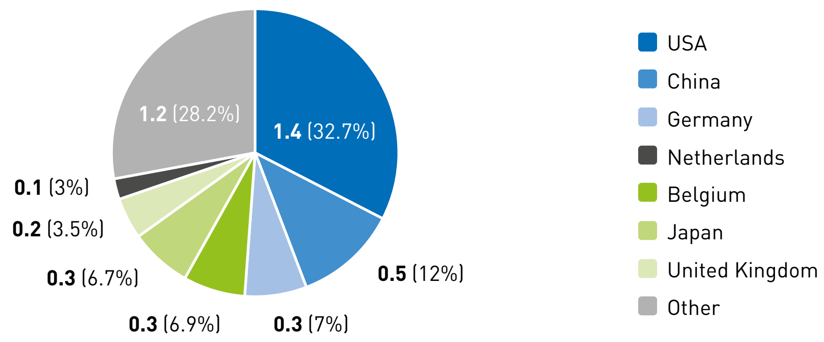
2. Long-term contract sales is a contract system ranging from 6 to 12 months wherein both parties agree on the SIR volume to be supplied by the seller to the buyer on a monthly basis with a selling price based on a certain formula during the contract period.

More than 95 per cent of KMG's sales are made through a long-term contract mechanism that uses the previous month's average natural rubber Singapore Commodity Exchange prices as the selling price (box figure 5.2). This contract does not involve TNCs. KMG as aggregator directly manages and controls the standard farming procedure. Because of the involvement of farmers and KMG, which sell the products to global tire producers including those in Japan, this mode is categorized as NEM contract farming. Box figure 5.2 illustrates KMG's long-term contract scheme.

[2] Subcontracting: Footwear

Subcontracting is a method of production and processing in which an outside company or provider is hired to perform specific processes of a business contract or project. Historically, Japanese companies have subcontracted to companies in China, which is nearby and has low labour costs. However, as labour costs rise in China, subcontracting is shifting to the countries of Southeast Asia. Indonesia is one of the Southeast Asian countries that receives a great deal of attention because, aside from its low labour costs, it has also developed its infrastructure, which makes carrying out production on consignment in several types of industries easier. Among subcontracted industries in Indonesia, the footwear industry is a significant player.

Figure 6. **Destination of Indonesian footwear exports, 2019** ($ billion)



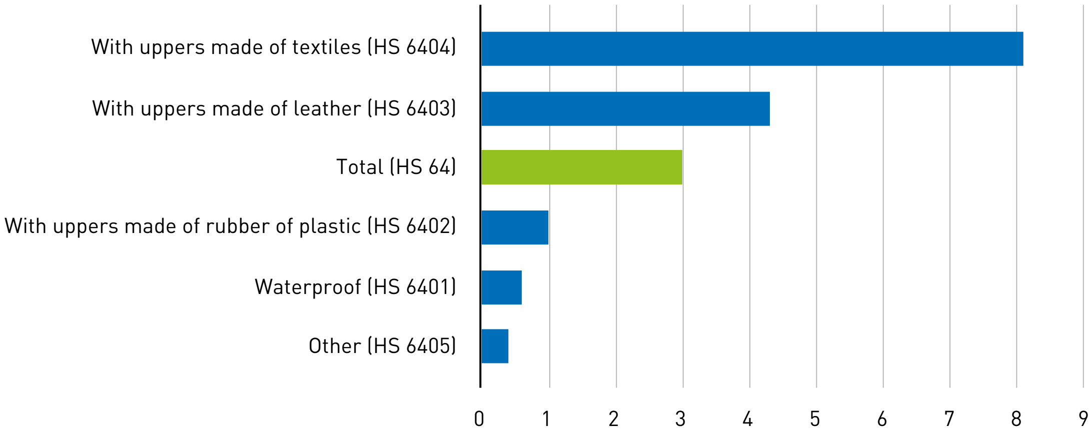
Source: UN Comtrade Database.

The Indonesian footwear industry started growing in the 1980s with the government's support for attracting foreign investment. This growth became stronger with the establishment of the Indonesian Footwear Association (APRISINDO) in 1988 (APRISINDO 2019). The industry continued to grow and has led Indonesia to become the third largest footwear exporter in Asia after China and Viet Nam.

Indonesian footwear products have remarkable global reach and are imported by 142 countries around the world. The five largest import countries account for more than half of total footwear exports. The most frequent destination for Indonesian footwear is the United States, followed by China, Germany, Belgium and Japan (figure 6).

Indonesian footwear exports have increased by 11 per cent annually since 2006. The value of Indonesian footwear exports was $4.4 billion in 2019. Footwear is technically classified as a product with the World Customs Organization's Harmonized System (HS) code 64. The largest global market share for a footwear product in Indonesia is footwear with uppers made from textile products (HS 6404) (figure 7). This product's share trails only behind China and Viet Nam in terms of global exports. Although walking shoes belong to this commodity group, athletic shoes mostly have uppers made from textiles.

Figure 7. **Indonesian footwear's global market share by type, 2019** (Per cent)



Source: UN Comtrade Database.

Box 6. **Outsourcing practices in the footwear industry**

Fashion brands that subcontract footwear products generally apply one of three modes of export: assembly, original equipment manufacturing (OEM) and original brand name manufacturing (OBM).

1. Assembly is a form of industrial subcontracting in which sewing plants are provided with imported inputs for assembly, most commonly in export-processing zones.
2. OEM is a form of commercial subcontracting. The supplying firm makes a product according to a design specified by the buyer. The product is sold under the buyer's brand name. The supplier and buyer are separate firms. The supplier lacks control over distribution.
3. OBM is the upgrading by manufacturers from the production expertise of OEM to first the design and then the sale of their own brand products.

Source: Goni and Kadarusman (2015)

Indonesian footwear factories are mainly located on the islands of Java and Sumatra, specifically in West Java, East Java and the North Sumatra Provinces. Each region specializes in a certain type of footwear. For instance, formal and casual shoe-manufacturing segments are mostly specialized in Yogyakarta, North Sumatra and East Java, while sandal manufacturers are mainly situated in Banten, West Java and East Java.

Indonesia has an important global presence in all types of footwear under different modes of export (box 6) and is especially prominent in athletic footwear. The presence of international athletic footwear firms in Indonesia has had a major impact on the sector's development. For example, Indonesia was the location of 25 per cent of Nike's footwear production in 2015. Many other top international footwear brands also have a presence in Indonesia, including Adidas, Puma and other international brands (box 7). The major domestic athletic footwear manufacturers are Adis Dimension Footwear, KMK Global Sports and Panarub Industry. Non-athletic industry leaders include Sepatu Mas Idaman, Mangul Java and Teguh Murni.

Box 7. **NEM case study: Adidas and PT Panarub Industry**

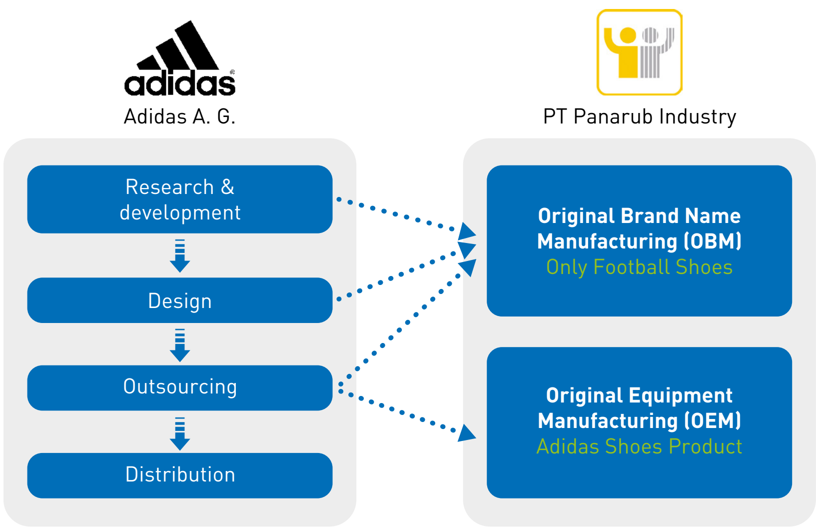
PT Panarub Industry is an Indonesian company established in 1968 by Lukas Sasmito that produces rubber sponge and "Lily" plastic sandals. Panarub is located in Tangerang with a factory area around 20 ha and has 25 high-tech production lines with around 9,000 employees. The company has had an historical collaboration with Adidas since 1988. In 1998, Panarub was chosen to be Adidas's football specialty center and began producing the Predator model for the World Cup in 2000. Panarub Industry expanded the business from one factory to two additional factories: Panarub Dwi Karya (Benoa) and Panarub Dwi Karya (Cikupa). The company expanded the business to set up a raw material company to support Panarub with technology called SL rubber—a special rubber used in Adidas professional football shoes since 2012. Panarub produced 1.25–1.4 million pairs of shoes per month.

When Adidas first began ordering from PT Panarub Industry in Indonesia in 1988, the factory only produced shoes as per Adidas design. The research and development, design and marketing of products came from Adidas, while Panarub Industry only produced based on Adidas requirements. Adidas as the lead firm was involved in most aspects, including supplier decisions for the raw material used in production.

In recent years, PT Panarub Industry has worked closely with Adidas in the stages of product development to completion of product prototype by supplying the customer with designs and the engineers with feedback on product designs. Together, the two companies developed certain proprietary technologies for manufacture, components and the processing technique. Adidas developed its primary supplier by involving Panarub in the development stages (box figure 7.1).

In the beginning, design and development came from the brand owner (Adidas), and the factory (Panarub) only produced the shoes. Because Panarub was chosen as an Adidas football specialist, Panarub continued to become a strategic partner for Adidas. In 2012, Panarub set up a division, Adidas Innovation Technology, that is responsible for developing a model for Adidas football shoes. Adidas allocates its employees to work together with the factory to develop new products. The factory sends the prototype product to Adidas marketing in Germany, then Adidas reviews it by offering shoes to the market (athlete, buyer and lab test) all over the world. Initially, salesmen sample approximately 5,000 pairs, then if buyers agree and commit to buy a certain volume, Adidas will ask the factory to produce.

Box figure 7.1. **Positioning of Panarub Industry in the value chain of Adidas**



Source: Goni and Kadarusman (2015).

[3] Management Contracts and Franchising: Hotel

Spectacular natural landscapes and rich diversity in cultural heritage make Indonesia a remarkable destination country that attracted 16.1 million international tourists in 2019. This opportunity has attracted the attention of international hotel chains to enter the Indonesian hotel industry. Indonesia is one of the ASEAN member countries that attracts tourists from all over the world. Market demand for hotels has been growing continuously in the past years (table 5).

Table 5. **Indonesia tourism indicators**

	Year					
Description	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**
No. of foreign tourists (million)	9.4	10.2	11.5	14.0	15.8	16.1
Revenue ($ billion)	3.6	3.8	4.0	4.2	4.4	4.5
Occupancy rate (%)	51.8	53.9	54.3	56.7	58.9	54.8
Number of star-rated hotel rooms	195,886	217,474	233,007	254,167	314,051	363,749

Source: Statistics Indonesia/Badan Pusat Statistik.

In 2019, there were around 3,516 star-rated hotels with roughly 195,886 rooms in Indonesia. These hotels are mostly located in Bali (507 hotels), West Java (495 hotels) and Jakarta (397 hotels). Table 6 lists major hotel chains in Indonesia.

Table 6. **Major international hotel chains in Indonesia**

Hotel chain	Hotel brand name
Accor Hotel (15)	All Season, Ibis, Formule 1, Grand Mercure, Pullman, MGallery by Sofitel, Novotel, Fairmont, Raffles, Swissôtel Hotels, Banyan Tree, The Phoenix Hotel, Royal Surakarta Heritage, Ramada Bali, Days Hotel & Suites
Archipelago International (12)	Grand Aton, Alana, Royal Alana, Royal Kamuela, Aston, Aston City, Aston Inn, Quest Hotels, Neo Hotels, Fave Hotel, Harper, 100 Sunset Boutique
Marriott International (29)	St. Regis Hotels & Resorts, The Ritz-Carlton, JW Marriott, Edition, The Luxury Hotel Collection, W Hotels, BVLGARI Hotel & Resorts, Autograph Collection Hotels, Le Méridien, Tribute Portfolio, Westin Hotels & Resorts, Renaissance Hotels, Gaylord Hotels, Marriott, Delta Hotels, Sheraton, Marriott Executive Hotels, Courtyard, Four Points by Sheraton, Springhill Suites by Marriott, Residence Inn by Marriott, AC Hotels, Aloft Hotels, Element by Westin, Moxy Hotels, Protea Hotels, Fairfield, TownePlace Suites
Grand Hyatt (3)	Grand Hyatt, Hyatt Regency, Hyatt
Swiss-Belhotel (7)	Grand Swiss Hotel, Swiss-Belhotel, Swiss-Belinn, Zest, Hotel Ciputra, Arion, Swiss Hotel
InterContinental Hotels Group (IHG) (4)	InterContinental, Crowne, Holiday Inn, Indigo
Discovery Hotels & Resorts (7)	Borobudur, Discovery, Home@36 Bali, Palaca Hotel Cipanas, Hotel Ebony, Kendari Beach Hotel, Discovery Express
Louvre Hotel Group (LHG)–Jin Jang Holdings International (4)	Royal Tulip, Golden Tulip, Kyriad, X2 Resort
Hilton (4)	Conrad, Hilton, Hilton Garden Inn, Double Tree
Best Western Group (2)	World Hotels Collection, Best Western Hotels & Resorts

Source: Rangkuti (2017) and hotel group's website

International hotels operate in Indonesia (box 8) under different types of contracts and different types of entry modes (table 7). One of the most critical factors affecting TNCs' decision to choose NEMs over FDI is local regulations. According to Ease of Doing Business Rankings data in 2020,[4] Indonesia ranks 6th out of ASEAN countries and 73rd globally. Due to such restrictive local regulations, Indonesia was largely bypassed when 33 Chinese-listed companies were looking for other locations in 2019 (Patunru and Surianta, 2020). Prior to that, in 2017, Indonesia only managed to attract 10 out of 137 Japanese companies moving into Southeast Asia (World Bank, 2019). Considering the bureaucratic difficulties involved in Indonesian inward FDI, foreign investors who own international hotel brands have to adopt a more flexible mode of entry such as contract management or franchise agreements.

In the global hotel industry, high degrees of control and lucrative revenues can be derived from establishing contractual agreements with local business rather than investing in real estate, (Quer et al., 2007). The internalization theory conceptually suggests that contract agreements allow firms more flexibility in modifying their decisions in response to unforeseen change in host country conditions. For example, high transaction costs could arise due to cultural differences in host countries particularly in the case of equity investment (Anderson and Gatignon, 1986).

Table 7. **Hotel operations by type of entry mode**

	FDI	**Management contract**	**Franchise agreement**
Ownership of the land and hotel	Owns hotel	Without ownership interest	Without ownership interest
Management control	Direct control	Direct leadership by expatriates from headquarters	Management training through manuals
Contract fees	Not applicable	Tend to be higher (10% or more of profit)	Lower (less than 10%)
Scale and speed of the hotel chain	Slow, smaller scale	Faster, medium scale	Very fast, larger scale
Hotel categories	First stage of hotel chain, 5-star hotel, independent hotel	Mostly 4-star class	Mostly 3-star class

Source: Adapted from Shinomiya (2016).

The hotel industry is connected to many other industries, including booking services, restaurant services, food and beverage services, furniture and decoration industries, transportation services and transport services. These linkages contribute to employment creation and the development of related industries in the country. Thanks to the development of the tourism sector, the hotel industry has a significant impact on job creation in Indonesia.

4 Ease of Doing Business Rankings is a World Bank database that can be accessed at https://www.doingbusiness.org/en/rankings.

Box 8. **NEM case study: Accor Hotels**

Accor Hotels is a global hotel operator that manages 2,359 hotels under direct management contract and an additional 2,572 hotels under franchise contract in more than 110 countries (as of June 2020). Its headquarters are in Issy-les-Moulineaux, France. Accor Hotels has approximately 748,000 rooms under 39 international hotels brands (see box table 8.1).

Box Table 8.1. **Chain categories and names of Accor Hotel brands**

Category	Brand
Luxury	Raffles, Fairmont, Sofitel, Orient Express, The House of Originals, Delano, SLS, SO/, Banyan Tree, Rixos, Sofitel Legend
Premium	Pullman, Swissôtel, Movenpick, Grand Mercure, Mantis, M gallery, 21c, Mondrian, 25 Hours, Hyde, Angsana, Peppers, The Sebel, Art Series
Midscale	Novotel, Mercure, Mama Shelter, Tribe, Mantra
Economy	Ibis, Ibis Styles, Ibis Budget, Jo&Joe, Adagio, Greet, Breakfree, Hotel F1, Onefinestay

Source: Accor Global Development Summary June 2020.

In November 2019, Accor Hotels signed a hotel management agreement with PT Wijaya Karya Realty (Wika Realty) to open an Ibis Styles brand hotel in Makassar. Founded in 2000, Wika Realty was previously a business unit of PT Wijaya Karya (Persero) Tbk, a state-owned construction company in Indonesia. Wika Realty conducts its business through residence development and property management. The properties that are currently managed include residences in the form of tower apartments and landed houses (under the umbrella brand Tamansari), club houses, industrial estates and office buildings. Of its properties, seven have been developed into hotel investment properties that spread across several major cities in Indonesia (see box table 8.2).

Box Table 8.2. **Wika Realty's hotel investment properties**

Hotel	City	International Partner
Ibis Styles Makassar Airport*	Makassar	Accor Hotels Group
Kyriad Airport Hotel	Tangerang	Louvre Hotels Group
Best Western Premier The Hive Hotel	Jakarta	Best Western Hotel Group
Best Western Premier La Grande Hotel	Bandung	Best Western Hotel Group
Best Western Papilio Hotel	Surabaya	Best Western Hotel Group
Best Western The Lagoon Hotel	Manado	Best Western Hotel Group
Golden Tulip Jineng	Bali	Louvre Hotels Group
Wyndham Tamansari Jivva Resort	Bali	Wyndham Hotel Group

Source: Wikarealty.co.id.
Note: *currently being developed

.../

Box 8. **NEM case study: Accor Hotels** (Concluded)

Accor Hotels generally operates its hotel chain under one of two business models: franchising and management agreements (see box table 8.3). Hotel projects can start either as newly built projects or as hotel conversion projects (from existing property).

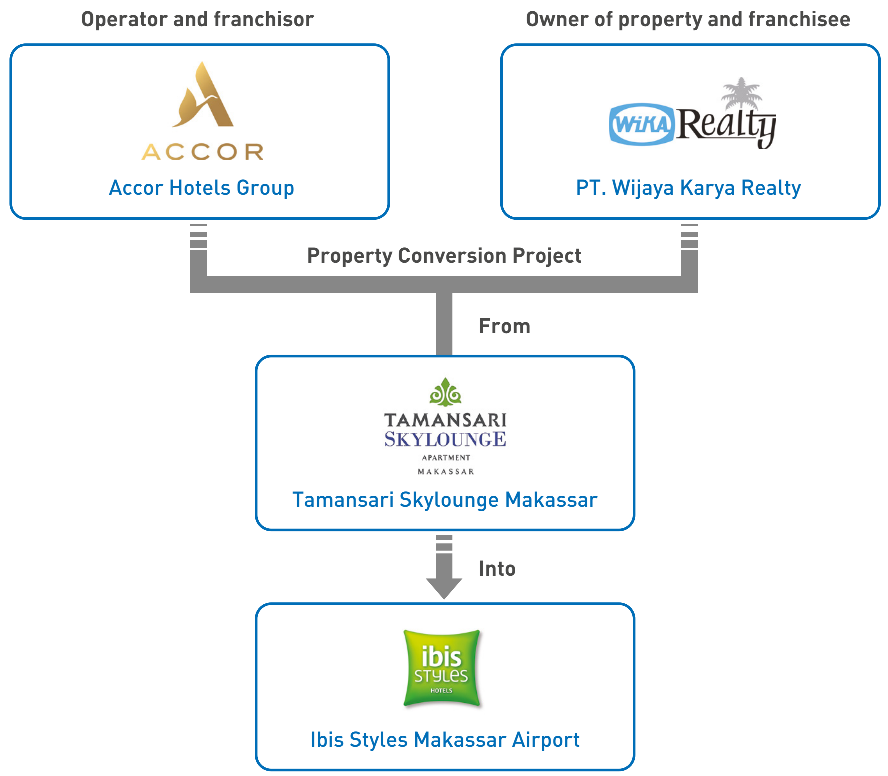
Box Table 8.3. **Accor Hotels business models**

	Franchising	Management agreement
Revenue	Initial franchise fee, revenue-based basic franchise, distribution and marketing, loyalty, information technology and property management system	Pre-opening, basic management (on revenue), distribution and marketing, incentive (on gross operating profit), loyalty, information technology and property management system
Features	2,572 franchised hotels, most are in the economy segment (65%) (as of June 2020)	2,359 company-operated hotels, most are in the economy segment (40%) (as of June 2020)

Source: Accor Master Your Development 2017, Accor Hotel Portfolio June 2020.

As a local host company, Wika Realty aligned with Accor Hotels to rebrand 170 rooms in one of its apartment properties, Tamansari Skylounge Makassar, as a hotel under the name Ibis Styles Makassar Airport. This hotel will start operating in 2021. Ibis Styles Makassar Airport will operate under a combination of the franchise and management agreement models (see box figure 8.1).

Box figure 8.1. **Ibis Styles Makassar Airport Hotel project**

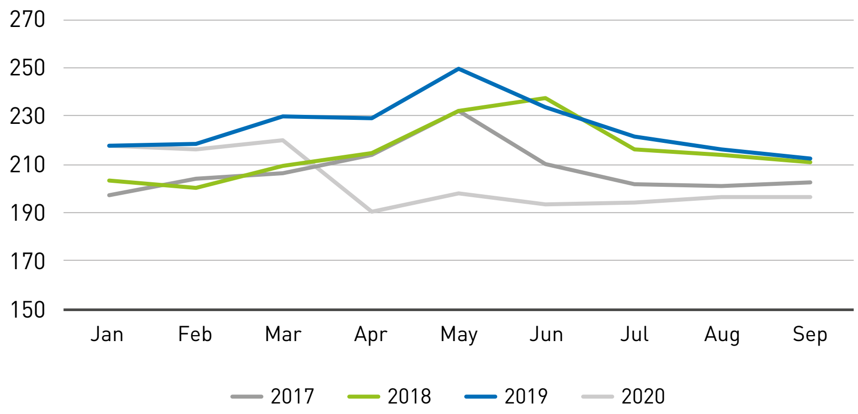


Source: Wikarealty.co.id.

[4] Franchise: Convenience Store

The dynamics of the retail industry in Indonesia are developing in line with growth in the middle market segment. The retail industry plays an important role in driving economic growth in terms of trade and consumption. Quoting data from Statistics Indonesia (BPS), in the second quarter of 2020, the trade sector made up 13 per cent of total GDP, while household consumption contributed 58 per cent of total GDP (BPS, 2020). This contribution is said to be quite large even though growth has decreased compared with the corresponding quarter in 2019 due to COVID-19. This is represented in figure 8, where the 2019 total retail sales index has increased compared with that of 2017 and 2018 and then decreased in 2020 due to the pandemic.

Figure 8. **Indonesia total retail sales index, 2017–2020**



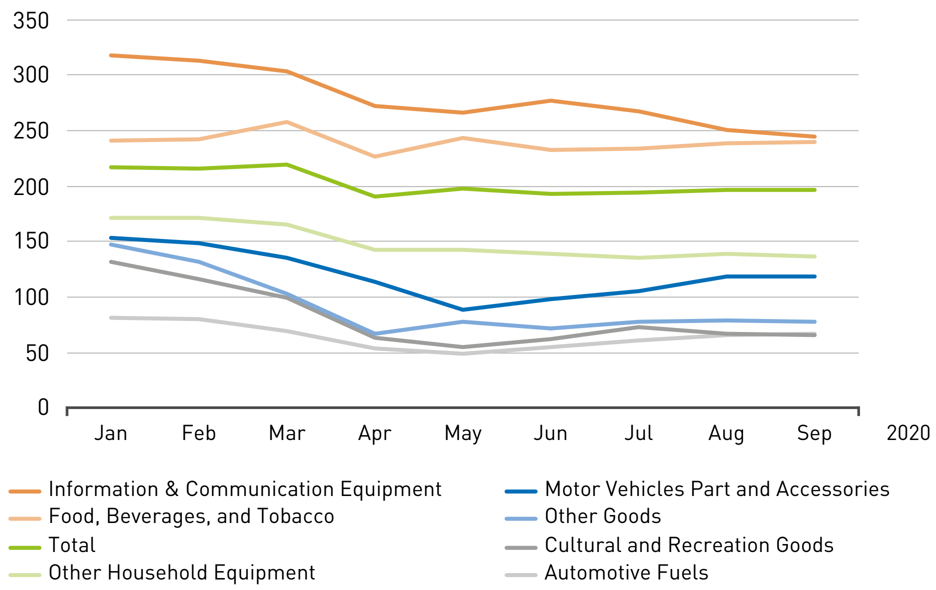
Source: Bank Indonesia.
Note: Base year is 2010.

One dynamic of the Indonesian retail industry is the rapid development of information technology, which requires retailers to adapt and provide online shopping services for an increasingly sophisticated population. Figure 9 shows that information and communication equipment dominate the 2020 retail sales index due to shifting most activities online or long distance. Even so, the food, beverages and tobacco sector remains in second place.

Amid these dynamics, the modern store segment, particularly convenience stores, is projected to be quite promising. Convenience stores have moved from providing impulse products, such as snacks, beverages and tobacco, to competing with fast-food restaurants by expanding their range of ready-to-eat and impulse items and adding many other services and products to attract consumers. Euromonitor 2020 data indicate that the number of convenience store outlets in Indonesia reached 34,780 in 2019, an increase of 7 per cent compared with 2013, and sales of $12 billion. This has triggered TNCs to see a great potential in expanding to Indonesia using NEMs, such as franchising.

Today, large companies operate 65 per cent of Indonesian minimarkets/convenience stores. For instance, Sumber Alfaria Trijaya owns Alfamart, while the Salim Group owns Indomaret. Other parties own the remaining 35 per cent through franchise agreements, including Lawson, Inc., from Japan (box 9), which initially granted the franchise rights to PT Midi Utama Indonesia (Alfamidi). Between 2011 and the present, Lawson Indonesia has already established 73 outlets. Under a franchise concept, PT Lancar Wiguna Sejahtera (a subsidiary of PT Midi Utama Indonesia), which oversees Lawson Indonesia, must pay a royalty fee to Lawson, Inc. (box figure 9.1).

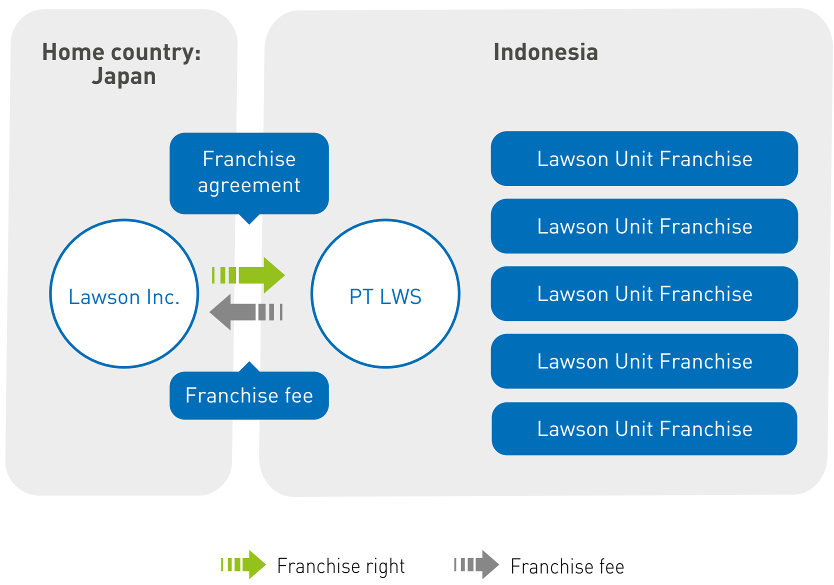
Figure 9. **Indonesia total retail sales index by sector, 2020**



Source: Bank Indonesia.
Note: Base year is 2010.

Box 9. **NEM case study: Lawson, Inc. and PT Lancar Wiguna Sejahtera**

Box figure 9.1. **Franchise framework of Lawson (Japan) in Indonesia**



Source: Lawson (2019).

.../

Box 9. **NEM case study: Lawson, Inc. and PT Lancar Wiguna Sejahtera** (Concluded)

The Lawson franchise was first developed in 2011 with PT Midi Utama Indonesia Tbk holding exclusive rights as a Lawson franchisee. On 6 June 2018, PT Lancar Wiguna Sejahtera (LWS), a subsidiary of PT Midi Utama Indonesia Tbk, signed a Master License Agreement with Lawson, Inc. of Japan. The agreement gave LWS exclusive rights to use and act as a franchisee of the Lawson trademark and knowhow in Indonesian territory for a period of 18 years, which could be extended based on agreement between the parties. Lawson, Inc.'s 99 per cent ownership of LWS will hopefully focus Lawson convenience store development so that its performance will become more optimal and will increase LWS's profitability. In return, LWS must pay a royalty fee to Lawson, Inc. of a certain percentage of the net income of Lawson stores, with expenses such as gondola rental, floor display rental and promotional participation deducted.

Lawson outlets that provide ready-to-eat food and drinks (convenience stores) sell various Japanese specialties and other foods such as onigiri, bento, fried rice, pasta and beverage products such as coffee, ice cream and others. As of May 2020, 73 Lawson outlets are operating in Indonesia.

2.3 Preferred Mode of Foreign Investment Based on AHP

To determine the best foreign investment mode for Indonesia, this study uses AHP (box 10) to understand better the choice of FDI or NEMs based on in-depth interviews with experts and business practitioners.[5]

Box 10. **Analytical hierarchy process**

AHP is a structured technique for organizing and analyzing complex decisions (box figure 10.1). Individual experts' experience is used to estimate the relative magnitude of factors through pairwise comparisons. Each respondent must compare the relative importance of the two items in each pair through a specially designed questionnaire on a scale of 1–9. Fundamentally, AHP divides a complex and unstructured problem into groups, arranges the groups into a hierarchy, assigns numerical values as a substitute for human perception in making relative comparisons and finally determines which elements have the highest priority. The AHP principle is to weight each factor, variable and indicator by comparing factors, variables and indicators with one another. A greater weight of an indicator signifies an indicator's greater importance in determining the preferred mode of foreign investment in Indonesia. The appendix presents a more technical explanation of the method.

To analyze the variables that determine the best mode of foreign investment in Indonesia, UNCTAD (2011) reports that NEMs, like FDI, have various types of development implications, including employment creation, increase in local value added, export generation, technology and skills acquisition, social and environmental impacts and long-term capacity building. Furthermore, Combs et al. (2004) argue that franchising—one of many NEMs—enhances growth and survival of

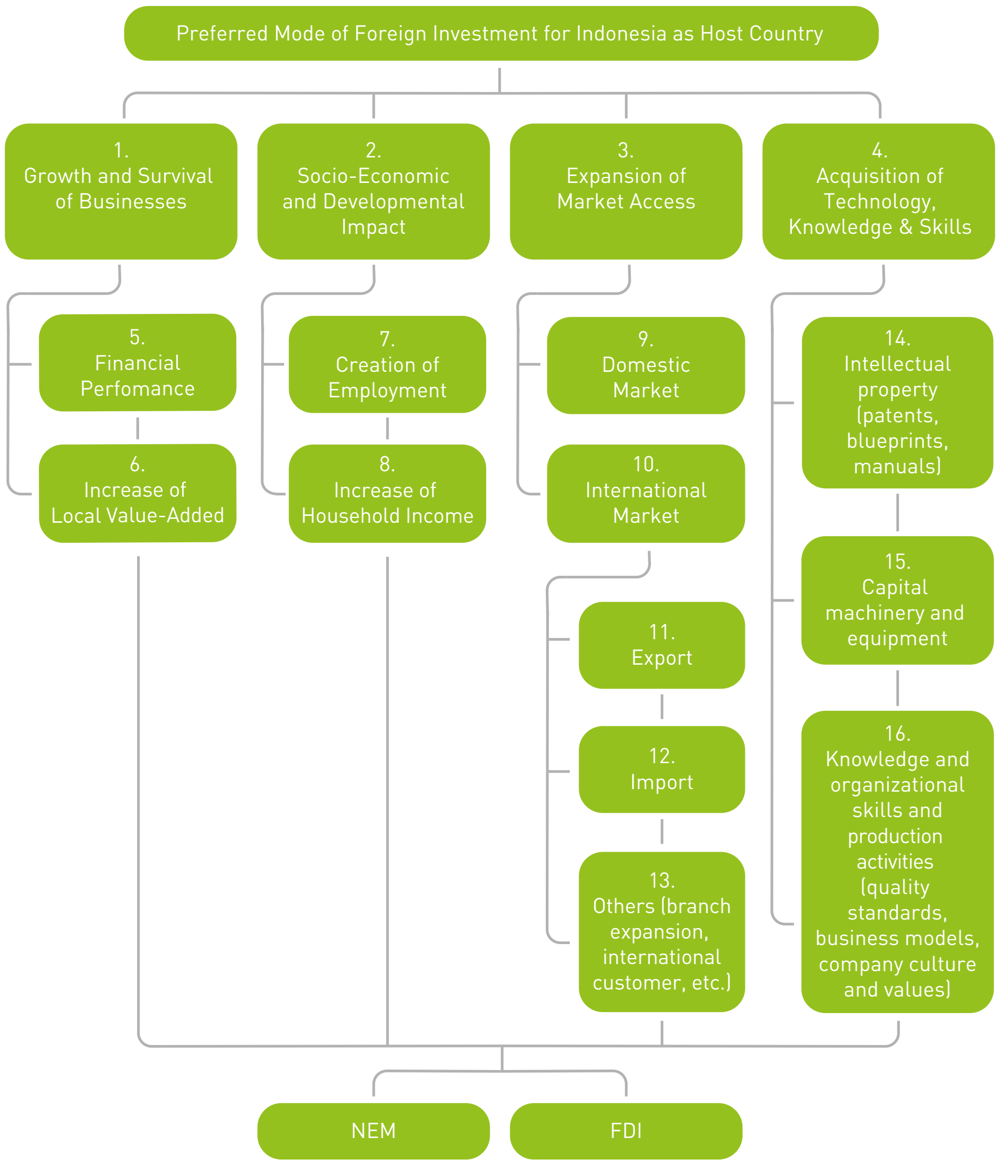
.../

[5] Two experts and one business practitioner participated. The former have expertise in international economics with a concentration in agriculture and tourism, and the latter is a businessman and a representative from GAPKINDO (Indonesian Rubber Association). The COVID-19 pandemic prevented interviews with more experts, weakening the statistical significance. Nevertheless, with this caution kept in mind, this section provides some important insights.

Box 10. **Analytical hierarchy process** (Concluded)

the franchisee's business. Besides franchising, contract farming led to higher household income (Bellemare, 2012). Furthermore, contract farmers earn higher yields due to technical assistance and specialized inputs (Miyata et al., 2009). Finally, Kim (2008) shows that hotels that participated in contract management had higher financial performance in terms of profitability, stability and operating indicators. These variables from the literature form the hierarchy of the AHP model of 16 variables and indicators seen in box figure 10.1. From this hierarchy model, the experts will select the preferred mode of foreign investment for Indonesia. NEMs and FDI will be evaluated using the predetermined criteria and sub-criteria as written in the hierarchy.

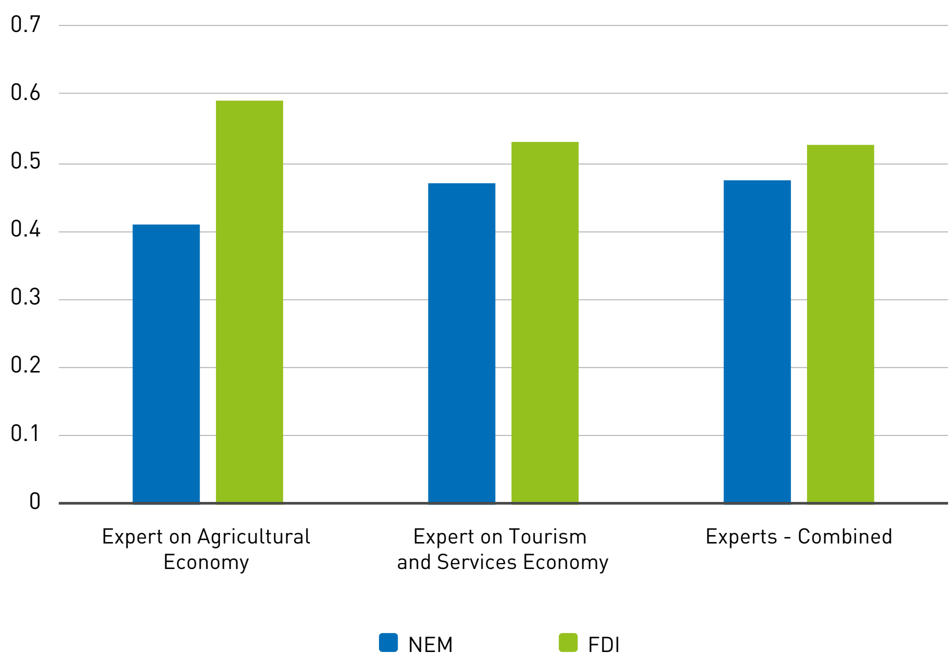
Box figure 10.1. **AHP model to determine FDI or NEMs**



Source: AJC.

In-depth interviews indicate that, in general, FDI still has a bigger impact on Indonesia than NEMs (figure 10). Thus, compared with NEMs, FDI is preferred under the defined set of variables and indicators in box 10. The expert in agriculture and the expert in tourism generally concur with this finding.

Figure 10. **Preferred foreign investment mode based on AHP results by expert** (Weight)

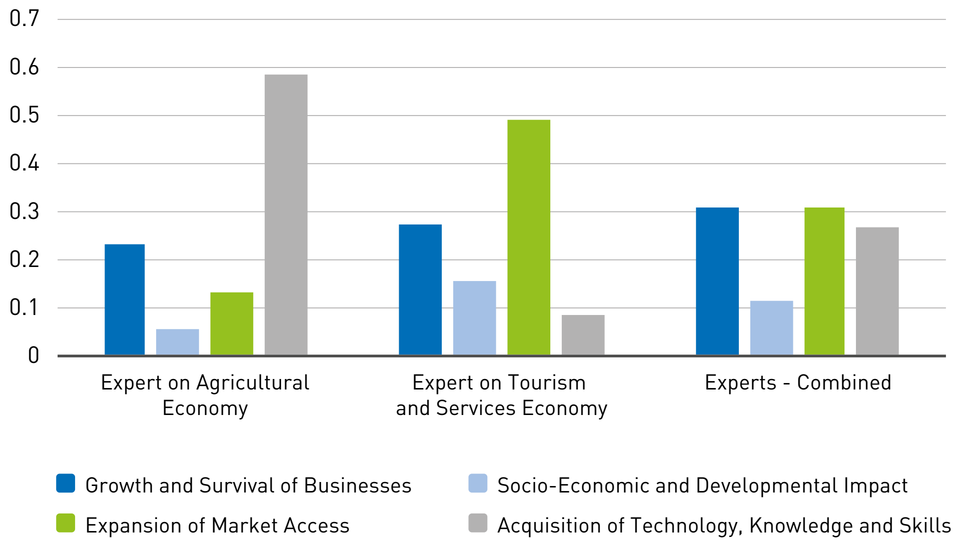


Source: AJC.
Note: The sum of weights is calculated to be 1.

While the experts' expertise likely influences the results, the agriculture expert and the tourism expert both agree that FDI has a greater positive impact on Indonesia. Both experts consider the preferred investment mode to be the one that yields the greatest positive impact for Indonesia. Generally, both experts heavily weight the ability of a foreign investment mode to ensure the growth and sustainability of a business and expand market access for a business (figure 11). Moreover, the agriculture expert emphasized the ability of an investment mode to provide access for businesses to acquire technology, skills and knowledge. In contrast, the tourism expert emphasized expanding market access.

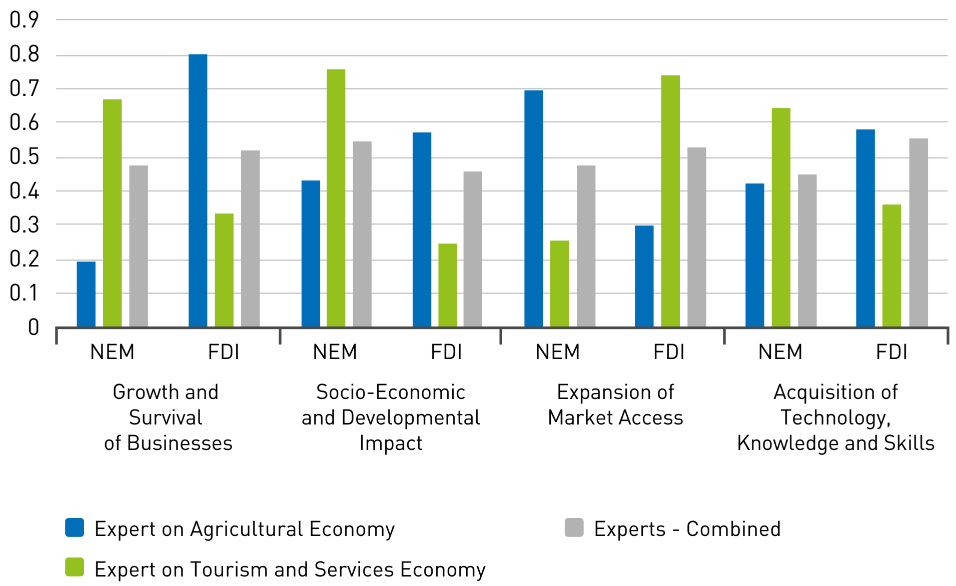
Figure 12 describes the advantages of each investment mode based on the criteria in more detail. Overall, FDI excels in three criteria: business growth and sustainability (1 in box figure 10.1), expansion of market access (3 in box figure 10.1) and acquisition of technology, skills and knowledge (4 in box figure 10.1). NEM only excels in terms of socioeconomic and development impacts (2 in box figure 10.1). Nevertheless, although NEMs provide a greater socioeconomic and development impact than FDI, the weight of socioeconomic and development impacts is only 0.115 of the total existing weights.

Figure 11. **Criteria for the preferred foreign investment mode based on AHP results by expert** (Weight)



Source: AJC.
Note: The sum of weights is calculated to be 1.

Figure 12. **Preferred foreign investment mode per criterion based on AHP results by expert** (Weight)



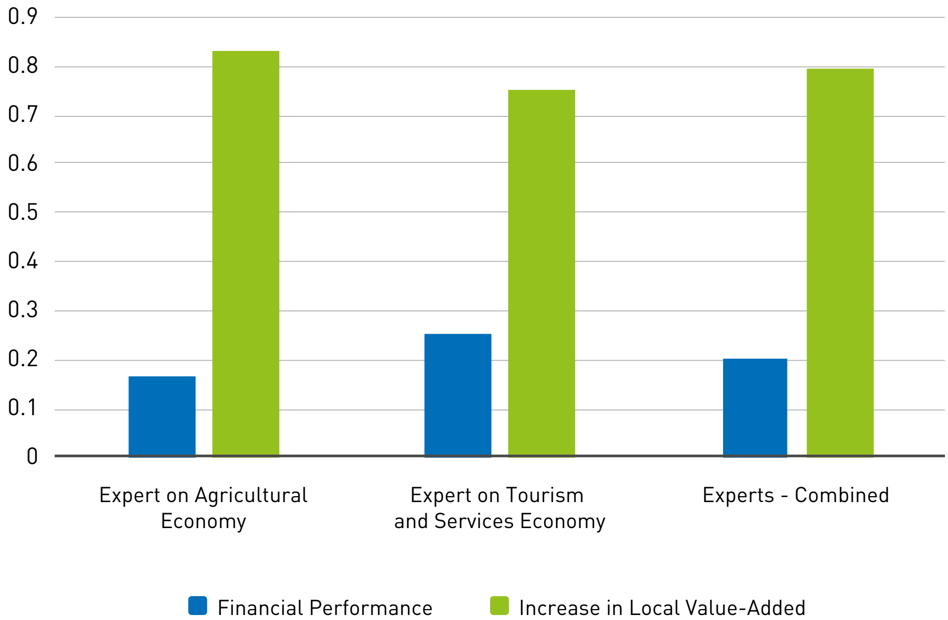
Source: AJC.
Note: The sum of weights is calculated to be 1.

For NEMs to become the preferred choice, TNCs wishing to implement NEMs in Indonesia, particularly in agriculture and tourism, must at least be able to promise business growth and sustainability and expand market access for Indonesian companies. In agriculture, opportunities to acquire technology, knowledge and skills are of paramount importance, and in the tourism sector, expanding market access is vital.

To encourage business growth and sustainability, the aspect that must be promised is increased sales and value added (5 and 6 in box figure 10.1) (figure 13). This is what Indonesian companies are most concerned about in driving the growth and sustainability of their businesses. To encourage the acquisition of technology, knowledge and skills, the acquisition of organizational knowledge and skills and production activities should be accentuated (16 in box figure 10.1) (figure 14).

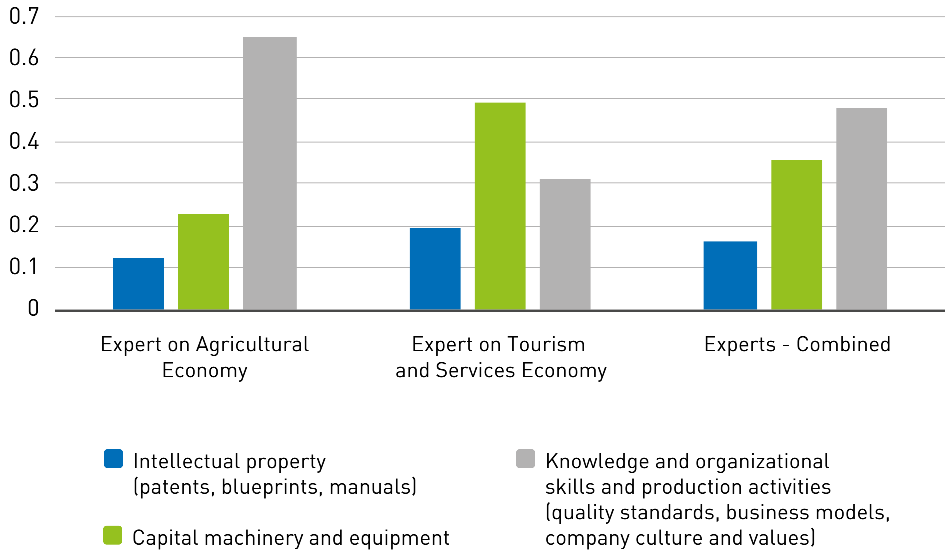
Thus, to expand market access, the international market becomes the most attractive aspect (10 in box figure 10.1) (figure 15). An investment mode that can expand a company's market access to international markets is a better investment mode than other investment modes. In particular, to encourage market expansion in international markets, aspects other than exports and imports have a higher weight (13 in box figure 10.1) (figure 16). This indicates that an investment mode that can promise companies access to international customers, new international partners and even branch expansion abroad would be preferred.

Figure 13. **The most important aspects to drive business growth and sustainability based on AHP results** (Weight)



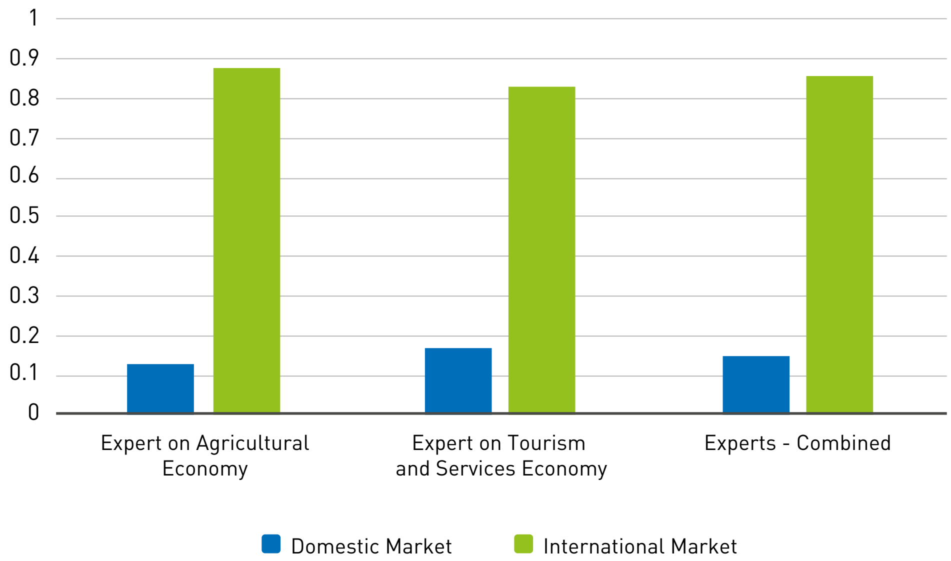
Source: AJC.
Note: The sum of weights is calculated to be 1.

Figure 14. **The most important aspects to encourage acquisition of technology, knowledge and skills based on AHP results** (Weight)



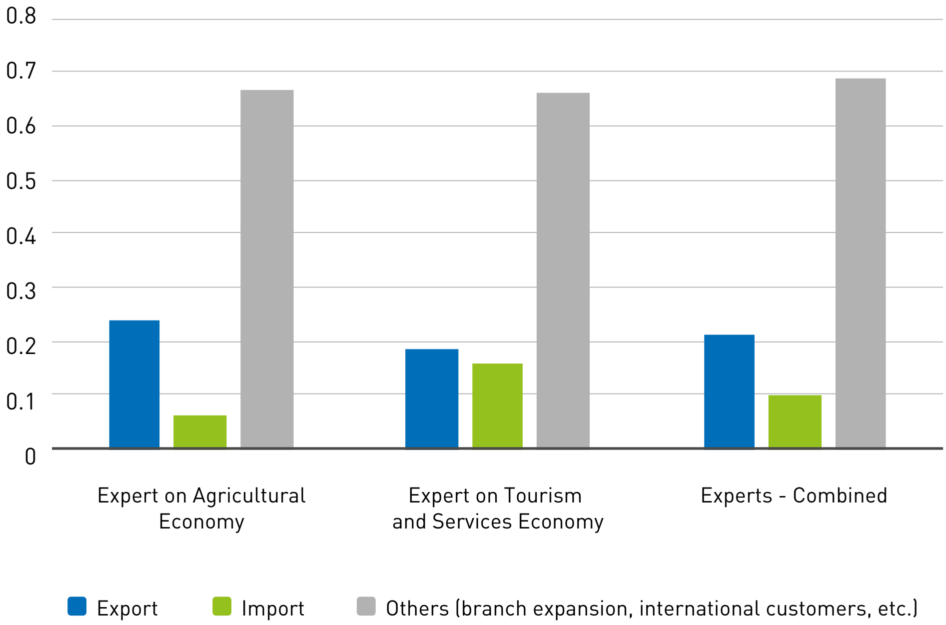
Source: AJC.
Note: The sum of weights is calculated to be 1.

Figure 15. **The most important aspects to expand market access based on AHP results by expert** (Weight)



Source: AJC.
Note: The sum of weights is calculated to be 1.

Figure 16. **The most important aspects to expand international market access based on AHP results by expert** (Weight)



Source: AJC.
Note: The sum of weights is calculated to be 1.

Box 11. **Results of the analytical hierarchy process in the rubber sector**

Due to sectoral differences, the representative from the rubber sector received more specific questions regarding NEMs in that sector. Specifically, the businessman representing this sector was not asked to compare modes of foreign investment. Instead, he was only asked about the benefits that domestic rubber companies that had NEM relations with TNCs would receive. The informant in the rubber sector represents GAPKINDO (Indonesian Rubber Association).

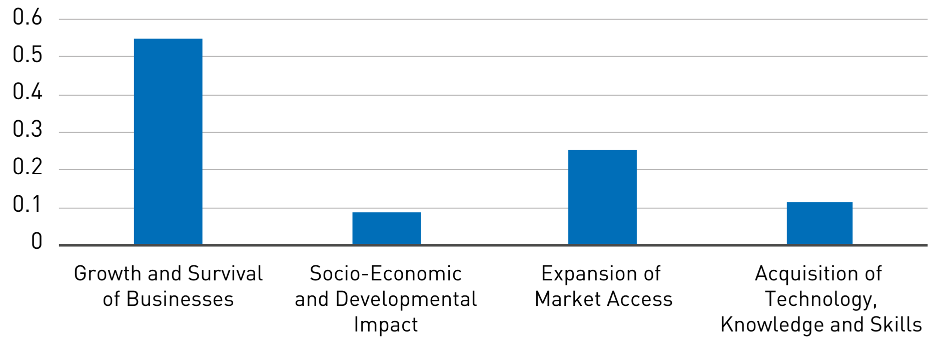
In-depth interviews and AHP data processing yielded results that were quite consistent with the results from the sector experts. Overall, GAPKINDO sees receiving a boost in business growth and sustainability (1 in box figure 10.1) as the biggest benefits of domestic rubber companies' NEM relationships (box figure 11.1). Aside from these aspects, NEM can encourage market expansion.

For GAPKINDO, in terms of encouraging business growth, NEMs can increase local added value and sales (box figure 11.2). NEMs are also beneficial for the expansion of a company's market because, for GAPKINDO, NEMs can expand rubber companies' market access to international markets, especially for exports (box figure 11.3).

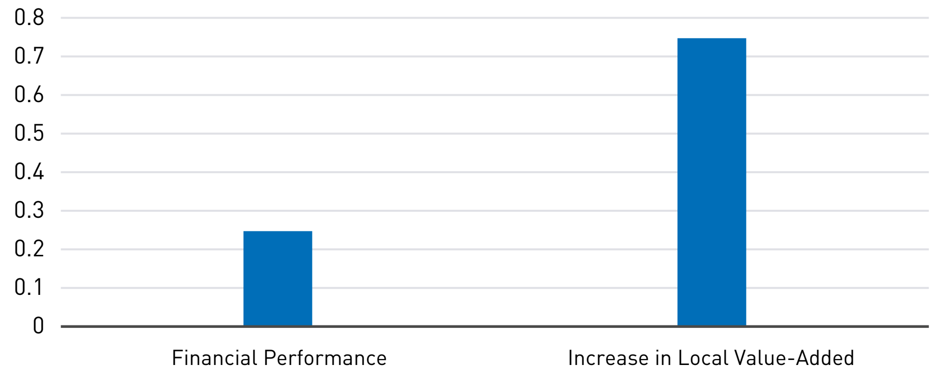
.../

Box 11. **Results of the analytical hierarchy process in the rubber sector** (Concluded)

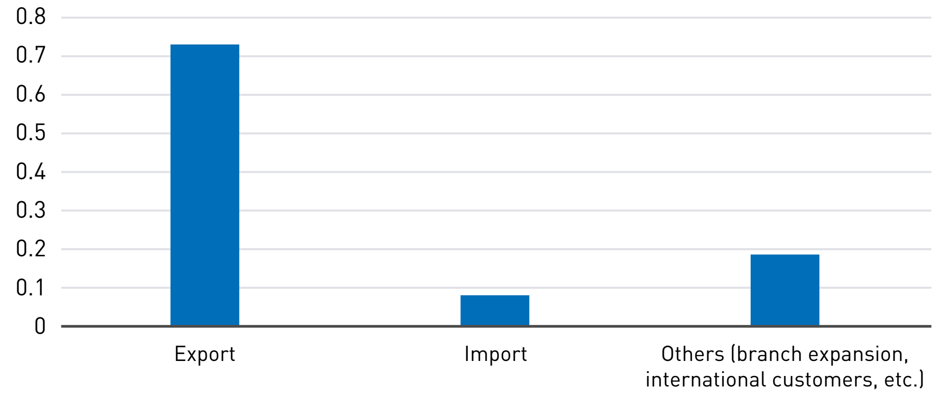
Box figure 11.1. **The biggest benefit of NEMs according to GAPKINDO based on AHP results by factor** (Weight)



Box figure 11.2. **The biggest benefit of NEMs according to GAPKINDO in the business growth and sustainability aspect based on AHP results** (Weight)



Box figure 11.3. **The biggest benefit of NEMs according to GAPKINDO in the international market expansion aspect based on AHP results** (Weight)

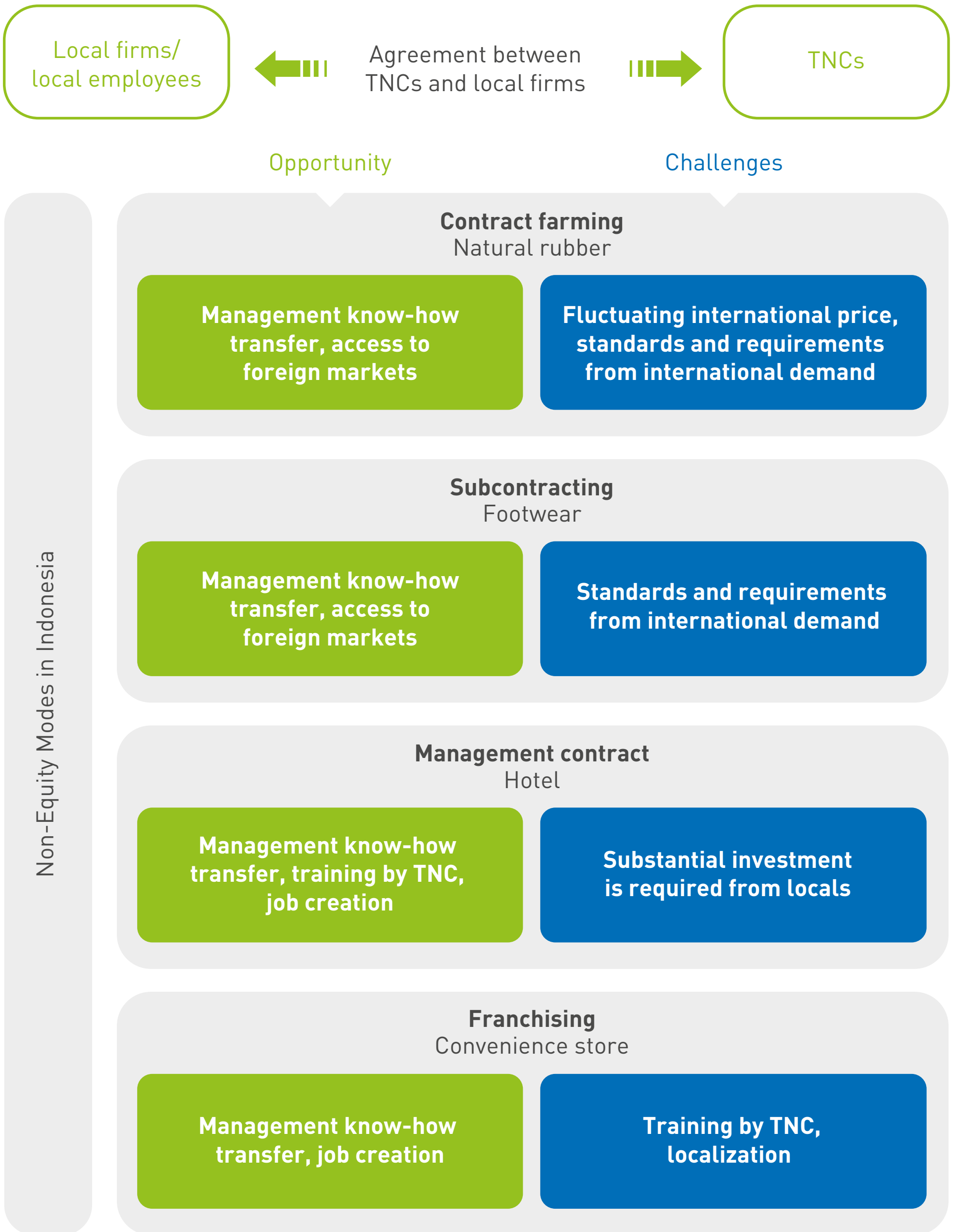


Source: AJC.
Note: The sum of weights is calculated to be 1.

3. OPPORTUNITIES AND CHALLENGES

This section analyses opportunities and challenges facing Indonesia in promoting and utilizing NEMs (figure 17). By establishing NEM agreements with TNCs, each industry will benefit from several opportunities. However, NEMs also present challenges to local firms, particularly because of the characteristics of NEMs.

Figure 17. **Opportunities and challenges for NEMs in Indonesia** (Major industries only)



Source: AJC.

3.1 The Pursuit of Industrialization in Indonesia

Indonesia is ambitious to get out of the middle-income country group. Rodrik (2013) states that an important prerequisite to achieving this is the manufacturing sector's development. At the same time, Hardiana and Hastiadi (2019) find that Indonesia needs at least 6 to 7 per cent growth in per capita income per year.

Therefore, Indonesia must have inclusive, stable and sustainable economic growth and a well-developed manufacturing sector. The decline in the performance of the manufacturing sector, as evidenced by the phenomenon of premature de-industrialization, complicates matters. The decline in manufactured exports further exacerbates the situation. So far, Indonesian economic growth in terms of trade relies heavily on commodity exports, which, in fact, are very vulnerable to global commodity prices (Wihardja, 2016). Indonesia must therefore switch to exports of manufactured products.

At least two things can help develop the manufacturing sector: encouraging manufacturing exports and supporting technology transfer. Although manufacturing exports have declined due to the manufacturing sector's declining performance, advancing manufactured exports will also boost the performance of the manufacturing sector. As the case study in box 11 described, NEM cooperation with TNCs increases demand for domestic products from abroad, in turn increasing manufacturing exports. The results of the AHP by GAPKINDO also show that NEMs can encourage increased local and export value added, two components that are critical in paving the way for Indonesia to industrialization.

Technology transfer is another important component in advancing the manufacturing sector (Hastiadi and Santoso, 2021). Krugman (1979) argues that obtaining technological transfer from developed countries through FDI or NEMs could strengthen future comparative advantages. Although experts suggest that FDI provides greater technology transfer, NEMs' contribution to technology transfer cannot be denied. Thus, NEMs can help Indonesia achieve industrialization through expanding market access, adding local added value and transferring technology.

3.2 Ownership

If a TNC does not yet have business activities in Indonesia, entering the market through NEMs will be easier. If a TNC can find a local company that can offer services rather than its own affiliate, it can contract with the local company instead. This is one of the advantages of having NEMs for the TNC in the host country.

Therefore, a potential opportunity exists for local companies in the rubber, footwear, hotel, retail and other industries to enter into contractual agreements with TNCs. However, while local companies may see such opportunities as attractive, they need to have a minimal level of management skills, including autonomy and initiative, technological skills and capacity, because TNC support is limited. In addition, contractual agreements with TNCs are unstable because such agreements are not guaranteed for a long term and can be terminated at any time. For example, if the TNC's demand shifts to a new position and the local company does not have the capacity to meet the new demand, the TNC can easily terminate its contract and move to another country.

3.3 Control

One of the features of NEMs is that foreign firms or TNCs do not directly own the business activities of local firms but control them indirectly, that is, TNCs' shares of equity do not control local firms.

Local firms face several challenges, as the contracts between local firms and TNCs are easily jeopardized. For example, in the natural rubber industry, when local firms do not provide the quality of natural rubber TNCs, such as international tire companies, require, TNCs can easily terminate their contract. In the footwear industry, if the demand of the TNC shifts to a new type of shoes, and local firms do not have the capacity to produce them, then local firms would lose the contract.

3.4 Localization Strategies

Governments often launch localization strategies when foreign TNCs engage in manufacturing for the domestic market. This is how Indonesia, Malaysia and Thailand initially promoted local suppliers in the automotive industry (Rasiah, 2010). Yet, these opportunities have been largely lost since deregulation began in the region (following the launch of the ASEAN Free Trade Area in 1992 and then the ASEAN Economic Community in 2015) and around the world by the World Trade Organization in 1995. Nonetheless, the government still enjoys the space to promote relations with national NEM companies without violating the World Trade Organization Trade-Related Investment Measures instrument, which prohibits differential trade treatment based on ownership (Rasiah, 2005).

TNCs operate globally, and the operations or activities of local companies are part of their global value chain (GVC), whether done with FDI or NEMs. If a local company needs to implement a localization strategy to meet the TNC's demand, the local company will have the initiative for the operation, which in turn will create more opportunities. In an industry with franchise agreements, operations or activities—for example, in the retail industry, especially convenience stores—require a localization strategy, which the hotel industry does not require. In the retail industry, the host country provides customers and demand. In the case of Indonesia, local companies such as Sumber Alfaria Trijaya (Alfamart) and Salim Group (Indomart) own most convenience stores. Indonesia has many Muslims leading some players to see an opportunity to create a business with a sharia concept. Several community-based (Muslim) companies have also started to emerge. For instance, 212 Mart has established itself as a modern sharia-based minimarket that offers halal products. Consequently, the TNC needs a localization strategy to meet the demands of local customers.

3.5 Relationships between NEM Modalities and Industries

Certain modalities relate to specific industries in Indonesia. For example, the rubber industry uses contract farming, among others; the footwear industry applies subcontracting and the hotel and retail industries predominantly implement contract management and franchising.

Management and franchise contracts should be promoted as foreign brand holders have demonstrated strong global marketing capabilities to attract tourists from around the world to countries and to hotels in those countries. However, because brand holders have strict requirements to protect their brands, national owners need to maintain high operating standards to remain attractive to brand holders.

In the retail industry, one scenario is a TNC implementing FDI, followed by NEMs. Another scenario is a local company (master franchisee) entering into a franchise agreement directly with a TNC in its home country. While the activities of the franchise unit may look similar in both cases, their impact on local franchisees differs significantly. The level of direct participation by foreign parent companies in a local franchise is minimal if the local master franchise has a direct NEM relationship with a foreign franchiser abroad.

3.6 Opportunities and Challenges for Local Firms through NEMs

The existence of NEMs provides several potential benefits for local companies to grow their businesses. However, Indonesian firms may face some potential issues that need to be considered. Table 8 illustrates opportunities and challenges that are grouped into four categories: (1) continuity issues, (2) typical NEMs issues, (3) capacity-building issues and (4) local firm initiatives and local embeddedness issues. If local firms can strategically maximize TNCs' know-how and technological skills by linking with them, they can build capacities to deal with the challenges and even expand their businesses by using the TNCs' networks.

Table 3. **Opportunities and challenges local firms that engaged in NEMs face**

Opportunities	Typical industries concerned	Challenges
Continuity problems		
Easier to find TNC partners in and outside the country through, for example, matching events and the Internet (because TNCs do not directly invest in the business)	Natural rubber and footwear	TNCs can easily terminate contracts, and long-term relationships are not guaranteed. If quality of services or goods do not meet the TNC's standard and if local firms in other countries are more competitive (e.g., competitors in the footwear industry in China and Viet Nam)
Typical NEMs issues		
Easier to enter a new market or new area even when demand is not yet present in the country. Skills, talents or resources that are available but not required in the country can be utilized outside the country.	Natural rubber, footwear and hotels	Using global brands can negatively affect a local firm's product if the brand (as a whole or a particular branch) has some issues (e.g., footwear and hotels under a global brand). Demand by TNCs may change depending on the interest and taste of their clients (e.g., changes in trends for tourism destinations and footwear styles).
Capacity-building issues		
Easier for local employees to work in business activities in the industry because of their low skill requirements at the entry level.	Natural rubber, footwear, hotels and convenience stores	Local firms struggle to build further capacity apart from receiving orders from customers as they get only relevant know-how at best (e.g., upgrading value chain activities through their own efforts is difficult).
Initiatives and local embeddedness issues		
Local firms and franchisees need to consider the localization model carefully, so local firms take a longer time to make profits. Therefore, they seek initiatives for their operations or activities that lead to embeddedness.	Convenience stores	TNCs should consider that local companies dominate convenience stores in Indonesia and prepare appropriate strategies. In the short term, franchisees or local firms may face difficulties in adapting TNCs' original strategies to local tastes and need to learn through experience until they become part of the community (e.g., in the retail industry, franchisees need to localize the TNCs' strategy to meet local customer demands that TNCs are not aware of).

.../

Table 3. **Opportunities and challenges local firms that engaged in NEMs face** (Concluded)

Opportunities	Typical industries concerned	Challenges
Local firms adapt to foreign design and management and do not need to think about local values and a localization strategy (that is, local firms make profits more quickly by using a TNC's business model).	Hotels and footwear	Local firms may lose their initiative, creativity and traditional values, aside from designing limited products in the footwear industry (e.g., local firms may follow TNCs' business models in the hotel industry as they do not need to implement a localization strategy).

4. POLICY IMPLICATIONS

Over the past decade, the broader ASEAN region has been attracting FDI inflows, while FDI to individual ASEAN countries has slowed in the past few years. Concerning the risk associated with inter-ASEAN relationships, the Indonesian government needs to aim to develop the economy so that it enhances opportunities at the local level rather than develop an externally dependent economy. To support this strategy, implementing NEMs has huge potential to make Indonesia become a major player in GVCs with locally based growth. NEM cooperation also has a major impact on a government's industrial development policy. Therefore, the Indonesian government must consider whether any special policy framework is needed to promote NEMs.

UNCTAD (2011) indicates that maximizing the benefits that developing countries can obtain from integrating local firms into a TNC's GVC requires policymakers in developing countries to formulate responses to several challenging areas (see table 9).

Table 9. **Maximizing development benefits from NEMs**

Policy area	Key actions
Embedding NEM policies in overall development strategies	• Integrating NEM policies into industrial development strategies • Ensuring coherence with trade, investment and technology policies • Mitigating dependency risks and supporting upgrading efforts
Facilitating and promoting NEMs	• Setting up an enabling legal framework • Promoting NEMs through investment promotion agencies • Securing home-country support measures • Making international policies conducive to NEMs
Building domestic productive capacity	• Enhancing technological capacities • Strengthening human resources • Developing entrepreneurship • Providing access to finance
Addressing negative effects	• Protecting labour rights and the environment • Safeguarding competition • Strengthening the bargaining power of domestic firms

Source: UNCTAD (2011), p. 165.

In addition to the UNCTAD proposal, the following sections present five strategies for Indonesia that the government, TNCs and local firms can consider to facilitate inclusive economic growth in Indonesia.

4.1 Enhancing the Capability of Local Firms

Local firm capacity must be increased so that local companies can meet demands from TNCs. TNCs generally already have quite sophisticated systems and technology. In establishing NEM relationships with local companies, TNCs will certainly look for local companies that are ready to adopt the system.

One issue is the low quality of human resources, which can be overcome with training. To address this issue of low quality of human resources, the government has launched a Pre-Employment Card program (*program kartu pra-kerja*), which provides related training. This program is very appropriate considering that, according to Statistics Indonesia, only 10 per cent of the national workforce participated in training in 2019. Ensuring such a training program as this Pre-Employment Card program is crucial because the Indonesian labour market will become more flexible after passage of the Job Creation Law. If applied to an unprepared environment, a flexible labour market actually increases inequality between high-skilled workers and low-skilled workers. A flexible labour market benefits high-skilled workers more because their skills make finding jobs again easier. This differs for low-skilled workers. Unlike high-skilled workers, the employability of low-skilled workers correlates with their ability to find skills-enhancing jobs and to diversify their work experience to maintain their reputation and potential for learning.

Unfortunately, a flexible labour market will make it difficult for low-skilled workers to upgrade their skills because such a labour market will reduce training participation. Contract workers may not receive adequate training from a company because they only have short-term contracts. Companies have less incentive to develop the human resources of their workers if their contracts expire. Therefore, many low-skilled workers will remain less skilled because they have never had job stability and training. Thus, lack of training will cause skills to decline, which in turn will reduce labour productivity.

The lack of training is generally experienced more by informal businesses and lower-class workers (blue-collar workers). The 2019 Statistics Indonesia data show that one third (30 per cent) of white-collar workers have participated in training. TNCs—which are more interested in establishing NEM relationships with companies with high capabilities—will primarily establish relationships with companies with many white-collar workers. TNCs will largely abandon MSMEs, which generally do not have white-collar workers. Allowing such a dynamic to continue will further widen inequality.

Overall, MSMEs in Indonesia encounter several problems such as lack of access to finance, poor quality of managerial and human resources, lack of access to markets and raw materials, minimal technology adoption and licensing. The government has so far launched several policies to overcome some of these problems. For instance, to improve MSMEs' financial access, the government has issued a people's business credit (*kredit usaha rakyat*) policy, followed by an ultra-microfinancing (UMI) policy. Another program worth mentioning is JakPreneur,[6] an entrepreneurial development or incubation program organized by the DKI Jakarta Provincial Government. This program includes various activities that include training for entrepreneurs and MSMEs, entrepreneurial assistance, licensing assistance, marketing assistance, training in preparing financial reports and capital facilitation. Specifically, under Regulation No. 2 of the Governor of DKI Jakarta of 2020, JakPreneur aims to increase the number of independent, quality, resilient and reliable entrepreneurs through developing the scale of productive businesses and increasing the productivity and competitiveness of MSMEs in supporting economic

[6] Formerly known as OK-OCE (One *Kecamatan* (District), One Center of Entrepreneurship) in 2017 and *Pengembangan Kewirausahaan Terpadu* (Integrated Entrepreneurship Development) in 2018–2019.

growth and equality. This program not only involves the government, but also society at large. The community can be involved as trainers, business assistants and business coaches.

4.2 Improving Investment Regulations

According to the 2017 Executive Opinion Survey conducted by the World Economic Forum, two of the 16 most problematic factors for doing business in Indonesia are corruption and inefficiency of the government bureaucracy, which includes issues of legal overlap and poor coordination between regional governments and the central government. These problems are an obstacle to the entry of foreign investment into Indonesia, including FDI and NEMs. In terms of the ease of doing business indicator released by the World Bank, Indonesia ranked 73rd out of 190 countries in 2019. In ASEAN, Indonesia ranks 6th out of 10 countries, losing to Singapore (2nd in the world rank), Malaysia (12th in the world rank), Thailand (21st in the world rank), Brunei Darussalam (66th in the world rank) and Viet Nam (70th in the world rank). Some of the aspects that most hampered Indonesia in terms of this ease of doing business indicator relate to starting a business and registering a property—aspects that relate closely to regulation and bureaucracy. In fact, the Indonesian government's ratification of the Job Creation Law at the end of 2020 aimed to solve this problem. Resolving this problem aims to improve the Indonesian business environment and attract TNCs to establish NEM relationships with Indonesian firms.

4.3 Promoting and Upgrading Skills and Expertise

The low skill of the workforce in certain industries has reduced TNCs' interest in establishing NEM relationships with Indonesian companies. Based on Statistics Indonesia data, in August 2020, of the 203 million national population aged over 15 years, only 10 per cent had completed higher education (academies, diplomas and universities). Moreover, 38 per cent of the population aged over 15 years were educated below the elementary school level, and the remaining 52 per cent had secondary level education (junior high, senior high and vocational schools or SMKs). Aside from the issue of low formal education attainment, Indonesia also grapples with the issue of matching, that is, the disconnect between what is taught in schools and what industry needs. In fact, SMKs should solve this problem. Yet, the facts show the opposite. In 2019, of the 7.67 million unemployed, 23 per cent or 1.78 million of them were SMK graduates. In terms of the unemployment education profile, SMK graduates are the most numerous. This is far from the purpose of SMKs, which should produce graduates who are immediately ready to work. However, instead of working, they mostly make up the ranks of the unemployed.

Facing such problems, in the short term, the government has launched a Pre-Employment Card program aimed at filling the skills gap left by educational institutions. The Pre-Employment Card provides beneficiaries with social assistance money and access to training. The only drawback of this policy is poor timing. The Pre-Employment Card is designed for a normal situation, not for the pandemic era in which unemployment is the result of a decline in economic activity. During the pandemic, economic activity has been forced to slow down, decreasing 25–50 per cent from its optimal level. Unemployment from declining economic activity is not due to a skills gap between the skills possessed by prospective workers and those that employers demand. The current condition is more accurately described as the disappearance of employers.

In the long term, the government has prepared several new education programs such as the *Kampus Merdeka* (free campus) program, which effectively enables students to take direct internships in industry or the world of work thus allowing students to catch up on their skills.

4.4 Promoting Connectivity and Coordination

Joint organizational support for NEM companies is not sufficient to stimulate technological upgrading. Strong connectivity and coordination between basic infrastructure and science, technology and innovation and NEM companies are required. Connectivity alone is a challenge for Indonesia as an archipelagic country. Hence, an emphasis on basic infrastructure will help companies build more efficient business practices, shorten waiting times and reduce costs. Then, the development of science, technology and innovation infrastructure; science parks; industry-university linkages and standard organizations, together with good quality and technically skilled university graduates, will help stimulate innovation synergies in the company. Companies must upgrade their technology to enjoy participation in high value added activities.

4.5 Promoting Integration into Global Markets

NEMs can help ASEAN become more integrated. In 2015, ASEAN committed to change economic integration from free flows of goods to free flows of investments, services and capital, pursuing this commitment through the implementation of the ASEAN Economic Community. The ASEAN Economic Community offers low to zero tariffs on most product lines. Through this agreement, ASEAN NEM companies can enjoy preferential treatment in the ASEAN market. The role of Indonesia in ASEAN is also important; not only because Indonesia holds the highest share of ASEAN GDP at around 38 per cent and has the highest share of ASEAN's population at around 41 per cent, but also because the Indonesian share of total intra-ASEAN trade is 17 per cent among the top four ASEAN members (Verico, 2017). The Regional Comprehensive Economic Partnership concluded in late 2020 further expands the market to a wider East Asia. Hence, the Indonesian government's efforts to maximize such opportunities include reduction of bureaucracy and deregulation in customs controls involving trade. Reduced bureaucracy and deregulation will help companies to enter the global market more efficiently, which will increase the competitiveness of Indonesian companies in the global market. Further, facilitating investment policies and a more flexible labour market are indispensable strategies to improve Indonesian competitiveness in the future.

The Government of Indonesia should consider implementing and strengthening the regulatory framework for NEM firms so that they can successfully export, expand employment and upgrade technologically. This initiative should start with a profound evaluation of the critical policy pillars shown in table 10. This would be a first step for the government to decide whether it will establish a policy framework for NEM promotion and, if so, to decide what, how and to what extent the government must do.

Table 10. **Checklist for NEM agreements and operations to maximize benefits and minimize costs from NEMs**

Government policy on NEMs	Compliance with laws	Whether an agreement exists on NEM contract performance
		Whether an agreement exists on contract terms (durations)
		Whether an agreement exists on contract termination and its process
		Whether an agreement exists on contract arrangements (additional contracts) and their process
	Respect for human rights	Whether rules cover non-discrimination
		Whether rules cover basic human rights
		Whether rules cover harassment (whether a power balance exists between local NEM firms and TNCs)
	Environmental considerations	Whether guidelines address air pollution by local NEM firms
		Whether guidelines address water contamination by local NEM firms
		Whether guideline address environmentally friendly goods or services by local NEM firms
	Work environment	Whether employment rules (laws) address age under the NEM agreement
		Whether employment rules (laws) address gender under the NEM agreement
		Whether employment rules (laws) address working environments under the NEM agreement
		Whether employment rules (laws) address working hours under the NEM agreement
		Whether employment rules (laws) address working conditions under the NEM agreement
		Whether employment rules (laws) address taking holidays under the NEM agreement
		Whether employment rules (laws) address treatment of absence under the NEM agreement
		Whether employment rules (laws) address maternity-related leave under the NEM agreement
		Whether guidelines address a safe and pleasant work environment under the NEM agreement
Government policy on NEMs	Work environment	Whether guidelines provide a support system of childcare and nursing care
		Whether employment rules (laws) address terminating employment contracts under the NEM agreement
	For local firms' development	Whether a program exists that local NEM firms can use to improve their technology/capacity
		Whether a program exists that local NEM firms' employees can learn from
		Whether a program exists that local NEM firms can take to understand the industry business environment
	Subcontractors and suppliers	Whether guidelines provide similar NEM policies for local subcontractors and suppliers

.../

Table 10. **Checklist for NEM agreements and operations to maximize benefits and minimize costs from NEMs** (Concluded)

For TNCs that the Indonesian government should address	Earning the trust of customers and consumers	Whether guidelines exist for TNCs to provide correct information on their products or services
	Mutual growth with partner companies	Whether guidelines exist for TNCs to respect free and fair trade rules
		Whether guidelines exists for TNCs to provide relevant information required for trading
		Whether guidelines exist for TNCs to develop relationships based on trust with local NEM firms
	Coexistence with local communities	Whether guidelines exist for TNCs to establish and maintain a good relationship with local communities where local NEM firms are located

Source: Adapted from Tokyo Chamber of Commerce and Industry (2013).

REFERENCES

Anderson, E. and H. Gatignon. (1986). "Modes of Foreign Entry : A Transaction Cost Analysis and Propositions". *Journal of International Business Studies* 17(3), 1–26.

APRISINDO. (2019). *Indonesian Footwear Industry Country Report 2019*. Jakarta: APRISINDO.

Barrett, C. B. (2010). "Measuring Food Insecurity". *Science* 327(5967), 825–828.

Bellemare, M. F. (2012). "As You Sow, So Shall You Reap: The Welfare Impacts of Contract Farming". *World Development* 40(7), 1418–1434. https://doi.org/10.1016/j.worlddev.2011.12.008.

BPS. (2020). "*Pertumbuhan Ekonomi Indonesia Triwulan IV-2020*". Retrieved from https://www.bps.go.id/pressrelease/2020/02/05/1755/ekonomi-indonesia-2019-tumbuh-5-02-persen.html.

Chanchaichujit, J. and J. Saavedra-Rosas. (2018). *Using Simulation Tools to Model Renewable Resources: The Case of the Thai Rubber Industry*. Cham, Switzerland: Palgrave Macmillan.

Combs, J. G., S. C. Michael and G. J. Castrogiovanni. (2004). "Franchising: A Review and Avenues to Greater Theoretical Diversity". *Journal of Management* 30(6), 907–931. https://doi.org/10.1016/j.jm.2004.06.006.

Goni, J. and Y. Kadarusman. (2015). "Local Company Contribution within Global Value Chain: A Case Study in the Indonesian Footwear Industry". *Mediterranean Journal of Social Sciences* 6(6), S5.

Grow Asia. (2018). "Case Study: Rubber in Indonesia". Jakarta, Indonesia : Springfield Centre.

Hardiana, S. N. and F. F. Hastiadi. (2019). "Overcoming the Middle-Income Trap: The Role of Innovation on Switching onto a Higher Income Group for ASEAN Member States". In *Globalization, Productivity and Production Networks in ASEAN*. Cham, Switzerland: Palgrave Macmillan, pp. 57–86.

Hastiadi, F. F. and J. P. Santoso. (2021). "전문가오피니언] 제조업을 통한 인도네시아 경제 혼란 타개". ("[Expert Opinion] Overcoming Indonesia's Economic Turmoil through Manufacturing"). Retrieved from EMERiCs: https://www.emerics.org:446/issueDetail.es?brdctsNo=312646&mid=a10200000000&systemcode=03.

Haustermann, M. and I. Knoke. (2019). *The Natural Rubber Supply Chain: How Companies Can Identify and Resolve Sustainability Issues*. Bonn: SüDWIND e.V.

Kim, S. Y. (2008). "Hotel Management Contract: Impact on Performance in the Korean Hotel Sector". *Service Industries Journal* 28(5), 701–718. https://doi.org/10.1080/02642060801988332.

Kirana Megatara. (2019). *Annual Report 2019*. Jakarta : PT. Kirana Megatara Tbk.

Krugman, P. R. (1979). "Increasing Returns, Monopolistic Competition, and International Trade". *Journal of International Economics* 9(4), 469–479.

Lawson. (2019). *Integrated Report 2019*. https://mldata.lawson.jp/en/ir/library/pdf/annual_report/ar_2019_e.pdf.

Miyata, S., N. Minot and D. Hu. (2009). "Impact of Contract Farming on Income: Linking Small Farmers, Packers, and Supermarkets in China". *World Development* 37(11), 1781–1790. https://doi.org/10.1016/j.worlddev.2008.08.025.

Patunru, A. and A. Surianta. (2020). *Attracting FDI Post Covid-19 by Simplifying Indonesia's Regulatory Framework*. Jakarta, Indonesia: Center for Indonesian Policy Studies.

Quer, D., E. Claver and A. Rosario. (2007). *Foreign Market Entry Mode in the Hotel Industry: The Impact of Country and Firm Specific Factors*. Spain: International Business Review, Elsevier.

Rangkuti, F. Y. (2017). *Hotel Restaurant Institutional Update: Indonesia*. Jakarta, Indonesia: USDA-FAS.

Rasiah, R. (1994). "Flexible Production Systems and Local Machine-Tool Subcontracting: Electronics Components Transnationals in Malaysia". *Cambridge Journal of Economics* 18(3), 279–298.

Rasiah, R. (2005). "Trade-Related Investment Liberalization: The Malaysian Experience". *Global Economic Review* 34(4), 453–471.

Rasiah, R. (2010). "Industrialization in the Second Tier NIEs". In R. Rasiah and J. D. Schmidt (eds.), T*he New Political Economy of Southeast Asia*. Cheltenham: Edward Elgar.

Rodrik, D. (2013). "Unconditional Convergence in Manufacturing". *The Quarterly Journal of Economics* 128(1), 165–204.

Röthemeyer, F. and F. Sommer. (2013). *Kautschuk-Technologie: Wekstoffe-Verarbeitung-Produkte, 3rd Edition*. Munich: Hanser.

Saaty, T. L. (1977). "A Scaling Method for Priorities in Hierarchical Structures". J*ournal of Mathematical Psychology*, 15(3), 234–281.

Shinomiya, Y. (2016). "The International Expansion Trajectory and Asia Pivot of Japanese Hotel Industry." *Journal of Asian Management Studies* 22, 3–15.

Tokyo Chamber of Commerce and Industry. (2016). *Corporate Code of Conduct (The Third Edition)*. Tokyo: The Tokyo Chamber of Commerce and Industry.

UNCTAD. (2011). *World Investment Report 2011: Non-Equity Modes of International Production and Development*. New York and Geneva: United Nations.

Verico, K. (2017). *The Future of the ASEAN Economic Integration*. London: Palgrave Macmillan UK.

Wihardja, M. M. (2016). "The Effect of the Commodity Boom on Indonesia's Macroeconomic Fundamentals and Industrial Development". *International Organisations Research Journal* 11(1), 39–54.

World Bank. (2019). *Global Economic Risk and Implications for Indonesia*. Washington, DC: World Bank. https://cepagram.com/index.php/2019/10/07/global-economic-risk-implications-indonesia-world-bank/#.

World Economic Forum. (2017). "The Global Competitiveness Index Report 2017". In K. Schwab and X. Sala-i-Martin (Eds.), *World Economic Forum (WEF)*. World Economic Forum. http://ci.nii.ac.jp/naid/110008131965/.

World Travel & Tourism Council. (2020). *Indonesia Annual Research Key 2020 : Key Highlights*. https://wttc.org/Research/Economic-Impact.

APPENDIX

APPENDIX A. Technical Explanation of the AHP Method

A fundamental problem of decision theory is how to derive weights for a set of activities according to importance. We usually set priorities to scale, that is, determining which priority is more important than others. Importance is usually judged according to several criteria. This multiple criterion decision-making is made through a hierarchical structure whereby rank ordering usually determines the most important thing. However, the precise weight cannot be acquired using such a method. The problem then is to obtain relative strength.

Saaty (1977) developed a method to scale the weight using a hierarchical structure. Saaty (1977) constructs a pairwise comparison matrix that can indicate the relative strength of each criterion and its alternative.

In conducting AHP analysis, the researcher(s) must first define the hierarchy's goal(s). For example, in this study the goal is to determine the preferred foreign investment mode for Indonesia. Additionally, the alternatives must be defined. In section 2, the defined alternatives are FDI and NEMs. The next step is to specify the criteria that determine what makes a given foreign investment mode the preferred mode. Researcher(s) could add sub-criteria to those criteria to further specify the preferred foreign investment mode. For example, the criteria specified in section 2 are (1) growth and survival of businesses; (2) socioeconomic and developmental impact; (3) expansion of market access and (4) acquisition of technology, knowledge and skills (see box figure 10.1).

To calculate weights and importance, researcher(s) conduct interviews with experts and fill in a questionnaire. Table 1A presents part of the questionnaire used in this study.

Table 1A. **Questionnaire**

No.	Preferred Mode of Foreign Investment for Indonesia as Host Country	9 Extremely	7 Very Strongly	5 Strongly	3 Moderately	1 Equally	3 Moderately	5 Strongly	7 Very Strongly	9 Extremely	Preferred Mode of Foreign Investment for Indonesia as Host Country
1	1. Growth and Survival of Businesses			✓							2. Socioeconomic and Developmental Impact

Source: Saaty (1977).

The experts were asked which criterion best depicts the preferred foreign investment mode for Indonesia. For example, table 1A shows that growth and survival of businesses is strongly more important than socioeconomic and developmental impact as a criterion of the preferred mode of foreign investment for Indonesia. Similar questions continue until all criteria have been compared. The results are then tabulated as in table 2A. After being tabulated, the values for each column are added up.

Table 2A. **Pairwise comparison matrix of the criteria**

Criterion	1. Growth and Survival of Businesses	2. Socioeconomic and Developmental Impact	3. Expansion of Market Access	4. Acquisition of Technology, Knowledge and Skills
1. Growth and Survival of Businesses	1	5	3	1/5
2. Socioeconomic and Developmental Impact	1/5	1	1/3	1/7
3. Expansion of Market Access	1/3	3	1	1/3
4. Acquisition of Technology, Knowledge and Skills	5	7	3	1
Column totals	98/15	16	22/3	176/105

Source: Author.

Next, the number in each cell in the matrix is divided by the sum for each column and each row's arithmetic mean is calculated as in table 3A.

Table 3A. **Row averages of pairwise comparisons of the criteria**

Criterion	1. Growth and Survival of Businesses	2. Socioeconomic and Developmental Impact	3. Expansion of Market Access	4. Acquisition of Technology, Knowledge a Skills	Row average
1. Growth and Survival of Businesses	0.15	0.31	0.41	0.12	0.248
2. Socioeconomic and Developmental Impact	0.03	0.06	0.05	0.09	0.055
3. Expansion of Market Access	0.05	0.19	0.14	0.20	0.143
4. Acquisition of Technology, Knowledge and Skills	0.77	0.44	0.41	0.60	0.552
				Total	1.000

Source: Author.

From the calculation shown in table 3A, the weights of the criteria are obtained. Thus, we can conclude that the acquisition of technology, knowledge and skills is the most important criterion for a foreign investment mode to be considered the preferred mode (with the highest value of 0.584). The second most important is growth and survival of businesses (with the second highest value of 0.233). The third most important is expansion of market access, and the least important is socioeconomic and developmental impact. The same steps are then taken for the sub-criteria and alternatives. For example, table 4A tabulates the sub-criteria for growth and survival of businesses.

Table 4A. **Pairwise comparison matrix of sub-criteria for growth and survival of businesses**

Growth and Survival of Businesses	5. Financial Performance	6. Increase of Local Value Added	Growth and Survival of Businesses	5. Financial Performance	6. Increase of Local Value Added	Row average
5. Financial Performance	1	1/5	5. Financial Performance	0.167	0.167	$\begin{bmatrix}0.167\\0.838\end{bmatrix}$
6. Increase of Local Value Added	5	1	6. Increase of Local Value Added	0.838	0.838	
Column totals	5	6/5			Total	1.00

Source: Author.

Table 4A shows that to ensure growth and survival of businesses, a foreign investment mode must first ensure the increase of local value added and then financial performance. Next table 5A shows an example of the tabulation of the alternative modes of foreign investment.

Table 5A. **Pairwise comparison matrix of foreign investment alternatives for sub-criterion increase of local value added**

6. Increase of Local Value Added	NEM	FDI	6. Increase of Local Value Added	NEM	FDI	Row average
NEM	1	1/4	NEM	0.20	0.20	$\begin{bmatrix}0.200\\0.800\end{bmatrix}$
FDI	4	1	FDI	0.80	0.80	
Column totals	5	5/4			Total	1.00

Source: Author.

Table 5A only shows the result of the preferred foreign investment mode in terms of the increase of local value added. To determine the preferred mode overall, we must get the result based on all criteria. First, we must calculate the weights of the alternatives based on the criteria. To do so, tabulate all the rows' averages obtained from pairwise comparison matrixes of alternatives and sub-criteria.

Table 6A. **Aggregation of row averages obtained from pairwise comparison matrixes of foreign investment alternatives and sub-criteria**

Alternatives	5. Financial Performance	6. Increase of Local Value Added	1. Growth and Survival of Businesses	Sub-criterion average
NEM FDI	0.167 0.838	0.200 0.800	5. Financial Performance 6. Increase of Local Value Added	$\begin{bmatrix}0.167\\0.838\end{bmatrix}$

Source: Author.

Then, multiply the vector in the left table and the right table.

Table 7A. **Row averages obtained from aggregation of pairwise comparison matrixes of foreign investment alternatives and sub-criteria**

1. Growth and Survival of Businesses	Calculation	Criterion
NEM	0.167 (0.167) + 0.200 (0.838) =	0.195
FDI	0.838 (0.167) + 0.800 (0.838) =	0.805

Source: Author.

Do the same for all sub-criteria and foreign investment alternatives to obtain the vector for the criterion, such as in table 8A.

Table 8A. **Aggregation of row averages obtained from pairwise comparison matrixes of criteria**

Alternatives	1. Growth and Survival of Businesses	2. Socioeconomic and Developmental Impact	3. Expansion of Market Access	4. Acquisition of Technology, Knowledge and Skills
NEM	0.195	0.431	0.698	0.418
FDI	0.805	0.569	0.302	0.582

	Criterion
1. Growth and Survival of Businesses	0.233
2. Socioeconomic and Developmental Impact	0.053
3. Expansion of Market Access	0.130
4. Acquisition of Technology, Knowledge and Skills	0.584

Source: Author.

Re-do the step as before by multiplying the vector in the left table and the right table so that the result is as in table 9A.

Table 9A. **Result of aggregated row averages obtained from pairwise comparison matrix of criteria**

Alternatives	Calculation	Final result
NEM	0.195 (0.233) + 0.431 (0.053) + 0.698 (0.130) + 0.418 (0.584) =	0.409
FDI	0.805 (0.233) + 0.569 (0.053) + 0.302 (0.130) + 0.582 (0.584) =	0.592

Source: Author.

Therefore, FDI is the preferred mode of foreign investment for Indonesia because it has a higher value (0.592) than NEMs (0.409). Each expert received the same questionnaire; therefore, each expert has his or her own table. To combine each expert's table, a geometric mean is used. For example, table 2A presents the judgement of expert 1 and table 10A shows the judgement of expert 2.

Table 10A. **Pairwise comparison matrix of the criteria of expert 2**

Criterion	1. Growth and Survival of Businesses	2. Socioeconomic and Developmental Impact	3. Expansion of Market Access	4. Acquisition of Technology, Knowledge and Skills
1. Growth and Survival of Businesses	1	3	1/3	3
2. Socioeconomic and Developmental Impact	1/3	1	1/3	3
3. Expansion of Market Access	3	3	1	4
4. Acquisition of Technology, Knowledge and Skills	1/3	1/3	1/4	1

Source: Author.

To combine these two judgements, the geometric mean is used as in table 11A.

Table 11A. **Combined pairwise comparison matrix of the criteria**

Criterion	1. Growth and Survival of Businesses	2. Socioeconomic and Developmental Impact	3. Expansion of Market Access	4. Acquisition of Technology, Knowledge and Skills
1. Growth and Survival of Businesses	1	3.87298	1	1/1.29099
2. Socioeconomic and Developmental Impact	1/3.87298	1	1/3	1/1.52753
3. Expansion of Market Access	1	3	1	1.1547
4. Acquisition of Technology, Knowledge and Skills	1.29099	1.52753	1/1.1547	1

Source: Author.

Generally, studies using AHP do not calculate the weight manually; researcher(s) usually use software such as SuperDecisions or Expert Choice.

ASEAN-
Japan
Centre

ISBN 978-4-910293-27-1

ASEAN Promotion Centre on Trade, Investment and Tourism
https://www.asean.or.jp/en