INDONESIA'S NATIONAL CAR PROJECT REVISITED

The History of Kia-Timor Motors and Its Aftermath

Christopher D. Hale

Five years have passed since Tommy Suharto launched Indonesia's Timor national car project, which operated for only one year amid intense controversy before being shut down. Despite its brief life span, the aborted project has had broader implications related to the nature of future economic growth in Indonesia and the country's integration into the regional economy. Furthermore, the effects of the project experience and its aftermath continue to resonate in the country's car industry. For all these reasons, it is beneficial to revisit the episode and examine the lessons that have been learned thus far.

In this article, I will briefly outline the history of automobile manufacturing in Indonesia. I then discuss the 1996 decision to create a national car industry with the help of Korean manufacturer Kia Motors and the possible reasons behind it. This is followed by a discussion of the international trade tensions that the Indonesian government's protectionist policies fomented, and how those tensions in turn combined with the regional economic crisis as well as problems faced by Kia at home to sink the Timor project. The outcome of these developments left Indonesia's relations with multilateral trade bodies in a shaky state and also produced lower levels of foreign direct investment (FDI). These factors in turn help to explain why there has been a noticeable rise in the Indonesian government's reliance on and courting of foreign companies willing to invest. Against this background, the article then

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addresses Kia's recent decision to help revive the hitherto disastrous Timor project and concludes with the future prospects for Kia's operations in Indonesia's automobile industry.

Automobile Manufacturing in Indonesia

Automobile production in Indonesia began in 1927 when the U.S. giant General Motors (GM) built an assembly plant in Jakarta that carried out simple assembly operations. The plant survived the war years, but GM failed to make further inroads. In the 1950s, it was nationalized under the Sukarno government's Program Benteng, the goal of which was to create a national car industry. In the early 1960s, the program remained stagnant because of a shortage of foreign exchange. Indonesia's automotive industry did not really begin to take off until 1964 when semi knocked-down (SKD) automobiles were imported and assembled locally by such companies as Kramayuda and Djakarta Motor of the Hasjim Ning group.

In 1967, General Suharto assumed power. His New Order government placed high priority on developing an independent industrial sector through import substitution. To nurture and help develop the automobile industry, he instituted a policy in 1971 that essentially banned imports on completely built-up (CBU) vehicles. Instead, it assigned local firms the task of importing completely knocked-down (CKD) cars and assembling them. Furthermore, the government implemented a variety of tariff and non-tariff barriers to protect the industry.[1] However, Indonesia's automobile industry continued to rely on imported parts in spite of such measures. In response, the government in 1976 directed the automotive industry to enact a full manufacturing plan, which was intended to build up supporting industries that required assemblers to use locally produced parts. This so-called "deletion" program was halted and reviewed by the government in 1977 but was reinstated the next year. It soon ran into various problems, especially in regard to high-tech components, because foreign principals were understandably hesitant to allow their local agents to become full-blown manufacturers.

The government eventually scrapped the scheme in 1993. In its place, an incentive program was implemented by which the government would lower import duties on imported components and sub-components for local manufacturers as long as they increased their levels of domestically sourced material. Local content was measured using a formula based on the percentage of value added achieved multiplied by the given weighted percentage of the component parts. Until 1995, components were considered local and received import duty exemption if they were locally manufactured and had at

1. Haryo Aswicahyono, Titik Anas, and Jose Rizal, *The Indonesian Automotive Industry* (Washington, D.C.: Pacific Economic Cooperation Council, 1999), pp. 1–3.

least a 40% composition of locally made sub-components for passenger cars and a 20% composition for commercial vehicles. In 1995, a deregulation package raised the incentive bar higher to 60% for passenger cars and 40% for commercial vehicles.[2]

Even with these incentives, local development continued at a slow pace. In 1995, the average local content of a sedan had reached a mere 11%.[3] The incentive plan was deemed a failure. Apparently recognizing its mistake of employing a protectionist policy that ran contrary to market principles, the government that year implemented a deregulation package that eliminated its restrictions on investments for new car production. The package lowered the ceiling on tariffs from 175% to 125% for CBUs, from 100% to 75% for CKDs, and from 40% to 25% for car components.[4] The government also pledged to limit its import duties by 2003 to 40% for CBU cars and 25% for CKD cars in accord with agreements reached under the auspices of the Association of Southeast Asian Nations' ASEAN Free Trade Area (AFTA) and the Asia Pacific Economic Cooperation (APEC) forum. This move was cautiously praised by Indonesia watchers around the world and the government finally appeared to be on the road to free trade and liberalization.

The Timor Project

It was at this juncture that President Suharto made an about-face from earlier promises and launched a national car project in February 1996. The program gave a three-year exemption from import duties and luxury taxes to those Indonesian companies that manufactured cars locally using an Indonesian brand name and local parts. Admittedly, the conditions attached to this exemption were demanding. They required companies to attain local content of 20% after the first year, 40% after the second year, and 60% after the third year.

It was what happened next, however, that really stunned the domestic business community and international observers. On February 27, Suharto announced that he was awarding "pioneer" national car status to the automobile manufacturing company in the Timor Putra National (TPN) group, a holding company created and owned by his son Hutomo "Tommy" Mandala Putra.

2. For details, see Paulsen Vandevert, "The Uruguay Round and the World Trade Organization: A New Era Dawns in the Private Law of International Customs and Trade," *Case Western Reserve Journal of International Law* 31:1 (Winter 1999), p. 5. The calculation of the local content of sub-components and other material was highly complicated, mainly due to the fact that Indonesian authorities had to devise formulas for measuring local content in a way that would compensate for the lack of authentic domestically produced parts.

3. Aswicahyono et al., *The Indonesian Automotive Industry*, p. 6.

4. Henry Sutanto, "Motor Vehicle Industry Overview: Indonesia" (Jakarta: U.S. Commercial Service and U.S. Department of State, 1999, 2000, and 2001).

This special status gave the automobile company a one-year exemption on tariffs and taxes despite the fact that it did not even make cars. As a result, TPN was effectively made the sole beneficiary of the new national car policy on local content. TPN had been created the day before Suharto's announcement, when Tommy's Humpuss group announced the creation of Kia Timor Motors (KTM). It was revealed that KTM would be a joint venture with Kia Motors of South Korea and the sole company under TPN. TPN and Kia were to hold a 70% and a 30% stake, respectively. The original plan was for KTM to build a $1 billion manufacturing complex in Cikampek, located 50 kilometers outside Jakarta, and assemble clones of Kia sedans under the Timor name. To outside parties, the fact that a newly formed company with not one auto assembly plant was nonetheless given such a lopsided advantage in the sedan market seemed to be the mark of a reversion to old-style nepotistic cronyism. Consequently, the Suharto government became the target of widespread criticism.[5]

Adding insult to injury, in June 1996 President Suharto issued a presidential decree that allowed the national car to be assembled in Korea for the first year of operation. In effect, TPN was given permission to import CBU Kia sedans from South Korea and sell them under the "Timor" brand name for one year. It proceeded to do just that, importing 39,715 Kia cars from June 1996 to July 1997. Furthermore, TPN could then sell those cars at a duty-free price that significantly undercut those of its competitors. For example, a similar type of car such as the Toyota Corolla would be subjected to an import duty of 50%, a luxury tax of 35%, an import surcharge of 2.5%, and a value-added tax of 10%. The Timor car, on the other hand, was exempt from all but the 10% value-added tax. The Corolla thus sold for around 70 million rupiah, or $30,000 at pre-crisis exchange rates, whereas the Timor sold for about half that price.[6] In fact, at a market price of 35.75 million rupiah the Timor was considerably cheaper than other similar import models such as those from Opel (GM) and Peugeot as well. The government intended to continue giving TPN its special status until the company completed work on a 50,000 unit-per-year assembly plant in Cikampek– financed by a consortium of state-owned banks ordered by the government to aid TPN. As of this writing, work on the plant has not yet been completed.

The real reasons why the union between TPN and Kia was achieved may never become public knowledge, but industry analysts point to a number of factors as likely explanations. First, Kia was willing to transfer technology more generously than Japanese companies, which were satisfied with the sta-

5. John McBeth, "All in the Family," *Far Eastern Economic Review* (*FEER*), March 14, 1999, pp. 50–51.

6. "Taking on the World," *Business Asia*, October 21, 1996, pp. 4–5.

tus quo that kept Japanese technology mostly in Japanese hands. This willingness was seen as being a key factor for a country like Indonesia, which lacked expertise in automobile manufacturing technology. Also, because Kia's own technology borrowed liberally from the cutting-edge designs of Japanese and U.S. automakers, the Suharto government saw the company as a suitable technological benefactor. Second, the daunting size of other foreign car companies in the region may have made a relatively non-threatening company like Kia seem more attractive. Choosing such a partner may have given Tommy Suharto more confidence in the control he could expect to have over the project than he would have had if he had joined with a major firm on the order of Toyota or GM. Third, Kia gave TPN the right to rename and redesign Kia cars. The Korean firm also agreed to aid in the sale of Timor cars in overseas markets. Finally, the prospects for the successful conclusion of a joint venture benefited from the timing, because at the time, Kia was frantically searching for markets outside of a domestic Korean market dominated by Hyundai and Daewoo.

The only real benefits that might have come from working with an automobile-manufacturing giant would have been the clout and financial backing that such a company might have provided. However, in Indonesia Tommy Suharto already had the right connections and the money, for he could use his father's influence with and power over the state banks to find the necessary funding– in the end, he would receive more than $690 million in loans from those institutions at low interest rates to finance the project. What he needed was a company with high-end automobile technology and a willingness to transfer it, and Kia fit this mold perfectly.

The Project's Collapse

Unsurprisingly, the special status the Indonesian government gave to the Timor project and the advantages this gave TPN were widely criticized, especially by the automobile manufacturing companies that were being adversely affected. The Japanese industry had the most to lose, because its 90% market share made it the most susceptible to any inroads made by Kia-Timor. Japan's major automobile manufacturers produce their vehicles through alliances with local business groups. Toyota has a 49% stake in Toyota-Astra Motor, which is Indonesia's largest carmaker. The Astra Group also assembles Daihatsu, Isuzu, and Nissan Diesel cars and possesses a strong component manufacturing division that contracts out mostly to Japanese companies. Suzuki has a 49% stake in Indomobil-Suzuki International, the country's second largest auto maker. The Indomobil (Salim) Group also contracts out to Nissan and Mazda. Two other business groups have notable levels of involvement in the automobile industry. They are the Krama Yudha Group for

which Mitsubishi is the dominant car producer, and the Imora Group's Prospect Motor for which Honda manufactures autos.[7]

While manufacturers from the U.S. and the European Union (EU) had a far lower share of the Indonesian market, they were similarly incensed by the protectionist measures. As a result, Japan, the EU, and later the U.S. filed suits with the Dispute Settlement Body (DSB) of the World Trade Organization (WTO). As expected, the DSB panel ruled against Indonesia on July 22, 1998, and required it to terminate the project, citing violations of numerous international trade agreements. The DSB further penalized Indonesia by requiring it to eliminate its 1993 incentive policy for attaining local content by July 1999, noting that this latter date was six months earlier than what was called for by the International Monetary Fund (IMF).[8]

The project's future had already been in doubt, however, owing to the onset of the Asian economic crisis. The economic crisis tightened its grip around East and Southeast Asia in early 1998 and Indonesia was particularly hardhit. Its currency depreciated against the U.S. dollar from 2,400 rupiah to $1 in early July 1997 to 16,000 rupiah in July 1998 before finally stabilizing around 7,000 rupiah toward the end of 1998. The government had no choice but to request financial assistance from the IMF. In January 1998, it signed a letter of intent with the IMF in which the government agreed to execute a stringent program of economic reform. The automobile industry was affected directly by one important part of this program. This was the structural adjustment plan, which called for a reduction in import tariffs, the elimination of the local content program by 2000 (pushed forward to July 1999 by the WTO), and an assurance from Indonesia that it would abide by the WTO decision.

As if this were not enough, trouble was also brewing on the Korean front. Even before the onset of the regional crisis, Kia's situation had deteriorated to the point that it had to be placed under a government bankruptcy shield in July 1997. Domestic overproduction of automobiles left Kia little room to make a profit and effectively compete against the giant conglomerates Hyundai and Daewoo. As a result, by the time the government stepped in, Kia had accumulated debts totaling 9.54 trillion won (US$10.7 billion). Had the government not stepped in that summer, Korea might have witnessed the failure of one of its big three automakers. The regional economic crisis spelled

7. For details, see Aswicahyono, p. 15.

8. WTO, Dispute Settlement Body, Panel on Indonesia, *Indonesia: Certain Measures Affecting the Automobile Industry*, July 2, 1998, <http://www.wto.org/english/tratop_e/dispu_e/distab_e.htm>. The DSB's specific citations of Indonesia were for violations of Article I and III of the General Agreement on Tariffs and Trade, Article II of the Trade Related Investment Measures Agreement, Article III of the Trade Related Intellectual Property Rights Agreement, and Article 5c of the Subsidies and Countervailing Measures Agreement.

the end of Kia as an independent entity. The company was placed under court receivership in April 1998 until Hyundai won a series of auctions for Kia in October 1998 and agreed to assume its debt.

By this point, 15,000 of the 40,000 Kia cars imported into Indonesia remained unsold and were sitting in a parking lot near Jakarta over a year after they had arrived from Korea.[9] As for the national car program itself, it was doomed. Indonesia had witnessed a steep drop in car sales– falling from almost 400,000 in 1997 to about 53,000 in 1998[10]– mostly as a result of the economic crisis's impact. This was compounded by pressure from the international organizations, with the IMF hounding the heels of the Indonesian government and the WTO ready to apply sanctions in case of non-compliance.

In May 1998 the Suharto government fell under a wave of protests and was replaced by that of B. J. Habibie. The collapse of the domestic auto market and cajoling and threats from the likes of the IMF and the WTO left Habibie's new government with no choice but to implement market-oriented reforms that affected the automotive sector. The government introduced major IMF-mandated reforms shortly after it rose to power; several of these dealt directly with the car industry. The national car project was eliminated and the government also abolished the local content scheme, both in accordance with the WTO ruling. The government also reduced import tariffs considerably in line with the country's commitment under AFTA and APEC. Tariffs on CBU sedans with engine capacity of 3,000 cc or less were capped at 70%, while tariffs on CKD sedans of the same type were capped at 40%.[11] Furthermore, the government began to grant import licenses, allowing any general importer to import CBUs and thereby repealing the previous policy that had restricted auto related imports to special sole agent licensees. At the same time, the government placed priority on developing sedans with an engine capacity of less than 1,500 cc, considered the weakest sector of Indonesia's domestic auto industry. The Timor was over.

The Timor's Impact

Despite the collapse of the national car project, the aftereffects of the fiasco continued to reverberate. Perhaps the most debilitating effect it had on the national economy was the way in which it scared away potential auto industry investors. For example, soon after the announcement of the creation of

9. John McBeth, "Win Some, Lose Some," *FEER*, January 29, 1998, pp. 53–54.

10. Sutanto, *Motor Vehicle Industry Overview* (2001), p. 1.

11. Tariffs on sedans with an engine capacity of more than 3,000 cc were limited to 80% for CBUs and 50% for CKDs. Tariffs on CBU minibuses and jeeps were capped at 45% and at 45% and 25%, respectively, for CKD minibuses and jeeps. On CBU buses, tariffs were capped at 40% while they were 25% for CKD ones. See Aswicahyono et al., p. 8.

Kia-Timor, Chrysler abandoned its plans to assemble Neon cars from kits in Indonesia. Ford had been preparing to build a small assembly plant in Indonesia, but the announcement of the national car program prompted it to delay further investments. The only U.S. car company that actually had facilities in Indonesia at the time was GM. The company announced in June 1996 that it would suspend its investment plans in Indonesia in order to review the situation. As Donald T. Sullivan, GM's vice-president for Asia-Pacific operations, explained, "We have put our investment on hold in that country because we want to get a better understanding of where the Indonesian Government is heading on their policy."[12] During this difficult period, GM had to rely on sales of automobiles outside the sedan market; most of its sales during this time were of its Opel Blazer, a sport utility vehicle that now holds 63% of Indonesia's market for that class of car.

The Timor project had a different effect on the regional operations of Japanese car companies. Because the Japanese firms already had saturated the Indonesian car market with their own manufacturing facilities, they did not have the flexibility to pull back and review the situation as the U.S. companies did. Instead, they muddled through the storm until the WTO released its decision.

Fortunately for foreign manufacturers, the Timor's initial success quickly died down owing to a lack of available spare parts and the project's controversial nature in addition to the above-mentioned overall shrinkage of the automobile market. By October 1999, Japanese manufacturers would once again claim the top spots in market share.[13] According to the Association of Indonesian Motor Vehicles Industries, Kia-Timor's sales dropped sharply from 19,471 units in 1997 to 2,493 units in 1998.[14] Since Tommy Suharto was a hated man in Indonesia and the blatant cronyism that became evident in connection to the national car project linked it to his name, the reputation of TPN and Timor sales suffered accordingly. Revealingly, the *Financial Times* quoted a source close to TPN as saying that selling Timor cars was like selling stolen mobile phones.[15] As riots spread through Java in May 1998, those who had bought Timors tore the "T" logos off their cars in an attempt to disassociate themselves with the hugely unpopular Tommy Suharto enter-

12. Keith Bradsher, "Angered, GM Halts Investment in Indonesia," *New York Times*, June 14, 1997.

13. At the time, Mitsubishi held 27.5% of the market, Toyota 26.9%, Suzuki 12.0%, Isuzu 10.9%, Daihatsu 9.1%, and Honda 1.6%. The Timor came in at 3.0% of the market, while other manufacturers combined for the remaining 9.0%. See Sutanto, *Motor Vehicle Industry Overview*, p. 11.

14. Economist Intelligence Unit (EIU), *The Automotive Industries of the Asia Pacific* (London: EIU, 2000), p. 59.

15. Sander Thoenes, "Officials to Seize Timor Car Assets," *Financial Times*, February 13, 1999, p. 4.

prise. They did not want to display the fact that they owned Timors and thereby attract unwelcome attention from the disillusioned populace. Of course, the national car fiasco not only scared away investors and buyers, but it also further solidified Indonesia's shady image in the consciousness of involved governments as well. However, the episode did not come as a real shock to anyone because most countries had already grown used to the manifest cronyism that had long been evident in the Suharto government.

Indonesia's Economic and Financial Crisis

In November 1999, Indonesia's domestic situation experienced a crucial change that made jaded international observers take note. That month, Indonesia's first democratically elected leader, Abdurrahman Wahid, took power. This development produced a flurry of expectations among Indonesia watchers, many of whom believed that trade liberalization measures were on the horizon. However, Wahid's sluggish and erratic style has proved disappointing to many thus far, with few expecting to see dramatic liberalization in the field of trade. Furthermore, in light of his current difficulties, it seems increasingly unlikely that he will retain his presidency through the end of the summer.

That said, the economy has fared better during his tenure than it did before he took office. According to the Economist Intelligence Unit, it grew at an average of 4.8% in 2000.[16] Many give the credit to the IMF-mandated reforms, however. Whether this assessment is accurate or not, it is true that Wahid has had to deal with prescriptions from that and various other multilateral organizations during his tenure over the question of trade liberalization. This paper has already addressed Indonesia's rocky relationship with the WTO during the national car fiasco, but it would be beneficial at this point to address the role of ASEAN, APEC, and the IMF in shaping the future of Indonesia's auto industry.

Thus far, the Wahid government has taken a cautious approach to the various trade liberalization policies put forward by these multilaterals. First to consider is ASEAN of which Indonesia is a founding member. ASEAN is slated to complete its current round of tariff reductions with the inauguration of AFTA, set to take place by January 1, 2003, for all member states except Vietnam, Cambodia, Laos, and Burma, which will join later. According to the current plan, Indonesia by that date must reduce the tariffs it imposes on imports from other ASEAN countries to 5% or less (which is not a large

16. EIU, *Country Report Indonesia, May 2001 Main Report*, May 2001, <http://www.eiu.com/>.

change from the current levels of 10%–15%).[17] The tariffs charged by most ASEAN countries on imports from Indonesia likewise will fall to similar levels.

As long as the other major ASEAN players follow through on tariff reduction, Indonesia has relatively little to lose with the implementation of AFTA and it favors moving forward. However, Mahathir Mohammad's Malaysia fears the impact of AFTA the most and especially with respect to trade in automobiles and automobile parts. Mahathir is concerned that neither the Proton, the national car project he initiated that is now a source of national pride, nor the Perodua, a second national car project, will be able to endure the increased competition that would result from the lowering of trade barriers to Japanese automobile manufacturers operating in the free-trade area. The auto markets of such countries as Indonesia and the Philippines are already saturated with Japanese products. Malaysia, however, has protected the 80% market share its national carmakers hold so far with tariffs on imports that range from 42% to 300%. Because of this, Malaysia sought and found a loophole in the AFTA agreement to keep its car industry on the exclusion list until at least 2005 in order to buy time to strengthen the two domestic manufacturers.[18] For the time being, this will have little impact on Indonesia's automobile industry because it has never exported many cars to Malaysia anyway. However, Indonesia has ambitions to export automobiles there in the long run, so Malaysia's protectionist policy may have a negative impact on Indonesia if it remains in force well into the decade.

Nonetheless, the AFTA project is moving forward, and even Malaysia is satisfied with the current stage of the process despite its fears over the eventual opening of its automobile market. At present, the ASEAN Industrial Cooperation (AICO) arrangement allows ASEAN members to voluntarily enact preferential tariff rates for one another ahead of the AFTA implementation date. Furthermore, under the AICO scheme companies in different ASEAN countries can purchase automobile parts and raw materials from one another and import them at preferential tariff rates (often as low as 5%) as long as the trade ministers of all the countries involved approve the trade. To date, the majority of the proposals made under the auspices of the AICO agreement have been accepted, making it easier for automobile and automobile parts manufacturers to achieve economies of scale within ASEAN.

The low AFTA tariff rates, of course, will apply only to goods imported from other AFTA countries. Goods imported from outside the free-trade area

17. See Government of Indonesia, Ministry of Finance, *Concerning the Establishment of Import Tariffs for the Import of Goods within the Framework of the Common Effective Preferential Tariff (CEPT) Scheme for the Period January 1, 2000, until December 31, 2003* (in Indonesian), Decree No. 273/KMK.01/2000, June 30, 2001, pp. 271–75.

18. Jochen Legewie, "Cars Get No Vroom from AFTA," *FEER*, May 4, 2000, p. 32.

will continue to face rates much higher than 5%. For example, in Indonesia tariffs on sedans with an engine of 1,500 cc in capacity or less imported from outside the region will be as high as 65% for CBUs and 35% for CKUs, while the tariffs on sedans with engines of more than 3,000 cc capacity will be as high as 80% and 50%, respectively. However, Western and Japanese car companies will be able to take advantage of the lower AFTA tariff rates if they export their products to AFTA countries from manufacturing centers inside the region. This is exactly what they plan to do and, in some cases, are already doing. GM, for example, has been exporting CBU Chevrolet Zafiras into Indonesia from its factory in Thailand.

The multilateral framework that could be the greatest source of downward pressure on ASEAN member states' tariffs on imports originating from non-ASEAN countries will be APEC. But APEC has placed the fewest binding rules on Indonesia, given that the grouping has progressed little beyond its status as a consultative forum that aims to promote increased trade and investment through the voluntary implementation of trade liberalization policies and economic cooperation. The forum does not have a multilateral dispute settlement system and it cannot sanction its members as the WTO can. Furthermore, APEC has no direct control over the purse strings for money bound to Indonesia as the IMF does. Finally, APEC's plan to achieve trade and investment liberalization for developed member countries by 2010 and developing countries by 2020 leaves comfortable breathing space for Indonesia, which qualifies as a developing country, and Indonesia has been continuing along this path.[19]

The APEC process is being tested, however, as both Indonesia and Thailand attempt to determine the damages that should be paid to them by Malaysia due to the latter's continuing refusal to join in the AFTA tariff reductions on automobiles and auto parts. At the time of writing, Indonesia was considering an increase in its own automobile luxury tax to partly offset the losses it saw itself as losing from having reduced tariffs. However, if the Indonesian government is successful in pressuring Malaysia to compensate it for these losses and in a way that is seen as fair by both sides, then the goodwill generated likely will alleviate the pressure on Indonesia to raise taxes on car imports. Thus, resolving this issue will provide a test of Jakarta's willingness to follow through on APEC tariff reductions.

As for the IMF, it has delayed payments on its bailout package to Indonesia several times due to irregularities and political uncertainties. For example, the IMF suspended payments in September 1999 until the Indonesian government could demonstrate that it had seriously investigated a campaign

19. Asia Pacific Economic Cooperation (APEC) Committee on Trade and Investment, *2000 Annual Report to Ministers* (Singapore: APEC Committee on Trade and Investment, 2000).

finance scandal involving elites from the ruling Golkar party. Controversy also surrounded alleged improprieties by senior officials from the Indonesian Bank Restructuring Agency (IBRA), which is in charge of reforming Indonesia's ailing banking system. Indonesia's relationship with the IMF improved somewhat in 2000, though it got off to a shaky start. After Indonesia's embarrassing failure to meet more than 42 of the deadlines set forth in its January 20 letter of intent to the IMF, the government had to write another such letter in May to convince the IMF to continue with disbursements from its extended fund facility. The IMF agreed to do so on June 3, approving the provision of $372 million in funds. On July 31, Indonesia signed another letter of intent that paved the way for a further release of $398 million in September.

Since then, the government has made decent progress on achieving its stated goals. It has increased asset sales and the amount of debt restructuring undertaken by the IBRA and the Jakarta Initiative Task Force, which was created in 1999 as a mechanism for getting the debts of these companies renegotiated voluntarily and restructured. It has also recapitalized and restructured its main state bank and applied a phased implementation plan for decentralization. All in all, these actions have been a step in the right direction and have helped strengthen the foundation of the economy and the confidence of outside investors. It remains to be seen whether Indonesia will fully implement the IMF-mandated reforms, and whether it will continue along the reform path at its own accord without IMF prodding. Whatever the case, the image that Indonesia projects to the rest of the world will have a large bearing on the perceived soundness of its economy, which will in turn affect the level of FDI inflow. Since the future growth of Indonesia's car industry will partially depend on the availability of outside investment funds, Jakarta's willingness to reform will have important implications on the industry.

The Progress of Reform

Foreign investors and traders operating in Indonesia, including Kia, have been closely following the country's implementation of economic reforms. So far, however, the process has had only mixed results. The banking reforms implemented thus far have not been enough to stimulate a return to normal lending in the private sector. Although bonds worth 405.9 trillion rupiah have been issued to finance recapitalization, banks have not been able to sell these bonds for additional liquidity due to the lack of investor interest. Moody's Investor Service warned in September 2000 that the only way the fragile banking sector could resume lending would be for foreign capital to enter the sector, which will not occur at a substantial level until outside investors feel more confident about Indonesia's political stability.

There are other problems. The debt restructuring process is also starting to gain some steam, albeit slowly, but there are signs that political wrangling and favoritism currently inhibit the process. Also disappointing is Indonesia's performance in the sale of assets, and there are fears that the IBRA may be facing growing political pressure to sell off assets to former owners at bargain-basement prices. Finally, the country's judicial system is currently seen as incompetent and corrupt. Since reforms to the judicial system pose the greatest challenge to vested interests and the existing connections between business and government, the reform process will be difficult indeed.

In light of these factors, it is no wonder that Indonesia is currently receiving a relatively low level of FDI. Yet, the country needs FDI more than ever to improve the strength of its economy upon which its car industry depends. Unfortunately, Indonesia's prospects of receiving substantially larger amounts will remain unlikely if the pace of reform continues to be sluggish and political instability persists. With its atmosphere of political uncertainty, a banking sector badly in need of restructuring and recapitalization, the IBRA's lack of success in selling off assets, and an incompetent and corrupt judiciary to boot, Indonesia is not an ideal contender for foreign investment. Add to this the likelihood that the price of oil will go down and interest rates and inflation will go up, one can see that Indonesia's economic future rests on shaky ground.

To steady the Indonesian economy, President Wahid has placed considerable emphasis on economic growth and investment, albeit within the existing government structures. Fortunately, the export promotion policies he pursued appear to have actually reaped benefits (or at least they have not hindered the market forces already in place). Oil continues to be the main commodity of Indonesia's trade; exports of both it and other products have been booming, collectively registering $62.02 billion for 2000 (compared to $48.67 billion for 1999), with $47.78 billion coming from non-oil/gas sales.[20] A large portion of Indonesia's overall trade continues to be with South Korea, which Wahid has been heavily counting on to continue this upward trend. Bilateral trade volume reached $6.52 billion in 1999, not quite as high as pre-crisis levels but a notable increase from $4.6 billion in 1998. Also, South Korea has become Indonesia's fourth largest export market, adding $3.32 billion to Indonesia's foreign exchange earnings in 1999.[21] All things considered, Korea-Indonesian trade has recovered remarkably since the crisis, and Korea is now the seventh-largest investor in Indonesia despite its own economic problems at home.

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20. See Republic of Indonesia, Statistics Indonesia, "Export Statistics, Selected Tables: Monthly Exports, Indonesia, Jan.–Dec. 1999, Jan.–Dec. 2000 (Million USD)," February 21, 2001, <http://www.bps.go.id/statbysector/ftrade/exports/table4.shtml>.

21. "South Korea to Invest over $100m in Indonesia," *Jakarta Post,* May 8, 2000.

The Revival of the Kia-Timor Project

As might have been expected, Wahid has taken advantage of the closeness with South Korea that these developments have produced in his bid to attract FDI. In February 2000, he made a state visit to Seoul to expand trading ties. Perhaps surprisingly, one of the main issues he discussed was the renewal of the Timor project. His intentions were clear, however, since it was widely known that his main desire was for Kia to share the 3.4 trillion rupiah ($493 million) debt and tax burden that had accumulated on the project. Kia, which under Hyundai's control had made quite a turnaround from its bankruptcy days, welcomed the opportunity to give the potentially huge Indonesian market a second try. Interestingly enough, Kia was rarely if ever implicated in the national car disaster. It was seen in Indonesia as having been a legitimate profit-seeking company that simply played by the imperfect rules of the country's corrupt system as any other foreign investor would do. As a result, it had no qualms about any potential negative response by the Indonesian public over reviving the project.

In this light, the Korean government agreed to restart the stalled joint venture. Now renamed Kia Mobil Indonesia (KMI), the deal was concluded in early May 2000 with an agreement signed in Jakarta by the South Korean minister of industry and trade and Kia's president. In a somewhat unusual arrangement, Kia agreed to complete the unfinished assembly plant in Cikampek (in which it had already invested $30 million) and in return it would receive 10,000 hectares of rainforest to harvest and the right to relocate mountain villages and grow an "unnamed crop" in five to six years.[22] The most important element of the negotiations, however, was the assurance by both sides that the project would have none of the national car benefits granted its predecessor. The Wahid government also promised that Tommy Suharto, who by this time had been convicted for corruption, would not be involved in any way. Instead, KMI joined up with the retired former military commander of the Jakarta Military District, A. M. Hendropriyono, who was made president-director of KMI. Furthermore, it was announced that South Korean companies would invest over $100 million in the Indonesian economy in the year 2000. Of this amount, $75 million was to be spent on enlarging a Nike shoe factory while most of the rest would go toward the Timor car project in which the government had taken over 100% ownership.[23]

As of early 2001, the Timor project was back on schedule. The factory in Cikampek has been producing Kia Sephia II sedans from CKD kits since

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22. A top eco-biologist in the region said the unnamed crop would probably be softwood, which could ruin the soil. See John Boley, "Return of the Timor: Kia and Indonesia Join Forces to Revive a Troubled Car," *Automotive News International*, June 1, 2000.

23. "S. Korea to Invest over $100m in Indonesia."

August 2000. There have been reports that the factory is scheduled to begin full-scale operations in May 2002, but Kia and the Indonesian government are still in dispute over the issue of tax incentives.[24] Meanwhile, Kia has been exporting other types of cars from its factories in Korea into Indonesia in CBU form, including the Carnival, Carens, Sportage, and Visto models. The Indonesian government's Financial Sector Policy Committee announced its approval of Timor's debt restructuring package on November 13, 2000, under the terms of which TPN would pay the IBRA $8.62 million in cash and transfer assets worth $5.13 million and at least 69% of its shares of KMI. Of the $466.6 million that remained from KTM's debt, $160.92 million was to be restructured into a 10-year loan with a grace period of three years while the other $305.68 million would be converted to IBRA shares in TPN.[25] Soon after the restructuring agreement was concluded, South Korea's Kim Dae Jung himself publicly voiced his support of the project during a state visit to Indonesia, though he stopped short of actually dropping by the Cikampek plant.

Conclusion

To be sure, both Kia and the Korean government will be watching the Indonesian government's actions closely in the coming years for their potential impact on the operations of Kia and other Korean companies in Indonesia and the Korea-Indonesia trade relationship as a whole. Indonesia's accession to AFTA is expected to have a significant and favorable impact because companies such as KMI will benefit from the tariff relief when exporting to other AFTA countries (with the possible exception of Malaysia). Furthermore, since Indonesia's auto market is already dominated by Japanese car companies, KMI will not have to worry about a new flood of cheap car imports wiping out the market share that it does have.

Another variable sure to affect Kia's operations and the willingness of other Korean firms to work in Indonesia will be the success, both perceived and real, of the country's domestic reforms. At present, Korean business people in Indonesia are growing restless because they see the country as lacking in law enforcement and order. The recent enactment of a new structure that grants provinces greater autonomy may be further diluting governmental effectiveness in performing such duties as tax collection and law enforcement. For foreign business individuals overseeing operations in the country, an additional concern is that this in turn may add to the inability of the government to keep labor disputes under control. Also, although there have been

24. Cheong-mo Yoo, "Kia's Indonesian Car Plant to Kick Off in May 2002," *Korea Herald*, January 29, 2001, p. 11.

25. "Gov't Approves PT Timor Putra Debt Restructuring," *Jakarta Post*, November 14, 2000.

complaints of Koreans mistreating their employees, there have been even louder complaints from Korean businessmen and women who claim that police do not arrest those who have obviously committed crimes and do not protect company property in times of labor unrest.[26]

Other foreign companies operating in Indonesia are similarly mixed in their attitude toward doing business in the country. Like the Koreans, other foreign business people are cautiously pleased with Indonesia's current economic growth but unsure of what lies around the corner. If Indonesia does not address the situation and improve the attractiveness of its business climate, trade and investment will naturally diminish. If that occurs, Indonesia's road to economic recovery will become a difficult one to travel indeed. The government must act quickly within a closing window of time, especially in regard to its investment from Korea, as it will not take long before Korean corporations will begin to wonder why they are putting up with Indonesia when a more lucrative and much larger market of 1.4 billion is opening right next door.

Furthermore, stability in Indonesia's trade relations with the outside world and respect for international norms on the government's part have hardly been evident, and the Kia-Timor project itself serves as a telling example. As Indonesia presses ahead with developing its indigenous car industry, it is clear that the disordered nation still has a long way to go in transforming its image to one of economic and political stability. The fate of both Indonesia's local car industry and its economy as a whole rests on the willingness of the Wahid government (and its successor) to continue the country's economic integration into the region and undertake a series of badly needed reforms.

On the bright side, the steep drop in automobile sales that resulted from the Asian financial crisis may have been a blessing in disguise for Indonesia's car industry. The decline opened the way for a few far-sighted policymakers to get Indonesia's industry to agree to the 1999 liberalization scheme, which represented a total break from a 40-year-old protectionist policy. Furthermore, Indonesia has successfully sustained the process of regional integration, and it seems likely that the Timor project in its current form will be able to benefit from this as Indonesia's relationship with Korea grows stronger. However, the future viability of this relationship depends on Jakarta's willingness to increase the transparency of Indonesia's laws and trade policies and enhance the effectiveness of law enforcement. Only with these reforms

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26. For more on the treatment of Indonesian workers by Korean managers, see You-Il Lee, "Korean Direct Investment in Indonesia in the 1990s: Dynamics and Contradictions," *Asian Perspective* 21:3 (Winter 1997), pp. 189–90. For more on the complaints of the Korean business community operating in Indonesia, see "Korean Investors Doubt Overall Situation in Indonesia," *Jakarta Post*, November 1, 2000.

will Indonesia be able to keep its tight relationship with Korea intact while maintaining the viability of its indigenous car industry and ultimately improve its damaged reputation in the world at large.