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INDONESIA'S ECONOMIC DIPLOMACY STRATEGY TO TOYOTA MOTOR CORPORATION IN THE POLICY OF LOCAL CONTENT REQUIREMENTS IN THE NATIONAL CAR INDUSTRY POST-REFORMATION

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Abstract: The Indonesian government's policy of local content requirements (LCRs) in the national car industry represents a significant initiative aimed at increasing sustainable added value for the national economy. This study examines how Indonesia, through its Domestic Component Level (TKDN) program, has encouraged foreign car manufacturers, including Japan's Toyota Motor Corporation (TMC), which holds over 36% of the market share, to support this initiative. The success of the program is closely linked to the government's use of economic diplomacy, which navigates domestic economic conditions as well as bilateral and multilateral relations. Using a qualitative approach through secondary data and a review of national and international regulations related to LCRs, this paper explores the Indonesian government's economic diplomacy strategies towards TMC within the context of both domestic and bilateral frameworks. Furthermore, the analysis considers key factors, including the significance of the Indonesian automotive market and the challenges posed by the current trade regime of the World Trade Organization (WTO), while highlighting the strategic interests of Japanese multinational corporations in Indonesia's automotive manufacturing industry.

Keywords: Local Content, Economic Diplomacy, Automotive Industry, Toyota Motor Corporation, Indonesia

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INTRODUCTION

The Indonesian government's effort to enhance local content requirements (LCRs) in the national automobile industry is part of a broader strategy aimed at fostering sustainable economic growth. After the ambitious vision of establishing a national car was curtailed by the Asian financial crisis and legal disputes with powerful countries in the late 1990s, LCR policies have become a pragmatic alternative to achieving long-term added value for the Indonesian economy. These policies have gained increasing relevance as Indonesia seeks to reduce its reliance on imported components, increase domestic manufacturing capacity, and create more robust supply chains in strategic sectors like the automotive industry. Notably, foreign automotive manufacturers, particularly Japan's Toyota Motor Corporation (TMC)—which commands more than 36% of the market—have shown support for these initiatives, with TMC actively engaging with Indonesia's Domestic Component Level (TKDN) program since its introduction in 2006.

Indonesia's automotive industry has witnessed rapid growth, positioning the country as a key player in Southeast Asia's automobile market. According to Trading Economics, Indonesia is the largest automotive market in the region, with local production consistently surpassing 1 million units annually over the last decade. Data from the Ministry of Industry reveals that the country is home to 22 vehicle assembly plants with a combined production capacity of 2.35 million cars per year. The automotive sector significantly contributes to the national economy, creating over 1.5 million jobs and adding more than IDR 100 trillion to Indonesia's GDP (Ministry of Industry, 2023). This surge in production capacity reflects the broader success of the government's LCR initiatives, which have increasingly tied foreign car manufacturers to the Indonesian market by encouraging the use of locally produced components.

The growing investment in Indonesia's automotive sector is a testament to the attractiveness of the country's market, both for foreign direct investment (FDI) and domestic investment. Despite the disruptions caused by the COVID-19 pandemic, the sector has shown resilience, with automotive investment peaking at IDR 25.23 trillion between 2019 and 2020. Foreign investment remains the dominant force in this growth, accounting for 90% (US$1.52 billion) of the total investment, while domestic investment contributed IDR 2.42 trillion. Japan, through companies such as TMC and its subsidiaries, stands out as the most significant investor, contributing IDR 116.1 trillion (83.31%) of the total automotive sector investment, followed by Korea and China (Ministry of Industry, 2023). This influx of foreign investment has accelerated the development of local industries, particularly in component manufacturing, which is crucial for increasing local content in automotive production.

However, the LCR policy faces significant opposition from various stakeholders, particularly from countries that view it as a protectionist measure that distorts free trade. Critics argue that LCRs, by mandating the use of domestic components in manufacturing, violate key principles of the World Trade Organization (WTO), particularly those related to National Treatment (Article III) and the Elimination of Quantitative Restrictions (Article XI) under the General Agreement on Tariffs and Trade (GATT). The principle of National Treatment requires member countries to treat imported goods no less favorably than domestically produced goods, while the Elimination of Quantitative Restrictions prohibits trade barriers like quotas that limit the importation of goods. These principles form the cornerstone of the multilateral trade regime established by the WTO to promote free and fair trade across borders. The legal implications of violating these principles are severe, as demonstrated by previous cases where Indonesia faced lawsuits under WTO rules. For example, in 2014, Indonesia’s LCR policies in the 4G LTE telecommunications sector prompted legal action from Japan, the United States, Korea, and Canada, highlighting the real risk of similar challenges in the automotive sector.

Despite these challenges, Indonesia’s LCR policy has been a critical tool for advancing domestic industrial growth. In particular, the bargaining power of economic diplomacy has played a pivotal role in balancing domestic interests with international obligations. Economic diplomacy, which focuses on leveraging a country’s economic strength to achieve foreign policy objectives, has been instrumental in navigating the complexities of LCR implementation. The Indonesian government has effectively utilized its position as a market regulator to compel foreign manufacturers like TMC to comply with LCRs by fostering partnerships with local industries. The government’s ability to create a favorable investment environment and maintain market dominance has given it leverage to pressure TMC into utilizing local components more extensively, thereby reducing Indonesia's reliance on imported automotive parts. The role of economic diplomacy is further reinforced by the fact that Indonesia's automotive market is of such critical importance to TMC that its presence in the market can be characterized as "too big to fail."

In addition to leveraging domestic bargaining power, Indonesia has also adopted a bilateral diplomatic strategy to mitigate potential violations of WTO rules. The WTO's weakened dispute resolution mechanism, particularly following the paralysis of the Appellate Body in 2019, provides an opportunity for countries like Indonesia to focus on bilateral agreements rather than relying solely on multilateral trade rules. In this context, the Indonesia-Japan Economic Partnership Agreement (IJEPA) serves as a critical tool for advancing Indonesia’s LCR agenda. The IJEPA, signed in 2007, contains provisions for technology transfer and industrial development, offering Indonesia a platform to negotiate with Japan—TMC’s home country—to ensure that TMC adheres to LCR policies while fostering the growth of Indonesia’s domestic manufacturing sector.

Recent developments further underscore Indonesia’s success in using economic diplomacy to influence Japan and TMC’s role in the Indonesian automotive industry. The transformation of the Manufacturing Industrial Development Center (MIDEC) program from a training-focused initiative to the New MIDEC in 2021, which centers on developing local automotive component industries, is a clear example of Indonesia’s ability to secure tangible outcomes from its bilateral engagements. Through strategic diplomacy, Indonesia has persuaded Japan to support the growth of small and medium-sized enterprises (SMEs) in Indonesia’s automotive component sector, in line with its LCR policies. This success demonstrates that, with the right diplomatic and economic strategies, Indonesia can navigate the challenges posed by international trade laws while advancing its national interests.

This paper aims to explore the effectiveness of Indonesia's economic diplomacy towards TMC within the context of LCR implementation in the automotive sector. It argues that a dual strategy—focusing on domestic market regulation and bilateral diplomatic negotiations—

can optimize the role of LCRs in building Indonesia's domestic automotive industry. By examining the impact of LCRs on foreign investment, technology transfer, and industrial development, this study seeks to provide a comprehensive understanding of the interplay between national policy and international trade obligations.

The research will address the following key questions: (1) How is the LCR policy institutionalized within the framework of the WTO? (2) What has been the impact of LCR implementation on Indonesia's automotive sector since the post-Reformation period? (3) What diplomatic strategies have been employed bilaterally to optimize LCR implementation, particularly in negotiations with TMC?

METHOD

This research employs a qualitative approach, focusing on an in-depth analysis of secondary data to examine Indonesia's economic diplomacy strategies in relation to the implementation of Local Content Requirements (LCRs) in the automotive industry. The study utilizes both descriptive and analytical methods to assess the effectiveness of the LCR policies and their impact on Indonesia's domestic automotive industry, as well as to understand the bilateral diplomatic relations between Indonesia and Japan, particularly concerning Toyota Motor Corporation (TMC).

The data sources for this research are secondary and include government reports, international trade agreements, industry statistics, policy documents, and academic literature. Key documents analyzed include reports from Indonesia's Ministry of Industry, the World Trade Organization (WTO), the Indonesia-Japan Economic Partnership Agreement (IJEPA), as well as academic studies on local content requirements and economic diplomacy. Additional data from reputable databases such as the World Bank, Trading Economics, and the International Trade Center (ITC) are also utilized to provide a comprehensive view of the automotive industry in Indonesia.

Data Collection Process

The data collection process involved a comprehensive literature review of both national and international regulations regarding LCRs, economic diplomacy strategies, and international trade laws, particularly within the framework of the WTO. The study also reviewed existing empirical studies on the impact of LCR policies on developing countries, focusing on Indonesia's automotive sector. Secondary data was collected from peer-reviewed journal articles, government publications, trade reports, and relevant policy analyses.

Data Analysis

The data collected were analyzed using a combination of content analysis and comparative analysis. The content analysis focused on identifying recurring themes and patterns related to the implementation of LCR policies and the diplomatic strategies employed by Indonesia to negotiate compliance with international trade laws. Comparative analysis was used to

examine the differences between Indonesia's approach to LCRs and other countries' strategies, particularly in relation to the global trade regime governed by the WTO.
In addition, the study employed the Growth Ratio and Compound Annual Growth Rate (CAGR) methods to assess the development of Indonesia's automotive sector under the LCR framework. The Growth Ratio was applied to measure the year-on-year growth of local content in car production, while the CAGR was used to analyze long-term trends in foreign direct investment (FDI) and local component production. This quantitative analysis was complemented by qualitative insights from economic diplomacy theory, providing a holistic view of how Indonesia's LCR policies have evolved within the constraints of international trade regulations.

Research Framework

This study is grounded in the theoretical frameworks of economic diplomacy and international political economy. The research aims to explore how Indonesia can leverage its economic and diplomatic power to implement LCR policies effectively while navigating the challenges posed by international trade obligations. Economic diplomacy is analyzed as a tool for Indonesia to negotiate favorable terms with TMC and Japan under the IJEPA, while the theoretical lens of international political economy is applied to understand how global trade dynamics influence national policy-making in developing countries.

RESULT AND DISCUSSION

This section examines two main areas: (1) Indonesia's Local Content Requirement (LCR) policy in the automotive industry post-Reformasi, and (2) Indonesia's diplomatic strategy toward Toyota Motor Corporation (TMC) and Japan concerning the LCRs program in the automotive sector. In the first part, Velozo's framework (2006) is used to analyze LCR as a policy that can offer added value to developing countries when implemented based on careful planning and considering a sustainable learning process within domestic manufacturing industries. The second part employs van Bergeijk & Moons' (2007) framework to examine Indonesia's diplomatic strategies, emphasizing three resources: (1) political/diplomatic relations, (2) economic assets, and (3) efforts to consolidate the political and international environment.

For the first resource, we examine Indonesia's bilateral strategy in renegotiating with Japan to ensure its commitment to technology transfer via the New MIDEC program. The second resource assesses how Indonesia leverages its domestic automotive industry—strengthened by LCR policies—as bargaining power to push TMC to establish Small and Medium Industries (SMIs) producing automotive components locally. The third resource focuses on Indonesia's efforts to uphold transparency in the global trade regime by notifying the World Trade

Organization (WTO) of its LCR policies, ensuring the country maintains a favorable international trade reputation.

Indonesia's LCR Policy in the Post-Reform Automotive Industry

Indonesia's LCR policy in the automotive sector gained momentum in the post-Reformasi period with the issuance of Ministerial Decree No. 10/2006. This regulation aimed to promote the use of domestic components in production without deterring foreign investment by offering incentives such as tax reductions and import duty relief. To standardize the calculation of LCR percentages, Ministerial Regulation No. 16/M-IND/PER/2/2011 was introduced, breaking down LCR into three main components: direct materials (raw materials), labor, and factory overheads.

The concept of LCR aligns with the "infant industry" theory, which suggests that developing countries should protect nascent industries until they become competitive internationally (Moon, 2012). Velozo (2006) emphasizes that the success of LCR policies depends on implementing a unique learning process for domestic industries, gradually increasing their competitiveness without overly relying on protectionist measures. However, such policies may lead to inefficiencies if not carefully structured (OECD, 2015).

Indonesia's LCR policies initially focused on the manufacturing sector but gradually expanded to cover other industries, including telecommunications, energy, and trade. Between 2006 and 2018, 13 regulations were introduced, including presidential decrees and ministerial regulations (Risnain, 2018). However, these sectoral policies often lacked coordination, leading to legal challenges in the WTO, particularly the lawsuit filed by Japan, the U.S., and Canada over Indonesia's LCR requirements in 4G LTE telecommunications.

In response to these challenges, President Jokowi reformed the LCR regime in 2018 through Presidential Decree No. 24/2018, which established the National Team for Increasing the Use of Domestic Products (P3DN). The team, chaired by the Coordinating Minister for Maritime Affairs and Investment, was tasked with overseeing LCR policies to ensure they align with both domestic and international trade considerations. This effort marked a shift from fragmented sectoral policies to a more integrated and coordinated LCR strategy.

The LCR framework adopted by Indonesia also emphasizes a "unique learning process" (Veloso, 2006) in which local industries progressively enhance their technical capabilities and product quality. By 2021, the automotive sector saw significant updates with the issuance of Ministerial Regulations No. 23/2021 and No. 852/2021. These regulations introduced more flexible LCR thresholds and tax incentives, allowing automotive companies that met a 60% local content threshold to receive tax discounts, compared to the previous 70% threshold.

However, Indonesia's LCR policy faced criticism for potential inefficiencies, as noted by economists and global trade organizations (Peterson Institute, 2013). Critics argue that LCR policies can distort markets by promoting domestic products that may not be cost-competitive or technologically advanced (OECD, 2015). These concerns were addressed by reforms that prioritized the development of domestic industries through capacity-building initiatives such as technical training and product standardization for local suppliers.

The following table summarizes the components of the LCR calculation based on Ministerial Regulation No. 16/M-IND/PER/2/2011, showing the three key components: raw materials, labor, and factory overheads.

Table 1. LCR Calculation in Manufacturing Based on Minister of Industry Regulation No. 16/M-IND/PER/2/2011

Spesification		Budget per 1 (one) product			%LCR
		Local	Foreign	Total	
1	raw material	(1A)	(1B)	(1C)	(1D)
2	labor	(2A)	(2B)	(2C)	(2D)
3	Factory Overhead	(3A)	(3B)	(3C)	(3D)
Production Cost		(4A)	(4B)	(4C)	(4D)

Indonesia's Diplomatic Strategy toward TMC in the Automotive LCR Program

TMC has expressed support for Indonesia's LCR policy, with several locally produced car models exceeding the required LCR thresholds. As of 2021, TMC’s production in Indonesia included nine car models with local content percentages ranging from 70% to 85%. While the labor and factory overhead components are predominantly sourced domestically, the raw materials—such as steel, resin, and aluminum—are still largely imported (Tjahjono, 2018).

Despite the significant progress in meeting LCR thresholds, the reliance on imported raw materials remains a critical challenge for Indonesia. The local automotive component industry, particularly in tier-3 manufacturing (i.e., raw material production), has not yet reached the level of sophistication seen in countries like Thailand, which has over 2,500 automotive component manufacturers compared to Indonesia's 800 (Otomotif-Bisnis.com, 2021). Nonetheless, TMC's strong market position in Indonesia presents an opportunity for the government to push the company to further invest in local industries.

Indonesia's diplomatic strategy leverages TMC's dominance in the local market as a key bargaining tool to push for greater investment in local component production. As shown in **Figure 2**, TMC brands such as Toyota and Daihatsu continue to dominate Indonesia's car sales, giving the Indonesian government leverage to encourage TMC to invest in local suppliers and enhance the country's automotive manufacturing capabilities.

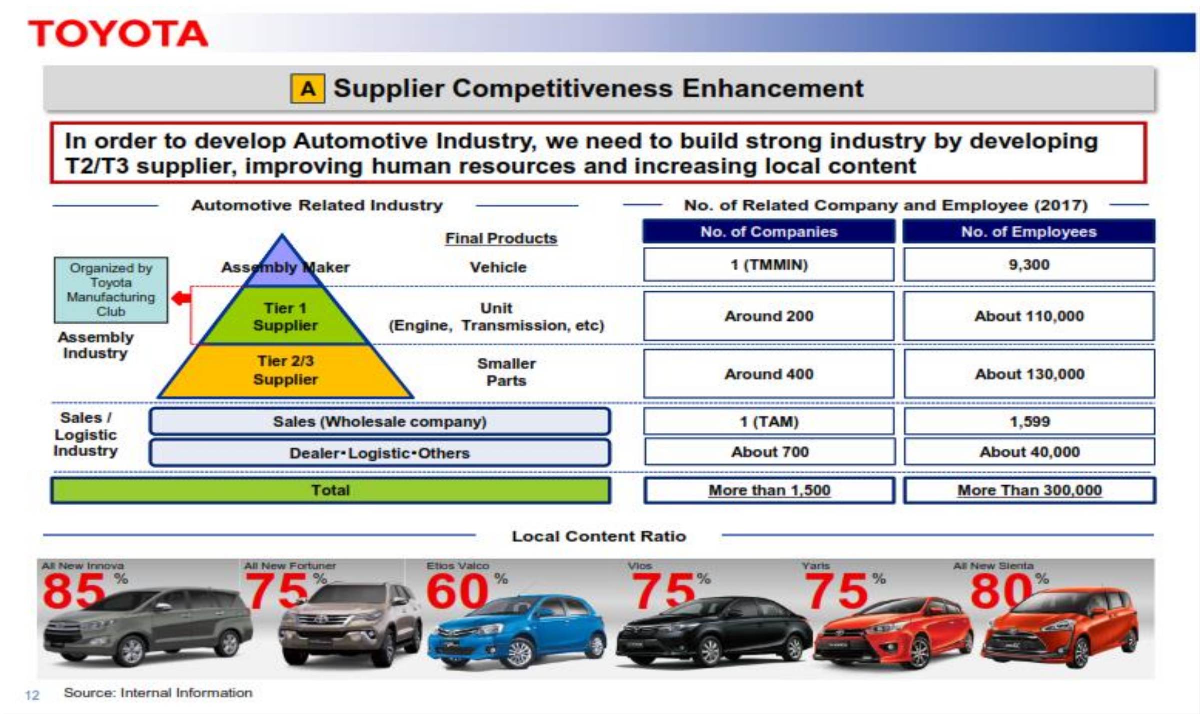

Figure 2. Local Content in TMC Car Products in Indonesia (2018)

In addition to domestic leverage, Indonesia's bilateral strategy with Japan has played a crucial role in advancing its LCR policy. Under the Indonesia-Japan Economic Partnership Agreement (IJEPA), Japan committed to a technology transfer program through the Manufacturing Industry Development Center (MIDEC). However, as noted by Febreani (2022), the initial MIDEC program did not deliver the expected benefits, focusing primarily on human resource development rather than industrial capacity-building.

In 2021, following Indonesia's renegotiation efforts, the MIDEC program was revamped into the New MIDEC program, which shifted the focus toward fostering SMIs and developing local industries that produce automotive components such as molds, dies, and jigs. This bilateral cooperation is a significant step forward in aligning Japan's commitments with Indonesia's industrial development goals.

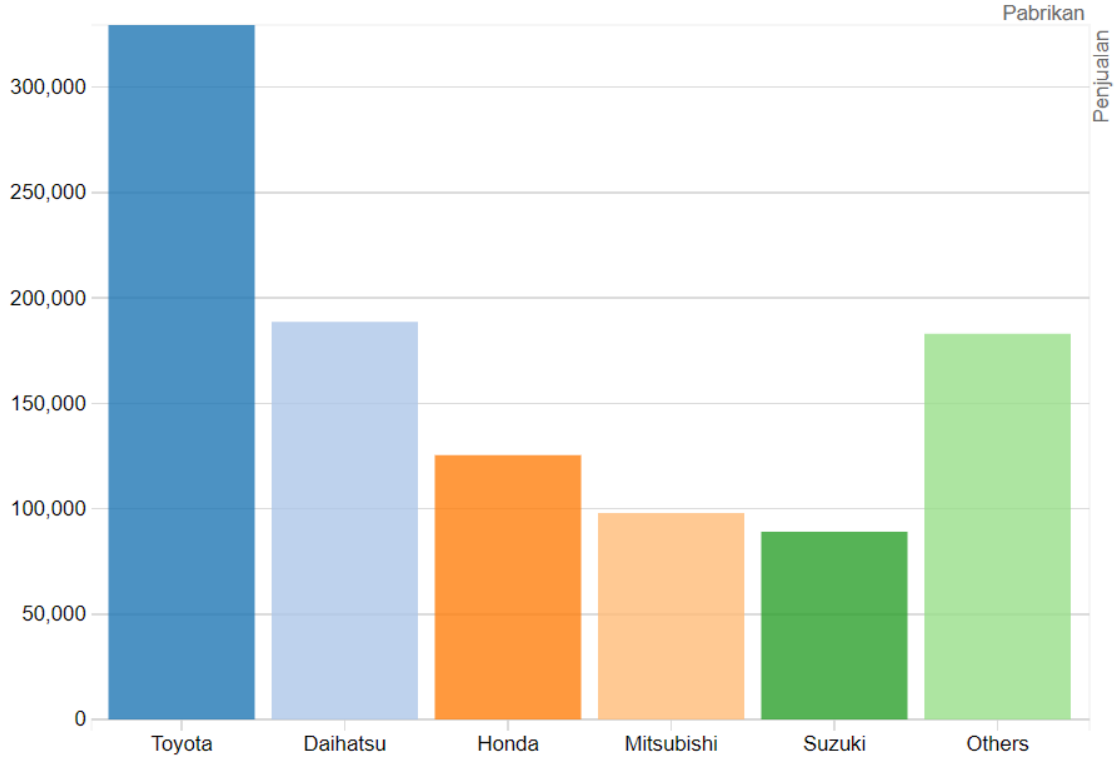

Figure 3. Indonesia-Japan Trade Before and After IJEPA (2001-2019)

While the full impact of the New MIDEC program remains to be seen, its potential to increase local content in Indonesia's automotive sector is promising. By focusing on niche industries such as mold and dies, which are critical to the production of automotive components, Indonesia is positioning itself to demand more substantial technology transfer from TMC and other Japanese multinational corporations.

Indonesia's LCR policy in the automotive sector has yielded significant progress, particularly in terms of labor and factory overheads. However, the challenge of developing a domestic raw materials industry remains. Through strategic use of its market position and bilateral agreements, Indonesia has managed to push TMC to further engage in local industry development. The New MIDEC program, in particular, offers a pathway for Indonesia to enhance its local automotive component manufacturing capabilities, ensuring the sustainability and growth of its automotive industry.

The literature review highlights that while LCR policies can lead to inefficiencies, they are an important tool for developing countries to foster domestic industries (Veloso, 2006; OECD, 2015). By leveraging its domestic and international diplomacy, Indonesia has demonstrated that it is capable of implementing a more sustainable and coordinated LCR strategy, while also navigating the complexities of global trade agreements.

CONCLUSION

The Local Content Requirement (LCR) policy in Indonesia’s automotive industry represents a vital step for the country, as a developing nation, to enhance its industrial capacity. Taking into account both domestic conditions and the international trade regime, this policy must be carefully structured around a "unique learning process" to ensure sustainable development of the national automotive manufacturing sector. The case of Toyota Motor Corporation (TMC) illustrates that to fully optimize the performance of the LCRs in Indonesia’s automotive sector, the government must focus on three critical factors:

First, the global investment climate. While Indonesia may find loopholes in the World Trade Organization (WTO) system to support its LCR policies, it must proceed cautiously to avoid any potential negative consequences. Maintaining a favorable investment environment is essential for attracting foreign investors to build the automotive industry in Indonesia. Transparency is also crucial, as demonstrated by the government's efforts to strengthen the Domestic Component Level Certificate (STKDN) program and notify the WTO of its policies to mitigate risks of litigation. Furthermore, incentives like tax breaks and other benefits should be designed to balance the growth of Indonesia’s domestic automotive industry with foreign investment flows.

Second, leveraging TMC's market dominance. Given that TMC holds a leading position in Indonesia’s automotive market, the government should employ strategies that promote LCR performance by incentivizing TMC to foster the growth of the domestic automotive industry, particularly the Small and Medium Enterprises (SMEs) sector. By building on successful initiatives such as the SME centers in Tegal and Ceper, the government should continue fostering partnerships between foreign multinational corporations (MNCs) and local suppliers, ensuring these SMEs become fully integrated into the global supply chain. This effort must include enhancing production management, quality control, and financial support systems to ensure the long-term competitiveness of local SMEs.

Third, bilateral diplomacy. Indonesia’s successful renegotiation with Japan to transform the original technology transfer program (MIDEC) into New MIDEC, which focuses on industrial development, exemplifies how Indonesia can use its market potential and domestic automotive industry growth as diplomatic leverage. Through this strategy, the Indonesian government can pressure Japan to align its technology transfer commitments under the Indonesia-Japan Economic Partnership Agreement (IJEPA) with Indonesia's LCR goals. As foreign investments from South Korea, China, and Europe increase, Japan may face challenges in maintaining its dominant position in Indonesia's automotive industry if it fails to align with Indonesia's proposals.

In conclusion, the combined use of domestic policy initiatives and international diplomacy will be crucial to further advancing Indonesia's automotive sector and ensuring the success of the LCR policy.

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