The Economist INTELLIGENCE UNIT

Turning inwards: what Asia's self-sufficiency drive means for business and investors

A report by The Economist Intelligence Unit

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Introduction

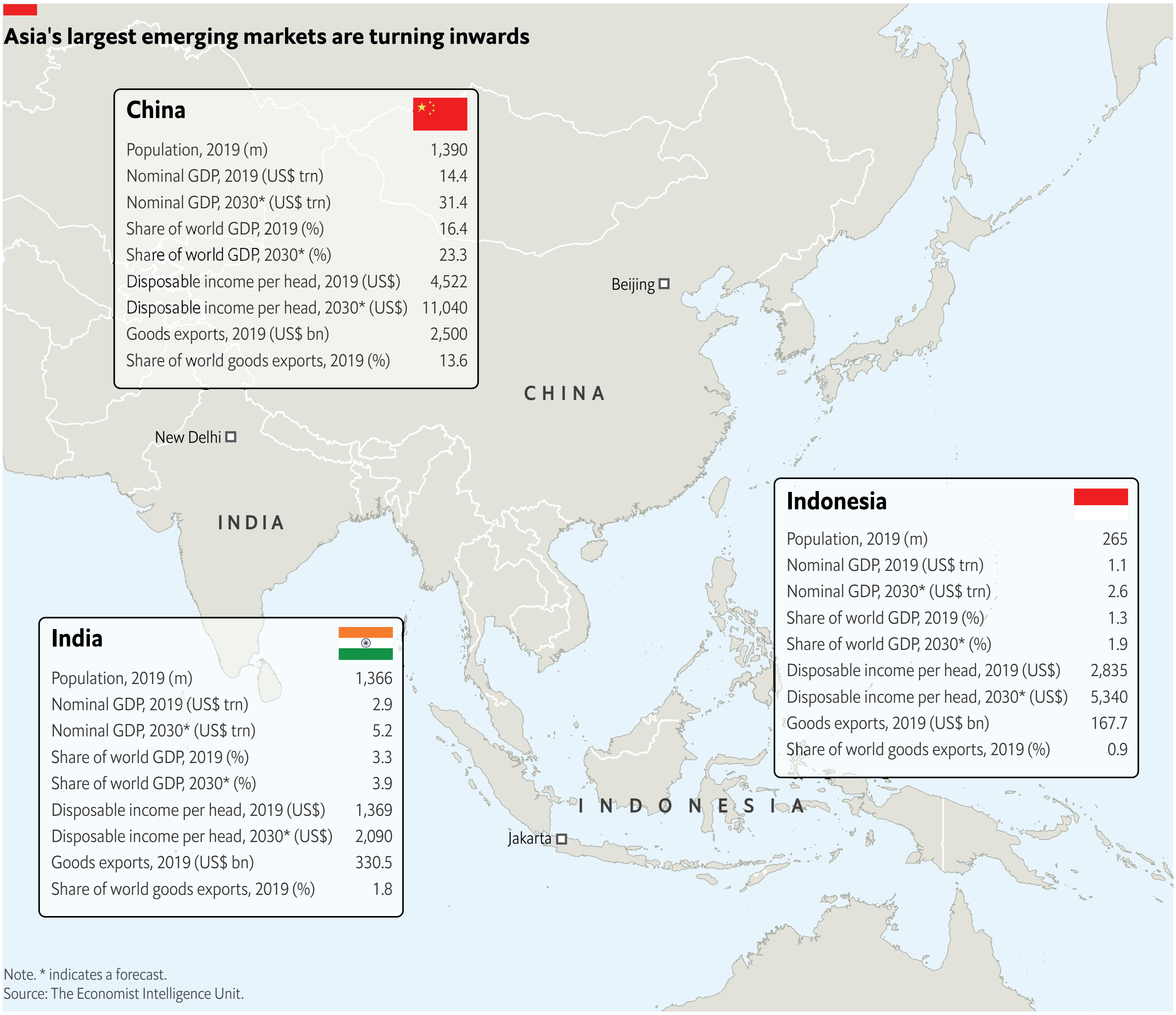
Asia's leading emerging economies are turning inwards. Having once seen the rest of the world as a source of growth and opportunity, governments in the region increasingly perceive uncertainty and (in some cases) threat. Underway is a reappraisal of economic development policy that is set to have lasting implications for business and investors. With the export-led growth model traditionally adopted in Asia out of favour, governments are looking to cultivate more self-sustaining economies.

An inward turn in economic policy was already underway in Asia before the arrival of the coronavirus (Covid-19), but the global disruption caused by the pandemic has accelerated this shift. In China, policymakers are discussing a "dual circulation" strategy that aims to foster resilience by emphasising the "internal" circulation of the domestic economy over the "external" circulation of the global economy. The Indian government has launched a "self-reliance" movement designed to reduce perceived supply-chain vulnerabilities. Meanwhile, amid the pandemic, Indonesia has unveiled import substitution policies aimed at supporting domestic industry.

In this paper The Economist Intelligence Unit clarifies the extent of the inward economic shift underway in Asia, focusing on the region's leading emerging markets of China, India and Indonesia, and provides advice for businesses and investors on its implications. Among its key findings:

- The inward turn in economic policy across emerging Asian markets is driven by geopolitical tensions and security concerns. China's focus on self-sufficiency is shaped by the worsening trajectory of its relations with the US, while India's shift in the same direction stems from concerns about economic dependence on China.
- Under these policy drives, more support will be forthcoming household incomes and spending, which will support Asia's domestic consumption sectors. We also see opportunities in industrial sectors tied to government efforts to reduce import dependency. Among the sectors we highlight are technology (China), electronics manufacturing (India) and consumer goods (Indonesia).
- Asia's inward turn represents a step back from closer global integration, but is not a move to autarky: countries in the region will still present significant commercial opportunities for foreign businesses and investors. However, we expect a trend towards operational localisation to intensify and, for global investors, grasping the opportunity in Asia while managing political pressures in their home markets will be increasingly challenging.

Asia's largest emerging markets are turning inwards



China

Population, 2019 (m)	1,390
Nominal GDP, 2019 (US$ trn)	14.4
Nominal GDP, 2030* (US$ trn)	31.4
Share of world GDP, 2019 (%)	16.4
Share of world GDP, 2030* (%)	23.3
Disposable income per head, 2019 (US$)	4,522
Disposable income per head, 2030* (US$)	11,040
Goods exports, 2019 (US$ bn)	2,500
Share of world goods exports, 2019 (%)	13.6

Indonesia

Population, 2019 (m)	265
Nominal GDP, 2019 (US$ trn)	1.1
Nominal GDP, 2030* (US$ trn)	2.6
Share of world GDP, 2019 (%)	1.3
Share of world GDP, 2030* (%)	1.9
Disposable income per head, 2019 (US$)	2,835
Disposable income per head, 2030* (US$)	5,340
Goods exports, 2019 (US$ bn)	167.7
Share of world goods exports, 2019 (%)	0.9

India

Population, 2019 (m)	1,366
Nominal GDP, 2019 (US$ trn)	2.9
Nominal GDP, 2030* (US$ trn)	5.2
Share of world GDP, 2019 (%)	3.3
Share of world GDP, 2030* (%)	3.9
Disposable income per head, 2019 (US$)	1,369
Disposable income per head, 2030* (US$)	2,090
Goods exports, 2019 (US$ bn)	330.5
Share of world goods exports, 2019 (%)	1.8

Note. * indicates a forecast.
Source: The Economist Intelligence Unit.

China's dual circulation model: managing risk trumps growth

Deteriorating diplomatic and trade relations, especially with the US, have deepened Chinese calls for greater economic self-sufficiency. This year, policymakers have been discussing a "dual circulation model" that identifies the domestic market as the mainstay of the Chinese economy, rather than global markets. They see an inward pivot as reducing China's exposure to the vagaries of the global economy, whether in terms of supply or demand. Dual circulation is set to feature prominently in China's five-year plan for 2021-25 due to be released in March 2021.

In some respects, dual circulation is a restatement of the long-held goal of rebalancing China's economy. Amid the 2008-09 global financial crisis, China's government called for efforts to "expand domestic demand" as the country's export-driven growth model showed its limits. However, while investment subsequently jumped, progress in increasing household spending has been slow. As a share of GDP, private consumption accounted for 38.8% in 2019, barely higher than a decade earlier. This year, amid the pandemic, private consumption is set to be the worst-performing part of the economy.

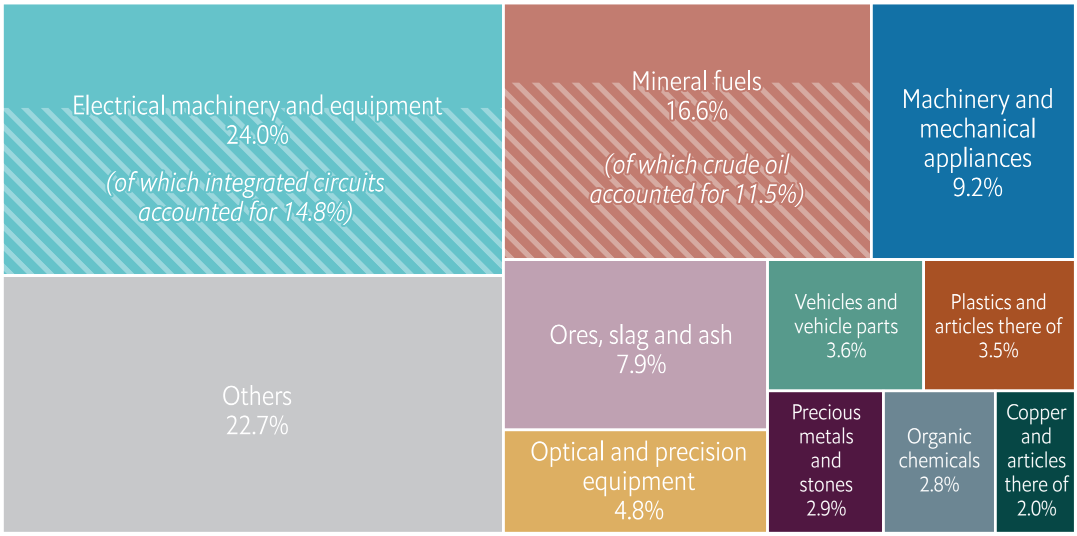
A fresh policy push behind rebalancing is therefore due; we also believe that efforts to boost domestic demand under dual circulation will be more emphatic. This is partly because, for China private consumption offers the best channel through which to deliver sustainable long-term economic growth, but it also stems from the government's sense of significant changes in the external environment. The US-China trade war and the desire of several countries to reduce their dependence on Chinese supply chains suggests that China faces diminished access to overseas markets in the future.

Besides cultivating the domestic market to drive growth, the other key element of dual circulation will be reducing risks tied to import dependency. Given the worsening trajectory of China's international relations, the authorities are concerned about the security of international supplies of food, energy and technology on which the country depends. We believe that, under dual circulation, reducing these vulnerabilities and fortifying self-reliance in production and distribution will be the priority even if it results in some economic inefficiencies. Risk prevention and the imperative of national security will trump "high-quality growth".

Technology, energy and food will be the sector focus

How will dual circulation play out sectorally in China? In terms of industrial policy, we expect policy to aim to match domestic supply chains more closely with the structure of domestic demand. This will contrast with the more sweeping goals of the controversial Made in China 2025 initiative, which aimed at securing global market share in various emerging sectors. Rather than promoting exports, industrial policy and support will focus on choke points where China is seen to have a dangerous reliance on imports.

Technology and energy dominate China's imports
(% of total goods imports, 2019; US-dollar basis)

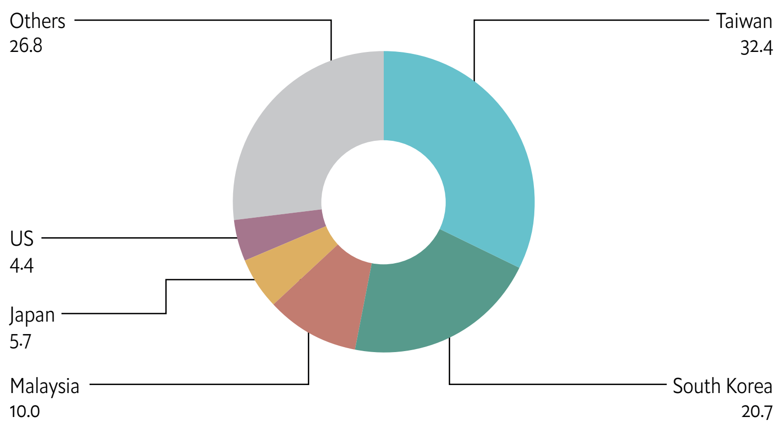


Sources: ITC Trade Map; The Economist Intelligence Unit.

Technology

Among all sectors, technology stands out as the area likely to receive the most overt support in achieving self-sufficiency, with semiconductors or integrated circuits (ICs) enjoying the strongest attention. The vulnerability has been highlighted by the pressure applied on Huawei and other Chinese technology companies by US actions to restrict their access to global technology through export controls.

Taiwan and South Korea are the main chip exporters to China
(China's imports by supplier; % of total value of integrated circuit shipments)



Sources: ITC Trade Map; The Economist Intelligence Unit.

ICs, a critical component in electronics manufacturing, are China's largest import category, accounting for roughly 15% of total imports in US-dollar terms in 2019, with Taiwan, South Korea and Malaysia the largest suppliers. China has pledged billions to develop domestic alternatives to imported ICs, including under a multi-billion dollar investment fund unveiled in 2014. Corporate income tax breaks announced in August 2020 offered ten-year tax exemptions for qualified IC producers, while efforts to enhance corporate research and development, co-operation with universities and talent-attraction schemes are expected.

Even with such policy support, however, it will be a challenge for Chinese firms to catch up with their sophisticated Taiwanese, South Korean and US competitors that retain key advantages in IC design and fabrication. Gaining ground in these areas will require the development of an ecosystem and cultivation of a wide talent base. Options to accelerate the upgrading of the domestic sector through mergers and acquisitions have also become more challenging as a result of greater oversight of Chinese overseas investment in recipient markets, especially in technology.

While Chinese firms will steadily erode the market share held in China by imports in the low- and mid-range of the sector, they are unlikely to be able to offer in the medium-term replacements for the most sophisticated foreign chips, including those required for 5G- and 6G-related application. Outside of ICs, another key area in the technology space to watch will be a likely push to shift more to local providers of software and information services, amid data security concerns.

The world's top semiconductor foundries

Company	Location of headquarters	Current mass production capability (by nanometre)
TSMC	Taiwan	5nm
Samsung	South Korea	5nm
Intel	US	10nm (planned by end-2020)
SMIC	China	14nm
UMC	Taiwan	14nm
GlobalFoundries	US	14nm

Note. Non-exhaustive list.

Source: The Economist Intelligence Unit.

Energy

As one of the world's largest importers of energy, China views energy security as one of its top priorities, with any risk to supplies likely to have significant implications for industrial production and consumption. In 2019 almost 85% of China's oil consumption was derived from imports, while imported gas accounted for over 40% of consumption. In contrast with technology, China is less dependent on the US and its allies for energy imports—Saudi Arabia and Russia are its largest suppliers of oil, while the bulk of gas imports come from Turkmenistan. Nevertheless, concerns about potential disruptions to shipments, including via sea-lanes in the South China Sea where geopolitical tensions have risen, suggest energy security will be a feature of the dual circulation strategy.

The most promising avenue for cultivating domestic energy resources will remain renewables, which accounted for nearly 20% of energy consumption in 2019. China has invested heavily in the area and the returns available from renewables remain high relative to other countries, with issues around grid connectivity also being steadily improved. Within the renewables sector, we think that wind power and nuclear will be prioritised. Offshore wind power remains relatively untapped and will likely see investment from coastal provinces, China's largest energy consumers. Dual circulation will further encourage the switching to local technology in renewables; in the nuclear sector, the 12 plants under construction or pending approval in China are set to use local technology rather than from the US or elsewhere.

As well as this, China will continue to deepen its international relations in the energy sector, many of them under the umbrella of the Belt and Road Initiative (BRI), and is likely to play a closer role in terms of overseeing and safeguarding such resources. Over the long-term, efforts to reduce energy intensity will also be a priority, pointing to opportunities for environment protection and green consumer industries.

Food

Major shocks have raised fresh concerns in China around food security. Beyond pandemic-induced supply disruptions, China has grappled with an outbreak of African swine fever—which has decimated pig production, a key protein source—since mid-2018, while also contending with reduced US soybean shipments (a critical staple for animal feed) as part of the trade war. Other pressures stem from domestic structural factors, with urbanisation and demographic ageing giving rise to rural labour shortages, alongside a strong reliance on imported seeds and foreign planting and processing technology.

Currently, in terms of agriculture production, China is dependent only on soybean imports to meet its domestic needs. The Chinese Academy of Social Sciences (a government think-tank), however, forecasts a production shortfall of 25m tonnes in wheat, corn and rice by 2025. Food supply has a direct bearing on consumer prices, risking consequences for wider social stability.

There is significant scope to bolster domestic production of staples to meet this shortfall. China's agricultural productivity is low and production is labour intensive, suggesting scope to raise yields through modernisation and application of technology. However, progress in this area has been hindered by the slow pace of rural land reform, suggesting that import dependency will persist. US farmers will enjoy some short-term opportunities, stemming from the agricultural product purchasing agreement set out under the January 2020 trade deal, but over the longer term China will be keen to maintain a diversified group of suppliers. This, in turn, should yield opportunities for farmers in Europe, Latin America and those along the BRI.

Healthcare and other sectors

Outside the key areas above, China is also likely to identify several other areas as priorities for industrial development, given the high levels of import dependency. For example, the country remains import dependent on key pharmaceuticals and medical devices, such as chemotherapy drugs and magnetic resonance imaging (MRI) devices, a topic that has gained renewed attention amid the Covid-19 crisis. As a result, we expect policymakers to push for stronger support for research and investment in these areas. Other specific areas in the industrial supply chain where China will push for more localisation include operational control systems used in rail and other transit; gas turbine components used in power equipment; and design and simulation software used in the aircraft and automotive industries.

While the above focuses on how industrial policy may be applied to tackle areas of import dependency, this alone will not be enough to make dual circulation a success. Policymakers have been slower to indicate a corollary strategy to promote domestic consumption and wean the economy off its reliance on exports. Without that component, policies aimed at boosting production in several areas could lead to new structural imbalances.

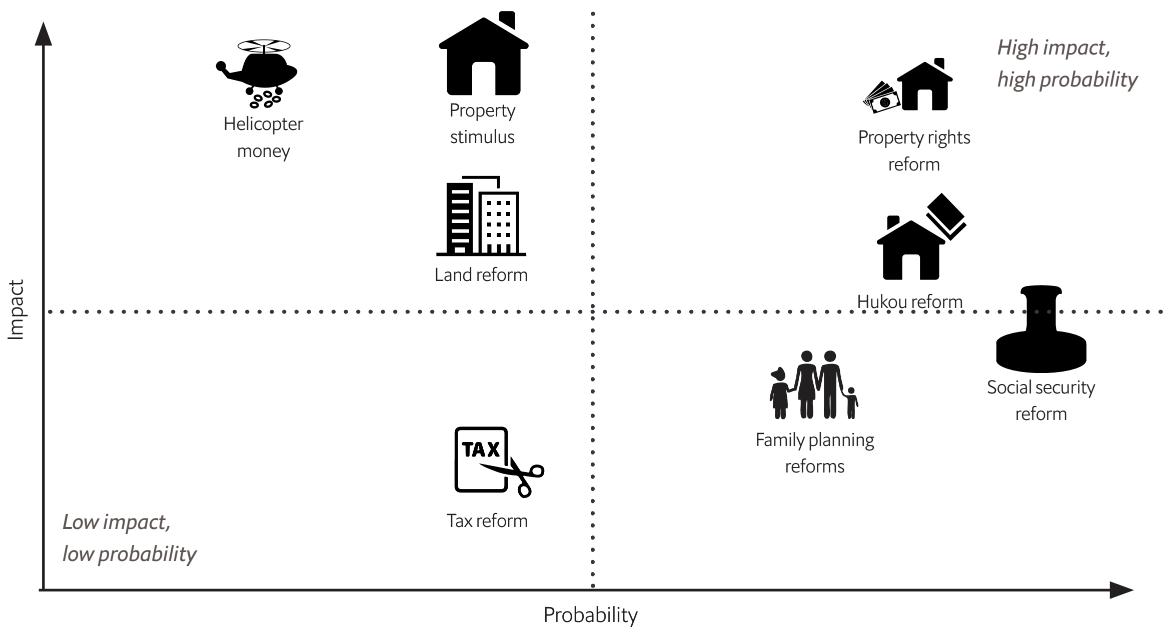
Consumer upgrading and digitalisation

Overall, we suspect there will be more focus on this area under dual circulation. Our baseline forecast is for a steady rise in personal incomes, with the number of households with incomes above US$25,000 expected to exceed 50% of the population by 2030 (at market-exchange rates). Underpinning this will be further investment in deepening the social safety net; possible income tax reductions; and facilitation of urbanisation, which will focus as much on smaller cities as larger ones. However, the sort of large-scale transfer of wealth to the household sector necessary to transform China's economy remains unlikely.

For consumer-facing segments of the economy, upgrading and digitalisation will be the primary themes. This will help accelerate replacement rates in consumer goods and bolster the already world-leading ecommerce sector. We expect that there will be opportunities in areas such as health services and pension provision, where demand will be firm, but fiscal constraints suggest that the government will lean heavily on the commercial sector as providers. Less positively, with the authorities looking to direct resources to the real economy, overall policy in the property sector will remain tight.

Property rights, hukou reform are key reforms to watch

Probability and impact of measures to boost household consumption in China to 2025

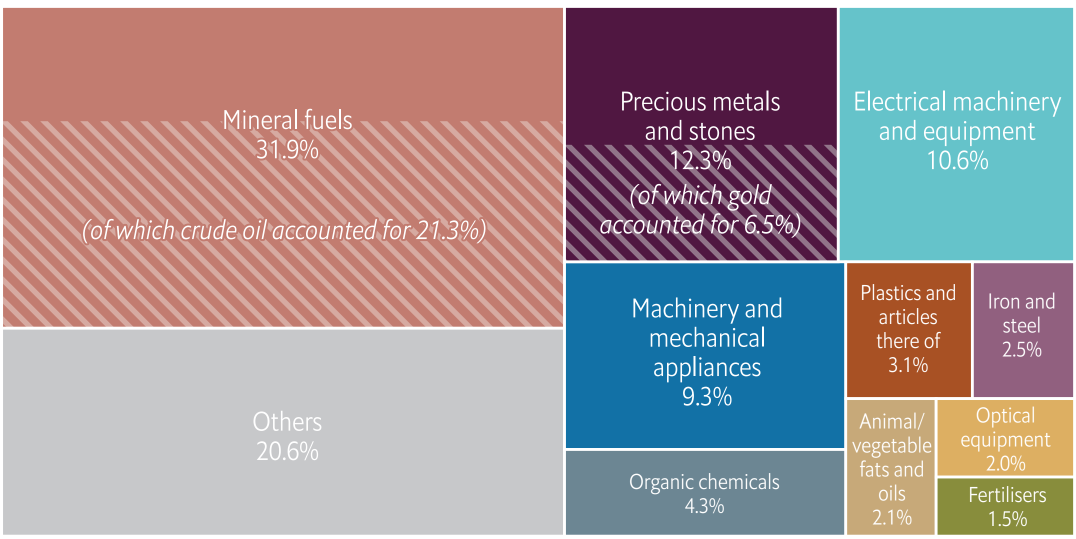


Self-reliant India: closing the door to China

The Atmanirbhar Bharat ("Self-reliant India") initiative is a culmination of different factors reflecting economic and security challenges faced by India. India entered the Covid-19 pandemic with significant economic challenges. Real GDP growth had been on a downward trend for three consecutive years, slowing to 4.2% in fiscal year 2019/20 (April-March), creating challenges in finding employment for the nearly 5m workers entering the labour force annually. India's low state capacity, poor healthcare infrastructure and highly populated urban centres have left it particularly affected by the pandemic, which has weighed further on the economy. The 23.9% year-on-year contraction in real GDP recorded in April-June amid lockdown measures was the steepest among any G20 economy over that period.

While the self-reliance initiative focuses on the Indian economy, it is as much about reducing India's economic dependence on China. India's views on China have hardened in recent years and border clashes involving the two countries in June 2020 have given rise to the view that its larger, more powerful neighbour represents a threat to national security. Self-reliance prioritises weaning India off Chinese imports and, at the same time, exploiting a reassessment of relations with China around the world to attract supply-chains shifting out of the country.

Energy, precious stones and electronics lead India's imports
(% of total goods imports, 2019; US-dollar basis)



Sources: ITC Trade Map; The Economist Intelligence Unit.

A conflicted policy

The self-reliance initiative, first announced by India's prime minister, Narendra Modi, in May, aims to achieve many goals. Most importantly, the policy tries to develop India's manufacturing sector by improving the domestic business environment and shielding it from international competition. The initiative also aims to position India as a significant exporter of goods to the world, with the help of these domestic industries and an increased inflow of foreign direct investment. Finally, the initiative aims to reduce India's dependency on external markets, especially China, for its domestic needs.

In trying to achieve the economic and security goals, the policy has a conflicting dynamic. For example, it aims to reduce domestic market access to imports, but at the same time open the economy and export to the rest of the world. In this sense, there are parallels with the earlier policy of "Make in India", which was launched in 2014 to boost growth in the manufacturing sector. However, we believe that given the more severe economic and political challenges faced by the country, there will be a more sustained and overt push towards protecting domestic industries under the self-reliance initiative, echoing India's pre-liberalisation stance before 1991.

Under the initiative, we expect the government to ease domestic regulations. Special importance will be given to the loosening of land and labour laws, which have been a significant pain point for private companies. While some progress has been made on this front, with various Indian states having suspended labour regulations for the coming years through ordinances, we expect permanent progress on this to be slow because of domestic opposition.

In addition, the authorities have committed to withdrawing (without a specified time frame) from non-strategic sectors of the Indian economy by privatising state-owned firms (known as public-sector undertakings or PSUs) and reducing their number to a maximum of four in strategic sectors, providing an opportunity for private and foreign investment. We expect the government to expand its existing incentive schemes (for goods production and setting up infrastructure) to attract foreign investors and support domestic manufacturers.

India's state-owned firms face consolidation and privatisation

Sector	No of public sector undertakings*	Likely to be deemed strategic
Banking	12	Yes
Chemical and pharmaceutical	14	No
Coal mining	8	Yes
Construction and technical consultancy services	43	Yes, mutiple strategic sub-sectors
Financial services (except banking and insurance)	20	Yes, mutiple strategic sub-sectors
Heavy and medium engineering	19	No
Industrial and consumer goods	11	No
Insurance	7	Yes
Oil and gas extraction	5	Yes
Other minerals and metals	9	Yes
Petroleum (marketing and refining)	6	Yes
Power generation	12	Yes
Power transmission	12	Yes
Steel	3	Yes
Telecommunications and IT	8	Yes
Transportation and logistic services	20	Yes, mutiple strategic sub-sectors

Note. * indicates an estimate.

Sources: Department of Public Enterprises; The Print; The Economist Intelligence Unit.

In a step to dissuade imports and further support domestic industries, we also expect the government to increase non-tariff barriers on low-cost competition to Indian manufacturing industries, such as through adjusting quality control standards, and increasing import tariff rates on products that could be alternatively made in India. The following sectors are positioned to receive the most policy support by the government in the coming years.

Electronics manufacturing and assembly

As part of the administration's drive for fostering self-reliance and reducing dependency on China, the electronic manufacturing and assembling sector is set to receive a strong policy push. The sector represented slightly more than 10% of the import bill in 2019, with China and Hong Kong accounting for more than half of the total. The sector is also highly dependent on imports, for instance, with mobile phones in India having nearly 90% of their parts being sourced outside the country.

There is a nascent ecosystem of mobile-phone manufacturing in India. This is because of the high tariff rates applied on its imports and incentive schemes by the government, such as the scheme for promotion of manufacturing of electronic components and semiconductors (SPECS) and Production Linked Incentive (PLI). SPECS provides a financial incentive worth 25% of the capital expenditure to support the setting up of necessary infrastructure, while PLI provides a 46% incentive on incremental sales of products for five years. These schemes have already led to investment by foreign manufacturers such as Foxconn, Samsung and Pegatron, among others. Given the success of these schemes and the keenness of the government to establish an ecosystem for other sectors as well, we expect the government to roll out similar schemes for the manufacturing of products like solar cells, automotive parts and batteries.

Pharmaceuticals and medical devices

India is a hub for low-cost pharmaceutical drugs manufacturing—an essential industry for domestic healthcare needs and an important export too. However, the industry is heavily dependent on imports, largely from China, importing 40% of the domestic demand for the key ingredients needed in the manufacturing of drugs. The import dependence in the case of medical devices is even higher at 60%, according to data from the Confederation of Indian Industry (a business group).

The government is keen to shift India away from imports in essential industries such as pharmaceuticals, especially owing to its frosty relationship with China. It rolled out a PLI scheme in July, similar to the one for mobile-phone manufacturing, to incentivise domestic manufacturing of key components for pharmaceuticals and medical devices. Apart from this, the government has also rolled out schemes to support the development of necessary infrastructure for both these industries.

Banking

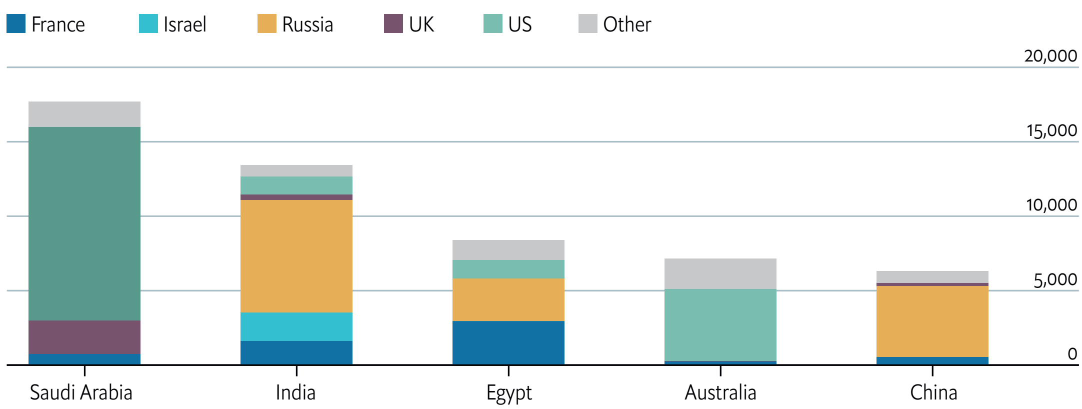
The government views the banking sector as strategically important, which, in line with the commitment under the "Self-reliant India" initiative, would mean that the number of state-run banks will be brought down to four from the current 12. We expect the Indian banking sector, especially the state-run banks, to be heavily affected by a rise in bad loans owing to the pandemic, and likely in need of large amounts of capital to absorb losses.

This, coupled with an already stretched fiscal account, will lead the government to divest stakes in many of the smaller PSU banks, not only because of its commitment to reduce the number of state owned banks to four, but also to raise funds to inject capital. In the absence of well-capitalised public-sector banks, private-sector banks that are well capitalised and possess a relatively low non-performing loans ratio, stand to increase their market share.

Defence and aerospace. India has one of the largest defence forces in the world, but the lack of a domestic defence industry also means that it is one of the largest arms importers in the world. As a result, the government has identified this sector as a candidate to support domestic manufacturing of equipment. The Ministry of Defence has committed to an embargo on the import of 101 items, from firearms to submarines and long-range cruise missiles, in a phased manner through to 2025. The armed forces together are projected to buy embargoed weapons worth Rs4trn (US$53.7bn) from the domestic market during that time. To further support the domestic production of arms, limits on foreign investment in the sector have been reduced.

India aims to reduce its dependence on arms imports

(Imports of arms by country; figures in SIPRI trend-indicator values expressed in millions, 2015-19)



Sources: Stockholm International Peace Research Institute; The Economist Intelligence Unit.

Downside economic risks

Besides sectoral opportunities, India's inward turn also poses some economic risks. A more protectionist trade stance and any increase in tariff rates for imports may lead to punitive tariffs or the revocation of trade benefits from its partners. Most recently this was seen when the US revoked India's access to its market under the generalised system of preferences, citing high Indian import tariffs. It will also ensure that India remains outside emerging regional trade blocs from which it could benefit.

Another risk with the self-reliance initiative is the possibility that the government, while implementing increasing tariff and non-tariff barriers, does not follow through on the broader reform agenda. If the government does not undertake the opening of various sectors to private enterprises, ease overbearing regulation and privatise loss-making PSUs, India's manufacturing sector will be rendered further uncompetitive. Furthermore, this would make future governments averse to opening up the economy again.

Indonesia: import substitution makes a comeback

In Indonesia, import substitution policies are showing signs of making a comeback. In recent years the country has appeared committed to outward-looking free-trade agreements. Association of South-East Asian Nations (ASEAN) countries, through the founding pacts of the ASEAN Economic Community (AEC), have secured significant tariff reductions across member states. Indonesia has also been among the more vocal supporters of the Regional Comprehensive Economic Partnership, a mega-regional trade agreement set to harmonise many existing trade agreements.

However, protectionist sentiment has never been far from the surface and it may be that the country sees such trade agreements primarily as ways to promote its exports. Indonesia's president, Joko Widodo (Jokowi), has expressed concerns about Indonesia being a destination for exports from other ASEAN members once the AEC is finalised. The Indonesian government has also managed to retain many non-tariff barriers, despite its rhetoric. According to the World Bank, 69% of goods imports to Indonesia are subjected to non-tariff measures, like pre-shipment inspection and traceability requirements, compared with 31.1% in Thailand and 38% in Vietnam.

Besides insulating parts of the domestic economy, Indonesian policy towards cross-border trade and investment is also influenced by structural factors. A persistent current-account deficit has been a longstanding concern for successive Indonesian governments owing to the volatility it can cause in the rupiah's value. A weak rupiah increases the cost of external debt repayment for the country.

A roadmap for import substitution

The coronavirus pandemic is further encouraging an inward-looking tendency. In July this year Indonesia's Ministry of Industry outlined a target of reducing import reliance across a range of sectors, including machinery, chemicals, metals and electronics, with a goal of shifting 35% of current imports in such areas to domestic sources by 2022. While the road map is still at the planning stage, it appears to be a more emphatic version of earlier self-sufficiency plans backed by the ministry, such as those targeting a higher share of domestic products in government procurement. The authorities hope that the drive will help increase utilisation rates for domestic manufacturing and create more jobs for locals.

While the specifics are still being shaped, direct import limits and prohibition, more pre-shipment inspections and some port restrictions are likely to be imposed. The government is contemplating

Indonesia aims for greater industrial self-sufficiency

(Targets for industrial self-sufficiency, 2020-24)

	2020	2024
Share of domestic components in industrial products (%)	49%	54%
Share of domestic products in government procurement (%)	46.60%	52.50%
No of industrial products certified with more than 25% of local procurement rate	6,200	8,400
Share of products required to have national standards system (SNI) certification	5%	20%

Sources: Ministry of Industry (Kementerian); The Economist Intelligence Unit.

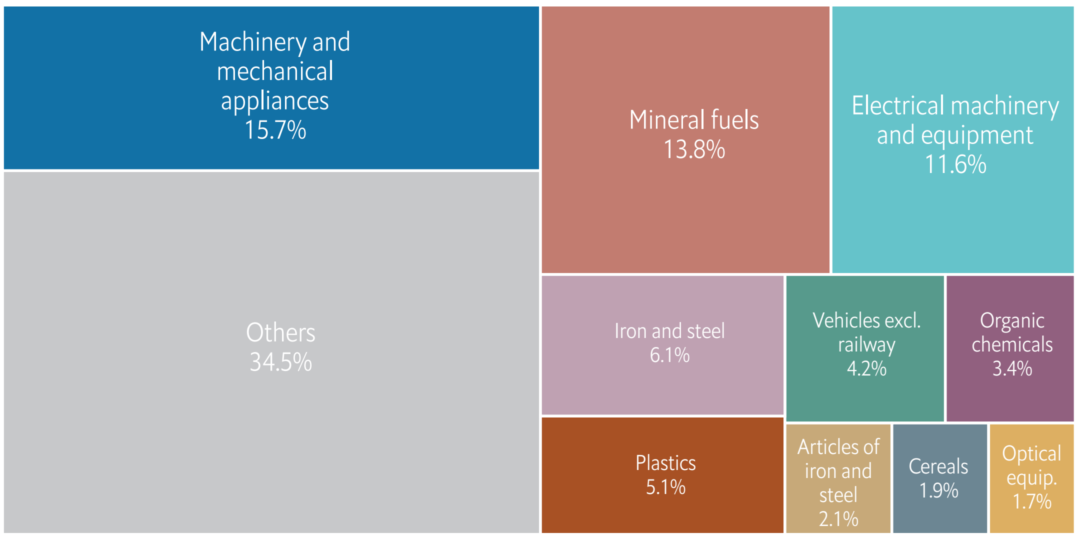
revamping national standards certification (known as the Indonesian National Standard or SNI) and applying them on more imports; reshaping a programme aimed at increasing the use of domestic goods (known as P3DN); and increasing the "most favoured nation" tariff on commodities.

The government's programme can be attributed to several concerns. First, the additional safeguarding will help distressed state-owned enterprises (SOEs). Among the more notable of these is PT Krakatau, a steel maker, which is dependent on government support and has been struggling to restructure its debt. The government has requested all import steels to be subjected to SNI starting from September, an initiative pushed by the firm. Alongside this, imports for capital-intensive goods in the electronics, machinery, and pharmaceutical sectors have drained Indonesia's foreign exchange and widened the trade deficit.

Consumer goods, metals to lead sector opportunities

Positive incentives for domestic entities operating in sectors where a large import dependency pertains are also likely. Indonesia's largest goods imports in 2019 included machinery, electrical machinery, iron and steel, and plastics. Such areas will be an area of policy focus for the authorities as they seek to bolster levels of domestic production.

Indonesia is dependent on imports for capital equipment, metals
(% of total goods imports, 2019; US-dollar basis)



Sources: ITC Trade Map; The Economist Intelligence Unit.

Prospects for import substitution will differ by sector. Reducing imports of machinery and other capital-intensive goods will be unlikely to succeed. Indonesia does not have a strong industrial foundation and lacks the domestic supply chain through which to produce higher-end capital goods. Insufficient intellectual property protection and weak research and development capacity make the production of indigenous advanced machinery a distant goal.

Consumer-facing industries stand a better chance of success, supported by proximity to a large and growing domestic market. Industries such as food and beverage and consumer goods manufacturing are likely to be recipients of government support, including tariff adjustments and subsidies. Opportunities could extend to sectors such as automotive and consumer electronics manufacturing if Indonesia is able to make broader progress on improving its business environment and infrastructure.

Metals, plastics and the oil and gas sectors will be other sectoral considerations given the structure of Indonesia's import demand. Domestic producers of aluminium, iron and steel will benefit from the revamped SNI requirement and a possible tariff hike on foreign metal. Barring strong investment in exploration, it is difficult to envisage Indonesia arresting the decline in oil production that has led it to becoming a net importer of the fuel, but it will seek to refine a greater quantity of its domestic output within its own borders. There will also be a desire to protect the trade surplus it maintains for natural gas, which could lead to tie ups with foreign investors.

The government's strategic work plan and the earlier "Make in Indonesia 4.0" plan outlined some general support measures, including setting up vocational training facilities, improving infrastructure access, and enhancing credit support to priority industries. However, few tangible support schemes are likely to be introduced, given the limited fiscal space. The policy focus will therefore be on strategic adjustments to the trade regime, including non-tariff barriers, and ongoing protection of SOEs.

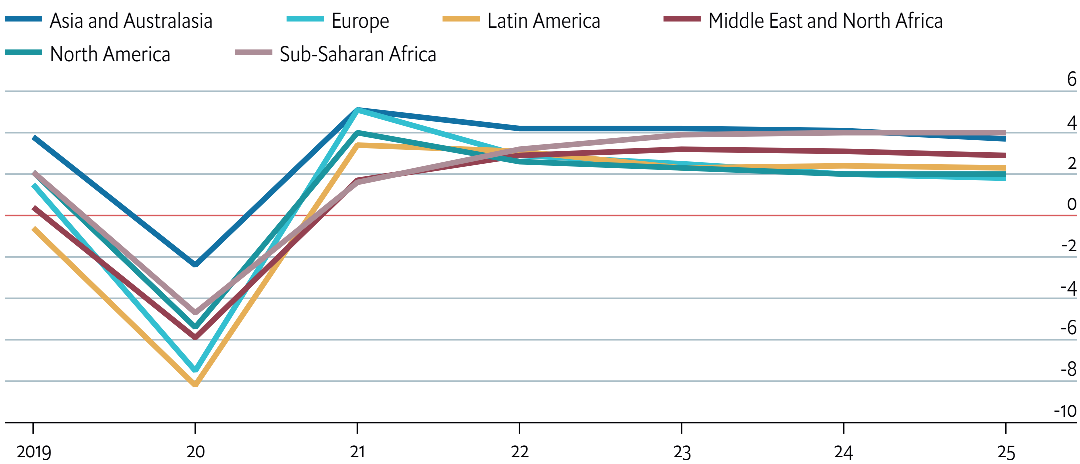
Unlike China and India, Indonesia's inward-looking policies are not guided by specific geopolitical concerns but are more an assessment of domestic economic interests. The country has few trade tensions with the US or China, for example. The trade deficit with China is substantial, but Indonesian exports to China have increased substantially over the past few years.

While investors may therefore find themselves relatively insulated from geopolitical tensions in Indonesia, navigating domestic political interests remains challenging. As noted, SOEs retain a protected role in key segments of the economy, such as finance, metal processing and construction. Scrutiny will also be applied by the authorities to investments in sensitive primary sectors, such as mining and palm oil plantations. A lack of skilled labour and trained scientists, as well as a poor record in protecting intellectual property rights, makes Indonesia a less desirable investment destination for research-intensive industries like pharmaceuticals.

Responding to Asia's inward turn

For businesses and investors that straddle national borders, Asia's inward economic turn is potentially troubling. Policies that aim to curb imports or prioritise local companies risk reducing their access to some of the largest emerging markets globally. Led by China, India and Indonesia, Asia posted some of the fastest rates of GDP growth globally pre-coronavirus and we believe that the region will be the quickest to recover economically from the pandemic.

The pandemic will have less of an impact in Asia than other regions
(Real GDP, % change)



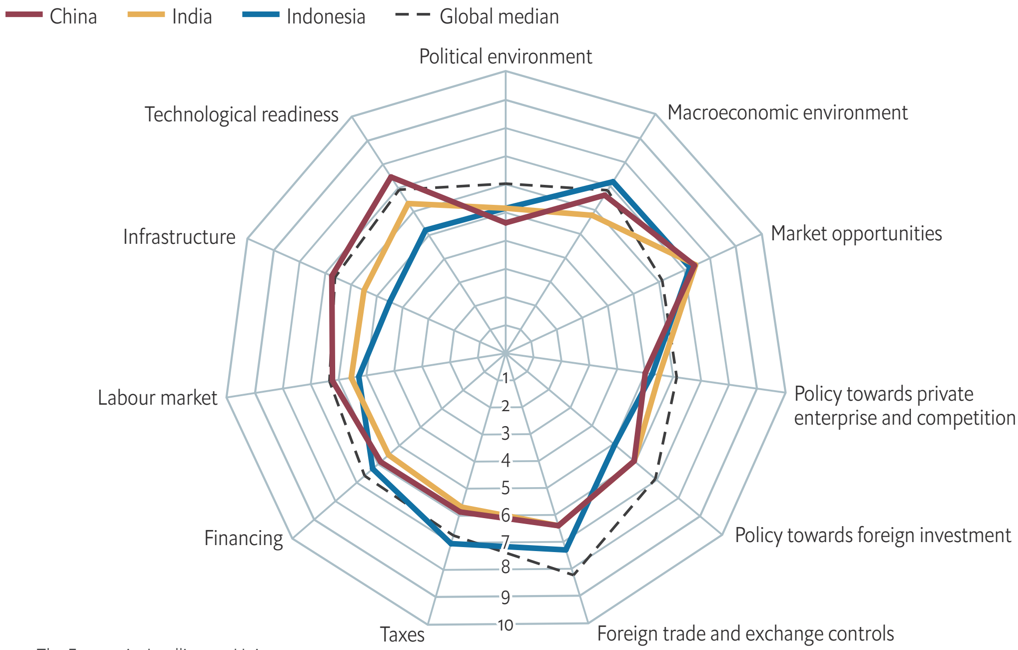
Source: The Economist Intelligence Unit.

In reality, the door is unlikely to close to foreign investors and we do not perceive a dramatic shift to autarky. China, India and Indonesia all retain a (varying) dependence on foreign goods and capital that it will be difficult to erode, even with concerted policy pushes. This should ensure a continued role for foreign trade and investment. Efforts by these countries to boost their domestic economies through structural reforms also point to enhanced commercial opportunities.

There will be variations among the three countries, however. China is the most economically advanced of the group and its embrace of foreign participation is likely to be most selective, given its greater domestic resources. There will still be areas where the authorities will be keen to entice more foreign capital when it aligns with strategic and economic goals; recent liberalisations for foreign investors in the financial sector, for example, will encourage local companies to lift their competitiveness while also providing an influential source of foreign support for stable diplomatic ties with China. The overall trend, however, will be towards a diminished role for foreign firms as strengthening domestic companies widen their market share. Besides support from the state, local companies are likely to be more adept at adjusting to domestic market preferences, especially in the consumer sector.

India and Indonesia are likely to be more embracing of foreign participation. India's "self-reliance" movement still retains a prominent role for foreign investment, other than from China. In Indonesia, too, despite the expansion of import substitution policies, the government remains keen to welcome foreign investment in areas such as manufacturing, ecommerce and infrastructure, while caps on foreign ownership in some sectors have been loosened. Both India and Indonesia will struggle in their goal of moving up the value chain without foreign support and they see an opportunity to attract investment amid supply chain relocation from China. The operational challenges for foreign investors will be significant, however, unless there is progress towards deregulation of land and labour markets in both countries.

China, India and Indonesia score highly for market opportunities
(Business environment rankings by country, 2021-25; 10 = most favourable)



Source: The Economist Intelligence Unit.

Strategically, Asia's self-sufficiency will have wide-ranging implications for foreign firms and investors. As companies come under pressure to demonstrate their value to the local economy and are required to be more adept in responding to local market dynamics, they will have to become more localised. Options for firms as they aim to make the transition will include increasing expenditure on local research and development; investment in an ecosystem of local firms and partnerships to gain early access to innovation; delegation of more resources to local offices; and careful alignment with government industrial policies and fiscal incentives.

Of course, moves towards more localised operations will create challenges of their own for multinational corporations, including global operational management and reputational concerns in home markets. The latter will be particularly difficult at a time when many governments in advanced economies are encouraging their companies to "reshore" overseas business operations. Successful localisation and investment in Asia will therefore need to be combined with an effective public relations strategy, which focuses on how a global footprint helps support jobs and productivity in home markets. In an era of deglobalisation, managing a global set of investments is becoming more challenging, but it can still be done.

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