

By Jon Grevatt, IHS Jane's Asia Pacific Defence Industry Analyst

Indonesia is set to introduce its inaugural defence offset policy from 2011 as part of wide-ranging changes to the country's defence procurement policies. The policy, which is being finalised by the Ministry of Defence (MoD), is expected to call on foreign contractors to transfer technologies to Indonesian defence companies to facilitate at least 40 per cent of a production contract to take place locally under licensed manufacturing arrangements.

The offset guidelines will be implemented by the MoD's Defence Industrial Policy Committee (KKIP) and will supplant existing ad hoc guidelines that relate to defence manufacturing and technology transfer and are based on counter-trade. The objective of the offset policy is to improve indigenous industrial capabilities, reduce dependency on imports, and create meaningful employment in a country whose economy is forecast to expand rapidly over the next decade. It will be supported by a government pledge to revitalise the state-owned defence industry over the next five years through financial support and a commitment to procure military equipment from indigenous sources whenever possible.

In a bid to shape the offset guidelines, a senior official from the MoD said Indonesia was talking to several foreign countries about their respective industrial participation and offset schemes in order to learn more about best practice. Commodore Sudi Haryono, director for technology and industry in the MoD's Directorate General of Defence Facilities, said: "With input and help from foreign countries, we will make regulations for defence offset for Indonesia's defence industry. We are now talking to other countries to get their input and to listen to their experience. I think it is important to make this [happen next year]. We want offset to build Indonesia's defence industry so we can improve."

The KKIP is headed by Defence Minister Purnomo Yusgiantoro and was created under a presidential decree earlier in 2010. Its policies are being shaped by the MoD but they are expected to form a central part of the government bid to improve defence industry capability. Officials have stated that the KKIP will focus on introducing the offset policy as well as guidelines related to promoting indigenous R&D activities, licensed production, technology acquisition and ensuring industry's access to loans from state banks.

As part of its policy-forming initiatives the MoD held a conference in Jakarta in late November, which was dedicated to raising awareness of offset and learning from the experiences of speakers from countries such as India (which is continuing to adapt its offset policy after its introduction in 2005) and Australia (which abandoned its offset policy in 2008 in favour of a participation programme that encourages growth through exports). In this conference, Yusgiantoro underlined Indonesia's need to develop its own such policies and vowed that the country's use of offset and related schemes will be expected to be utilised "in every purchase of defence equipment from abroad". He added: "The offset programme will build the capacity of [Indonesia's] domestic defence industry... The government is determined to revitalise the defence industry: it is one of the priorities of the cabinet."

Another of the speakers at the offset conference was Professor Ron Matthews, deputy director of the Institute of Defence and Strategic Studies at the S Rajaratnam School of International Studies in Singapore. Prof Matthews, a regular adviser to Southeast Asian governments on their defence industry policy initiatives, said that despite Indonesia being one of the first countries in Southeast Asia to introduce a counter-trade policy in the 1970s, the country has never documented a defence offset policy and defence production has never had any credit values associated with it.

Prof Matthews said, however, that Indonesia is now taking defence offset "very seriously" as it attempts to build the capabilities of state-owned defence companies, many of which continue to struggle financially: a result of years of under-funding, a dearth of contracts, and the lingering effects of the last economic crisis in Southeast Asia during the late 1990s. These entities are exemplified by naval shipbuilder PT Pal, which during the past year has undergone a restructuring process to turn around the company's ailing finances. This process will see more than half the company's 2,400 employees made redundant.

Prof Matthews said: "In my view, Indonesia does need a robust offset policy. At the moment, Indonesia's defence industry is withering on the vine almost. Indonesia is increasing its defence budget and procuring more equipment... [but] there is no work coming into the Indonesian defence factories. So I think that really needs to be addressed." He added that, in order to benefit from a defence offset policy, Indonesia needs to invest in modernising facilities to enable the absorption of foreign technologies. "It is not just putting an offset policy in place that is important," he said. "It is also about investing in the relevant associated infrastructure."

Indonesian defence officials, however, have indicated that they intend to do just that. Executives from PT Pal, for instance, have said that the modernisation of production facilities is regarded as a priority with funds expected to be sourced from state-owned banks. The House of Representatives' defence commission has provided firm political backing for such moves arguing that without such investment companies will struggle to not only win contracts but also support technology transfer through offset.

Securing such funds for investment has been problematic in the past decade or so while Indonesia's military modernisation ambitions have been limited by a lack of funds. But this time it's expected to be different. Indonesia remained relatively unscathed by the global financial crisis and the economy is now forecast to expand due to an increase in foreign investment, strong domestic demand and, in particular, the emergence of oil and gas deposits. Such factors prompted the International Monetary Fund to state recently that Indonesia is set to become one of the world's fastest-growing economies over the next five years. It has also prompted the Indonesian government to outline a number of ambitious procurement programmes – such as additional submarines and combat fighters – as well as a pledge to increase defence spending from 0.8 per cent of the GDP in 2009 to at least 1.5 per cent by 2014. Such spending plans could take the defence budget closer to the USD10 billion-mark that the government says it needs to effectively secure such a vast archipelago of more than 18,000 islands.