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## Settling outside the WTO: the case of the Indonesia-US *kretek* cigarette trade dispute, 2010–2014

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### ABSTRACT

In 2010, Indonesia officially filled a complaint to the World Trade Organization (WTO) over a dispute regarding the US import ban on clove cigarettes. Despite the fierce exchange of arguments in the WTO Dispute Settlement Body (DSB), in 2014, Indonesia and the US agreed to cease the formal pursuit and resolve trade disputes through signing of a Memorandum of Understanding (MoU) encompassing a more comprehensive trade partnership. This paper examines the reasons behind Indonesia's preference for settling the clove cigarette dispute by signing the MoU with the US, stemming from the Indonesian Government's perception of the shared benefits generated and WTO DSB's institutional weaknesses. The MoU also allows the Indonesian Government to advance its foreign policy agenda and its trade diplomacy objectives, offering broader sets of advantages.

### KEYWORDS

WTO; shared benefits; trade diplomacy; dispute settlement

## Introduction

In 2009, the US issued the Family Smoking Prevention Tobacco Control Act (FSPTCA), known as the 'Law on Prohibiting the Production and Sale of Flavoured Cigarettes'. This law prohibits the sale of flavoured cigarettes within the US. Exporting countries reacted against the law, Indonesia, as a supplier of clove-flavoured cigarettes (*kretek*), being one of many. In 2010, Indonesia's tobacco industry represented US\$433.845 million of exports (Ministry of Industry 2014), about US\$7.5 million of this contributed by cigarette exports to the US. The industry provided almost six million jobs and generated more than 95% of Indonesia's excise revenue (Ministry of Industry 2019). Indonesia protested against unfair treatment of Indonesian clove-flavoured cigarettes, given that the US still allowed menthol-flavoured cigarettes, which are domestically produced, to be distributed. Nevertheless, the US went ahead with the law, claiming that it aims to protect the public from the danger of smoking (WTO 2014).

On 7 April 2010, the Indonesian Government requested a consultation with the US Government through the Dispute Settlement Body (DSB) of the World Trade Organization (WTO). The DSB's role includes handling trade disputes between WTO members/government members and ensuring the enforcement of WTO's primary principles. Such a role is applied through three stages: (1) Consultation; (2) Adjudication by the Panel and

Appellate Body (if requested by the disputing party(ies)); and (3) Implementation of the Panel and/or Appellate Body's decisions. The dispute resolution process in WTO is member-driven, which means the DSB can only be formed, perform its duties and assure implementation of its decisions upon demand from members (WTO 2017).

At the consultation stage, Indonesia claimed that US law is inconsistent with WTO agreements, and argued that the US continues to allow menthol-flavoured domestic cigarettes to circulate while specifically and unfairly banning clove cigarettes (WTO 2014). The process continued at the Panel and Appellate Body. Both institutions reinstated Indonesia's claim that the law was inconsistent with the Technical Barriers to Trade (TBT) Agreement article 2.1; 2.9.2 (on obligation to notify WTO members on enforcement of technical regulations) and 2.12.

The Appellate Body recommended the US to immediately adjust the Act, and hence refrain from discriminating against imported products (clove cigarettes), by including menthol-flavoured cigarettes in the ban or revoking the Act. The US ignored the recommendation (Sibanda 2017). Consequently, Indonesia requested authorization of Article 22.2 of the Dispute Settlement Understanding (DSU) Agreement, requesting formulation of a mutually acceptable agreement, or imposition of retaliatory trade sanctions. The US in turn requested authorization of Article 22.6 of the DSU Agreement to form Arbitration, which awarded Indonesia the right to impose retaliatory measures of US\$55 million (WTO 2016).

However, Indonesia preferred to end the dispute through signing a MoU, considering that the US is the country's third largest trade partner. Both countries agreed: (1) a General System of Preferences (GSP) for Indonesian products will expand; (2) the US will not file a WTO claim against the Indonesian ban of raw mineral exports; (3) sale of cigars and cigarillos from Indonesia will not be restricted; and (4) the US will provide support to Indonesia's efforts in strengthening Intellectual Property Rights (IPR) protection. The dispute officially ended on 3 October 2014, after both countries notified the WTO.

This article demonstrates reasons behind the choice to take this route. Despite considerable pressure to protect the tobacco industry's workforce, which was directly threatened by the ban, settling the dispute outside the WTO provided Indonesia with broader sets of economic benefits. The MoU protected the mining industry, which represented more than 14% of Indonesia's export to the US in 2014, and incorporated textiles and seafood into the GSP, products and commodities that gradually became Indonesia's top exports to the US (Ministry of Industry 2016). Although tobacco products have domestic economic significance, contesting the US in the global arena may have been contentious: the MoU could generate greater good than persisting in fighting for *kretek* exports that represented a small fraction of total tobacco, let alone national, exports from Indonesia. The choice, therefore, resonated well with trade diplomacy objectives. Moreover, Indonesia's foreign policy agenda at the time emphasized 'a million friends and zero enemies', i.e. avoidance of adversarial conflict with major powers – particularly the US. This also supported President Yudhoyono's endeavour to sign a comprehensive partnership with the US.

This article utilizes a qualitative method, where secondary data such as official documents or press releases from the government websites are analysed inductively. We use the principal-agent theory as a lens to analyse the WTO dispute resolution system's perceived reliability; and negotiation theory to demonstrate expanded benefits.

This study provides several insights on debates in the field of International Relations. First, it provides understanding on how an emerging middle power perceives a global mechanism relative to their power. Second, it sheds light on the discussion regarding how trade policy is mobilized as a part of an emerging power's foreign policy agenda. The rest of the article is organized as follows: in the second section, we discuss limitations of the WTO DSB. The third section examines Indonesia's preference in settling the *kretek* trade dispute. The fourth and fifth sections illustrate how this choice enables Indonesia to pursue its foreign policy agenda and trade diplomacy objectives.

## DSB weaknesses and implications for the clove cigarette dispute

The Dispute Settlement Mechanism is one of the most significant developments in WTO's operations. It encompasses international level legal processes, ensuring compliance of member states' domestic regulations, both developed and developing countries, with WTO agreements (Picciotto 2005). Its legitimacy lies with its quasi-judicial proceedings (Keohane, Moravcsik, and Slaughter 2000). The regime provides security and predictability to the WTO rule-based multilateral system.

The WTO's dispute resolution is regulated by the Understanding on Rules and Procedures Governing the Settlement of Dispute, commonly referred to as Dispute Settlement Understanding (DSU). DSU governs interpretation and implementation of Article 1111 GATT 1947 and assigns a DSB as an implementing entity, which is a part of the WTO General Council. All member countries are bound to its rules and procedures, and enjoy equal rights to access its mechanisms.

Given its importance, the role of the dispute settlement mechanism has been widely studied by scholars, particularly with regards to its benefits for developing countries (Bown 2004; Davis and Bermeo 2009; Shaffer and Meléndez-Ortiz 2010). Some conclude that although the dispute settlement mechanism is expected to benefit all WTO member states, in practice, developing countries face greater challenges in applying cases and enforcing rulings (Davis and Bermeo 2009; Horlick and Fennell 2011). Others perceive that the system can potentially help developing countries overcome threats to their economies, given its impartiality (Lopes 2019).

DSB procedures facilitate broadening of third parties' access through appellate proceedings, participation and positive spillover from *amicus curiae* briefs, and endorsement of private counsel as representatives. These potentially benefit developing countries. The Appellate Body, however, is considered to exacerbate inequalities: intricate legalistic systems tend to side with countries with better access to legal resources. Some scholars even accuse international organizations, including the WTO, of being 'imperialist', putting developing countries consistently at a disadvantage (Hawkins et al. 2006).

As suggested by Smith (2004), several factors may explain the paradoxical gap in the perceived interests of developing countries in an adjudicatory dispute settlement system within the DSB. Firstly, the multilateral rules conceivably are biased in favour of advanced economies, hence offering lower value to developing countries. Secondly, international political economic imbalances may stand in the way: threats of aid withdrawal are real. Thirdly, exorbitantly high litigation costs may impede effective legal representation. Lastly, the system of remedies, relying on economic sanctions, may also aggravate developing countries' economic conditions.

In order to address issues of inequity, a number of reforms have been proposed. These include a green room procedure to reflect the diversity of interests; changes to the structure of negotiations; changes to collective retaliation and mandatory penalties; changes to remedies; and the assignment of expert prosecutors to address resource concerns. Thus, in response, the WTO Secretariat has undertaken incremental steps, including the provision of training and educational workshops for developing countries' representatives, and limited access to two part-time staff attorneys.

The presence of the Appellate Body, with its own rules of procedures, potentially enhances WTO's dispute resolution system. With mandates to resolve issues, its decision is considered final and binding. Its assumed authority, however, remains weak in many respects (Iida 2004). Firstly, the failure to comply with rulings is a constant danger. Secondly, complex 'new areas' of agreements require complex interpretations, which are challenging. Finally, there is an inherent constitutional disparity between the WTO's 'legislative' and 'judicial' roles, with the Appellate Body being invited to legislate from the bench. Such a dichotomy could erode trust.

After the WTO's processes, Indonesia saw that the WTO is inherently powerless against powerful member states. Member countries' rights include the ultimate right to accept or ignore resolutions. The relationship between the member states and international organization in this dispute, therefore, is best explained through the principal-agent theory.

Neoliberal institutionalism establishes that international organizations are conceived out of a shared desire to avoid potentially hostile interactions and to advance cooperation goals. Also, international organizations offer less uncertainty and smaller transaction costs, manage mutual expectations, and eliminate barriers to cooperation (Hellmann and Wolf 1993).

A variant of the neoliberal institutionalism, i.e. principal-agent theory, explains that states as principals delegate some tasks to international organizations as agents, while attempting to control performance through various mechanisms (Dür and Elsig 2011). Delegation on one hand operates as a form of international cooperation, where consensus is made and mutual adjustment ensues (Keohane 1984). It is intended that outcomes produced by agents follow the interests of the principals, and shirking behaviour (agents not fully mobilizing their ability to carry out tasks on behalf of the principal) or slippage (acting according to their preferences instead of the principal's) are prevented. Meanwhile, control mechanisms take the form of *ex-ante* (such as agent selection and precision of mandate), on the spot (by influencing decision-making) and *ex-post* (through reporting, re-contracting and sanctioning) (Elsig 2011) measures.

Thus, the relationship formed between principal and agent is one-way. The principal has the authority to regulate the working pattern of agents, making them instruments performing delegated tasks (Vaubel 2006). This relationship can turn complex when conflict arises between principals (or international organizations' member states) (Petersmann 2018). For example, a lack of consensus and an unclear mandate from the principals may occur. This creates an antinomic delegation, undermining an agent's performance.

The principal-agent theory arguably fits in explaining state interaction dynamics within the WTO. Members assert their common interest for international trade liberalization, and exert control over the DSB through agreed rules and procedures. Delegation

is given *ex-ante* through its mandate – selection of the Panel (of three) conducting hearing, investigations and decision-making; and selection of Appellate Body (of seven) conducting examination of findings and decisions of the Panel – and *ex-post* through sanctioning (Elsig 2011). Tasks are given through the WTO Secretariat and subject to members' approval (WTO 2017).

Based on the DSU Agreement, dispute resolution pertains: (1) consultation; (2) adjudication by the Panel and Appellate Body (when requested); and (3) implementation of decision. If a sentenced party (defending member country) fails to carry out rulings, resolution may take the form of compensation or retaliatory measures. The choice depends on member countries (McRae 2004), as domestic enforcement is members' prerogative. The DSB's effectiveness is thus contingent on members' concurrence. This is a form of sanctioning control mechanism, where the DSB's performance is controlled through implementation or non-implementation of decision (Brimeyer 2001).

However, there is danger of capture by powerful states. This is particularly evident in instances of power imbalances or when heterogeneous and divergent interests arise among parties in dispute (Hawkins et al. 2006). Mechanisms may become non-functioning when parties disagree on the outcomes. Member states, in fact, retain rights to deviate away from cooperation mechanisms offered by international organizations such as the WTO.

The above conditions unfold in the clove cigarette dispute. Initially, both parties requested the DSB to facilitate dispute resolution (WTO 2011). The Appellate Body recommended the US to be consistent with the TBT Agreement. After US rejection, Indonesia as the plaintiff (complainant) requested mutually acceptable compensation and this too was subsequently rejected. This drove the DSB to form Arbitration, which awarded retaliatory measures amounting to US\$55 million. Indonesia hence realized the DSB's weak position, evidenced by the blatant refusal of the US to comply with its decision.

### **Indonesia's preference for memorandum of understanding over WTO DSB**

Indonesia and the US were adversaries in the WTO dispute resolution process. Negotiation positions and settlement range were rigid, restricted to claims presented to the Panel. Such delegated dispute resolution or judicial processes in the WTO may pose a threat to international cooperation in the long run (Williamson 1985), as they often neglect future considerations, which otherwise would be communicated in bilateral discussions.

Negotiation theory explains that success is influenced by several factors, such as shared benefits of outcome from agreements produced (Daoudy 2009). Nevertheless, benefits received by each party are different, due to differences at the outset as well as the positions and influence of the parties involved (power asymmetries) (Craig and George 1995).

Countries in negotiations must go through a bargaining process embarking from different resistance points, until a settlement range is established (Hartzell 1999). This is when parties are not willing to give further concessions i.e. their interests are non-negotiable. In order to stay within their resistance limit, each will formulate a maximum demand (exceeding expected limits) and a minimum demand (actual interests expected to be achieved) (Korobkin 2014). A settlement range helps identify whether an

agreement accommodates interests at the outset or scope has expanded. When these two conditions arise, countries will realize that the agreement will still be beneficial for them, which may not be achieved otherwise.

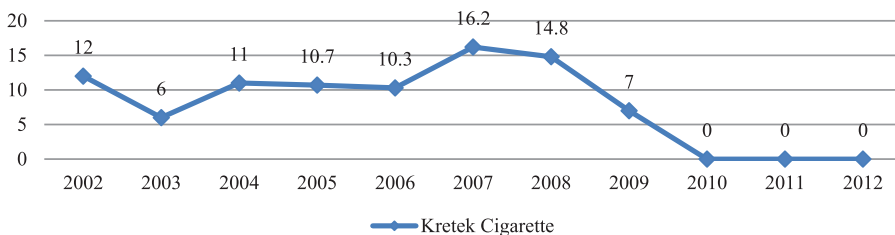
Indonesia's actual interest was to protect clove cigarettes producers, and this formed the resistance point. Thus, the agreement had to reach or relate to this. Clove cigarettes had significant market share in the US, but since 2010 this had dropped to zero (see [Figure 1](#)).

Subsequently, Indonesia was set to formulate the maximum demand and minimum demand. The maximum demand can be identified from the WTO claim, i.e. the US removing its discriminatory trade practice. Indonesia's minimum demand, on the other hand, was closer to the resistance point, which was to protect cigarette producers.

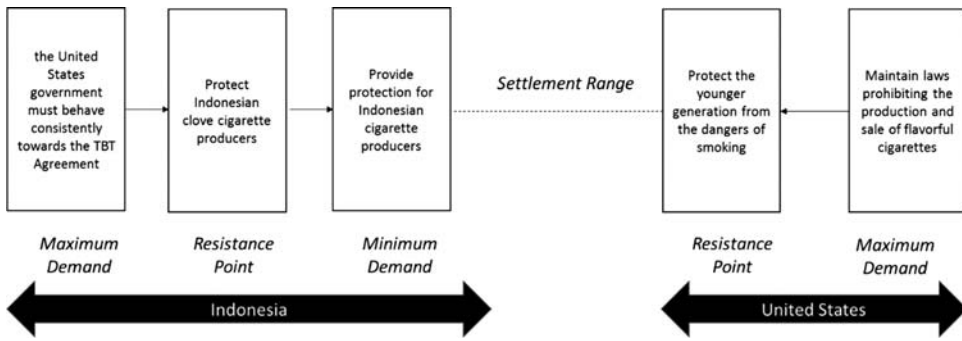
During DSB processes, Indonesia's resistance point, maximum demand and minimum demand remained consistent. However, after the US rejection, Indonesia's maximum demand and resistance point shifted. Indonesia asked for authorization of article 22.2 of DSU Agreement, demanding compensation from the US Government, which could take forms other than monetary payment, such as reducing tariff barriers equal to the benefits obtained by the discriminatory practice. If the US failed to do so, the Indonesian Government was entitled to pursue retaliatory measures. [Figures 2](#) and [3](#) illustrate the transgression. The US, on the other hand, was consistent in maintaining its resistance point (protecting youth from dangers of smoking), maximum demand and minimum demand (maintaining the law).

The Arbitration's ruling was in Indonesia's favour, but this route was also abandoned: publication of the decision was delayed from 23 June 2014 to 3 October 2014. Both parties agreed to dismiss the dispute resolution of the DSB through negotiating and signing an MoU, which contains several agreements: (1) Expansion of Generalized System of Preferences for Indonesian Products; (2) US non-filing of WTO claim against Indonesian policies limiting export of raw mining products; (3) Removal of Indonesian cigars and cigarillos restrictions; and (4) support to Indonesia's protection and enforcement of IPR. [Table 1](#) demonstrates the comparison between the settlement range offered by the WTO and settlement range offered by the bilateral negotiation path (MoU).

The settlement range therefore expanded. The MoU protects the economic interests of other sectors, not just cigarettes. Amicable negotiation of this MoU also provided immaterial benefits in maintaining good relations between the two countries. This is critical to US foreign policy strategy achievement in the Asia Pacific region ([Murphy 2010](#)).



**Figure 1.** Indonesian cigarette exports to the US 2002–2012 (million US\$). Source: United States Trade Representative (2013).



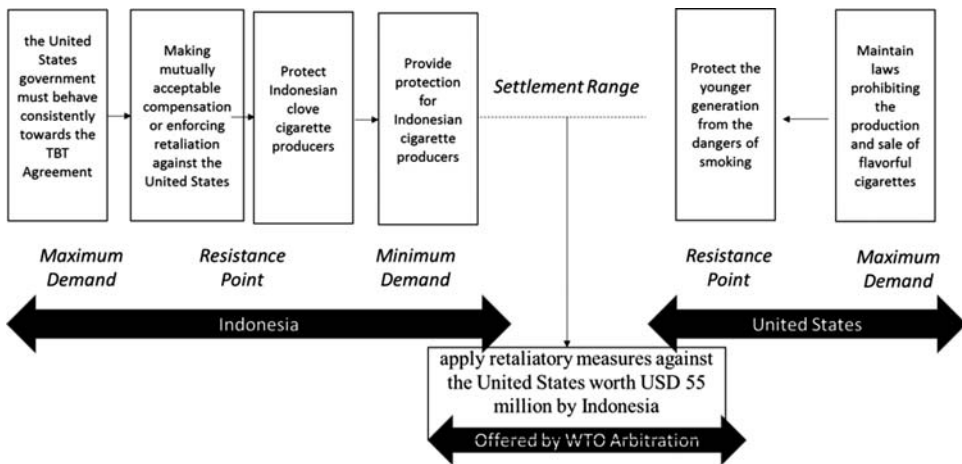
**Figure 2.** Indonesia’s resistance point, maximum and minimum demand: DSB Panel and Appellate Body. Source: Data processed from WTO (2012).

Indonesia is an important partner for the US, being the third largest democratic country in the world, the largest Muslim population, and having the tenth biggest purchasing power (Acharya 2014). These were US rationales to end this dispute through the MoU.

**The signing of the MoU and contributions to foreign policy**

Indonesia’s foreign policy in 2010–2014 was based on a doctrine of achieving ‘a million friends and zero enemies’ (Laksmana 2011). Under President Susilo Bambang Yudhoyono’s leadership in the period, it had two main foci: (1) Maintaining good relations with all countries (bilateral and multilateral) to create a million friends for its vision to be a just and prosperous nation; and (2) Avoiding conflicts (zero enemies).

A number of studies have shown that Yudhoyono’s doctrine has shaped Indonesia’s growing role in regional and global fora (Fitriani 2017; Roberts, Habir, and Sebastian 2015). In the context of geopolitics, this doctrine also reflects Indonesia’s aspiration to be a regional balance ‘manager’, maintaining equal distance from both the US and



**Figure 3.** Resistance point, maximum and minimum demand: after US rejection of Appellate Body’s recommendations. Source: Data processed from WTO (2012, 2014).

**Table 1.** Comparison of settlement range from WTO and MoU.

Settlement range by WTO	Settlement range by MoU
1. Indonesia can impose retaliatory measures of US\$55 million to the US	1. Dismiss the clove cigarette dispute in the WTO. 2. GSP for Indonesian imported products will expand. 3. US will not file WTO claim against Indonesian Government for its trade restriction policy. 4. No restriction for cigars and cigarillos products from Indonesia. 5. Support to Intellectual Property Rights (IPR) protection.

Source: United States Trade Representative (2014).

China as a rising power (Karim and Chairil 2016). In Yudhoyono's words, this was a paramount strategy for Indonesia to navigate a turbulent ocean (Tan 2007).

In the context of economy and trade, this doctrine translated into Yudhoyono's active pursuit of bilateral and regional trade agreements. Under his leadership, there were at least seventeen Preferential Trade Agreements (PTAs)/Free Trade Agreements (FTAs) initiated, both with developed and developing countries. Some of them were still at the negotiations stage during his presidency while others were signed and implemented (Table 2). Arguably, Indonesia's seeming hunger for FTAs can be seen as a strategy to fulfil its foreign policy agenda. In addition, as suggested by Syarip (2020), Yudhoyono's presidency used FTAs as instruments to maintain the geopolitical and geoeconomic relevance of ASEAN. Although the pursuit of such instruments has resulted in fragmented domestic interests producing incoherence (Indonesia seems to be initially strongly 'pro-ASEAN', but lacks rigour at implementation level), this has not deterred the country.

The quantity and coverage of trade agreements signify the prominence of economic-driven bilateral, regional and multilateral alliances in Indonesia's foreign policy. Trade and economic objectives are also the most important drivers of Indonesia-US relations. The path taken by Indonesia in its dispute with the US was in alignment with such objectives. It contributed in (1) avoiding an adversarial resolution produced by WTO mechanisms (through retaliatory measures); and (2) ensuring that good relations with US remain strong and beneficial. These will be explained further.

First is the avoidance of conflicts: the prolonged dispute at the WTO had strained bilateral relations. It had been four years of claims and counter claims, at the behest of

**Table 2.** FTA/PTAs initiated by Yudhoyono's presidency.

Negotiated	Signed
<ul style="list-style-type: none"> <li>• ASEAN-Hong Kong FTA</li> <li>• India-Indonesia Comprehensive Economic Cooperation Arrangement</li> <li>• Indonesia-Australia Comprehensive Economic Partnership Agreement*</li> <li>• Republic of Korea-Indonesia Free Trade Agreement*</li> <li>• Indonesia-Chile Free Trade Agreement</li> <li>• Indonesia European Free Trade Association Free Trade Agreement</li> <li>• Regional Comprehensive Economic Partnership</li> </ul>	<ul style="list-style-type: none"> <li>• ASEAN Free Trade Area</li> <li>• ASEAN-Australia and New Zealand Free Trade Agreement</li> <li>• ASEAN-India Comprehensive Economic Cooperation Agreement</li> <li>• ASEAN-Japan Comprehensive Economic Partnership, ASEAN-People's Republic of China Comprehensive Economic Cooperation Agreement</li> <li>• ASEAN-Korea Comprehensive Economic Cooperation Agreement</li> <li>• Japan-Indonesia Economic Partnership Agreement</li> <li>• Pakistan-Indonesia Free Trade Agreement, and Preferential Tariff Arrangement-Group of Eight Developing Countries</li> <li>• Trade Preferential System of the Organization of the Islamic Conference</li> </ul>

Note: \*concluded during Joko Widodo's presidency

Source: Ministry of Trade (2019).

the two countries. The situation was hostile. The MoU therefore was expected to ease or even reverse tension.

President Yudhoyono's foreign policy championed cooperative pursuits with major powers, as evidenced by public diplomacy strategies at the time and Indonesia's approach towards global affairs. Improving and strengthening US relations was an important pillar. Therefore, conflicts with the US as a superpower and the most influential country in the world were kept to a minimum to realize this impetus (Murphy 2010).

The MoU in fact helped to strengthen relations with the US. During this period, both countries entered into a new era of bilateral comprehensive partnership. Both committed to enhance bilateral cooperation levels – previously focused on traditional issues, such as politics and economics – now expanding to education, health, energy, environment and socio-culture. In 2010, this comprehensive partnership was formed. Until 2014, concrete steps were taken through Joint Commission meetings run by six working groups. Four meetings were conducted at Minister of Foreign Affairs level and produced several Plans of Action: (1) a Higher Education Partnership aiming to increase the number of Indonesian students studying in the US and vice versa, in the next five years; (2) to conduct intensive consultations and share best practices on climate change and the environment and (3) to strengthen trade and investment sector cooperation through TIFA (Trade and Investment Framework Agreement) and TIC (Trade Investment Council). Thus, this partnership would bring about mutual long-term positive impact, with good relations serving as crucial foundation.

The Indonesian Government's decision to sign the MoU constituted an effort to avoid disruption to its bilateral relations with the US. The comprehensive partnership discussion was at an advanced stage. Clove cigarette disputes had been protracted, and the clash of national interests prolonged. This was contrary to its foreign policy objectives of avoiding confrontation in international relations. The MoU was expected to restore relations back to friendly terms.

The choice also underlines Indonesia's inclination to resolve conflicts based on mutual benefits rather than relying on international institutions when dealing with major power. It further illustrates how Indonesia's trade diplomacy is not only aimed at strengthening economic interests but also its foreign policy agenda. As suggested by Karim (2020), Indonesia's engagement in the WTO is characterized by placing its foreign policy agenda over domestic economic interest, as evidenced by Yudhoyono's administration selective use of multilateral trade governance as a platform to enhance its global role than to fight for its domestic economic interest. In the dispute, foreign policy considerations were significantly influential.

### **The signing of the MoU and contributions to trade diplomacy**

Indonesia's trade diplomacy is implemented through multitrack strategy in international and bilateral forums. In 2010–2014 there were two main objectives: (1) to increase Indonesia's participation in international forums, and (2) to strengthen quality of negotiations to advance national interests. Success is measured from number of international negotiations pursued by Indonesia and extent of benefits generated from such.

The tobacco industry, particularly *kretek*, is recognized as one of Indonesia's domestic strategic sectors. It has a strong competitive advantage and continues to make a

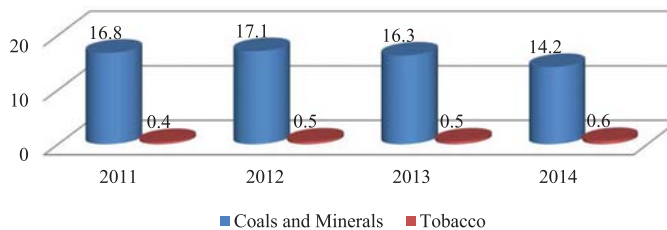
significant economic contribution. This includes employment and state revenue generation. Tobacco and cloves have been popular produce for smallholder and large-scale plantations, making them important commodities. Cigarette tax receipts contributed approximately 95.8% of the total national excise tax revenue. Even after the dispute ended, the sector remained a major contributor to the economy. The Ministry of Industry (2016) noted that the contribution of the tobacco product industry in 2016 provided excise tax payments of IDR138.69 trillion or 96.65% of the total national excise tax. The industry is also labour intensive. Approximately 4.28 million people were employed in manufacturing and distribution, and 1.7 million people worked in plantations. *Kretek* cigarettes are also perceived as intrinsic to Indonesian culture: inherited from ancestral innovations and passed down for generations (Ministry of Industry 2019).

On the other hand, tobacco products, accounting for under 1% of Indonesia's exports, may be less important than other export commodities (Workman 2020). In 2010, the value of Indonesia's cigarette exports was US\$433.845 million (Ministry of Industry 2014) as compared to a total export of US\$157.73 billion, and *kretek* constituted a small fraction of this. This has remained consistent even after the end of the dispute. In 2017, the export value of rolled tobacco was only US\$827.98 million or around 0.54% of Indonesia's total exports. It is minuscule compared with export products such as palm oil, which accounts for almost 10% of Indonesia's exports.

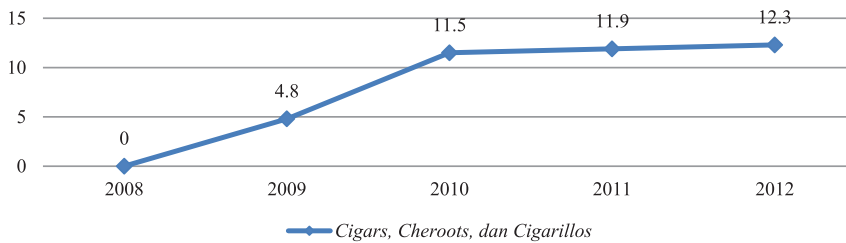
Thus, arguably, ending the dispute by signing the MoU contributed to the achievement of trade diplomacy objectives. A broader trade agreement was secured, covering IPR, cigars and cigarillos, minerals and coal, and other goods enjoying expansion of GSP. The MoU, most importantly, secured an agreement covering the mining sector, a significant contributor to national revenue. Figure 4 compares the contribution of tobacco (such as clove cigarettes) and mining products (such as minerals and coal) to Indonesia's total exports.

The US agreed to refrain from filing a claim to the WTO against trade and energy ministerial regulations, pursuant to Article XXIII or XXIII of the 1994 GATT Agreement. The regulations prohibit the export of raw materials, and require mining companies to build smelters, expected to add values to exports and generate downstream employment.

The US also promised to leave market access of cigars and cigarillos products undisturbed. This is expected to have a positive impact on the industry, as the value of exports of Indonesian cigars and cigarillos to the US has begun to increase annually, as indicated in Figure 5.



**Figure 4.** Contributions of coals and minerals and tobacco sectors to Indonesia's total exports (%). Source: Data processed from the Indonesian Ministry of Trade, 2016.



**Figure 5.** Exports of Indonesian cigars, cheroots and cigarillos to the US 2008–2012 (in million US\$). Source: United States Trade Representative (2013).

In addition, the US agreed to add to the list of imported products eligible for GSP facilities, and to continue providing a Competitive Need Limitation (CNL) waiver to Indonesia for the subsequent five years. GSP is a trade preference programme providing opportunities for developing or undeveloped countries to use trade as a tool to boost economic growth and poverty alleviation. The CNL waiver is a facility in the GSP programme that allows certain imported products to enter the US market without tax (duty-free), therefore boosting competitiveness. The programme was initiated in 1974 and was renewed by President Barack Obama (Blanchard and Hakobyan 2015), where Indonesia is a beneficiary. In 2011, Indonesia was declared the fourth largest GSP user in the world, with total exports worth US\$19 billion.

In 2013, at the time of the dispute, the US decided to stop providing the GSP facility to Indonesia, after a review by the US Senate. This decision was reversed through the MoU and in 2015 the US renewed the GSP facility to Indonesia. In 2016, Indonesia benefitted from a US\$1.9 billion tariff reduction from a total of US\$20 billion tariff imposed (Ismail 2019). In 2017, although from the 3500 products with GSP granted to Indonesia, only 519 took advantage, and few of them were the country's strongest exports, they accounted for more than 50% of Indonesia's exports (Dewo 2018). Commodities such as textiles and footwear, palm oil (for food and cosmetics) and seafood (including tuna and shrimp), have benefitted immensely from the extended GSP. Ostensibly, GSP enhances the competitiveness of Indonesian products and eventually provided a boost to the country's exports. Table 3 illustrates the trend for selected commodities.

The MoU also governs cooperation with regards to IPR. The US support pledged to Indonesia aims to promote its growing creative and innovation sector. By strengthening IPR awareness and law enforcement cooperation, Indonesia might be delisted from the US priority watch list of countries with serious IPR deficiencies, which potentially hinders investments (Ismail 2019). In 2018, Indonesia managed to improve its ranking on the US Chamber of Commerce's 2018 International Intellectual Property Index, an evident impact of the MoU (Yuniarti 2018).

The Indonesian Ministry of Trade reported in 2015 that at the end of President Susilo Bambang Yudhoyono's term, the value of trade between the two countries had reached US\$27.7 billion, making the US the third largest trade partner to Indonesia, after China and Japan. Indonesia had a net trade surplus of US\$5.14 billion with the US. In comparison, the US\$55 million compensation offered by the WTO process represents approximately 0.01% of the total trade covered by the MoU.

**Table 3.** Value of Indonesian exports benefitting from GSP (in thousands of US\$).

Product	2015	2016	2017
Textile product	3,942,214	3,827,815	4,317,405
Rubber	1,653,589	1,637,358	1,836,842
Shrimp	768,605	919,530	1,145,030
Footwear	1,267,279	1,296,987	1,333,662
Palm oil	332,747	458,316	584,971

Source: trademap.org

Based on the four pillars of agreement of the MoU, their contribution and value offered, it can be concluded that the signing of the MoU contributed to trade diplomacy targets for 2010–2014, as evidenced by an increase in increasing export, trade value and potential investments generated.

## Conclusion

The article demonstrates the reasons behind the Indonesian Government's decision to settle the clove cigarette dispute outside of the WTO, from the lens of principal–agent theory and negotiation theory. First, the Indonesian Government viewed the DSB of the WTO as an agent that had a weaker position *vis a vis* powerful member states such as the US. This risk of capture and ineffectiveness materialized in the *kretek* ban dispute. Second, the adversarial position created by WTO mechanisms potentially eroded foreign policy and trade policy objectives. By shifting and expanding its negotiation position, Indonesia believed that the MoU could bring significant shared benefits, aligning perfectly with Indonesia's foreign policy and trade diplomacy objectives for 2010–2014. The article successfully illustrates how the application of the principal–agent theory and negotiation theory can be useful in analysing the underlying rationale for countries in deciding to take their trade disputes settlement away from a multilateral DSB and instead opt for establishment of bilateral agreements (Memorandum of Understanding being an example).

This article contributes to our understanding of how trade policy is mobilized as a part of emerging powers' foreign policy agenda. As argued by scholars of Indonesian foreign policy (Karim 2018; Laksmana 2011; Rosyidin 2017; Santikajaya 2016), Indonesia's foreign policy leaders gained importance, allowing Indonesia to play a greater role in the global order. This was achieved through exercising a position supporting US-led global order instead of being in opposition. The article shows how Indonesia is willing to cooperate with the status quo great power to enhance its global presence, and demonstrates that Indonesia's economy is the core of its foreign policy. The main assumption for supporters of economic diplomacy promotion within the Ministry of Foreign Affairs is that emerging countries like Indonesia should prioritize economic interests over political interests. This stems from the belief that a strong economy would increase Indonesia's bargaining and relative power.

The case of Indonesia's preference provides several main lessons for Indonesia's trade policy going forward. First, settling disputes through WTO's dispute settlement procedures may not offer the best outcome for Indonesia. The Indonesian Government must consider broader and longer-term trade-offs. There is a rising trend in Indonesia to file claims at the WTO, which depicts Indonesia's trade diplomacy preference.

However, this should be considered as a last resort given the time, energy and exorbitant cost (including opportunity cost) required in preparation and in its proceedings. The second lesson is that cost effectiveness can be better achieved when Indonesia takes matters bilaterally with the counter party(ies). Indonesia should also consider broader trade-offs, which include bilateral and long-term trade relationships.

Although the article touches upon Indonesia's trade diplomacy, there is a need for in-depth study related to its implementation in other trade-related issues. The article only illustrates what type of dispute resolution or negotiation model can provide greater benefits for the Indonesian Government, whether through multilateral forums (such as the WTO) or bilateral measures (such as the MoU). The authors suggest that an in-depth analysis of the contribution of economic diplomacy towards Indonesia's engagement in the international arena is necessary to understand the nexus between the economic statecraft and foreign policy of Indonesia.

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