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IMPLICATIONS AND RESPONSE TO EU DEFORESTATION-FREE SUPPLY CHAIN REGULATION

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EXECUTIVE SUMMARY

The latest EU export restrictions include a wide range of commodities. The due diligence regulation, which prohibits items that promote deforestation, has evoked a range of views. Palm oil products and derivatives are one of the restricted commodities.

Several aspects of the deforestation-free supply chain regulations are of concern to Indonesia. The first is about the breadth of commodities, with palm oil being one of the commodities seen to have the potential to contribute to deforestation. There is also a broader definition, which includes not just deforestation but also forest degradation, even those employed for sustainable harvesting. Each Stakeholder has a unique entrance force.

Some demand 12 months following the implementation of the rule, while others require 18 months, with a 24-month exemption for SMEs. The regulation's expiration date is likewise questionable. The first plan requires palm oil established after December 31, 2020 to adhere to the most recent requirements. The deadline for the Council is December 31, 2021, and the deadline for Parliament is December 31, 2019.

The Indonesian government has various options here. Among them are joint letters signed by 14 nations, letters to 17 EU member states, and so on. If this phase cannot be completed, Indonesia can concentrate on increasing exports to other nations.

BACKGROUND

Regulations from the EU about a deforestation-free supply chain, in which many standards must be followed for commodities imported from other nations, have elicited a variety of views. Some believe it is necessary for environmental sustainability, yet many are opposed to the new regulations. Many objections came from commodity exporting countries because the requirements were deemed cumbersome and overly abrupt.

The regulation emphasizes commodities that are free of illicit logging and do not harm biodiversity. The location of these commodities must also be approved by indigenous peoples. Administration

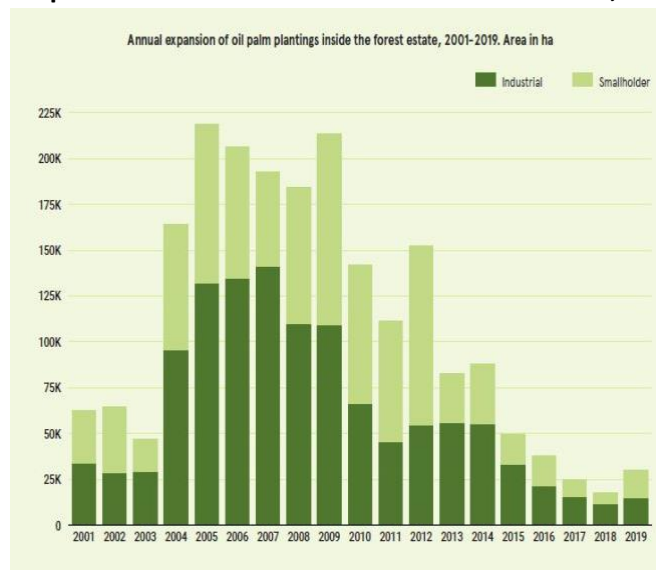
requirements, such as ISO infringement and due diligence, must also be completed. Companies must also disclose geolocation for the purpose of tracking the region.

The palm oil commodity is one of the most affected by this legislation. Companies must accept the constraints imposed in order to export their products to the EU. The most onerous requirement is the issue of deforestation, which forces certain corporations to terminate ties with smallholder farmers who do not comply. Small farmers will feel the brunt of this influence as well. Instead of sacrificing time and money to oversee and accompany small farmers, the corporation will opt to end its collaboration with some of them and keep others who can already qualify.

If the EU just concentrates on one of the SDGs, namely the environment, while ignoring other targets, such as poverty reduction, the EU's consistency with the SDGs must be questioned once more. Palm oil is one of the commodities that consumes a lot of labor in Indonesia. Palm oil is also the most valuable product in terms of foreign exchange, hence protecting it is one of the state's attempts to protect its people.

Each year, the spread of oil palm plantations in forests has also begun to slow. This demonstrates that Indonesia is already concentrating on increasing palm oil output rather than acquiring more land.

Annual Expansion of Palm Oil in the Forest Environment, 2001-2019



Source: Greenpeace (2021)

A large portion of oil palm land was converted from agricultural land (23 percent) between 1990 and 2018. Ex-logging sites that have been converted from shrubs to oil palm land are commonly employed by the New Order administration to establish oil palm plantations and cedar cells with transmigration programs, particularly on the Indonesian islands of Sumatra, Kalimantan, and Sulawesi. As can be seen, the palm oil commodity does not match the current storyline

DEFORESTATION-FREE SUPPLY CHAIN REGULATION

The regulation raises various concerns. The first is the scope. There are various commodities in dispute, including beef, timber, palm oil, soya, coffee, cocoa, and byproducts. It also deals with the environment. The definition of deforestation is addressed here. Does it simply refer to deforestation, or does it also encompass land damage and diminished diversity?

Geo-location is also an issue, as correct location based on internet (maps) is essential. A variable cut-off date is also an issue. Furthermore, benchmarking is used to determine if a country is classified as high, standard, or low risk. This rule also requires that compliance be checked on a regular basis (including assessment). There are other criteria for financial institutions that must comply with EU green economy objectives.

IMPLEMENTATION OF DEFORESTATION FREE SUPPLY CHAIN REGULATION

Several aspects of this deforestation-free supply chain idea are of concern to Indonesia. The first is about the scope of commodities, and palm oil is one of the commodities that is thought to be a factor in creating deforestation. There is also a broader definition, which includes not just deforestation but also forest degradation, even those employed for sustainable harvesting.

Some propose 12 months following the implementation of the rule, while others require 18 months, with a 24-month exemption for SMEs. The regulation's expiration date is likewise questionable. The first plan requires palm oil established after December 31, 2020 to adhere to the most recent requirements. The deadline for the Council is December 31, 2021, and the deadline for Parliament is December 31, 2019.

Another point to mention is the requirement for due diligence. One of them is about benchmarking in commodities management. Furthermore, because palm oil is a high-risk commodity, it risks being unable to export to the European Union. These are undoubtedly an issue for palm oil commodities since they can become trade barriers and have the ability to harm the well-being of oil palm growers.

One of the parameters that must be satisfied is geolocation. Exporters must constantly update their company locations from upstream to downstream so that they can be tracked. Of course, this will be tough for smallholders because not everyone is capable of dealing with this problem if there is no companion. Financial institutions are also drawn in, as it is unlawful for them to fund the activities of enterprises accused of deforestation. It also compels financial firms to follow due diligence guidelines.

IMPLICATIONS FOR THE PALM OIL INDUSTRY

Because there is a negative view of palm oil, particularly palm oil from Indonesia, this legislation has the potential to be discriminatory. The livelihood system, particularly smallholders, would be impacted. The DFSC legislation is also seen to make it difficult for independent smallholders to satisfy

the standards, necessitating additional support. Furthermore, various issues will occur as a result of this. There is a risk that other goods (particularly non-energy items) would face issues similar to those faced by palm oil commodity stakeholders. Economic disruption may potentially occur in Indonesia as a result of the regulation.

They risk losing money if this regulation is not followed with changes for Indonesia. The EU's consistency with the SDGs is called into question once further if it just concentrates on one of the issues, notably the environment, and ignores other areas such as poverty reduction (BPDP, 2019). The DFSC regulation has actually a positive impact on Indonesia. Such policies can strengthen governance and boost transparency in the palm oil chain, resulting in increased palm oil production. Furthermore, with the DFSC, smallholders will be given greater attention so that they can fulfill the legality requirements. However, it should be underlined that the traceability legislation must stay consistent with Indonesian regulations, and the EU must also give support.

GOVERNMENT REACTION

The Indonesian government has taken several initiatives. Creating an ISPO, publishing a Letter from the Minister of Trade, 27 letters and 1 letter to the EU trade commissioner, in which the Minister of Trade expresses the economic impact that will occur if the proposal becomes a rule are among them. One of them is economic and supply chain disruption in Indonesia. The Indonesian Embassy in Brussels approached in the form of joint letters from 14 nations with comparable objectives. Through international forums such as the World Trade Organization

POLICY RECOMMENDATIONS

- 1. Indonesia needs to organize smart diplomacy.** Despite Indonesia's ongoing adherence to international sustainable growth requirements, controversy over palm oil will endure. As a result, Indonesia must engage in bilateral and international negotiations, with a focus on positive palm oil agricultural campaigns and technical issues related to deforestation-free supply chain requirements. To ensure that the technical rules of deforestation-free supply chain legislation do not make Indonesia a high-risk country that destroys forests and the environment, intelligent diplomacy is necessary.
- 2. Indonesian producers must prepare for improved traceability.** The traceability feature is critical and significant in the concept for a deforestation-free supply chain arrangement. As a result, every palm oil producer and exporter must be prepared to provide precise and transparent traceability.
- 3. Indonesia may retaliate if the European Union continues to make difficulty for palm oil products to reach the European market.** Retaliation should have been avoided since it would have resulted in a zero-sum game for both countries. However, if constant diplomacy fails, retaliation is the last option.

4. **Exports to the European Union should be halted.** The actions are the ultimate options, but keep in mind that palm oil exports must first enter new markets in Africa, the Middle East, and other Pacific areas.

5. **Indonesia has the potential to open up new markets for palm oil to nations such as China, India, the United States, and Africa.** Despite continued geopolitical tensions between Ukraine and Russia, market conditions in China, India, the United States, and Africa are expected to stay favorable. Indonesia should use this to increase the diversity of palm oil derivatives as well as the quantity of palm oil exports.

6. **Improving the domestic markets.** Indonesia must strengthen its domestic market arrangements. As the global palm oil market is disturbed by extensive geopolitical crises, a strong domestic market will act as a buffer for palm oil price stability.