CHAPTER I:

INTRODUCTION

1.1. Background

In an increasingly interconnected and interdependent world, the role of the state in shaping and navigating the complex dynamics of international affairs has attained significant relevance. Participation in the global affairs is no longer a choice, but a necessity for any country seeking to advance its interests. Over the past few years, Indonesia has been able to showcase leadership qualities beyond its conventional role as mere participant in the international affairs – it housed the annual meeting of Group Twenty (G20) for the first time ever in 2022 and assumed the ASEAN leadership in 2023[1]. These remarkable accomplishments are significant milestones for Indonesia's foreign policy, particularly given that both were achieved in the aftermath of COVID-19 pandemic and the ongoing Russian-Ukrainian conflict which profoundly affect the international order.

This significant engagement within the global community have definitively granted an increase in political standing and strengthen Indonesia's overall diplomatic posture in the region as well as international stage. Thus, it goes without saying that Indonesia as a nation-state is keen on expanding its influence on the world stage, leveraging its strengths to achieve outcomes that align with its national

[1]Having effectively led the G20 presidency, Indonesia has once more been given the responsibility of chairing ASEAN in 2023. Under the theme "ASEAN Matters: Epicentrum of Growth," the country aims to enhance ASEAN's standing as a stable, peaceful, and inclusive region with sustainable economic growth. The event is still on-going the moment this thesis was written.

interests. Furthermore, active participation in world affairs is a manifestation of Indonesia's multilateral diplomacy as well as the implementation of free and active foreign policy, as mandated by Law Number 37/1999 concerning Foreign Relations (Republic of Indonesia, 1999). Such vision also came in parallel with the country's very own preamble to its constitution, that aims to establish:

> "…a **world order based on freedom, perpetual peace and social justice**, therefore the independence of Indonesia shall be formulated into a constitution of the Republic of Indonesia…"

The successes of Indonesia in improving its leadership capabilities as suggested earlier was not an overnight work, or as the English playwright John Heywood aptly noted, "Rome was not built in a day." This adage captures the painstaking journey of Indonesia as it aspired to establish itself as a more prominent international participant, particularly in adjusting to the demands of global neoliberal economy post-Asian Financial Crisis, which served as a crucible change for Indonesia. Originating in Thailand, the Asian Financial Crisis of 1997-1998 had its inception with the financial collapse of the Thai baht, triggered by the Thai government's compelled decision to allow the baht to float due to an insufficient reserve of foreign currency to maintain its fixed exchange rate with the US Dollar (Zhuang & Dowling, 2002). As the crisis rippled through the region, neighboring Southeast Asian nations, and subsequently Japan and South Korea, witnessed the depreciation of their currencies, a devaluation of stock markets, as well as a notable rise in private debt (Yamazawa, 1998). Foreign debt-to-GDP ratios escalated from 100% to 167% during the period of 1993 to 1996 across the four major ASEAN entities, not devoid of Indonesia, surging beyond 180% during the most severe phase of the crisis. When the Indonesian rupiah faced mounting pressures, it transitioned to a free-floating exchange rate system in August 1997. Consequently, it experienced a sharp depreciation, with its nominal worth plummeting to just 30% of its June 1997 value by January 1, 1998. Leading up to 1997, numerous private Indonesian enterprises had taken unsecured, short-term offshore loans denominated in US dollars, which ultimately turned into a ticking time bomb (Soedrajad, 2001). The ongoing depreciation of the rupiah exacerbated the situation considerably. Indonesian companies rushed to acquire US dollars, intensifying the downward pressure on the rupiah and worsening their debt predicaments. It became inevitable that Indonesian firms, including banks, some of which were already fragile, would incur substantial losses (Soedrajad, 2001). With a shortage of new foreign exchange resources and foreign creditors withholding loans for Indonesian companies, Indonesia eventually reached out to the International Monetary Fund (IMF), a decision laden with neoliberal implications.

Guided by the IMF's $43 billion bailout package, the government implemented thorough structural reforms, including the removal of subsidies, privatization of state-owned enterprises, and the establishment of a social safety net. These reforms aimed to stabilize the economy, restoring confidence in the weakening rupiah and enhance Indonesia’s overall competitiveness in the global market. However, the initial set of financial reforms imposed by the IMF backfired and it failed to address the deeply rooted system of patronage led by President

Soeharto[2], contributing to ongoing economic turmoil (Djiwandono, 2007). Concurrently, environmental factors, such as the El-Nino drought, and political uncertainties surrounding Soeharto's health added to the country's woes during that period.

Amid Indonesia's ongoing economic decline, notably marked by the significant devaluation of the rupiah in January 1998, the imperative need for a second IMF agreement became evident. This agreement encompassed a comprehensive reform agenda, incorporating measures such as the establishment of a social safety net, gradual reduction of public subsidies, and the ambitious goal of dismantling the entrenched regime of Soeharto. However, the implementation of these reforms was hindered by Soeharto's reluctance, leading to criticism that the IMF's demanding requirements exacerbated the situation. Ultimately, it became apparent that dismantling the patronage system was a pivotal step in surmounting the crisis. Concurrently, amid this economic tumult, social and political tensions surged, with widespread protests and censure of Soeharto's leadership culminating in violent riots after the 'Trisakti Shootings,' where four Indonesian students were shot during a massive protest (Landler, 1998). As chaos prevailed, President Soeharto resigned on May 14th, 1998, as politicians declined participation in a new cabinet, signifying the transition from a financial crisis to a full-fledged social and political upheaval.

[2] Widely perceived as military dictator by international observers, President Soeharto reigned an authoritarian regime for 31 years after the fall of his predecessor Soekarno in 1967.

With Soeharto's departure, Indonesia witnessed a transformation in leadership with Bacharuddin Jusuf Habibie becoming President. Under his presidency, Indonesia entered into a fourth agreement with the IMF in June 1998 (Suryadinata, 1999). This agreement allowed for a wider budget deficit and increased funding for the economy. A slow and discernible recovery unfolded with the strengthening of the rupiah, a decrease in inflation, and an upward trend in the Jakarta stock exchange. By the end of the year, non-oil exports displayed improvement, and in the fourth quarter of 1999, the GDP exhibited a noteworthy growth rate of 5.8%, compared to the same period the previous year. This contributed to a modest overall growth for the calendar year 1999. This revival is primarily driven by increased consumption and the gradual reduction of excess inventory, mirroring the recovery patterns witnessed in other Asian countries (International Monetary Fund, 2000). Inflation has remained relatively stable since June 1999, and interest rates have been restored to the pre-crisis levels.

	1996	1997	1998	1999	2000**
			(Percent change)		
Real GDP Growth	8.2	1.9	-14.2	1.5 to 2.5	3 to 4
Consumer prices (period average)	5.7	12.9	64.7	-0.6	5.4
			(Percent of GDP [minus sign signifies a deficit])		
Central government balance	1.2	-1.1	-2.2	-3.3	-4.8
Current account balance	-3.4	-0.9	4.4	3.1	1.9
			(In billions of US dollars)		
External debt	127.4	135.0	149.9	147.6	149.1
			(Percent of GDP)		
External debt	54.5	163.1	129.0	91.0	86.9

Table 1.1: Indonesia's Gradual Economic Recovery Post-Asian Financial Crisis. Source: IMF

It can be concluded that IMF’s conditionality, which included fiscal austerity measures, deregulation, and trade liberalization, set the stage for Indonesia’s gradual adjustment to the neoliberal international financial structure. In the aftermath of the crisis, Indonesia began its integration with the G20 during its initial establishment at Ministerial level (Hermawan et al., 2011). Since then, the country's active involvement in the G20 is evident in its substantial contributions and influential roles within the organization. This is exemplified by its co-chair positions in various working groups and the G20 task force. Indonesia has strengthened its involvement in the G20 arena, showcasing its commitment through actions like suggesting a security strategy for the financial sector as well as banking and real sector defense at the Washington G20 Summit in 2008. The country also proposed the creation of a Global Expenditure Support Fund and advocated for global financial system reforms to tackle the crisis at the G20 London Summit in 2009. In the context of development, Indonesia eagerly emphasized the agenda during the Seoul Summit in 2010 (Salim, 2010). Concurrently, in August 1999, Indonesia joined the Asia Pacific Group (On Money Laundering)/APG and assumed the rotating role of the organization’s co-chair from 2006 to 2008. And finally, as of 2021, Indonesia is registered as a member of 200 intergovernmental international organizations (IO), which are supported by 49 ministries or institutions across the government as leading agencies (Yazid, 2021).

Indonesia's path from the late 1990s financial crises to emerging as an active participant, even assuming a leadership role, in the global neoliberal economy, demonstrates its remarkable resilience and adaptability. The nation's proactive engagement with international financial institutions, coupled with its diligent implementation of reforms and adherence to international standards, has catapulted it into a prominent position within the realm of international financial regulations. While challenges persist, Indonesia's unwavering commitment to the tenets of the global neoliberal economy has paved the way for sustained economic growth and seamless integration into the broader international economic landscape.

This is reflected on Indonesia's strategic decision to ultimately apply as a member of the **Financial Action Task Force** or commonly abbreviated as FATF. It is an intergovernmental organization established in July 1989 by the G7 Summit in Paris, France. The FATF operates from the OECD headquarters in Paris, but it is an entirely distinct organization from the OECD. The task force is not a formal global organization, but rather, as it name suggests, a regulatory watchdog funded by its member-states to undertake specific projects and fulfill its mandate as global community's joint dedication to upholding the stability and integrity of the international financial system by implementing comprehensive global policy standards to combat money laundering. Following the events on 9/11, the FATF's responsibilities were expanded to include combatting the funding of terrorism. Since then, the task force has centered its key policies on the 40 Recommendations concerning Money Laundering and the 9 Special Recommendations regarding Terrorism Financing (Vermaark, 2023). Although these recommendations lack legal enforceability, nations are anticipated to align with FATF's official position and integrate the most recent recommendations to the greatest extent possible. Failure to do so may result in being included in the "Non-Cooperative Countries or

Territories" (NCCTs), also known as the **FATF Blacklist**, which can lead to being shunned from global commerce in a prompt manner. Presently, the FATF boasts a membership of 36 nations and 2 regional jurisdictions, encompassing the largest economies across the globe. These nations are also affiliated with nine regional bodies that emulate the FATF, thereby enabling the FATF to expand its influence across more than 200 nations worldwide (Financial Action Task Force, 2023a).

FATF Member-States		FATF Member-Regional Organization	Associate Members
Argentina Australia Austria Belgium Brazil Canada China Denmark Finland France Germany Greece Hong Kong Iceland India Indonesia Ireland Israel Italy	Japan South Korea Luxembourg Malaysia Mexico Netherlands New Zealand Norway Russian Federation Saudi Arabia Singapore South Africa Spain Sweden Switzerland Türkiye United Kingdom United States	European Commission Gulf Co-Operation Council	Asia/Pacific Group on Money Laundering (APG) Caribbean Financial Action Task Force (CFATF) Committee of Experts on the Evaluation of Anti-Money Laundering Measures (MONEYVAL) Eaurasian Group (EAG) Eastern and Southern Africa Anti-Money Laundering Group (ESAAMLG) Financial Action Task Force of Latin America (GAFILAT) Inter-Governmental Action Group against Money Laundering in West Africa (GIABA) Middle East and North Africa Financial Action Task Force (MENAFATF) GABAC

Table 1.2: FATF Jurisdictions and Associate Members. Source: FATF

As the world witnesses an era of unprecedented financial complexity and innovation, the threat of financial crime looms larger than ever. The staggering costs of financial crime are not just measured in terms of dollars and cents, but in shattered lives, destroyed businesses, and eroded public trust in financial institutions. With the rapid advancement of digital technology, financial crime has taken on a whole new dimension. The prevalence of electronic transactions, the widespread use of cryptocurrencies, and the increasing sophistication of cyber criminals have all created new opportunities for financial crime and made it more difficult to detect and prevent.

Indonesia's unique blend of abundant natural resources, strategic location, vibrant culture and vast population make it an irresistible magnet for foreign investors seeking opportunities in one of the world's most promising markets. As an emerging Southeast Asian powerhouse comprising over 1 trillion USD GDP, the country's salient strength also lies within its ability to manage a relatively stable democratic political environment[3] (The World Bank, 2022). However, Indonesia's economic environment remains vulnerable and is rampant with financial-related crimes, which severely restricts the efficiency of business operations. This is marked by officials exploiting vague legislation for informal payments and bribes, which is a source of notable apprehension for foreign investors. This unethical practice occurs frequently during business registration, tax filling, and, at times, the permit acquisition processes.

Corruption also plagues government institutions in Indonesia. In the latest Corruption Perception Index (CPI) published in February 2023, the country saw not only the biggest drop in its score to 38 in 2022 from 34 a year earlier, but also in the global ranking from 96th to 110th out of 180 countries surveyed. The score has placed Indonesia in parallel with Malawi, Nepal and Sierra Leone (Transparency

[3] Since the collapse Soeharto's authoritarian regime in 1998, Indonesia has achieved noteworthy progress in terms of democracy. It has managed to establish substantial pluralism in both politics and media, and has undergone several peaceful transfers of power between different political parties for consecutive major elections.

International, 2023). The CPI, which is published annually by Transparency International, measures public perceptions of corruption in each country and assigns scores ranging from 0 (highly corrupt) to 100 (very clean). A comprehensive chart of Indonesia's CPI scores from 2014 to 2022 is depicted

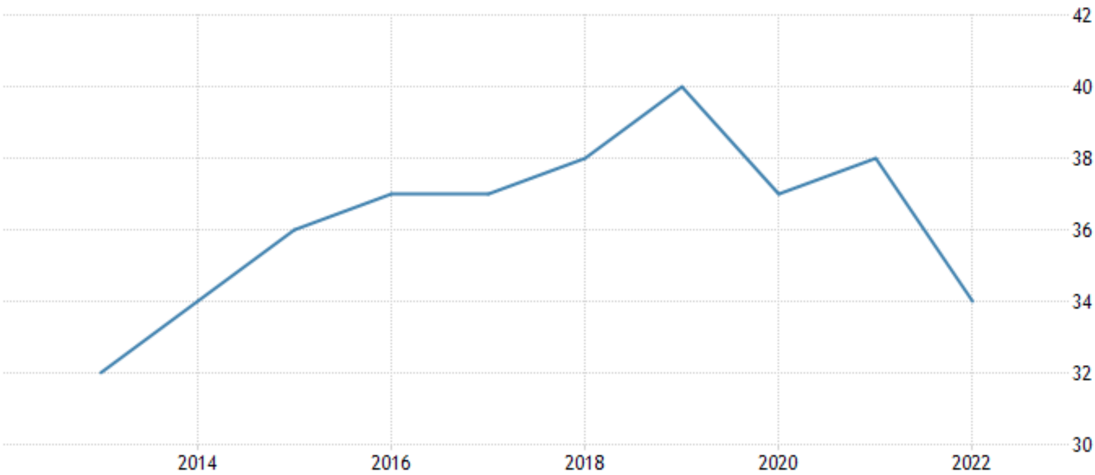

Figure 1. 1: Indonesia's Corruption Perception Index from 2014 to 2022. Source: Transparency International

When corruption is widespread in a society, it creates an environment in which illicit activities can flourish. Bribery, embezzlement, and abuse of power are common forms of corruption that can result in the accumulation of large sums of illicit wealth. The financial system is then frequently utilized to launder this wealth, camouflaging its origins and presenting a façade of legitimacy. Money launderers seek out weak or non-existent regulatory frameworks to operate in, and corruption in government and law enforcement agencies provides them with opportunities to evade detection and prosecution. The proceeds of corruption often flow across borders, making it challenging for national authorities to track and recover them.

The classification of money laundering as a *transnational crime* stems from this reason.

In the case of Indonesia, money laundering is typically associated with a range of activities beyond just drug-related crimes, including gambling, prostitution, banking fraud, theft, credit card misuse, maritime crimes, prohibited goods trade, illegal logging, and corruption. Indonesia has a significant problem with smuggling due to its vast, uncontrolled coastline, and the law enforcement system in the country is contaminated by corruption. Criminal activities in Indonesia often result in funds being sent overseas and then returned to the country to meet commercial and personal needs (Karo et al., 2022).

Moreover, as indicated in the "Indonesia Risk Assessment on Money Laundering 2021" report, crafted in 2023 by the Indonesian Financial Transaction Reports and Analysis Center (INTRAC), commonly referred to as *Pusat Pelaporan dan Analisis Transaksi Keuangan* (PPATK) in Indonesian, money laundering emerges as a formidable menace casting shadows over the credibility of financial institutions and the broader financial sector in Indonesia. Functioning akin to financial intelligence units (FIUs) in other nations, INTRAC spotlights the 8 provinces witnessing the highest incidences of money laundering, designating the capital city of DKI Jakarta as the riskiest province, earning a perfect score of 9 on the assessment scale. This index is calibrated on a scale from 3 to 9, where a score of 3 to 4.99 is categorized as low risk, 5 to 7 denotes medium risk, and a score of 7.01 to 9 is labeled as high risk.

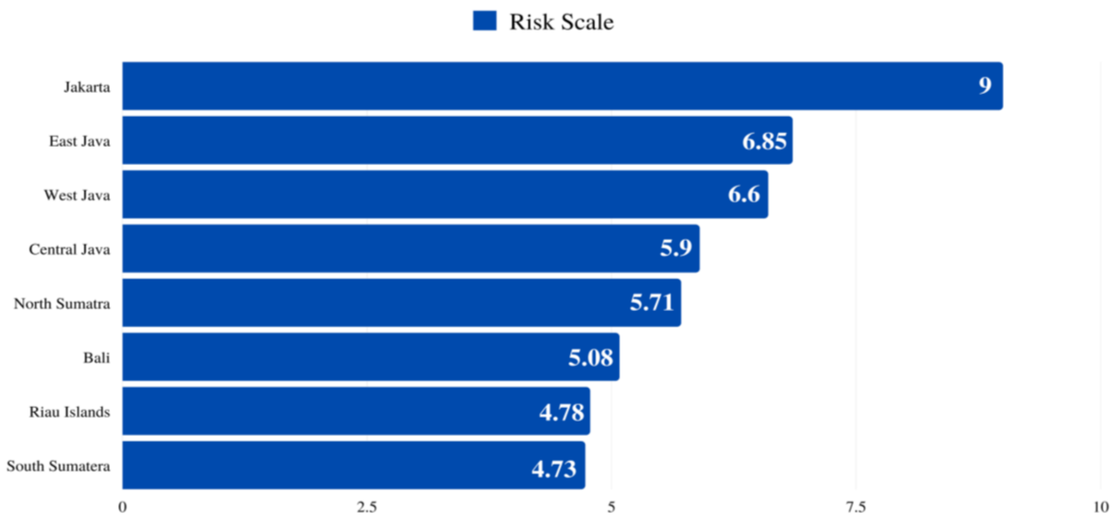

Figure 1. 2: Risk Scale of ML in Indonesian Provinces. Source: INTRAC

Having discussed the key backgrounds for Indonesia's money laundering hazard, there are at least four reasons of why such condition could engender unfavorable consequences for the nation's international perception and credibility. ***First***, it is essential to understand that money laundering is often associated with other illicit activities such as corruption, fraud, and organized crime. Therefore, a country that is perceived as having a high risk of money laundering is also seen as a place where these activities thrive. This could hurt the country's reputation and make it less appealing to businesses and investors from abroad. Countries that are seen as safe havens for illegal activities are frequently viewed as unstable and unpredictable. As a result, it can be challenging for these nations to attract investment and forge strong relationships with other nations. ***Second***, money laundering can have a negative impact on a country's relationships with other countries. Many countries have enacted legal frameworks and regulations aimed at preventing money laundering, anticipating reciprocal efforts from other countries in this regard. If a country is perceived as not taking money laundering seriously, this can damage its relationships with other countries and make it difficult for it to conduct international trade and commerce. ***Third***, Money laundering is often seen as a sign of weak governance and ineffective regulation. Countries that are perceived as having a high risk of money laundering are often seen as lacking in transparency and accountability, and this can damage their credibility in the eyes of other countries. This can make it difficult for them to negotiate international agreements and treaties, and can limit their ability to influence global decision-making. ***And finally,*** money laundering can have a negative impact on a country's domestic economy. Money laundering often involves the use of illegal proceeds to invest in legitimate businesses, which can distort competition and lead to market distortions. It can also lead to the concentration of wealth in the hands of a few, which can lead to social unrest and political instability.

After highlighting the susceptibility of Indonesia's economic climate, it is logical that the country opts to pursue a permanent membership of the FATF. Prior being a member, Indonesia was also the only member of the G20 that was not yet a full member of the task force. Despite already belonging to the APG and the Egmont Group[4], attaining permanent membership in the FATF is imperative for Indonesia to increase its credibility, both in economic and political perspectives (Sinartha, 2022). From an economic point of view, Indonesia’s inclusion in the FATF is poised to make favorable contributions to the country’s global standings

[4] Situated in Toronto, Canada, the Egmont Group of Financial Intelligence Unit stands as a global organization fostering collaboration and the exchange of financial intelligence among FIUs around the world.

and investment environment. It is also anticipated to bolster the trust of Indonesia's trading partners in the reliability of national financial system. Politically, Indonesia will be considered equal to developed countries in implementing anti-money laundering and counter terrorism financing (AML-CTF) framework. As a result, Indonesia will have greater opportunities to play a role in the international arena (Sinartha, 2022).

From mid-2000s onwards, the FATF has been diligently overseeing and evaluating Indonesia. Specifically, FATF scrutinizes the measures undertaken by Indonesia to combat the of money laundering, encompassing the established systems, legal framework, and various endeavors. Based on their findings, Indonesia's vulnerabilities can be summarized as follows:

1. There is an absence of legislation that renders money laundering as a criminal offense;
2. The creation of FIU is yet to materialize;
3. There is no requirement to report dubious financial transactions to the FIU;
4. The incorporation of Know Your Customer (KYC) principles has recently been introduced, but primarily limited to the banking domain; and
5. Inadequate international collaboration.

In June 2001, following an assessment conducted by the FATF, Indonesia was officially added to the list of Non-Cooperative Countries and Territories (Hakim, 2015). Realizing the magnitude of the negative impact caused by Indonesia's inclusion in the NCCTs list, especially if the FATF were to impose counter-measures sanctions, the Indonesian government immediately took concrete steps to improve, especially in an effort to overcome the various weaknesses highlighted by the FATF. This step began with the passing of Law No. 15 of 2002 concerning the Crime of Money Laundering (*Tindak Pidana Pencucian Uang/TPPU*) on April 17, 2002. Additionally, the government also went along with the establishment of INTRAC as the financial intelligence unit. Furthermore, various policies were put in place to reinforce the legal framework, increase supervision in the financial sector, and strengthen cooperation between domestic and international institutions as well as law enforcement.

Since 2016, Indonesia has actively pursued permanent membership in the FATF—a goal that has proven to be a complex and protracted endeavor. From 2019 to 2023, Indonesia held observer status within the organization. While actively participating in FATF meetings and discussions during this period, Indonesia did not possess full membership privileges or voting rights. Fortunately, on October 25, 2023, Indonesia achieved a significant milestone by becoming the 40th full member of the task force during the Plenary in Paris, France. These recent developments prompt a closer examination of the role played by the FATF in the global context, signify a transformative moment to warrant an exploration into the motivations behind Indonesia's pursuit of permanent membership, as well as presenting an opportune moment to investigate the potential strategic advantages that may accrue to Indonesia as a consequence.

1.2. Research Questions

Having elucidated the background above, this thesis raises three interrelated questions that will serve as a foundation for the exploration of this study:

1. What is the role of FATF in the global governance to counter money laundering and terrorism financing?
2. Why does Indonesia need to apply permanent membership of the FATF?
3. What are the strategic advantages that can potentially be gained if Indonesia becomes a permanent member of the FATF?

1.3. Research Objectives

This research serves as a study to inquire the significance of the FATF on the global political-security dynamics, especially in transnational financial crimes and how does it work as a manifestation of global commitment to counter money-laundering. This research is also an attempt to scrutinize Indonesia's series of efforts in becoming the permanent member of the FATF that has been going on since it was blacklisted in 2001. It hopes to capture the urgency, the reasoning (***why)*** and the strategic advantage (***what)*** that can potentially be gained through the obtainment of such membership.

1.4. Research Significance

The research in this study will provide substantial contributions to the development of international relations, both as a discipline and practice. First, the research questions are timely and relevant in the current global context where countries are increasingly facing threats from ML/TF. Understanding the role of the FATF in global governance to counter these threats and the potential strategic advantages of becoming a permanent member of the FATF is crucial for policymakers in Indonesia and other countries. It can contribute to the existing literature on global governance, international organizations, and financial regulations as well as provide insights into how countries can navigate the complex international landscape to protect their national security interests and promote global cooperation.

Secondly, Indonesia's relationship with the FATF is long-standing and has gone through various phases, from being blacklisted to eventually being accepted as a full member. Over the years, Indonesia has made significant efforts to improve its AML/CTF regime, and joining the FATF complete its efforts in compliance with global standards aimed at preventing and detecting such activities. This research aims to shed light on Indonesia's efforts to combat ML/TF, with potential implications for the country's foreign policy and national security strategy. Specifically, the study can provide policymakers with evidence-based insights into the benefits of becoming a permanent member of the FATF and how it can enhance Indonesia's position in the global financial system. The research evaluates the measures taken by the Indonesian government to improve its compliance and highlights the potential strategic advantages of being a permanent member of the FATF. Ultimately, the study can offer valuable insights into how Indonesia can strengthen its position in the international community, making it an essential piece of research for policymakers and scholars alike

1.5. Research Structure

Chapter 1: INTRODUCTION

This chapter introduces the topic of the research by providing an overview on the background of Indonesia's money laundering situation. It elucidates Indonesia's strategic resolve to seek permanent membership in the FATF, laying the groundwork for the ensuing sections of the thesis. It formulates three key research questions that will serve as guiding pillars throughout the investigative journey. The rationale behind the selection of these questions is expounded upon, emphasizing their relevance within the realm of international relations as a scholarly discipline.

Chapter 2: LITERATURE REVIEW & THEORETICAL FRAMEWORK

This chapter provides a comprehensive review of the existing research and literature on the topic. Studies and scholarly articles that is related to Indonesia and the FATF will be thoroughly discussed as to provide information on the length of knowledge on this topic. Neoliberalism or neoliberal institutionalism theory of international relations will also be introduced in this chapter as the main theoretical framework that is being utilized to explain the phenomenon.

Chapter 3: METHODOLOGY

This chapter discusses the methodology of the research to provide an understanding of how the research was conducted, to demonstrate the validity and reliability of the results obtained, and to showcase the data collection method and analysis.

Chapter 4: RESULTS & DISCUSSION

This chapter unfolds the culmination of the research endeavor, presenting a comprehensive analysis of the results and findings derived from the research process. It aims to shed light into the role played by FATF as global governance, the urgency of membership in the task force and whether the permanent membership in the FATF can grant Indonesia the improved international reputation, specifically in political leverage and financial credibility that it had initially hoped for. It will also explore the journey of Indonesia in adapting to the international financial system by adhering to the FATF recommendations as preconditions to become a full-fledged member, which presents opportunities to enhance its standing, both regionally and globally.

Chapter 5: CONCLUSION & RECOMMENDATIONS

After conducting an extensive analysis of Indonesia's strategic advantage decision to apply permanent membership of the FATF, this chapter brings the thesis to a close by summarizing the key findings based on the research inquiries and provides several policy recommendations that arise from the conclusion for the government of Indonesia.