The Important Role of Services Sector in the Economy

- The service sector is not only one of the sectors of production that is labor absorbing but also is an important catalyst, intermediate input in activity and economic development.
- A healthy competition can improve the performance of the service sector and encourage service providers to become more efficient. This is linked to a regulatory reform that creates a business environment encouraging a healthy competition.
- It is necessary for an independent regulatory body or independent of the existing interests, especially each service sector free from government interests.
- A financial sector that is strong, efficient and reaches across parties are conditions of a healthy economic development. It is necessary to change the structure of the banking market by increasing competition, which currently has oligopolistic tendencies.

The service sector is a sector that is increasingly becoming large and important in countries likes Indonesia. Currently, the service sector contributes more than 45% of economic value added and absorbs more than 35% of the workforce. But more than that, an important role of the service sector is not only reflected in its proportion of GDP or labor statistics but also in its role as an intermediate input and enablers of all economic activity.

Based on the data Input-Output Indonesia in 2005, the service sector contributes 35% of the total intermediate inputs required by the production sector in Indonesia. The retail, wholesale and transportation dominate many sectors of intermediate inputs for processing in the service sector (Duggan, Rahardja and Varela, 2013). The service sector plays an important role in improving the competitiveness of the industrial and export products. The service sector is also a key to reducing poverty and achieving equity: the logistics sector and the distribution of quality will reduce the price disparity between the various locations of Indonesia.

Unfortunately, despite its significant role, the service sector in Indonesia still faces major problems. The first is the lack of available providers and infrastructure providers in many areas. Moreover, a variety of major services such as transportations, telecommunications and financial services are often lacking. The second issue is to do with the quality of the products services, which often are unreliable. Studies from the World Bank (2014) showed that approximately 44% of the logistics costs had a high level of uncertainty in the delivery of goods, resulting in having to pay more inventory. The third issue is that the costs to services are still high. For example, currently, the cost of transport still take more than 25% of the GDP while other ASEAN countries are around 10-15%.

For that, it needs a fundamental improvement to the development of the service sector so it becomes more qualified. One thing that is important is increasing competition in many service sectors. Various studies such as those done by Arnold, Mattoo and Narciso (2008) on African countries and Fernades and Paumov (2008) on Chile indicate that increased competition in the domestic service sector is proven to increase not only the productivity of the service sector but also the processing industry.

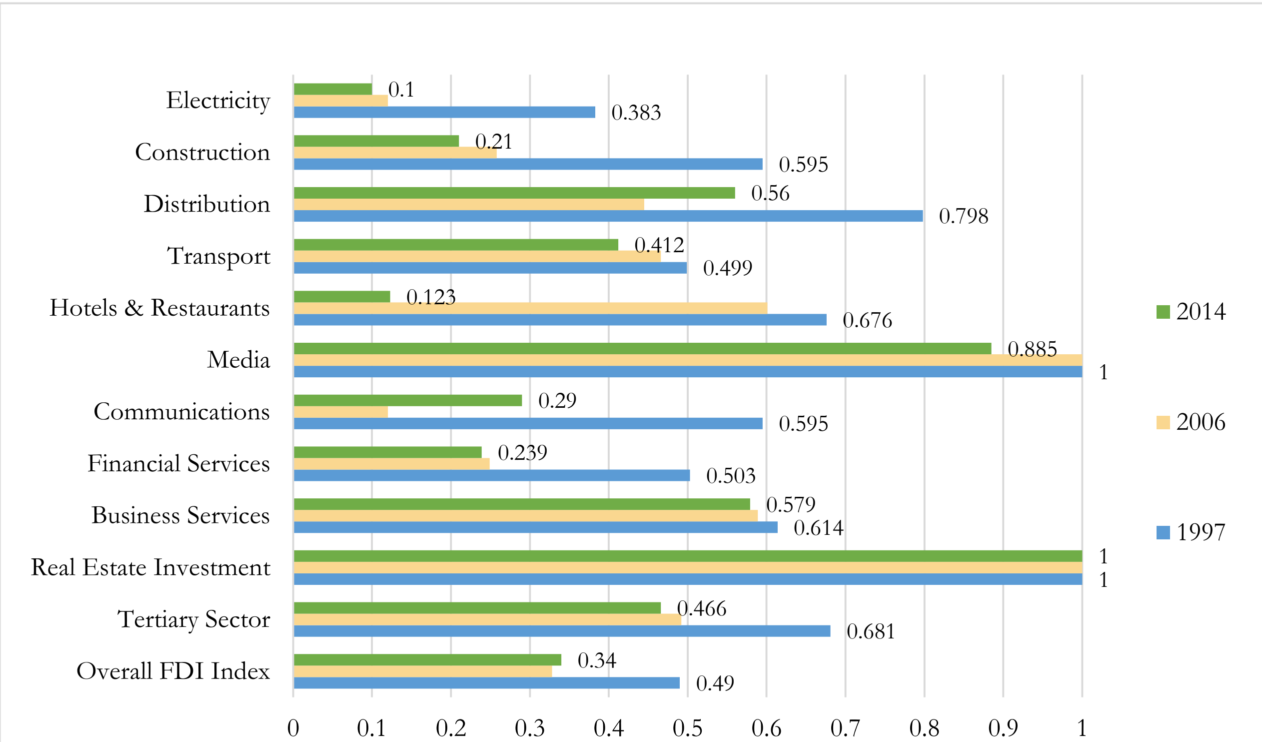
Today many service sectors in Indonesia are getting excessive protection. There are many rules that limit the number of providers in the service sector or set the prices lowest for various sectors. Granting exclusive rights are still widely seen, especially the service provider of SOE. Regulation plays a role in determining the performance of the service sector as the government in general wants to regulate the service sector due to the potential failure of the market (market failure) and/or in order to meet specific social goals (Dee 2012). Hence, increased efficiency in the service sector is strongly associated with regulatory reforms.

In the case of many service sectors there is a common obstacle, which is the unavailability of independent regulatory agencies, or the independence from various interests, free of the government interests. Therefore, one way to improve the performance of the service sector, which leads to the efficiency of the regulatory body, is to be completely independent.

There are still many service sectors that are closed to foreign investors. Indonesia's Index OECD FDI Regulatory Restrictiveness shows that although there is progress in Indonesia's openness to foreign investments from 1997 to 2014, some of the service sectors recorded a very low degree of openness. Several other service sectors like the distribution sector, hotels and restaurants and business sectors also noted that there was an increase to the index.

Foreign investment in the service sector could help to achieve efficient service. International service providers will increase competition in the domestic service market that helps improve the performance of domestic service providers. Services will be more readily available, better and cheaper. They will also introduce technology and the management that will be better adopted in the country. The series of deregulation in the early 2000s is an example of how the openness of the service sector led to the improvement in performance and the encouragement of economic activity. The rapid development of aviation services improved the performance of domestic airlines.

Figure 1. Evolution of FDI Regulatory Restrictiveness Index for Indonesia



Source: OECD FDI Regulatory Restrictiveness Index

Note: A value of 1 means that the sector is closed for foreign investment, and 0 means the sector is fully opened to foreign investment.

Financial Service Sector

The financial sector can be assumed as the heart of the economy that helps to make the economic activity go well. The most important is the bank, which is the main source of financing. Compared to the capital market (the other alternative source of financing), the number of bank credit until May 2015 reached IDR 3.757 trillion. At the same time, the value of stocks and bonds issued reached only IDR 684 trillion and IDR 441 trillion. The assets of the banking sector are also much larger (IDR 5.838 trillion), compared to the finance company asset (IDR 426 trillion) and mutual funds (IDR 267 trillion).

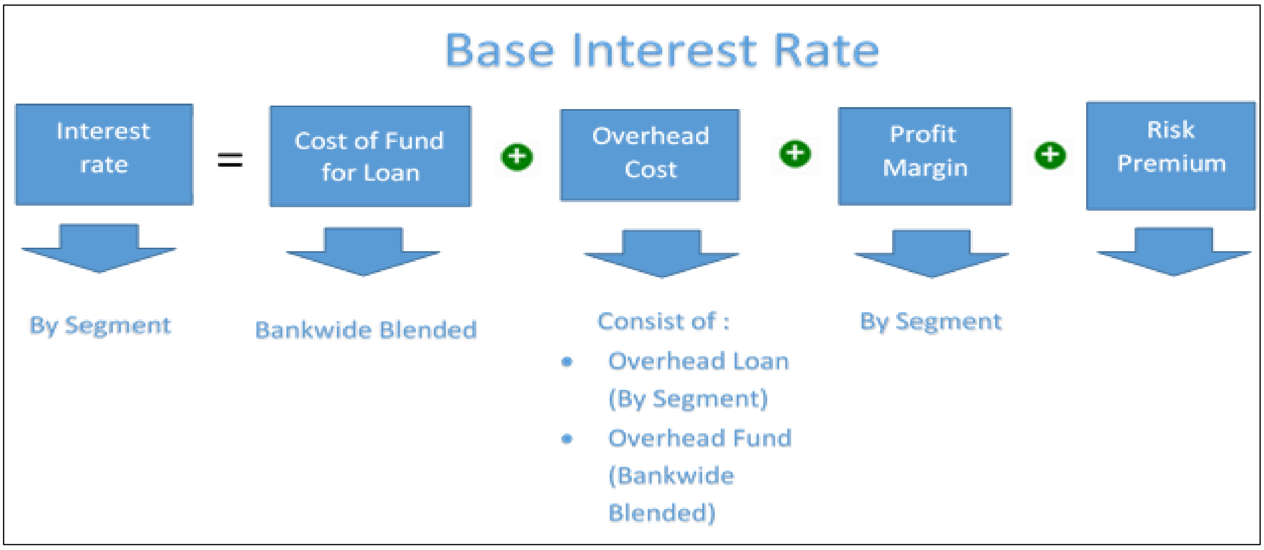
The importance of the banking sector is ironic because in Indonesia, the access to the banking sector is still very limited. Only 20% of the population has access to extensive banking, compared to India (35%) or China (64%). Banking assets in Indonesia is still relatively small, only 54% of the GDP, which is below Philippines (84%) or Thailand (142%).

Currently, the regulation and supervision of the banking sector is much better than before. A lot of banks are lending to the business sector with affiliated ownership. However, the banking market structure remains oligopolistic although competition for third party funding and lending is quite high. As a result,

1. Most of the liquidity is concentrated in large banks.
2. In addition, the majority of third party funds are from short-term tenor deposits.
3. The amount of credit provision fund has also become the characteristic of the banking sector in Indonesia mainly because the financial markets are shallow, limited deposit guarantee insurance scheme, and the high uncertainty in the function of the lender as last resort.

The above three factors, in turn makes the transmission of monetary policy not effective.

Another problem is the banking sector related to pricing strategies/bank interest rate. In general, the components determining the level of bank lending are in the figure below.



The Cost of Funds for Credit (HPDK) component depends on the condition of liquidity in the economy. Currently, bank liquidity has become more limited, resulting in a high HPDK.

The second component that determines the level of mortgage interest is overhead cost that consists of high overhead acquisition of funds. Sub-components other than the cost of the distribution and collection of credits depend on the customer segments served. In general, for corporate customers, overhead costs range from 1% while micro customers can reach to 10% due to the need to employ sales/marketing/collection to serve many micro clients.

The third component is profit margin. It depends on the structure of the banking market's oligopolistic tendencies in high concentrations. The decline has to do with increasing competition, both between banks, for example consolidating with a small bank as well as other financing sources.

The final component is the magnitude of the risk premium depending on the ability of risk management and banking.

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