POLICIES TO IMPROVE INDONESIA'S ECONOMIC COMPETITIVENESS

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This policy brief is the result of an activity entitled "Economic Policymaking in Indonesia' which is jointly conducted by Centre for Strategic and International Studies (CSIS) and Economic Research Institute for ASEAN and East Asia (ERIA). This activity is a contribution from research community that is expected to assist the government in formulating more effective economic policies in the future. In this activity, CSIS and ERIA invited 16 economists with specific fields of expertise from some leading research institutions to conduct in-depth discussions on seven strategic issues facing Indonesian economy (infrastructure development, competitiveness, investment climate, food policy, services sector policy, fiscal policy, and social protection policy), which is then summarized into policy briefs covering each of the topics.

Dissemination of the findings and recommendations produced by this activity is conducted through several channels. First, this activity has made efforts to engage the relevant government officials through some Focus Group Discussions (FGD), the publication of High Level Policy Notes, and hearings with some strategic policymakers with regard to each of the strategic issues mentioned above. Secondly, this activity also conducts widespread public disseminations through Public Seminars on each of the strategic issues, along with publications of the Policy Briefs and supporting multimedia that can be accessed online through www.paradigmaekonomi.org.

BACKGROUND

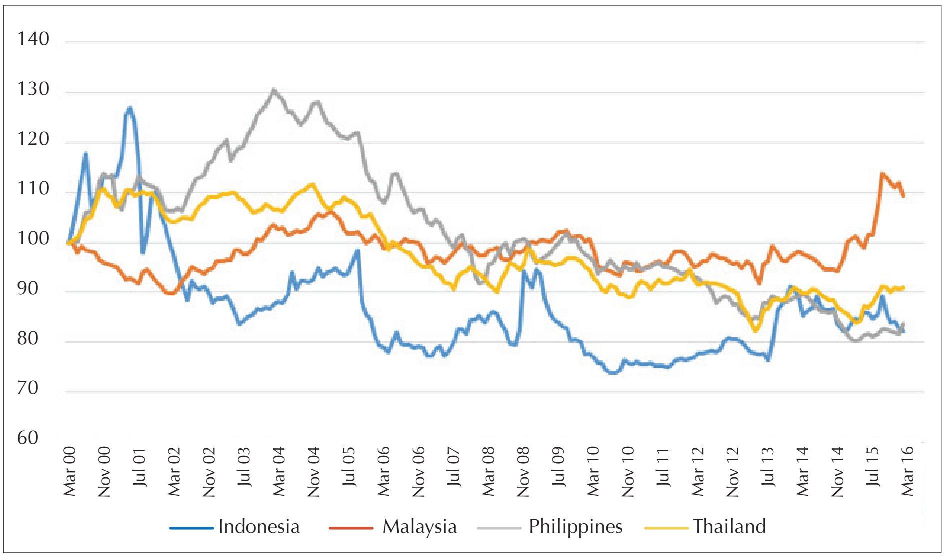
In short, Indonesia does not have a problem with the competitiveness of its economy, since it has managed to achieve relatively rapid economic growth, with slight fluctuations. Since the *Asian Financial Crisis* (AFC), Indonesia's average annual economic growth rate is 5.3%. In recent years, Indonesia has also always ranked second or third among the G20 countries. Some of the causes of this are the management of prudent macroeconomic measures and the government's success in drastically suppressing the government debt to GDP ratio since the AFC. Currently, the government debt to GDP ratio is among the lowest in the region. With careful economic management, Indonesia managed to persevere through the *Global Financial Crisis* (GFC) and minimize the negative impacts that the GFC had on the Indonesian economy.

Indonesia's economic performance, which has been good lately, might not necessarily continue and address the world's external environmental challenges that have changed the new external environment with the implementation of the ASEAN Economic Community (AEC). First, for the foreseeable future, the International Economic situation is predicted to remain sluggish. Second, the relatively good economic performance has been supported by the commodity boom and the capital inflow from developed countries as a result of the US's quantitative easing (QE) policies, which seek higher returns. That being said, the commodity boom is now over, and the QE policies are also coming to an end. Third, and most importantly, several indicators of international competiticeness, which will soon be discussed further, shows Indonesia's poor economic performance.

THE WEAKENING OF INDONESIA'S COMPETITIVENESS

There are several underlying reasons for the recent weakening of Indonesia's competitiveness. First, Indonesia has experienced increases in *terms of trade* throughout the commodity boom of the last few decades. The consequences of this increase in terms of trade is the appreciation of the real effective exchange rate (REER), due to the increase in the nominal exchange rate and/or the increase of domestic inflation relative to Indonesia's trading partners. As aforementioned, there has recently been capital inflow from OECD countries that seek higher returns. Increased capital inflow to Indonesia has contributed to the real appreciation of the Indonesians Rupiah. Dutring the 1998 crisis, the Indonesian rupiah experienced quite a drastic depreciation, even though Indonesia's relatively high inflation compared to its trading partners minimized the effect of this depreciation on Indonesia's competitiveness.

Figure 1. Comparison of the REER of Indonesia, Malaysia, Thailand and Philppines

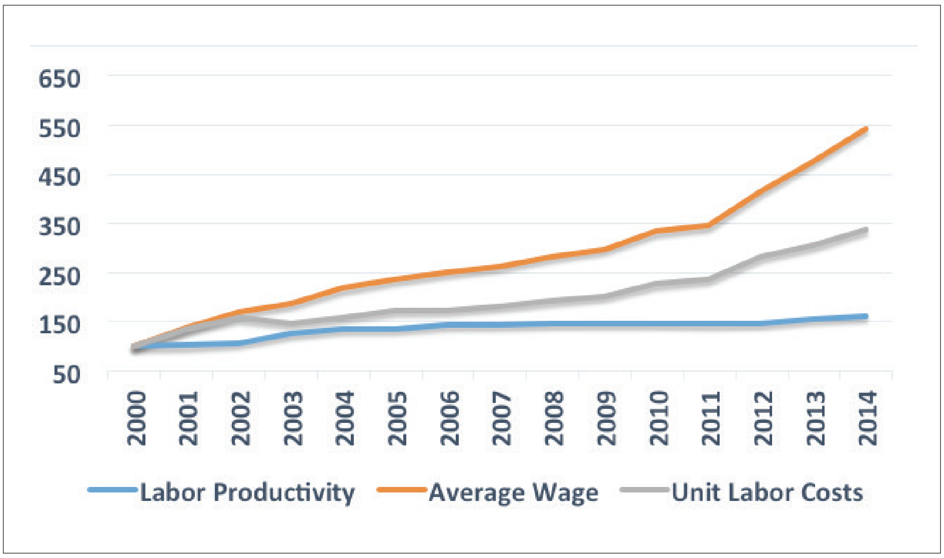


Source: BIS

Second, Indonesia's competitiveness has weakened due to their failure to undertake regulatory reform after the AFC. Looking back for a moment, Indonesia undertook major reforms in the mid-1980s when Indonesia experienced an economic crisis due to falling oil prices, major reforms that resulted in a healthier economy. With a more diversified economy, Indonesia reduced its dependence on oil and gas, and increased private sector participation. Regardless, since early 1990, there were *deregulation fatique* and endless economic (and political) crises in 1998. In 1998, there occurred again massive economic and political reforms. For the most part, these reforms have been able to restore Indonesia's economic growth pretty well. However, the resulting more assertive Parliament, a rainbow cabinet, a weaker Presidency, the lack of legal certainty, and a more active civil society have spawned policies that tend to be populist and nationalistic.

Take employment policies for example. After the AFC, employment policies became more pro-labor, compared to before the AFC. These policies changed the implications for production costs, especially for labor-intensive industries. Graph 2 shows the productivity of labor, average wages, and the Unit Labor Cost (ULC) for the manufacturing sector in Indonesia.

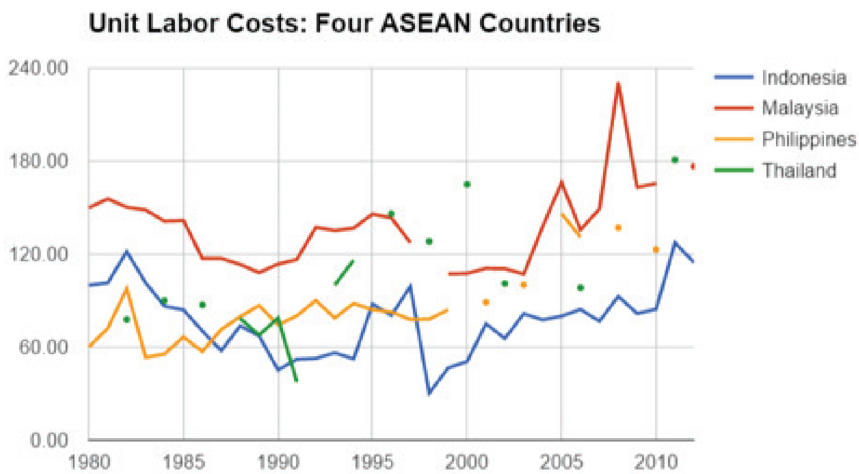
Figure 2. ***Unit Labor Costs*** **Indonesia 2000-2014**



Source: Author's Calculations

The data depicted in the graph above shows that during 2000-2014, average wages grew much more rapidly than productivity. As a result, ULC increased 3.5-fold. The highest wage growth occurred in early 2000 as a reasonable adjustment to the high inflation resulting from the 1998 crisis. Wages increased again between 2012-2014, while labor productivity showed no significant changes. Figure 3 shows a comparison of the ULC for ASEAN countries.

Figure 3. Comparison of Unit Labor Cost across ASEAN Countries



Source: Author's Calculations

Indonesia is not the only country that has experienced a rapid increase in wages. Neighboring countries, especially Thailand and Malaysia, have also experienced relatively high wage inflations. So, relatively speaking, at least up until 2012, Indonesia's ULC remains competitive. Unfortunately, the available data did not include the surge in wages in 2013 and 2014. The sharp increase in Thailand's ULC in 2011 due to a decrease in their productivity, is mainly caused by a major flooding in 2011, as opposed to wage increases (the new minimum wage spike occurred in 2012).

In addition, another example of the failure of the regulatory reforms occurred within the logistic sector. Regulations that do not support competition within the logistics sector's performance worsened the logistics sector. In contrast to the deregulation the air transportation sector, which promotes competition leading to the rapid growth of the sector, the sea transportation sector has become increasingly restrictive. The 2008 Shipping Law further tightens the specialization of cabotage in Indonesian waters for domestically owned cruise ships. Although the government continues to increase its commitment to build infrastructure, the question remains as to whether the government is also able to eliminate crucial barriers in the logistics sector. These crucial barriers include the lack of coordination between central and local governments, and the uncertain environment for policies in the logistics sector.

The third underlying reason for Indonesia's weakening competitiveness is that, while Indonesia has not been able to increase the sophistication of its production technology relative to other countries; Brazil, Russia, India, China, South Africa (BRICS), for example, Indonesia has managed to obtain a new competitor from countries with lower labor costs such as Vietnam and Bangladesh.

FALSE APPROACHES TOWARDS INDUSTRIALIZATION

Added Value and Downstream Obsession

Lately, there has been an intensified discourse on the need for Indonesia to apply the strategy of pursuing added value. This is not, in fact, a new discourse. 20 years ago in a dialogue on the construction of the Centre of Information and Development Studies (CIDES) Habibie, it was suggested that Indonesia implement the development strategy based on value-added using technological and industrial orientations. More recently, the strategy of pursuing added value is contained in Law No. 4 of 2009 on Mineral and Coal Mining (Mining Law). Through the Mining Law, the government will control the export of raw minerals to process increasing added value in the country optimally through the downstream industries.

Ricardo Haussmann shows that downstreaming idea is not only wrong but also dangerous as it limits the diversification of its raw materials, whereas ownership of the raw material only has more value to the extent of the cost to transport raw materials between countries. Transportation revolution has eliminated this surplus value, even for minerals.

Haussmann explains further,

"both theory and practice provide reasons to question the presumption that downstream processing is an appropriate development path. The skills and other inputs required to process raw materials and market finished products could be very different from those required to mine or grow them. The key input for producing Aluminium, for example, is cheap energy, not local Bauxite deposits, and that is why South Africa could develop Aluminium exports, even though it had no Bauxite and why Jamaica produces Bauxite but does not process it."

Indonesia, who is currently experiencing an energy deficit, definitely does not have a comparative advantage in producing downstream products in the mining sector.

Reasons for Labor Absorption

By definition, added value is the difference between the company's total revenues and their spending on goods and services and raw materials purchased from outside the company. Generally, added value is divided into two components: wages given to the workers and the return that is given to (owners of) capital.

The more skilled the workers who process raw materials are and the greater the capital used in the production processes, the greater the added value generated by the company or the industry. Based on data from the 2005 Input-Output Table issued by BPS, for example, the added value per worker in the chemical industry is 276 times more than the added value per worker in the rice farming industry and 10 times more added value per worker in the textile, clothing and leather tanning industries. In terms of capital requirements per worker, the chemical industry is 30 times more capital intensive than the agricultural sector and eight times more than the textile, clothing and leather tanning industry.

In short, the high added value industries or sectors are sectors that are relatively intensive in physical capital and/or human capital.

Strategy Options to Improve Added Value

Without new investment, an increase of the added value of an industry would mean the reallovation of resources from low added value sectors to high added value sectors. So what if this increase in added value could be done through new investments rather than through the reallocation of resources? However, the question would still remain: Why is this new investment held by the capital-intensive manufacturing industry, and not in sectors that has much more labor absorption?

You might then ask: If we only dwell on the aspect of employment, wouldn't that condemn Indonesia to being stuck in the state of underdevelopment, continuously producing goods with low added value, and simple technologies? The answer is no.

Imagine if Indonesia could continuously increase its investment at a rapid speed. In a short amount of time, labor will be completely absorbed so that labor will become scarce in the labor market. In the midst of the scarcity of labor, wages will be driven up. Producing labor-intensive goods will no longer be profitable, and in turn, employers will adapt to the shift to capital-intensice industries of experts.

In other words, if investment grew rapidly, Indonesia will naturally shift towards industries with higher added value. The difference between this strategy option and the downstream strategy is that this strategy will increase added value in a graceful manner, without picking winners, and will keep the economy in maintaining its full employment condition.

Indonesia has been successful in implementing the above strategy. The rapid growth of labor-intensive industries, that occurred from 1986 until just before the 1998 crisis, has absorbed millions of workers. Chris Manning in his paper, "*Lessons from Labor Adjustment to the East Asian Crisis: The Case of South Korea, Thailand and Indonesia*" indicates that before the 1998 crisis, Indonesia has entered the era of scarce labor. If the 1998 crisis had not occurred, then this natural increase in added value would have happened on its own within this era of scarce labor.

With the onset of the crisis, the Indonesian economy got back an abundance of labor. However, that does not mean then that Indonesia should leave the task of labor absorption and move to a strategy that targets industries that creates added value. Quite the opposite, Indonesia's government needs to work twice as hard to create jobs. Unfortunately, rigid labor policies, combined with high minimum wages, make it difficult to do so. Capital-intensive industries with high added value have developed since the crisis, even though the absorption of labor is still low.

Protectionism and the Import Substitution Policy

Since its independence up until the 1998 crisis, Indonesia has always remained abivalent about globalization. The pendulum shifted from protectionism to liberalization, and vice versa, throughout the history of the Republic of Indonesia, from closed economies in the early 1960s, to an open regime in the late 1960s, and returning again to a regime loaded with government intervention in the oil boom era of the 1970s, to a deregulation era in the mid-1980s.

Since the reform, a result of the 1998 crisis, little can be said of any great effort towards liberalization, but the economy has remained relatively open with an average tariff rate of 6%, and non-tariff measures (NTMs) are generally limited in the agricultural sector and the upstream industry. Supporters of reform and balanced protectionism generates economies that are 'precariously open' as Basri and Hill (2004) says.

But lately the trend toward protectionism rebounded (Patunru and Rahardja, 2015). The *percent tariff line* on the imports side, subject to NTMs, increased from 37% in 2009 to 51% in 2015. On the export side of the NTMs, this figure had risen three-fold within the same period and covers 41% of export value (Jakarta Post, 2015).

As discussed earlier, the downstream strategy is also applied in the form of export bans and export taxs for various mineral products, such as bauxite, copper, nickel, steel ore, tin. This protection has led to high economic costs for both the industry and consumers. It is estimated that trade barriers has pushed up the cost of living up by 7.5%.

One of the arguments that are often cited to support protectionism are import substitution policies, which were popular in the 1970s. The logic of the 1970s import substitution policies is based on the infant industry argument, as follows. Indonesian industrial products are less competitive, in terms of price and quality, than foreign products. Due to this lack of competitiveness, there will be no production of such goods. If Indonesia does not produce the goods, then there is no opportunity to learn to produce goods (economics of learning by doing) and enjoy economies of scale to lower the cost and quality of the goods.

However, this argument has a weakness. The following simple illustration can give you an idea. Let's say that the import price of product A is Rp. 1000/unit, while the price of its production in Indonesia is Rp. 1500/unit. In order for the domestic product to compete with imported products, then tariffs of as high as Rp. 500 is necessary. If, for example, the price of the domestic product could be lowered to Rp 50 per year, then in 10 years time, this domestic product will be competitive against imported products. The simple count aforementioned assumes that the price of imported is not lowered every year. If, say, thanks to a variety of business efficiency and greater research on the part of foreigners, the price of imported products could be lowered to Rp. 60 per year. If this happens, then protection must be given continuously, and the industry will continue to be an infant industry that cannot compete. Bear in mind that the cost of protection is covered entirely by the consumer.

Continuous protectionstic scenarios, such as the one above, are likely to occur in a corrupt country, and many rentiers. Employers will compare costs to lowering the prices of products to make it competitive against imports (eg the costs of R & D) vs. the cost of lobbying decision makers to continuously provide protection. In a state with high-level corruption and rampant rentier, it is most likely that the employer will choose the strategy of chasing rents than lowering the price of products. If this happens then that industry will continue to be an infant industry that is not competitive, and consumers will continue to suffer.

GLOBAL PRODUCTION NETWORK (GPN)

The Global Production Network (GPN) is the vertical integration of trade and production, which involved many countries becoming an increasingly large part of global intra-industry trade, especially among the countries of East Asia. Among the ASEAN countries, intra-industry trade associated with GPN covers more than 50% of total trade (Athukorala, 2010).

Despite GPN being especially prevalent in the automotive and electronics industries, it can also be applied in various industries. Unfortunately, Indonesia is lagging behind in this GPN. Between 2010-2011, Indonesia was only involved in 0.5% of GPN; far behind Malaysia (2.6%), the Philippines (1.2%), and Thailand (1.6%).

The aforementioned import substitution and downstream policies are no longer relevant to the paradigm of the *global production network*. Within the global production network, the number of countries producing goods from upstream to downstream is decreasing. Each country will produce components to their comparative advantage, in order for these components to later be combined into a final product in a country that is the production hub.

Indonesia needs to adjust its trade and industrial policies in order to participate in the global production network. Participation within the GPN requires a very open trade and investment regime, availability of a wide range of excellent supporting services, especially logistics, so that the production process runs efficiently and in a timely manner, and a competitive workforce ranging from the unskilled to the managerial level. Indonesia is lagging behind in the GPN due to its inability to adequately meet these three prerequisites.

CONCLUSION AND POLICY RECOMMENDATIONS

Changes in the trade and industrial policies paradigm is one key factor to improving Indonesia's competitiveness, due to the existing policies issued within recent years that tend to be *protectionist* and *inward looking*. One of these existing policies is the downstream strategy, which is no longer relevant in international trade scene. In addition, Indonesia also must be able to take advantage of the opportunities for cooperation in the free trade areas such as the Trans-Pacific Partnership (TPP). As it is, policy makers should not think only of the cost-benefit of joining a trade agreement, but also cost-benefit of not joining the agreement. In this case, the government should be more active in trade facilitation, and not just in publishing restrictive rules. This paradigm shift must be done thoroughly in order to avoid inconsistencies and unsynchronization of government policies, which often occur.

Associated with GPN, as described earlier, there are three things that a country must possess in order to be able to participate in the GPN, and that is labor, an efficient services sector, as well as open trade and investment regimes. Rigid labor policies have caused Indonesia to lose its competitiveness in labor. This can be corrected by improvements in the service sector and also by the enforment of policies to liberalize trade and investment. An example is Vietnam, who has successfully been assessed to have increased its role in the GPN, and who is also actively involved in international trade agreements.

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