Growth, Convergence and Income Distribution: A View from Indonesia

Maria Monica Wihardja[1] *Economist, World Bank Office Jakarta*

Global Growth and Convergence

Emerging economies, including China, India, Brazil and Indonesia, have become an important engine of global growth in the post-crisis period. However, high growth in emerging countries often hides deep structural issues that make it unsustainable. Painful structural reforms, politically and economically, that might require economies tolerating a slowdown in growth in the near term, are needed to support high growth in the long term. Such reforms require strong leadership at the highest level. Some economies have already experienced slower growth following the implementation of structural reforms and Indonesia is no different, with real GDP growth moderating from a level of 6.8 percent in the last quarter of 2010 to a projected 5.2 percent in 2014.[2]

This paper explores Indonesia's specific challenges in maintaining high growth and avoiding the middle-income trap. Indonesia's experiences are not unique, and we will see that many of its structural challenges have been present in other emerging economies like China, India and Brazil, and that there are many lessons to learn from the often painful structural reforms undertaken in these countries.

Neither sustained high growth in emerging countries, nor convergence in income per capita between emerging countries and advanced economies, is automatic. As the cases of China, India and Brazil demonstrate, structural reforms form the basis of sustained long-term growth, albeit often with short-term losses. There are also common structural shifts among emerging countries that will determine the rate of convergence, or divergence, several of which are listed by Spence (2011). First, large middle-income economies need to develop domestic sources of growth—"we can expect a gradual strengthening of endogenous domestic-growth drivers in emerging economies, anchored by expanding middle class." Second, distribution matters and failure to address rising inequality can hamper sustained growth. Third, as long as advanced economies maintain low interest rates and expansionary monetary policies, all emerging economies will experience volatile capital flows, raising the risk of capital reversal, inflation and asset bubbles. Fourth, the continued presence of a stable and open global economy cannot be taken for granted— "sustained high growth rates in emerging economies [are] closely linked to an open, rules-based and globalized economy. Yet this global construct is coming under pressure—seen as a zero-sum game. Such a world requires better global governance, as well as implementation of overdue institutional reforms that will give emerging economies proper voice and representation in international institution."

Like elsewhere, fundamental domestic structural reform in Indonesia must become a priority before the country can achieve long-term sustainable growth. Such reform is also needed to enable Indonesia to manage its "twin deficits," namely its current account balance and fiscal budget, both currently under pressure and symptoms of structural threats to the country's macroeconomic stability.

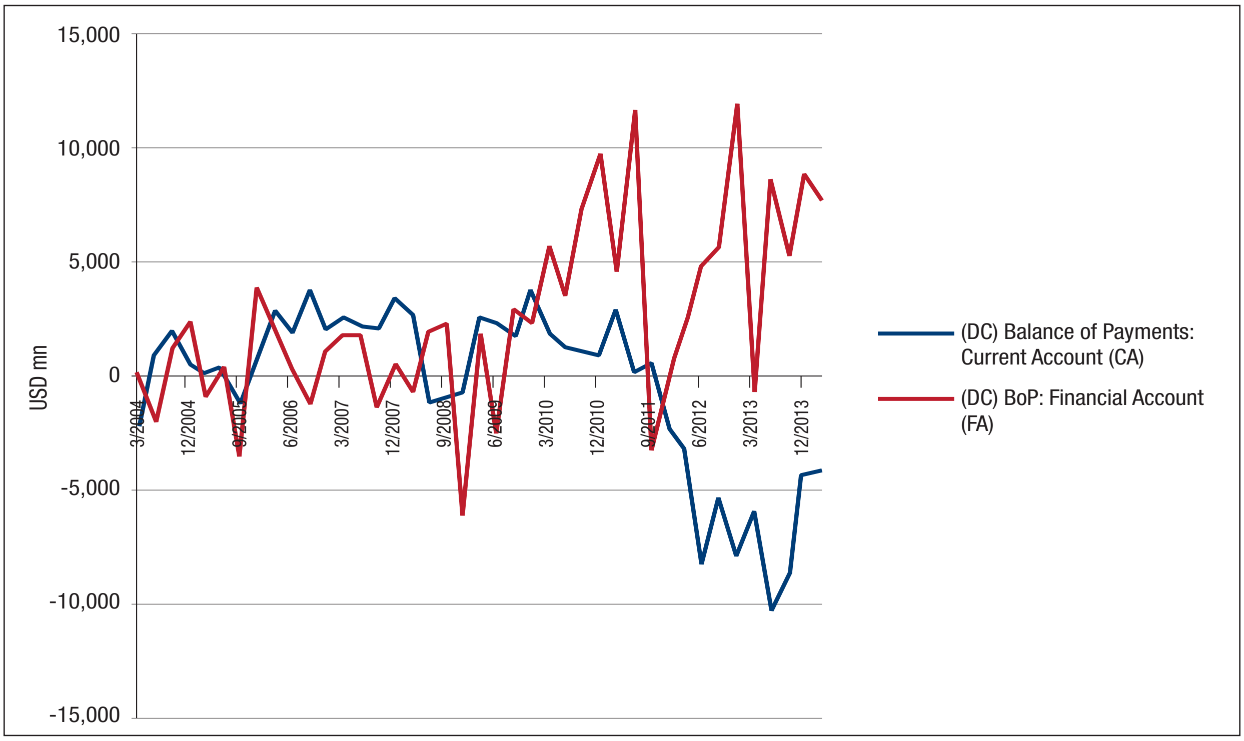
Pro-stability Monetary Policy

Since 2009 and the advent of "easy money" in advanced economies, Indonesia's current account and capital and financial account balances have seemed to diverge as the financial account skyrocketed and the current account slumped into deficit (see Figure 1). The surge in the financial account resulted from relatively stable direct investment and strong, albeit more volatile, portfolio investment. By the first quarter of 2014, net portfolio investment was at a decade-high, but it brought with it a concern about financial fragility in the event of the flows reversing once the U.S. increases its interest rate and quantitative easing ends.

The plunge in the current account balance was due to both strong imports and weak exports (see Figure 2). By the second quarter of 2014, the current account deficit to GDP ratio was about 4.3 percent. With a growing consuming class, demand for goods and services is growing but domestic supply growth is not fast enough to respond. The country's heavy reliance on commodity exports meant that, once the commodity boom ended in 2012, exports weakened, and manufacturing and services exports were not able to make up the losses. Another macroeconomic fragility comes from the fiscal budget. The burden of the fuel subsidy—at about US$21 billion in 2014 or about 20 percent of the central government's budget—stifles other spending including social assistance and capital expenditure. Meanwhile, fuel subsidies are poorly targeted, with higher-decile households benefiting more. The subsidies are also contributing to the current account deficit through increasing oil and gas imports. By July 2014, the government has revised its 2014 budget, which includes cutting the budget for line ministries by $3.5 billion (World Bank, IEQ, July 2014). Without fuel subsidy reforms, the fiscal budget deficit could have reached 4.7 percent of GDP in 2014,[3] surpassing Indonesia's 3 percent fiscal rule limit, and raising the possibility of the president's impeachment for defying the law.

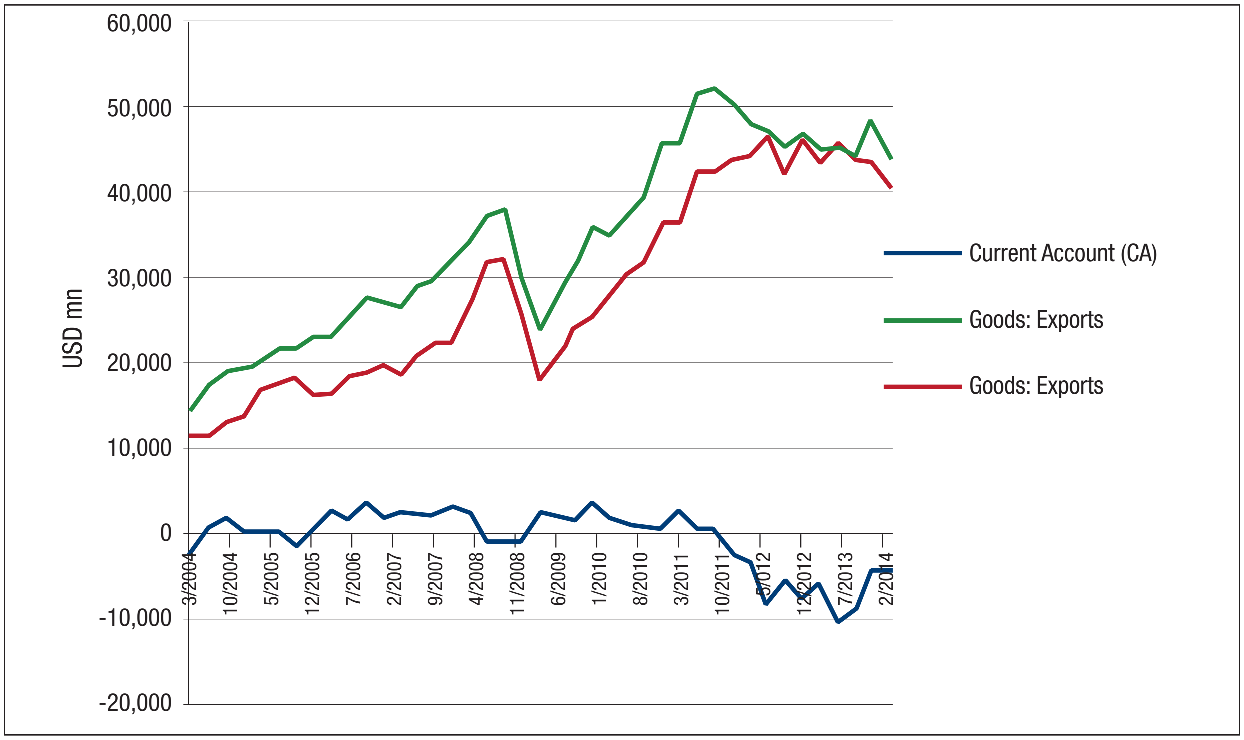
By end of September 2014, the Rupiah had depreciated to a recent low of Rp.12,100/ US$ passing the psychological barrier of Rp.12,000/ US$. Many factors could have contributed to this: political uncertainty for investors awaiting the appointment of cabinet ministers in late October, economic

FIGURE 1. BALANCE OF PAYMENTS



Source: CEIC.

FIGURE 2. CURRENT ACCOUNT BALANCE



Source: CEIC.

uncertainty over the market reaction to increasing foreign debt payments due this quarter, as well as private investors beginning to shift capital back to the U.S. amid its improving economic climate.

With the uncertain global economic environment plus pressures on the fiscal budget, it is likely that Bank Indonesia (BI) will keep its interest rate high (currently 7.5 percent) and continue with its pro-stability stance in order to sustain capital flows and lessen inherited risks. BI is also:

- maintaining a flexible exchange rate with selective sterilized foreign exchange intervention;
- enhancing monetary operation strategy;
- conducting capital flows management, as well as imposing targeted macro-prudential measures.[4]

The central bank believes that such a comprehensive policy mix could maintain the capital inflows trend, shift the composition of investment in financial instruments, expand foreign direct investment (FDI), and eventually contain exchange rate volatility.

Concerns over Liquidity Constraints

Liquidity constraints will continue to be a concern at least until next year. As of April 2014, the loan to deposit ratio (LDR) of the banking system had reached 90.8 percent, almost hitting Bank Indonesia's 92 percent threshold for individual banks, at which point they have to increase their minimum reserve requirement.[5] Deposit growth has been declining since July 2012. This has constrained the supply side of credit. However, the demand side of credit also shows weakness, especially in the mining sector, possibly due to lower commodity prices and the ban on mineral exports implemented at the beginning of this year. This is partly evident from the narrowing of the net interest margin, where increases in the deposit rate have not been accompanied by increases in the lending rate,[6] indicating weak credit demand because of the inability of banks to pass on the higher cost of deposits to lenders of credit.

The Mineral Export Ban and its Impact on Exports and Fiscal Revenues

The big elephant in the room for Indonesia is its recent ban on mineral exports and the resultant pressures it has placed on export and fiscal tax revenues. The ban was introduced in 2009 through the Law on Mining of Coal and Minerals.[7] One of the most significant changes under the law is the requirement for miners to "increase value added" by conducting ore processing and refining activities domestically (Article 102-103). Then, on January 1, 2014, the government went further by banning exports of all raw minerals except coal, though some mining companies are engaged in high-level talks with the government to secure exemptions.

At a time when Indonesia must narrow its current account and fiscal deficits, the mineral export ban has proved to be a further burden on growth. The contribution of net export growth to year-on-year growth in the first quarter of 2014 declined to minus 0.1 percent, compared to the fourth quarter of 2013, when exuberant minerals export growth was the main driver of growth. The mineral export ban not only hurts the current account balance but also the fiscal balance given lower tax revenues from mineral exports.

By January 2014, the Investment Coordinating Agency had issued investment permits for 30 companies to build smelter plants. If projects stay on track, three will be completed this year and the rest in the next two years, with total value of over $12 billion. The question remains whether the rate of investment in smelters and the rate of exports of smelted products can make up for the rate of loss in exports of raw minerals and fiscal tax revenues.

FDI as a Stable Source of External Financing

Investment has been relatively strong in Indonesia for the past few years. Gross fixed capital formation has increasingly contributed to Indonesia's growth—from 17 percent in Q1-2009 to 24 percent in Q1-2014, reaching a peak of 45 percent in Q2-2012. Similarly, from the external balance's point of view, net FDI inflow has also been significant for the past few years—from $1.9 billion in Q1-2009 to $4.5 billion in Q1-2014.

FDI has been an important and relatively stable source of external financing, while portfolio investment has been much more volatile. Net FDI was $2.2 billion in 2007, and increased to $22.3 billion in 2013 with relatively low volatility, while net portfolio investment was $5.5 billion in 2007 and $9.8 billion in 2013, with relatively high volatility reaching $13.2 billion in 2008. FDI is important since some parts of Indonesia's current account deficit are structural, such as trade in services and the oil-and-gas industry, which need stable, long-term foreign investment.

Although volatile, portfolio investment in Indonesia's sovereign bond market, Surat Utang Negara (SUN), has been stable. Currently, about 30 percent of Indonesia's SUN is foreign-owned, compared to 16.6 percent foreign ownership at the end of 2007. As part of macroeconomic prudential measures in response to massive capital inflows from 2009 to mid-2012, the central bank set policies to shift the composition of portfolio investment in financial instruments to a more productive portfolio.[8] By February 2011, the central bank stopped the issuance of the Central Bank Certificate, Sertifikat Bank Indonesia (SBI), with maturity less than nine months.[9] Investors shifted their investment from SBI, a monetary instrument and not an investment instrument, to bonds and stocks. While, foreign ownership of SBIs dropped from 39 percent in 2009 to just 1.2 percent in September 2012, foreign ownership in SUN remained strong at around 30 percent. By 2010, FDI also began to play a more dominant role in the capital flows composition. Whether or not this trend will continue will partly depend on the premium of investing in the financial market versus the real sector.

Much of the increase in FDI since 2009 has been driven by the primary sector—invested mainly in the mining sector (including coal) and food crops and plantation industries (including palm oil)—and the secondary sector—mainly in motor vehicles and other transport equipment, the food industry, and metal, machinery, and electronic industries.

Setting the Right Mindset for Trade and Industrial Policy[10]

One of Indonesia's greatest reform challenges is to set the right policies and mindset to tap Indonesia's potential for investment and complete its structural transformation. The end of the commodity boom in 2012 means that the appetite to invest in the commodities sector is likely to continue to decline. This encourages the government to set an industrial policy to contain imports by protecting or developing import-substitution industries and to boost non-commodities exports.

There is a sense of *déjà vu* inherent in Indonesia's 2014 trade and industry laws. These new "twin sisters" protect domestic markets and import-substitution industrialization, just as they had in the 1970s and early 1980s, and serve only to confirm Indonesia's increasingly inward-looking trade and industrial policy. The government has stated as much publicly: "The trade law affirms our standpoint that Indonesia does not fully embrace free trade,"[11] and "with the implementation of the newly approved industrial law, Indonesia will have a strong legal base to promote import substitution as well as downstream industries in efforts to reduce the manufacturing sector's heavy reliance on imports of components and machinery."[12] The detailed articles of the trade and industrial laws permit significant discretionary protectionist actions by government.

Although what is stated in the law is important, what is omitted is much more significant. There are at least two important clauses missing from the trade law, which might give some indication as to how the law will be implemented. Firstly, the law does not mention Indonesia's international obligations under WTO agreements and the ASEAN legal framework. In fact, it goes so far as to state that the government, with the approval of parliament, can review and/or cancel the existing international trade agreements.

Secondly, the law makes no mention of how the huge discretionary power given to the minister of trade over the implementation of regulations will be made accountable and transparent. This is particularly important since the regulation-making process is still extremely weak, if not absent, and allows for loopholes to be exploited for rent-seeking activities related to licenses and quotas. Although Indonesia has a national law to regulate the issuance of regulations, namely the National Law No.12, 2011, which requires some cost-benefit analyses, academic studies and public consultation before issuance of high-order regulations, the implementation rules for this law have yet to be published. Also, it does not apply to lower-order ministerial decrees. The silence on good regulatory processes in the law could create uncertainties and huge economic inefficiencies, such as those stemming from Indonesia's export policies on raw minerals, foreign-ownership restrictions on mining investment and agricultural and livestock trade policies.

What can we learn from the past? It is remarkable how easily we forget about the failures of protectionist trade and import-substitution industrial policies, as Thee Kian Wie recorded in his 1984 paper.[13] Trade and industrial policies will impact the nature of FDI and, in the longer term, any structural transformation in the future. During the period of import-substitution trade and industrial policies, FDI in manufacturing served Indonesia's protected industries. Only with Indonesia's shift to an export-oriented strategy did FDI in manufacturing follow suit. From 1987 onwards, Asian Newly Industrialized Countries (NIC)—namely South Korea, Taiwan, Hong Kong and Singapore—that were suffering from increasing domestic real wages and rents, dominated Indonesia's FDI with export-oriented projects. The share of NIC investment out of total approved FDI rose from 14.6 percent in 1987 to 57.9 percent in 1990, and the share of export-oriented projects in 1990 from Asian NICs reached 83.6 percent.[14] By contrast, in the years prior to 1987, dominant Japanese FDI was very much "anti-trade oriented" because it came in to fill in the protected domestic market's demands for banned imports products. Moreover, most of the components and parts of Japanese FDI were imported from Japan through implicit agreement between Japanese investors and their Indonesia counterparts.

What impact on trade and industrial policies do we expect to see with the passage of the new laws? Import-substitution industrialization seems to be the way chosen for Indonesia. Inward FDI will tend to flow more towards industries for which inputs are available domestically, i.e., those products with no high-import components, which are very limited at this stage. With a lack of regulatory clarity creating uncertainties in the imported intermediate input markets, coupled with its underdeveloped infrastructure, Indonesia is less likely to attract FDI for global value chains. How does this import substitution affect the domestic economy? Import substitution can take the form of protecting upstream industry from foreign competition, essentially by taxing downstream processes involving protected inputs. As a result, the economy will likely become less efficient.

In addition, as a result of excessive domestic protection for import substitution industries, there will be fewer incentives for domestic producers to focus on globally competitive products. How will these inefficiencies affect the economy? Studies show that all forms of protectionist measures have negative effects on growth and trade.[15] A decline in growth will undermine the government's objective to reduce unemployment and poverty, which leads to the question of just how long the economy can sustain lower growth.

Given the sizeable challenges for domestic industry, such as dilapidated infrastructure, as well as a huge untapped domestic market and emerging consuming class, import substitution may make some sense. But at the least, such measures must be pursued in an accountable and transparent way. Discretionary decision-making processes to protect trade and certain domestic industries will simply institutionalize corruption and rent-seeking activities.

Given such "open-ended" trade and industrial laws, monitoring the subsequent implementation of regulations will be necessary. Ministers must adhere to good regulatory practices as required under National Law No.12, 2011, even if the law does not technically apply to ministerial decrees. The government should also take into account the views of consumers, which risk losing out to those of the more politically influential domestic producers. Without such precautions, Indonesia will continue to suffer from uncompetitive industries, lower growth, and higher rates of unemployment and poverty.

Inequality and Regional Convergence

Inequality has been rising steadily since 1999 in Indonesia, as elsewhere. Between 2003 and 2010, consumption among the poorest 40 percent grew at only 1 to 2 percent per year, while for the richest 10 percent it grew at 6.5 percent, and 5.5 percent for the second richest decile.[16] Indonesia's strong growth hides distributional problems. Inequality rose 11 percent between 2000 and 2013, and even that figure is likely to be underestimated because of the absence of top income earners from household surveys.[17]

What explains this rise in inequality? There are two reasons. The first reason is rising inequality in capital income. This is essentially Thomas Piketty's argument that the rate of return on capital is much higher than the growth rate.[18] Though data on capital income are sparse, we can estimate the return on capital. Between 2002 and 2013, the Indonesian Stock Exchange Composite Index rose by 22 percent per year (11 times in nominal value), while the corresponding property price index increased by 23 percent per year (12.5 times in nominal value), compared to a 7 percent annual rise in the consumer price index.[19] High returns to capital would not be a problem except for the fact that access to capital remains extremely limited and ownership of capital is highly concentrated. For example, in 2013, only about 1.2 percent of Indonesian households had active mortgage loans with banks.

The second reason for rising inequality in Indonesia is rising inequality in wage income.[20] Real wages for more highly skilled workers (those with tertiary education) have grown by about 20 percent between 2002-13, while wages for unskilled workers (those with primary education or below) have grown much less rapidly, by around 9 percent.

Conclusion

For the past decade, Indonesia's strong growth has hidden serious structural issues. Strong growth has not led to equally distributed growth. Indonesia's reform agenda in the short-term should be to continue with its pro-stability monetary policy. In the medium and long terms, the government should set the right policies and mindset to tap Indonesia's potential for investment and complete its structural transformation. Regulatory and policymaking reforms will be key. Indonesia's next administration under the presidency of Joko Widodo will face enormous fiscal challenges, especially in reforming fiscal subsidies. It will also face a very complex political system with a parliament dominated by a coalition of opposition political parties.

Indonesia's reform challenges are not unique among emerging countries but point to the country-specific challenges that will determine whether or not the country converges with advanced economies.

References

Hoda, Anwarul, and Durgesh Kumar Rai. 2014. "Revitalizing India's Manufacturing Industry." East Asia Forum, September 24.

Huang, Yiping. 2014. "China's mini-stimulus package can't support rapid growth without broader reform." East Asia Forum, August 10.

Ilmma, Amri, and Matthew Wai Poi. 2014. "Patterns of Regional Poverty in the New Indonesia." Chapter 5 in Regional Dynamics in a Decentralized Indonesia, Ed. Hal Hill, ISEAS Publishing, Singapore.

OECD. 2012. "Towards A More Open Trading System and Job Rich Growth." available at http://www.oecd.org/trade/50452757.pdf

Piketty, Thomas. 2014. *Capital in the Twenty-First Century*. Belknap Press, First Edition.

Sarwono, Hartadi A. 2012. "Managing Capital Flows: Indonesia's Experience." paper Presented in RBI-ADB Conference on Managing Capital Flows, Mumbai, India, on November 19.

Spence, Michael. 2011. The Next Convergence. *The Future of Economic Growth In A Multispeed World*. D&M Publishers, Inc., New York.

Thee, Kian Wie. 1984. "Japanese Direct Investment in Indonesian Manufacturing." Bulletin of Indonesian Economic Studies, 20:2.

Thee, Kian Wie. 1991. "The surge of Asian NIC Investment into Indonesia." Bulletin of Indonesian Economic Studies, 27:3, 55-88.

World Bank. 2013. "Bolza Família. Brazil's Quiet Revolution." available at http://www.worldbank.org/en/news/opinion/2013/11/04/bolsa-familia-Brazil-quiet-revolution

World Bank. 2014. Indonesia Economic Quarterly. July 2014.

Endnotes

1. These are the author's personal views that do not necessarily reflect the views of the World Bank nor those of its Board of Directors
2. World Bank, IEQ (2014)
3. World Bank, IEQ (July 2014)
4. Hartadi, 2012
5. World Bank, IEQ (July 2014)
6. World Bank, IEQ (July 2014)
7. Law 4 (2009)
8. Hartadi (2012)
9. SBI is a monetary instrument used by the central bank for sterilization purposes.
10. This section is taken from unpublished article by T. Anas and M.M. Wihardja, 2014.
11. Source: http://www.theaustralian.com.au/business/jakarta-freely-admits-it-is-shielding-local-stakeholders/story-e6frg8zx-1226830971710#
12. Source: http://www.thejakartapost.com/news/2014/02/07/ri-focus-import-substitution-industry.html
13. Thee (1984)
14. Thee (1991)
15. OECD (2012)
16. World Bank, IEQ (July 2014)
17. Ibid.
18. Piketty (2014)
19. World Bank, IEQ (July 2014)
20. Ibid.