

Rethinking economic policies in Indonesia

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Recent news headline: 'Red-White Coalition Would Not Accept Sri Mulyani as Minister'

- An activist from the Human Rights Commission for Social Justice ... said Joko should avoid appointing Sri Mulyani.
- 'She would not be a good minister because she was frequently *associated with neoliberal economic concepts that he said were not suitable for Indonesia*'.

'Neoliberal' economic concepts

- People who use that term typically don't know what it means – and it means different things to different people
- In my own view, neoliberal economics involves:

using economic analysis to design and/or analyse economic policies relative to the *objective of maximising the benefit to the general public* and, especially, to those who are relatively *less well off*

- I think all of us here would agree with these objectives
- So: are we all neoliberals?
- Let us forget about labels that stifle debate, so we can concentrate on objective economic analysis!

In this presentation, my aim is to analyse a number of current economic policy issues in terms of exactly that objective:

maximising the benefit to the general public
and, especially, to those who are relatively
less well off

A preliminary observation

- Most of the policy errors to be highlighted here have also been made, and some continue to be made, in Australia
- So Indonesia can learn a lot from Australia's mistakes

Growth before and after Soeharto

- Economic growth was faster during the Soeharto era than it has been subsequently
 - Incomes increased by two-thirds per decade *vs* less than half per decade
- Inequality has also been rising in the recent post-Soeharto era
- The implication is that economic governance was better under Soeharto than subsequently
- Better design of economic policy is what is needed
- I have a long list...

1 Energy subsidies

- When oil and gas are taken out of the ground, Indonesia is using up some of its assets
- Sensible policy would be to *convert underground assets to aboveground assets*, particularly infrastructure
- This was the policy under Soeharto (INPRES)
- SBY policy was to consume those assets, *resulting in net asset depletion*
 - Not surprising that growth is being held back by inadequate infrastructure
- A large proportion of the energy subsidies go to higher income groups
 - Not surprising that inequality is increasing

1 Energy subsidies

- Jokowi off to a good start?
- Retail price of petrol already increased significantly
 - Saving US\$8 billion p.a.
- But...
- SBY did the same thing when he first came to office
- Neither president abolished the subsidy altogether
- And neither even cut the link between the size of the subsidy and the world oil price
- So, if world oil price increases, Indonesia is back to square one

2 Minimum wages and poverty/inequality

According to the late Milton Friedman (top neoliberal economist and Nobel Prize winner):

“The real tragedy of minimum wage laws is that they are supported by well-meaning groups who want to reduce poverty. But the people who are hurt most by high minimums are the most poverty stricken.”

Why so?

2 Minimum wages and poverty/inequality

- Imposing minimum wages makes it *unprofitable to employ low skill labour*
 - Suppose employing an extra unskilled (i.e. low productivity) worker would increase my firm's revenue by \$100
 - But the government forces me to pay that worker \$120
 - My profit would fall by \$20
 - Obviously, I would not employ that worker
 - I would look for more productive (more highly skilled) workers
 - And/or I would consider producing different products that don't use low skill labour
- (Exam question: When you live in Indonesia, do you employ a *pembantu*? How about in Australia? Discuss.)

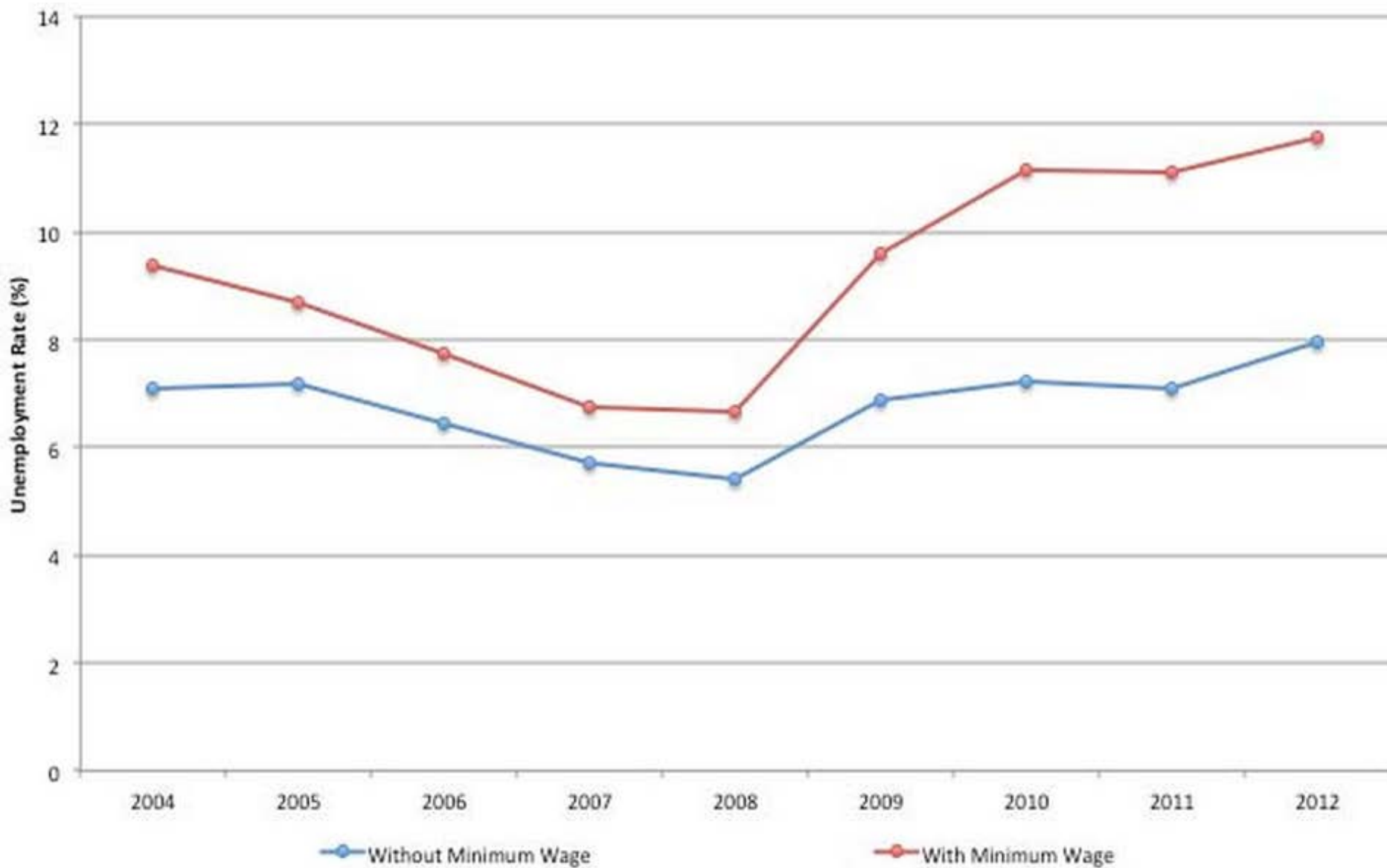
2 Minimum wages and poverty/inequality

- Indonesia's poorest/least skilled workers have lost income-earning opportunities
- They are forced to remain in the informal sector (where the regulations are not enforced), where remuneration is lower
- Minimum wage is not about workers *vs* employers
- It is about low-skill *vs* higher skill workers
- We pretend to care about the poor, but in fact we prevent them from competing for work in the best market
 - It is not surprising that inequality is worsening

2 Minimum wages and poverty/inequality

- There are countries in the world that *do not have* minimum wage legislation
- E.g. in the European Union:
 - Austria, Cyprus, Denmark, Finland, Germany, Italy, and Sweden
- Average *unemployment rates are significantly lower* in these countries

Average Unemployment Rate of EU Countries With & Without Minimum Wages



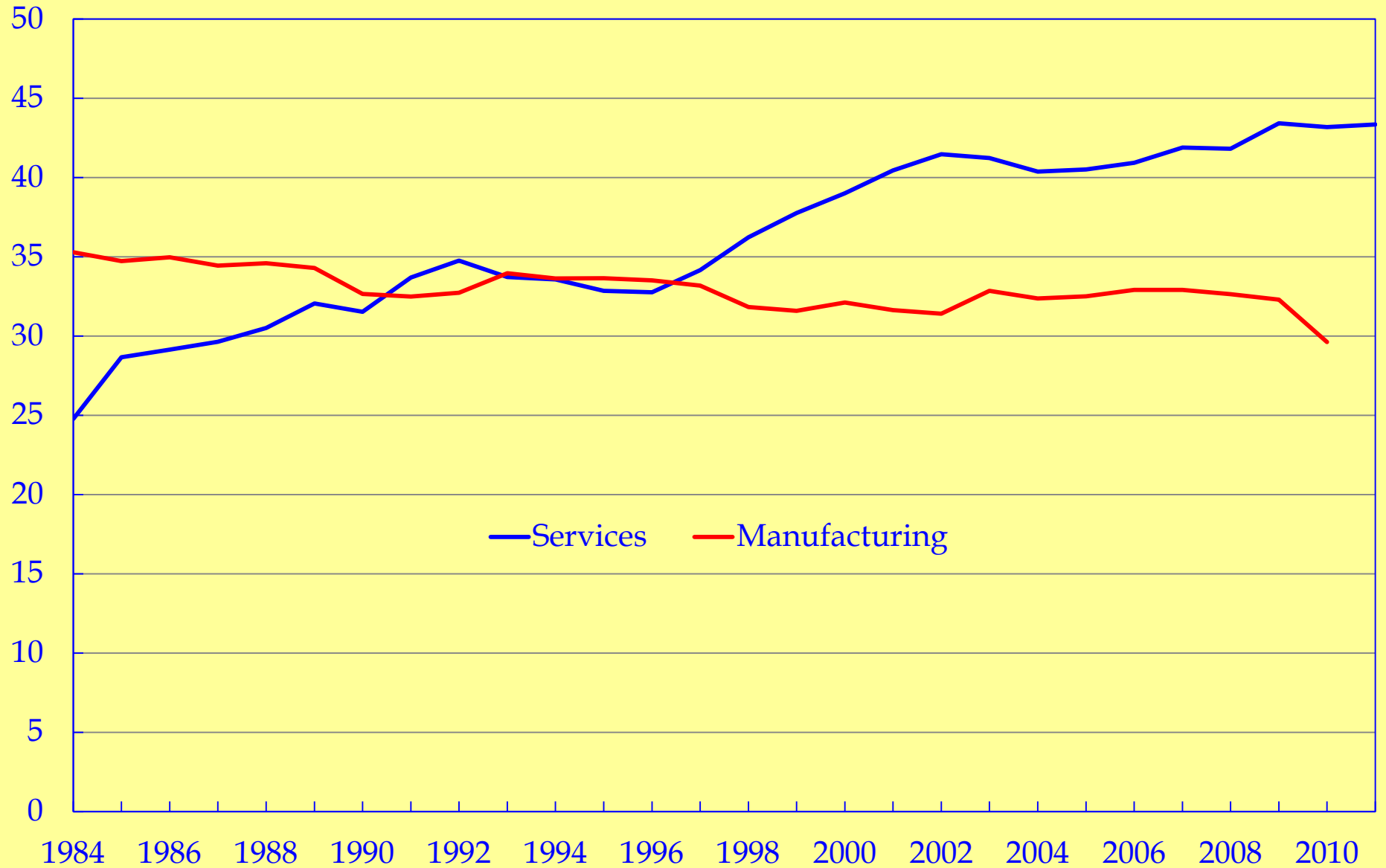
3 The decline of manufacturing

- Current concern about the declining role of manufacturing is misplaced
- It should be seen as a sign of success
- All countries, as they develop, experience this
- Our consumption patterns change as we become better off
- We *demand more services*, most of which cannot be imported
- So we must produce more domestically, which requires reallocation of labour and capital from manufacturing, causing its share to decline
 - The peak share of manufacturing in GDP is 25-35%

3 The decline of manufacturing

- China has the best growth performance of all countries over the last 2 decades
- Is this because of its manufacturing sector?
- No! Manufacturing has generally grown more slowly than the economy as a whole: it has been a drag on growth in that sense
- The share of manufacturing has declined throughout this period
- And the share of services has steadily increased

China: Shares of Manufacturing and Services in GDP (%)

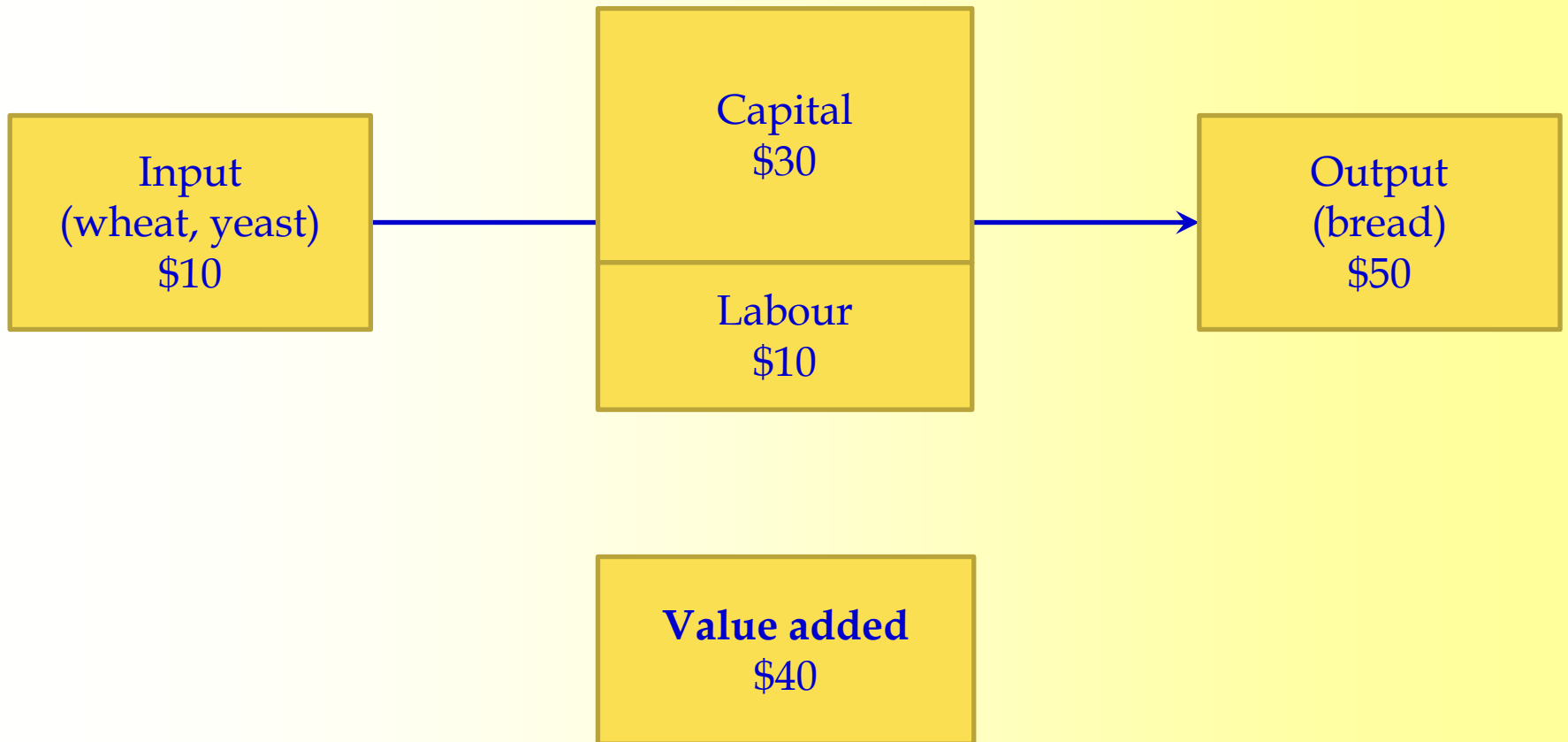


4 'Value-adding' in minerals

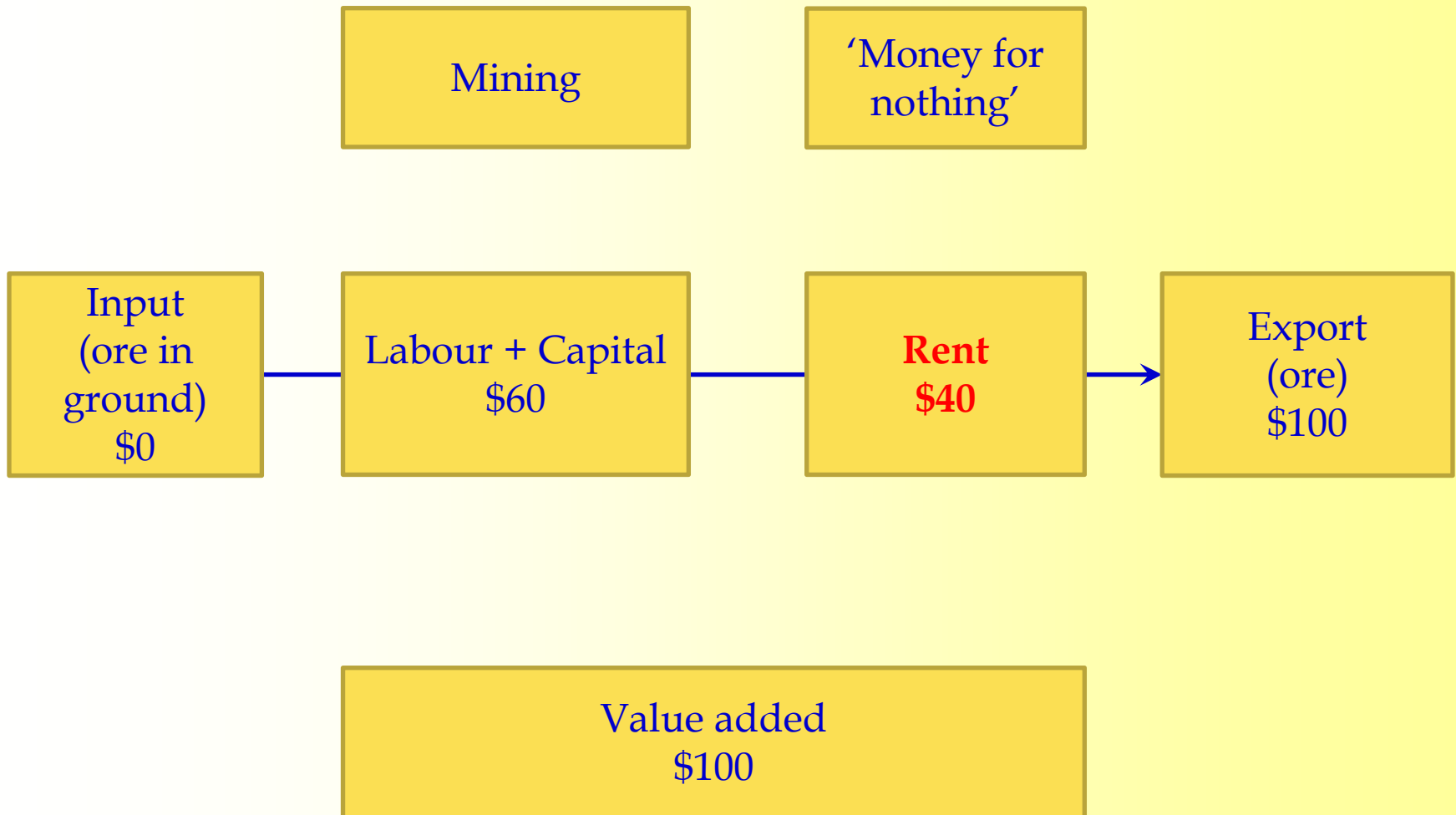
- Policy should ensure that Indonesians derive maximum benefit from exploitation of their natural resources
- How to achieve this?
- Old policy: export unprocessed ore (@ say \$100/ton)
- Current policy: process ore and export metal (@ say \$500/bar)
 - Allegedly resulting in 'greater value added'
 - Note that assumed world prices imply processing cost (world's best practice) is \$400/bar (or \$400 per ton of ore)
- What *is* 'value added'?

Concept of Value Added in Production

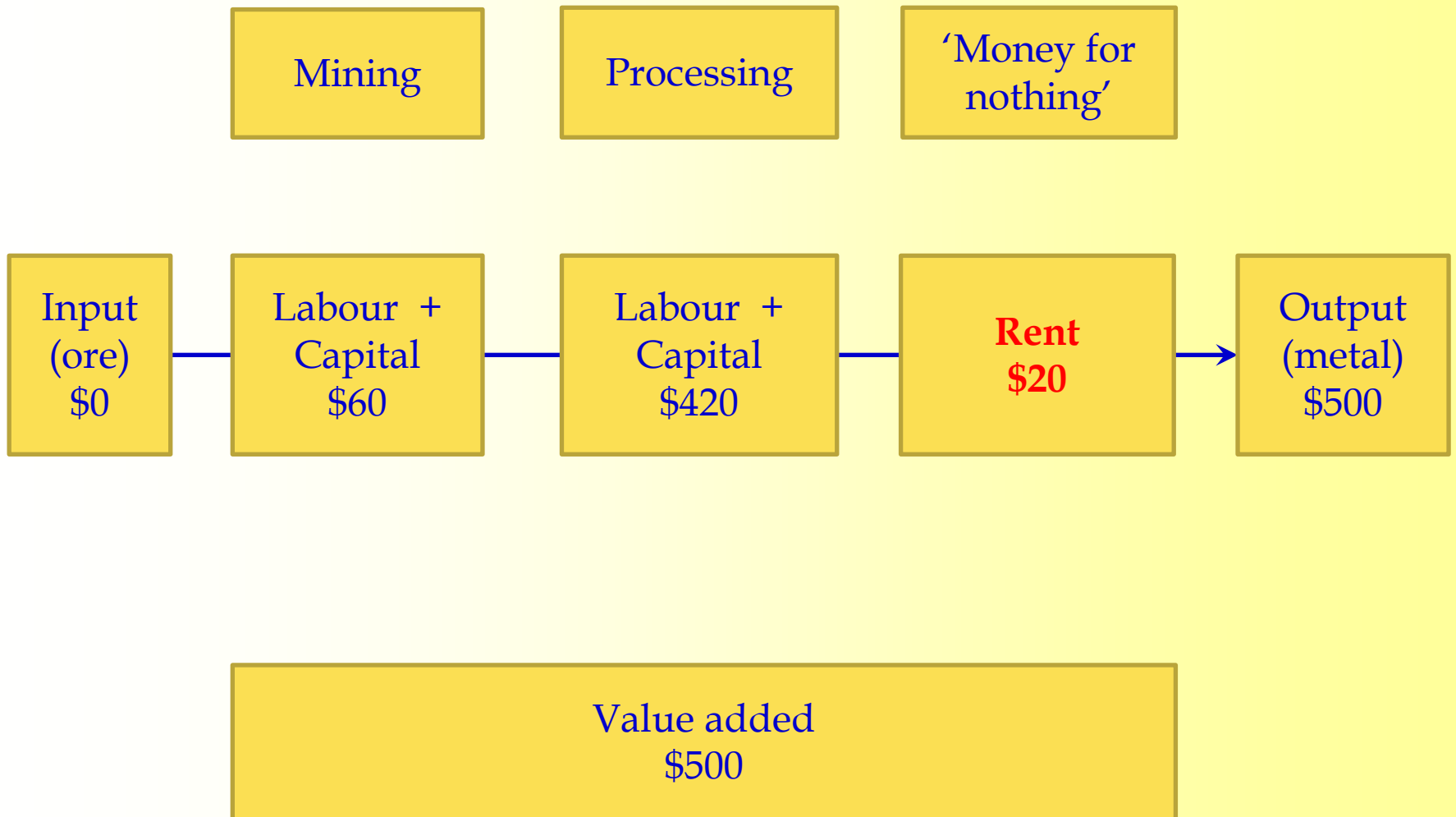
(simple case of bread making)



VA with Natural Resources Rent (1)



VA with Natural Resources (2)



4 'Value-adding' in minerals

- Big gain (5x) in VA in this sector (from \$100 to \$500/ton)
- But this is *at the expense of* VA in other sectors, due to the reallocation of labour and capital
- Bottom line: gain to Indonesia from exploiting this natural resource (the rent) *falls* from \$40 to \$20 per ton
- I assumed domestic production cost is higher (i.e. Indonesia is not as efficient as world's best practice)
- Reasonable?
- If Indonesia was world's best practice, the market would ensure processing occurred in Indonesia, without any compulsion from government
- Conclusion: Indonesia is shooting itself in the foot!

5 Infrastructure

- Infrastructure spending has been much lower in the post-Soeharto era
- SBY claimed the government couldn't afford what was needed
- 10 years ago the SBY government had great hopes that the private sector would supply the finance needed to construct new infrastructure through PPPs
- Two international infrastructure summits with that objective have achieved almost nothing
- The SBY government offered two excuses:
 - Private sector can't get finance
 - Too difficult to acquire the land needed

5 Infrastructure: finance

- Instead of private sector finance, three new government financial institutions have been established
 - The effect of which is to put infrastructure back into the budget!
- Indonesia has a long history of creating government financial institutions to deal with supposed financial constraints
 - Remember Bapindo? Askrindo? Bank Ekspor Indonesia?
 - These all achieved nothing (except to lose money)
- In fact it is not a problem for the private sector to finance very big projects
 - Provided there is a *reasonable expectation of sufficient profitability* to offset the risks involved
 - But government insistence on controlling pricing (user charges) leaves potential owners subject to vagaries of politics
 - Evidently the risk is unacceptable

5 Infrastructure: Land procurement

- Difficulties with land procurement are always the main excuse for lack of progress
- Existing landowners have no incentive to see land disputes resolved quickly
- Landowners (or land speculators) hope to gain by holding out for a higher price
- Relevant parts of the bureaucracy have no incentive to see land disputes resolved quickly
- Bureaucrats are able to ensure that excessively high prices are paid eventually in return for kickbacks
 - Just as with other forms of government procurement

5 Infrastructure: Land procurement

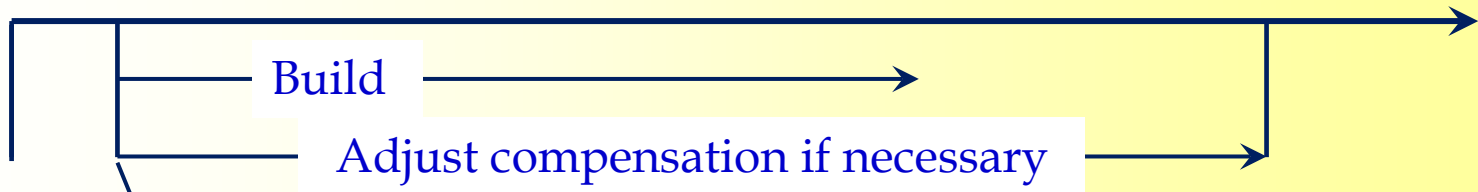
- The solution will *not* be found in the new law
 - Already the 2012 law is proving ineffective
- The Constitution (Art. 33) clearly empowers the government to take over land in public interest
- Laws since 1960 have required it to pay fair compensation
- The solution is to keep *land acquisition* separate from *compensation*
 - Take over land *immediately it is required* (with reasonable advance notice), *with immediate compensation*
 - Landowners should then have the right subsequently to *challenge the compensation amount in court* (at the risk of possible downward adjustment)

Current timeline



Identify
needed
land

Accelerated timeline



Identify
needed
land

Acquire land
and pay
compensation

5 Infrastructure: Land procurement

- In short, building the infrastructure does not need to wait until the compensation issue is settled
- The Constitution puts all the bargaining chips in the government's hands
- Existing landowners only have bargaining power because the government gives it to them unnecessarily

6 The current account deficit

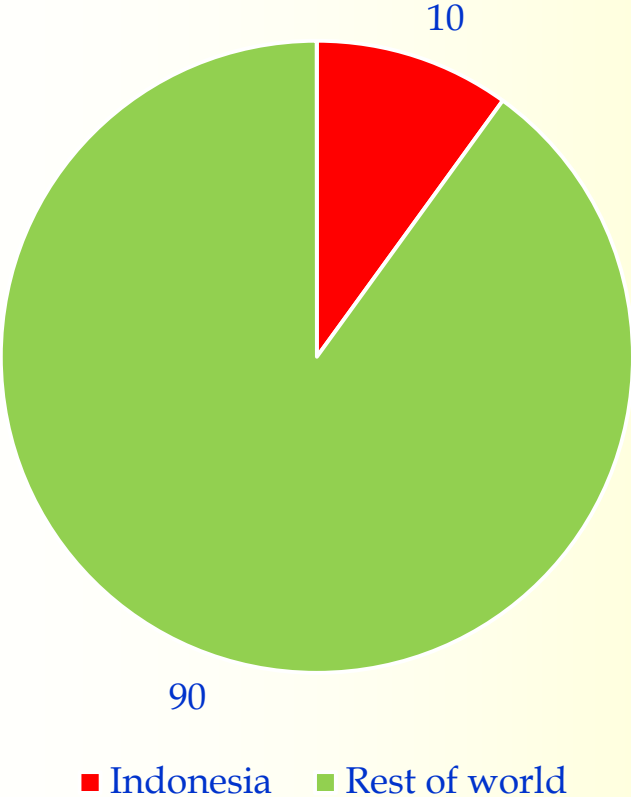
- The standard, fundamental measure of economic progress is national income per capita
- Our income determines our living standards
- The current account deficit does not
- If we want to look at how average living standards are changing, we look at the growth of national income, not the current account deficit

6 The current account deficit

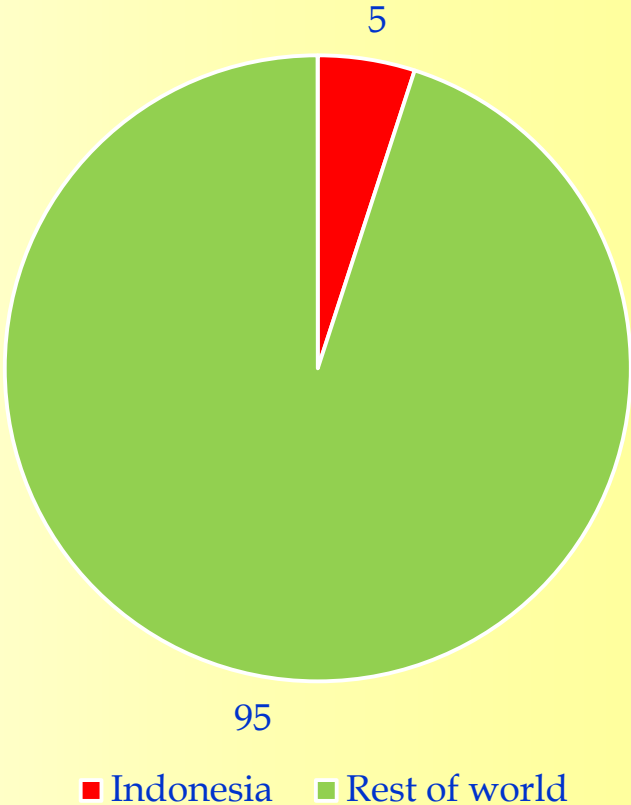
- The current account deficit (roughly speaking, the gap between imports and exports) is typically offset by a capital account surplus (capital inflow)
- If the current account deficit increases, investors may get nervous, leading to capital outflow
- Or, conditions in world financial markets may change, with the same result
- This is merely a rebalancing of portfolios such that Indonesia has a smaller weight

Rebalancing international investment portfolios

When Indonesia looks good...



When Indonesia looks dubious...



Rebalancing international investment portfolios

- How to get from 10 to 5?
- Exposure to Indonesia is determined by:
 - Quantities (of shares, bonds, SBIs etc), *multiplied by*
 - Prices (in Rp), *divided by*
 - Exchange rate (Rp/\$)
- In the absence of BI or government intervention, prices will fall, and Rp will depreciate
- 10 down to 5, problem solved!
- If you're quick, you'll sell (reduce quantity) before prices change
- But once the prices have changed, what you feared has already happened
- Your portfolio has been rebalanced, so no incentive for capital outflow remains

6 The current account deficit

- Indonesia hardly suffered at all from the global financial crisis (2008-09), precisely because it allowed the rupiah to depreciate while keeping control of the money supply
- It suffered enormously in 1997-98 AFC because it neglected the latter
 - But the authorities haven't figured this out yet...
- During the greatly over-rated 'Bernanke crisis' of mid 2013, Indonesia eventually got around to doing the same
- Bottom line: Balance of Payments crises are usually the consequence of poor macro policy
- Policy makers need not lose sleep over the current account deficit

7 Growing inequality

- What matters most is that poverty should be falling
- This is the case in Indonesia
- The poor are getting richer, but many Indonesians are able to seize opportunities through education and initiative to earn considerably higher incomes
- Political instability is the result of poorer people having the perception that *richer people are getting rich through corruption*
- This perception undoubtedly exists in Indonesia
- The focus should be on *combating corruption*, not inequality *per se*

8 The 'middle income trap'

- This is a crazy concept
- There is a specified upper level that defines 'middle income' (roughly US\$12,000?)
- For a country to be 'trapped' below this level, its growth rate needs to fall to 0!
- That is not in prospect for Indonesia
- Indonesia will not experience any noticeable change in its living standards on the day it crosses the threshold
- What matters is the steady increase in living standards day by day, and this depends only on the growth rate
- All we need to worry about is *maximising economic growth*: there is no trap!

9 Bank lending to small businesses

- It is true that banks lend relatively little to small businesses
- It is also true that *small businesses are thriving*: there are millions of them in Indonesia
- So they are managing to finance themselves somehow
- Some small businesses don't grow simply because their owners are not good entrepreneurs
- Beware of the *solution in search of a problem!*

9 Bank lending to small businesses

- Small business minimises its capital needs by hiring or renting capital items and by purchasing second-hand capital items
- Small business borrows in the form of trade credit and supplier credit and from informal sources
- Small businesses that are well run make large profits, which they reinvest
- Banks cannot compete very well with all these financial options
- Relax! No need to fuss over small business financing.

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Decline of Manufacturing in Selected 'Industrialised' Countries (% of GDP)

