

Indonesia's Domestically Driven Growth: Where Will the Jobs Come From?

A Joint Open Forum With

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A recent study by the Asian Development Bank (ADB), [Asia 2050: Realizing the Asian Century](#), stated that if Asia continues in its current growth trajectory, by 2050 per capita GDP will attain a level similar to Europe today. The study cautions, however, that Asian countries will have to overcome the middle-income trap, a situation that occurs when a country's growth plateaus and stagnates after reaching middle-income levels, unable to move up to more value-added production. While other Asian countries have based their growth on manufacturing exports, Indonesia has been a remarkable example of growth driven by domestic demand. However, employment generation has been a challenge in Indonesia since the 1998 Asian financial crisis. In fact, fewer jobs were created through manufacturing exports in 2005 than before the crisis.

On August 30, 2012, USINDO hosted a Joint Open Forum with ADB and The National Bureau of Asian Research. Douglas H. Brooks, Assistant Chief Economist and Director of the Development Indicators and Policy Research Division of the Asian Development Bank presented, while Meredith Miller, Vice President of Trade, Economic, and Energy Affairs & Outreach at The National Bureau of Asian Research (NBR) and Director of NBR's Washington, D.C. office moderated the discussion. This brief is USINDO's summary of the talk.

The presentation was based on insights from an October 2011 ADB Economics Working Paper by Haryo Aswicahyono, Douglas H. Brooks, and Chris Manning entitled [Exports and Employment in Indonesia: The Decline in Labor-Intensive Manufacturing and the Rise of Services](#).

Macroeconomic Picture

Following the Asian Financial Crisis, economic growth in Indonesia has been stable; as well the country was only mildly affected by the global financial crisis in 2009. This stability was largely due to stronger regional economic ties, a healthy share of private consumption, and sound macroeconomic fundamentals sustained by fiscal reforms undertaken during the post Suharto era. The healthy growth figures, the size of Indonesia's economy, and the size of its market (population) have made Indonesia the country to watch among the Southeast Asian nations.

However in recent years, with regard to exports, Indonesia tends to be highly dependent on mineral and oil and gas products. This is a reversal from the 1980s where the country deliberately and successfully diversified away from oil and mineral products as world oil prices plummeted, with exports of labor-intensive manufacturing products growing tremendously.

There are also fundamental weaknesses that can threaten Indonesia's sustained growth.

1. While the economy has generally remained open throughout the Asian Financial Crisis, the same cannot be said of services. This is an important issue because services lubricate an economy, thereby facilitating economic activities and transactions. Indonesia can benefit highly from improvements in services brought about by competition. This is especially true for infrastructure services.
2. Important reforms such as those on investment laws (contraction of the negative lists) were pushed shortly after Suharto stepped down. But the implementation of these reforms has been slow, patchy, and inconsistent.
3. Decentralization of government functions was a very big systematic reform that Indonesia went through. This has empowered local governments to tailor policies according to the needs of constituents. But the flip side of this is that the multitude of laws and policies vary across the country such that uncertainty is heightened, and transactions/information costs increased. This situation tends to encourage rent seeking behavior. Overall, they may contribute to a deterioration of the investment climate.

Another concern about the Indonesian economy is that productivity remains low, and that productivity growth has mainly been driven by the accumulation of capital rather than increase in labor productivity due to skill accumulation.

Indonesian Labor Market: Patterns and Trends

In 2009, the Indonesian labor market was characterized as one with a supply side that consists of a large, youthful, and low skilled population, and a demand side made up of a large agricultural sector (a tradable sector of agriculture, mining, and manufacturing, and a large non-tradable sector). A large part of the labor force was employed in poor quality

jobs, as is demonstrated by the large informal sector (61.2%), and the percentage of white-collar workers in the labor force. There were high rates of unemployment among the educated, as well as low agriculture productivity and low real wages.

The agriculture and services industries are the main employing sectors in the economy. In rich countries, as the economy becomes more knowledge intensive, deindustrialization occurs, causing the manufacturing sector to shrink and the services sector to expand. However this is not happening in Indonesia. The large services industry is a reflection of an increase in low skilled employment as housemaids, drivers, sales clerks, hawkers, or market vendors. As is the case in most countries, youth unemployment is also higher than among the population as a whole – over twice as much.

When we compare 2009 statistics with the time before the Asian Financial Crisis, we see a dramatic decline in the rate of job creation outside agriculture. Also, the share of employment in light manufacturing industries has declined, with a slight increase in the share of those employed in heavy industries and chemicals. But the job creating potential of the latter industries is much less compared to the labor-intensive light manufacturing activities.

The Indonesian modern sector labor market has always been highly regulated, and historically closer to those of the Philippines and Brazil than Malaysia and Thailand. But compliance is low and regulations have been fragmented. Post Suharto reforms improved some aspects of the labor market but regulations, in general, remain restrictive. These reforms are in contrast to general international trends towards increasing labor market flexibility, and increasing access and range of safety nets.

Exports and Employment Nexus

The October 2011 ADB Economics Working Paper tried to address what role exports have in generating employment. The analysis covers five main industries: primary, food processing, light industries, heavy industries and chemicals, and services. But the main focus is on manufacturing industries: light industries, heavy and chemical industries, and food processing.

Their analysis found that in absolute terms, the number of export-induced jobs has been increasing since 1985. As a proportion, it has more than doubled from 7.1% in 1985 to 16.6% in 2005. As of 2005, export activities are estimated to have induced close to 16 million jobs across all sectors. This particular analysis did not control for the amount of exports of each sector. But examining the jobs generated for every millions of dollars spent on exports reveals that job creation has been falling for most sectors. Though some sectors have shown increased job generation capacity when compared to their 1985 levels, such as the primary sector, light industries, and the services sector. Meanwhile, it is easily apparent that services, light industries, and the primary sector have the highest job generation capability per 1 million dollar of exports in these industries.

Examining the job generating capacity of manufacturing reveals backward linkages across sectors. The input output analysis shows that light industries, aside from creating jobs directly, have strong backward linkages to services and primary industries. It is also interesting to note that food processing creates a small number of jobs directly, but creates quite a significant number of jobs in upstream industries, notably in the primary sector. The same can be said of the heavy and chemical (H&C) industries although the effects are less in magnitude. An aspect of the H&C employment that is worth noting is the skill composition of workers employed in the sector. Compared to those employed in the primary and light industry sectors, skill levels are expected to be higher in the H&C industry. Therefore, higher exports of H&C products will only create more jobs if Indonesia has a sufficient supply of labor that meet the skill requirements of the industry.

In summary, the analysis shows a decline in the major labor-intensive export industries, with big impact on employment. There will also be broader implications within the labor market such as a halt in real wage increases and a decrease in labor being pulled from the agricultural sector. There have been big shifts in export values and employment across major industry groups over time. In 1985, pre-deregulation, the primary sector dominated, followed by a slight decline, and then re-asserted itself in the 2000s. Manufacturing exports grew fast after deregulation, and then saw a large decline in relative terms in the 2000s. Whereas the services sector (especially tourism) bounced around in export values but had a big influence in terms of indirect employment effects.

Policy Implications

The working paper recommends four areas for policy reform. First, supply side constraints within Indonesia are a major problem, specifically with respect to production, trade, and labor regulations. It is important for the country to focus on industries that create the most jobs for blue-collar workers. In addition, labor productivity remains low, which calls for investments in education, through formal or informal channels.

Second, the concern for the security of workers and their working conditions is a valid one, but the pursuit of these objectives should not come at the price of slowing investments and job creation. Labor regulations should be more employer friendly and responsive to changing economic circumstances. In addition, labor regulations should also provide greater worker social security through safety nets.

Third, Indonesia could benefit from a deregulation of international trade and investment services. In the short-term, this could be accomplished through opening business services, construction, and transport to overseas investors. In the long run, this can be done by allowing greater foreign participation in education and health, which would result in productivity and welfare gains.

Lastly, Indonesia should make better use of its comparative advantage in the food processing industries.

Questions and Answers

Q: What would be the impacts of an economic slowdown in China, as well as a prolonged slowdown in the G3 Economies?

Douglas Brooks – A slowdown would impact Indonesia's commodity markets, which are a big source of the country's exports. A slowdown in China would affect the quantity of exports and commodity prices, which could mean a significant drop in export income through the primary sectors.

Q: What opportunities do you see for U.S. firms in Indonesia?

Douglas Brooks – In Indonesia, the service sector is a low skilled, low-paid, low productivity area with a lot of room to move into higher value added activities. An improvement in this area depends on raising the levels of human capital through things such as an improved education system and better training. Although there is protectionism in these areas, as is the case in most countries, there is potential for opening up these sectors and bringing(?) in best practices as well as foreign investment to improve conditions, which should be a good market for U.S. firms.

Q: What is the practical likelihood of any changes in labor regulations?

Douglas Brooks – My best guess is that it will be a while before things change because the government wants to wait for a more stable political situation. We do expect the trend toward more reform to continue, but not at a rapid pace and not without some ups and downs.

Q: Discuss in more detail the mismatch with education and the workforce.

David Merrill (President, USINDO) – There is a lack of agreement within Indonesia about where the focus should be on education and what kind of jobs should be emphasized. There are some ministers and opinion makers talking about the need to create high value jobs for the 21st century, for an international economy. And yet there are others who feel the emphasis should be on vocational jobs, jobs mainly held by low-income people. There is still division on this issue and no coherent policy.

Meredith Miller – One of Suharto's great successes was instituting primary education throughout the archipelago. So you have very high literacy rates today. A recent OECD study, which focuses on higher education and some of the deficiencies in training, cites several international companies who state they have had to retrain many college graduates themselves. There is a lack of skills among the higher education set.

Q: Is a more social security oriented system likely in Indonesia?

Douglas Brooks – In terms of the social safety net, 60% of unemployment is in the informal sector, and people working in this sector generally are not covered by social safety nets.

There are short term and long-term issues. In the short term, it is important to make sure there is some social protection for everyone, but doing so for a large number of people is difficult in such a short time. Longer term, it is important to bring these people into the formal sector, which will help with the development of the social safety net. Education is a part of all this, and perhaps a debate within Indonesia about the goals of education would be helpful, not just among the ministers, but at lower levels as well.

In ADB's dialogue with the Indonesian government, they want us to focus more on higher education and technical education. For more insight on their approach to education, the government is borrowing money to fund projects that focus on higher education, and they are using grant assistance to fund projects that focus on primary and secondary education.

Samuel Tumiwa (Deputy Regional Director, Asian Development Bank) – ADB's education program in Indonesia is based on the discussion and dialogue that we have had with the government and because of these discussions is focused more on technical education and university education. The government recognizes the need to address issues within the entire education system and it is working with ADB and other donors to improve the system at all levels.

Q: What is the role of the pesantren (Islamic boarding school) with respect to the public schools?

Samuel Tumiwa – ADB gave a loan to the Indonesian government for public education to develop the *pesantrens*, but not much work has been done on this, the loan has not moved a lot. The problem with the work in this area is that the government is not in agreement, some want to promote *pesantrens* as an alternative, but some do not. The government seems to be recalibrating and moving toward a more secular public school system and the *pesantren* loan has since been canceled.

Q: Prabowo Subianto stated in a recent speech that 0.17% of the Indonesian population controls 45% of the GDP – is this a problem?

Douglas Brooks – This is a concern. [Asian Development Outlook](#), one of ADB's annual flagship publications, was released in April 2012 and has a special chapter about inequality in Asia. The trend we find across Asia is that inequality has been growing in recent years. Our study shows that in Asia it appears it may have reached a peak of inequality and that it is starting to decline. It is certainly something to watch in Indonesia. Income is the easiest dimension of poverty for us to focus on, but it is not the only one. There is new work in economics on trying to expand the range of dimensions of poverty and well being. We are trying to find better measures than just GDP or GDP per capita.

Q: Why have issues with infrastructure not been addressed by the government?

Douglas Brooks – Financing infrastructure is challenging for a government to do on its own. The private sector needs to get involved and working out the relationship between the public and private sector has a lot to do with risk allocation, procurement processes, and

the potential for abuse of those processes. Developing these public private partnerships appears to be our best hope of getting improved infrastructure, but this is impacted by the cultural and political contexts, and the enforcement of regulations.

Carol Hessler (former Managing Director for Infrastructure, Environment and Social Assessment at MCC) – Public private partnerships are not the answer in every case. It should be noted that the government has made great progress in addressing land use issues and that Parliament recently passed an imminent domain type law where land use is concerned and put in place the implementing regulations. Also, some feel, that Indonesia could benefit from looking at the use of management contracts.

Samuel Tumiwa – There is a lot of wealth in Asia that is being invested in the Western world. The question is, can we capture that wealth and have it invested in Asia. ADB has conducted research in this area. The idea is that ADB creates a fund – such as the ASEAN Infrastructure Fund or a fund for one specific country, the governments of these countries put money into the fund and ADB will co-finance through private sector operations. After two to three years of operating, we would like to have these funds rated, ideally AAA rated. This would free up a lot of domestic capital to invest domestically.

Q: Indonesian Ministry of Trade Regulation 27 deals with new import licensing requirements specifically, foreign companies can import products throughout production or import finished product for distribution, but no one company can do both. What effect do you think the new trade policy will have on job creation and foreign investment in Indonesia?

Douglas Brooks – I would expect a small effect. Companies will find ways around the regulation.

Q: In your research did you examine the difficulty of navigating fees of entry, i.e. unpublished fees and corruption?

Douglas Brooks – No, in our study we focused on the quantitative relationships between different parts of the economy and not the policies influencing them. The World Bank's [Doing Business Surveys](#) would be an excellent source of information for these factors.

Q: Policies have been put in place or proposed to restrict the exportation of raw materials. From an economic point of view, does this work?

Douglas Brooks – From a theoretical point of view no. From a practical point of view, sometimes, it depends on the conditions. It can generate inefficiencies. As an economist I would oppose those types of regulations, but there could be good reasons for doing them.

Q: What types of things constitute the informal and formal sectors?

Douglas Brooks – Each country defines this differently. It depends on whether or not they are working for themselves or for an employer. And as well, sometimes social protections are covered for those who are not in the formal sector.

Q: With the ASEAN Economic community opening their borders for trade between countries, will this boost Indonesia's exports?

Douglas Brooks – I don't have particular evidence to back up the claims. In general, it should be a good thing, but it will probably not work as quickly and efficiently as planned. I learned a good quote by the former American baseball player and manager Yogi Berra, who had a particular way with words, "In theory, there's no difference between theory and practice. In practice, there is." These agreements are great in theory, but will they work in practice. Quite often, especially at first, things don't work the way they are supposed to. So I would expect to see some boost for Indonesia, but probably not as big or as quick as we might hope for.

Q: What is Indonesia's role with trying to help the different parties concerned with the Chinese security threat in the South China Sea? Where will the Indonesian government come down if the Chinese continue to be as aggressive as they now are?

David Merrill – I would frame this in two different categories, one is Indonesia within ASEAN and the other is Indonesia in East Asia with China. Within ASEAN, Indonesia is very concerned about what happened in Phnom Penh (with the ASEAN Foreign Ministers being unable for the first time to reach a joint communiqué at the 45th ASEAN Foreign Ministers Meeting this past July). The Indonesian government has tasked Foreign Minister Marty Natalegawa with trying to see if he can play a moderating or constructive role in weaving some kind of ASEAN common position. Whether that has succeeded or not, I am not sure. I know the Indonesians are very committed to assisting in this process. If you consider the second situation, beyond ASEAN, with Indonesia taking a role in settling a dispute between China and any of the countries in the region, I think it's much less likely Indonesia will take the lead on that. Indonesia tries to find a way to be constructive behind the scenes, whether it's moderating or facilitating. So if there is a role to be played along those lines that is what they will probably do.

Meredith Miller – Indonesia has a long history of informally leading ASEAN in dialogues with China and the South China Sea. This is a very tense time and I think it's a mark to Indonesia's credit that they have invested their foreign minister in rebuilding what was a very fracturing event in Cambodia – not being able to issue a communiqué. But Indonesia does have huge equities where China is concerned. It's difficult to overstate the impact that China's economy and security outlook is going to have on the region. I think they will continue to play an active role in ASEAN. Doug, would you like to comment on the effect the slowdown in China might have on Indonesia or the region more broadly?

Douglas Brooks – I think it would have a significant effect through the trade linkages, in particular. The majority of trade within developing Asia is also within developing Asia, rather than to the U.S. and Europe. But a lot of it is parts and components as part of international production networks. And a big stage in these networks is in China where final assembly often takes place. Much of the final goods might be exported to the U.S. or Europe, but trade is measured in terms of gross value rather than value added at different stages, although we are trying to differentiate them. Because China is a big part of trade in the region, and trade is a big part of growth in most Asian economies, especially Southeast Asia, we do expect that any slowdown in China would have an impact on the other economies. Also, it's hard to say what the impacts inside China would be. It has been said for many years that China needed to maintain 8% growth, to maintain full employment. But what if they don't do that? Are they going to accept higher rates of unemployment? Does that have any implications for political stability? Does that have any implications for their actions with their neighbors? There could be many other implications that also have economic implications as well.