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Economic Resurgence in ASEAN

Navigating Convergence, Innovation, and Trade for Enhanced Productivity

Edited by

Fithra Faisal Hastiadi

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CHAPTER 1

Indonesian Economy in Time of Covid: Surviving the Turmoil through Manufacturing Sector

Fithra Faisal Hastiadi

Abstract Despite the global economic recession in 2020 due to the COVID-19 pandemic, the structure of the Indonesian economy remained relatively unchanged. However, a closer look reveals a long-term trend of deindustrialization since the early 2000s, affecting the export performance of the manufacturing sector. This chapter identifies a need for strategic interventions to leverage the manufacturing sector's contribution to economic growth, emphasizing the importance of manufacturing in achieving convergence and escaping the middle-income trap. We argue that revitalizing the manufacturing sector is crucial for sustained and inclusive economic growth, countering the trend of premature deindustrialization. This chapter also suggests that Indonesia must prioritize the development of its manufacturing sector through addressing issues of financing, trade imbalances, and infrastructure. The government's efforts, such as the omnibus law on job creation and infrastructure development, are

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recognized as steps in the right direction, but the study emphasizes the importance of a comprehensive approach to support the manufacturing sector's growth and enhance Indonesia's overall economic competitiveness.

Keywords Covid • GDP • Indonesian Economy • Industry

Background

Indonesian economy has been overshadowed by its past remarkable economic growth during the New Order era. During those years, the presence of several commodity booms did assist Indonesia's high-paced economic growth. Aside from this, Indonesia's manufacturing sector also significantly contributes to assisting Indonesia's economic growth, where it provides the most significant portion in terms of contribution to GDP in 1991, compared to other sectors. But soon after the Asian financial crisis in the late 1990s, the growth momentum had halted.

A persistent decrease in export performance may explain the poor performance of Rupiah. Indonesia experiences current account deficit since the fourth quarter of 2011, and it has prolonged ever since. The major problem here is the deficit in primary income account and trade balance. The deficit in primary income is mostly (around 64%) attributable to investments, be it direct, portfolio, or other investments.

The structure of the Indonesian economy in the last five years has generally remained the same without any significant changes. Despite the recession in 2020, caused by the pandemic, Fig. 1.1 presents no significant changes in the structure of the economy. By far, the industrial sector, exports of electrical machinery and equipment and parts thereof alone reached 5.78% or the third largest among Indonesia's leading export commodities. Meanwhile, the agricultural sector, in this case exports of animal or vegetable fats and oils and their cleavage products, constituted 11.31% of all Indonesian exports in 2019 or the second largest.

As far as the structure of the economy is concerned, despite no significant changes in the last five years, if we look at a longer span of years, we can see a significant change in the structure of the economy.

Fig. 1.1 GDP by sector. (Source: Statistics Indonesia)

Causes and Analysis

Over the last decade, the poor export performance has become a product of depleting performance of Indonesia's manufacturing industries. These industries have a major role in Indonesia's exports besides the primary commodities. Alas, export had experienced a negative year-on-year (YOY) growth. This officially brings the country over to the third quarter of 2020; investment has otherwise slumped. After experiencing a negative YOY growth of -7.32% in the second quarter, investment plunged further in the third quarter with a YOY growth of -10.77%.

Some of the main sectors that have high multiplier effect such as manufacturing, transportation, as well as retail and trade have been the hardest hit. Even though these sectors started to recover in the third quarter, their growth in the second quarter was one of the worst. Indonesia's economic growth in 2021 was projected to be ranging from 3.46% (pessimistic), to 4.8% (moderate) and then to 6% (optimistic) due to the baseline effect.

Nevertheless, Indonesia has been experiencing a persistent deindustrialization since early 2000s, as shown in Fig. 1.2. A similar situation also seems to have occurred in terms of Indonesia's manufacturing export

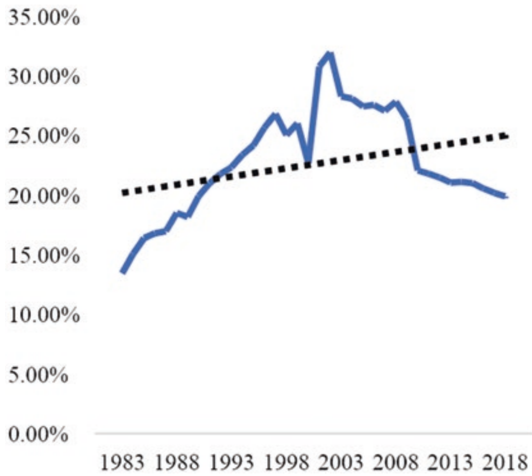

Fig. 1.2 Manufacture sector value-added (%GDP). (Source: Statistics Indonesia and World Bank)

performance. After a strong share of export domination within the period of early 1990s to mid–2000s, the share of export contribution from manufacturing sector fell behind raw commodities and tended to show a negative trend (Wihardja, 2016). That phenomenon is believed to have been occurred due to the impact of commodity boom during 2001–2013. Measures over the last five years have naturally restrained domestic demand. But sluggish exports, thanks to the premature deindustrialization, have been compromising every effort to curb the current account deficit. Fortunately, personal consumption remained buoyant amid the heavy external pressure. But it is important to note that the consumption growth is somewhat below average.

The key strategy lies on how we can leverage the manufacturing sector contribution to the economy. According to Rodrik (2013), manufacturing sector is a mode of growth for developing countries that could help them achieve convergence, due to positive correlation between sector growth and productivity. From this standpoint, it is important for Indonesia to clearly utilize its manufacturing sector, especially with its current position as a middle-income country that needs to prepare itself in order to escape from the middle-income trap problem. Productive growth through manufacturing sector is what Indonesia needs to achieve, instead of service sector that seemed to be more productive, but only valid if the country already has a strong human capital endowment.

Future Expectations and Implication

Despite job expansions, the situation of informal employment—often known as jobs with low productivity and income and unsafe work practices—has not changed. Job opportunities for young people (aged 15–24) are still underdeveloped. This youth unemployment is somewhat staggering since its ratio to the total employment is quite dominant (62%). Moreover, with the current rate of income-per capita growth (3.9%), escaping from the middle-income trap is somewhat far-reaching. We need at least 6 to 7% of income per capita growth (Hardiana & Hastiadi, 2019) in order to be classified as one the high-income countries. Considering the period of demographic bonus, we will lose the momentum if the government still sees this as business as usual.

Manufacturing sector could provide a smoother structural work transformation (Szirmai, 2012) compared to service sector, since it enables a relatively easier transition for low-skilled labor from agricultural sector to adapt and participate in manufacturing sector. One might argue that the penetration of information technology (IT) could help a country to directly leap from agriculture economy to service-driven economy. Technological transfer is arguably the most important feature from manufacturing sector that each economy needs to pursue. By obtaining technology from more advanced economies through foreign direct investment (FDI), developing economies could absorb any important features of specific industry that they will develop and might become their comparative advantages in the future or strengthening their comparative advantages (Krugman, 1979). Although the concept of technological transfer sounds harmful for advanced economies, it is conspicuous that several countries successfully build their strong economy based on the foundation of technological transfer, such as Thailand, Vietnam, and, most notably, China (Archibugi & Pietrobelli, 2003). Therefore, despite Indonesia's immense and comfortable economic growth since past decades, it is believed that by developing and maximizing potential from manufacturing sector, Indonesia could provide a more sustainable and inclusive economic growth. Improvement in terms of Indonesia's human capital could also be obtained through technological transfer. From this scheme, it is believed that Indonesia's manufacturing sector could be developed due to knowledge obtained from foreign firms that invested in Indonesia and much better equipped workers to participate in this sector. In order to achieve a strong manufacturing sector, defining problems that hinder the