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Outlook 2015: What Lies Ahead for ASEAN and Indonesia

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Abstract

While ASEAN is ripe with opportunity, it is not immune from the dynamics of the global economy. For any member country, including Indonesia, it would be ill-advised not to keep an eye on and follow closely the dynamics taking place within ASEAN and globally. Of numerous problems faced by ASEAN, it is argued that if the goals stated in the ASEAN Charter and the targets aimed at by the ASEAN Economic Community (AEC) are to be achieved, trade-related competitiveness and the decelerating trend of productivity are among the region's most important economic challenges. By using some examples, it is shown that such dynamics can pose new challenges as well as opportunities to the region and to any member country.

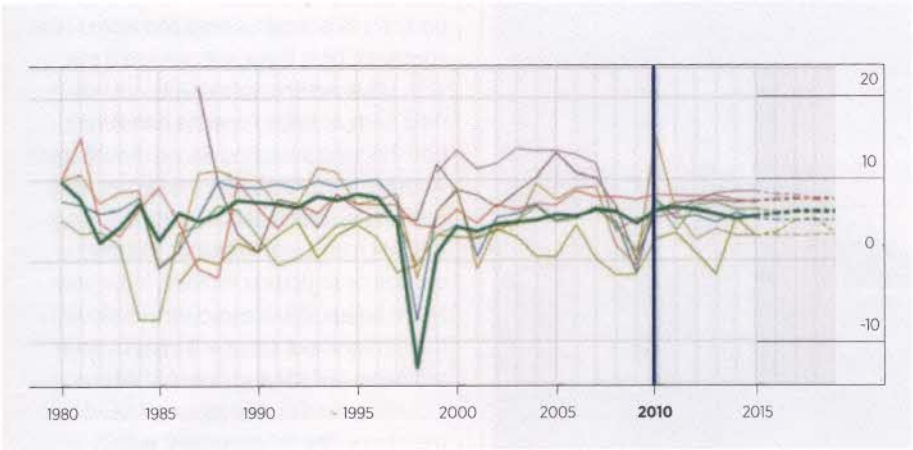
The Setting

The formation of ASEAN in the late 1960s was much influenced by the political and security environment of the Cold War. As indicated in the ASEAN Charter, formalised two decades later, the Association's purpose is to '*maintain and enhance peace, security and stability and further strengthen peace-oriented values in the region*'. The achievement of it, however, requires a multidimensional approach to secure 'regional resilience by promoting greater political, security, economic and socio-cultural cooperation'.

In economic affairs, the Charter highlights the need for the region '*to create a single market and production base which is stable, prosperous, highly competitive and economically integrated with effective facilitation for trade and investment in which there is free flow of goods, services and investment, facilitated movement of business persons, professionals, talents and labour, and freer flow of capital*'. If those narratives sound clichéd, the statement on the welfare goals is more important to note. Here the Charter reflects the Association's awareness of the Triple Bottom Line, spelling out '*to alleviate poverty and narrow the development gap within ASEAN through mutual assistance and cooperation. To promote sustainable development so as to ensure the protection of the region's environment, the sustainability of its natural resources, the preservation of its cultural heritage and the high quality of life of its peoples. To develop human resources through closer cooperation in education and life-long learning, and in science and technology, for the empowerment of the peoples of ASEAN and for the strengthening of the ASEAN community.*'

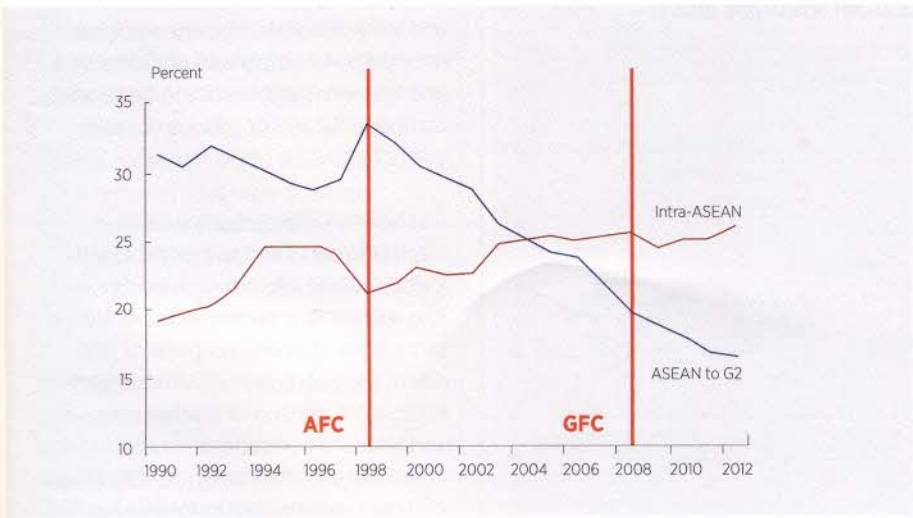
ASEAN has been fairly successful in achieving freer flows of goods, enhancing trade and investment that supports growth. Interrupted by the 1997/98 Asian financial crisis (AFC), the region's growth recovered since the early 2000s (Figure 1). A robust production network, driven by strong economic growth in China among others, boosted trade and investment in ASEAN. When the 2008 global financial crisis (GFC) hit, growth began decelerating – although the region's rate remains higher than in many parts of the world. This boosted ASEAN's capacity to reduce poverty and raise living standards, although at the same time the resulting relative income inequality worsened.

Figure 1: Real GDP Growth of ASEAN Members



Source: IMF Data Mapper
Note: Darkest curve is for Indonesia

Figure 2: Export Share of ASEAN



Source: Processed from UN Comtrade

Growing trade and foreign direct investment (FDI) has indeed contributed significantly to ASEAN's growth performance. But intra-ASEAN trade, promoted through the ASEAN Free Trade Area (AFTA) established in 1992, has never been dominant and has not changed much in the last decade; around 25 per cent and lower when entre-port Singapore is excluded. Much of ASEAN's overall trade performance has been largely driven by each country's unilateral policy, not by AFTA or any FTAs involving ASEAN.

Yet, absent of a benign external environment, unilateral policies alone would not have been enough to produce a strong trade performance. While in the past members of ASEAN have benefited from a strong global economic growth, they are not immune from external shocks like the GFC. As the external conditions are predicted less benign at this moment (e.g., slower global growth, tighter liquidity associated with the normalisation of monetary policy in the United States, and elevated risks of geopolitical conflicts), ASEAN members including Indonesia need to redouble their efforts to overcome the main challenges. Unarguably, there are numerous challenges – from environmental degradation, income inequality, demographic changes and slower growth, to geopolitical risks. All these are mirrored in the region's competitiveness and decelerating trend of productivity.

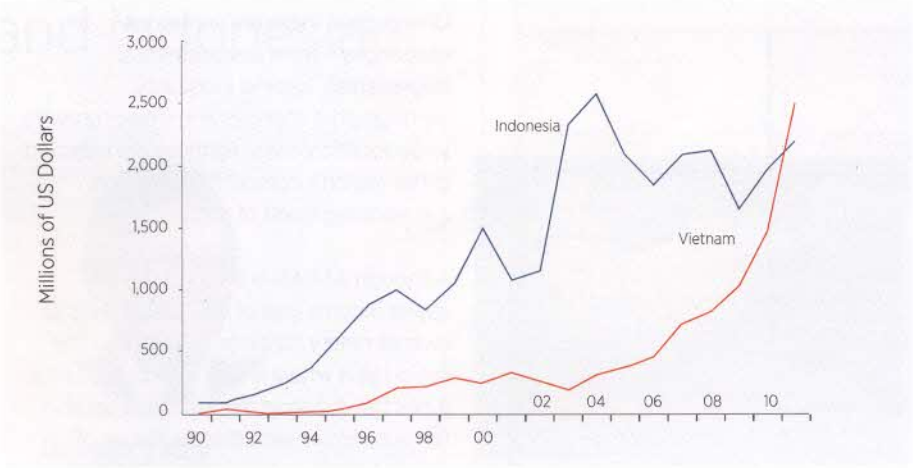
Although ASEAN is diverse (the per-capita income gap of two members is as high as ninety times on PPP terms), the region as a whole is ripe with opportunity. It has the dynamic market made up of ten economies with diverse stages of development and investment landscapes, as well as a strategic location. But the region is not immune from what happens in the global economy. With rapid changes currently taking place, globally and regionally, and if the targets aimed by the ASEAN Economic Community (AEC) are to be met, it is unwise not to keep an eye on such changes, especially for an open economy like ASEAN.

Competitiveness and Diversification

As far as trade in final goods is concerned, ASEAN trade with advanced economies like the US and Europe (G2 countries) has been intensive. On the other hand, intra-ASEAN trade is dominated by intermediate and primary goods. Such a trade pattern reflects the region's strong production network, involving other major Asian players such as China, Japan and Korea. The kind of primary and intermediate goods each ASEAN member is able to export determines the value-added accrued. Exporting unprocessed primary or intermediate goods generates less value-added and creates small multipliers in the economy.

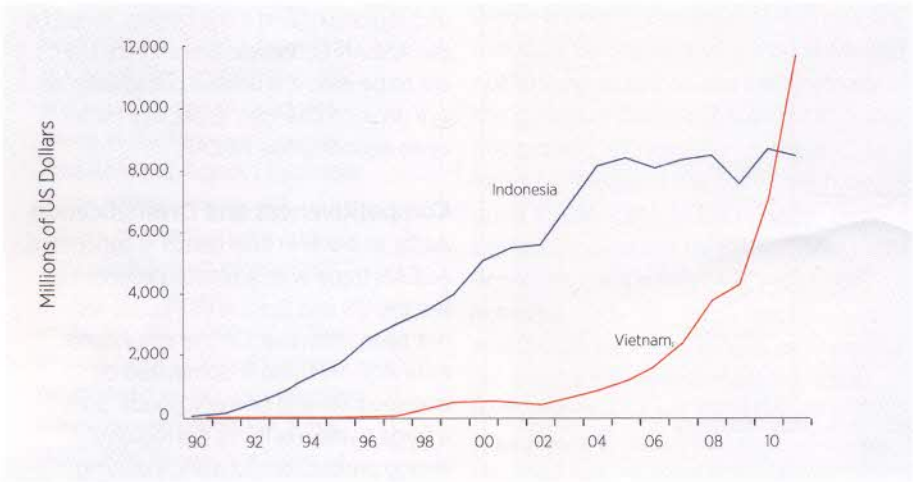
What happened with exports to the US and Europe when these two world's biggest economies suffered from a major recession during the GFC? As depicted in Figure 2, export share of ASEAN to G2 has been persistently declining since the onset of the AFC. Notice also that the pace of decline accelerated immediately after the AFC and the GFC. Not shown in the

Figure 3: Imports of Electronic Parts and Components by Vietnam and Indonesia



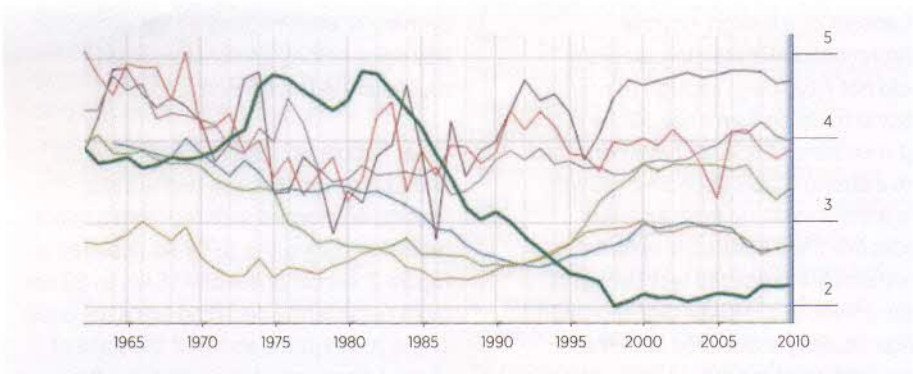
Source: Processed from CEPII-CHELEM database and W. Thorbecke (unpublished).

Figure 4: Exports of Final Electronics Goods from Vietnam and Indonesia



Source: Processed from CEPII-CHELEM database

Figure 5: Index of Export Diversification in ASEAN Countries



Source: IMF Data Mapper, Note: Darkest curve is for Indonesia

figure is the rising trade between ASEAN and the region's most important trading partners like Japan, China and Korea (the so-called 'plus three'), as well as trade with other emerging markets outside Asia such as Latin America and Africa, boosting the so-called South–South trade. Another important new trend post-GFC is the rising trade of final goods among ASEAN members. Whether this shift is cyclical or structural remains to be seen. Nonetheless, the trend clearly indicates the dynamics of competitiveness, both between ASEAN and non-ASEAN including the G2, and among ASEAN members. The development within ASEAN itself can pose new challenges to any member country. It would be ill-advised for Indonesia not to follow closely the development progress and the dynamics of other ASEAN members, and learn from their experience when necessary. A comparison of Indonesia's and Vietnam's experience in electronics components and goods is a notable example.

As shown in Figure 3, imports of electronic parts and components into Vietnam have taken over imports into Indonesia in recent years. At the same time, Vietnam's exports of final electronic goods that include computer equipment, consumer electronics goods and telecommunications equipment also exceeded exports from Indonesia (Figure 4). This suggests that Indonesia has not been able to join electronics production networks at the speed taken by Vietnam.

A broader trend indicates an even bigger challenge for Indonesia. As shown in Figure 5, the country's index of export diversification has persistently declined since early 1980s, and remained the lowest in ASEAN since the onset of the AFC. A more careful look at different time periods in different sectors reveals that things have not been in the right direction since the early 2000s. During the decade of the 1990s, Indonesia's share of primary exports declined from 46 to 33 per cent, while the share of exports of equipment goods and high and medium tech increased from 2 to 9 per cent and 7 to

22 per cent, respectively. This is a normal pattern expected in the development process of any economy. All ASEAN countries have also followed such a trend. But since the early 2000s, Indonesia's export pattern has been upside down: rising primary goods and declining share of equipment goods and high and medium tech sector. Clearly, Indonesia did not successfully diversify.

This carries multifaceted implications. On the one hand, it reflects a lack of policy reform, especially since the mid-2000s. As commodity prices rose and exports surged, pressures to reform languished. It also reflects problems with competitiveness, particularly in the manufacturing sector. The case of Indonesia's exports of electronic goods cited earlier is only one of many examples. More seriously, failures to diversify leave the economy vulnerable to external shocks, as evident in recent years when commodity prices fell and the global recession led to weakened external demand. The repercussions reached beyond a disappointing export performance. With a deteriorating balance of payment, a reversal of capital flows rattled the financial market and weakened the currency. Rising repayment of the private sector's foreign debt added a further pressure.

Problems with competitiveness are closely related to productivity growth. Indeed, productivity as one measure of efficiency is a main source of competitiveness. What is the trend of productivity in ASEAN?

Productivity

ASEAN's productivity growth cycle follows the output growth pattern: falling during and immediately after the AFC, recovering in the early 2000s before tumbling again in 2008. A closer look indicates that since early 2000s, the role of China has been significant. China's productivity growth accelerated during the period, where rapid capital accumulation accompanied reforms and reduced distortions in product and factor markets, higher spending on research and development (R&D), rising numbers of patents, and further opening to foreign capital and international trade. But as China's productivity growth fell following the GFC, so did the productivity growth in ASEAN. Demand factors have clearly been at play. But constraints on the supply side as reflected in the persistently low spending on infrastructure and languishing reforms in most ASEAN members caused the deceleration of productivity growth to be unusually sharp.

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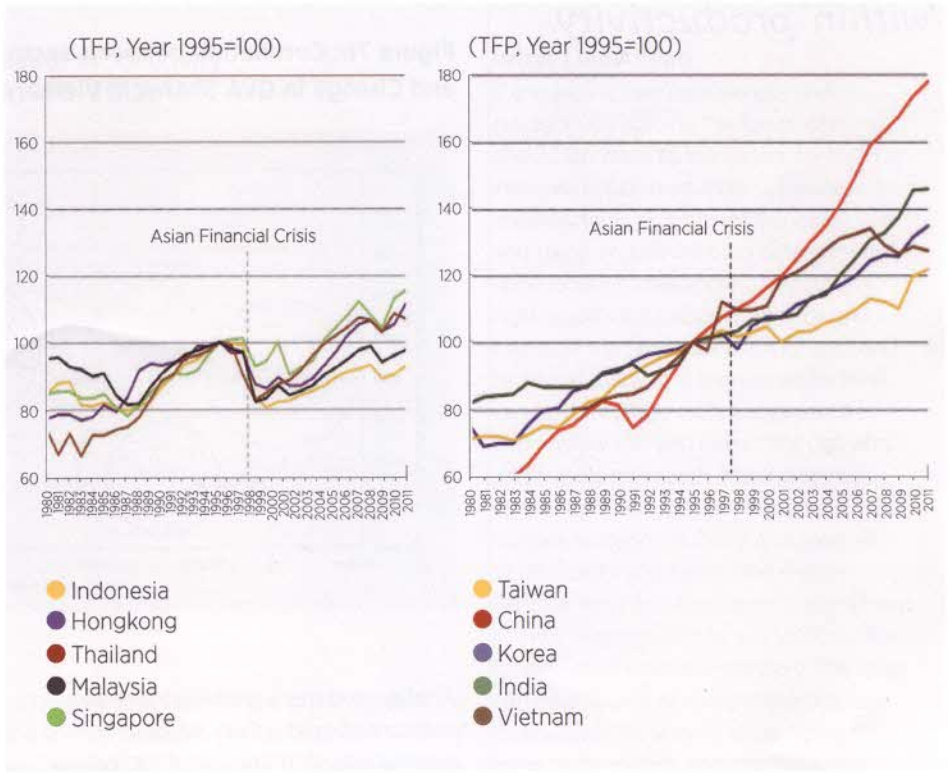
Figure 6: Total Factor Productivity (TFP) in ASEAN



Taking account of capital, labour and other inputs, the trend of total factor productivity (TFP) growth in most ASEAN countries has been modest, not exemplary. Depicted in Figure 6, many ASEAN countries suffered from falling TFP during the AFC, and only a few of them were able to recover to reach a higher than the pre-crisis level. Indonesia and Malaysia are not among them.

With the use of technology and enhanced human resource capability, some activities in ASEAN have shown a labour productivity improvement; this is also known as 'within' productivity.

Figure 7a: Correlation between Sectoral Labor Productivity and Change in GVA Shares in Brunei Darussalam (1990–2012)

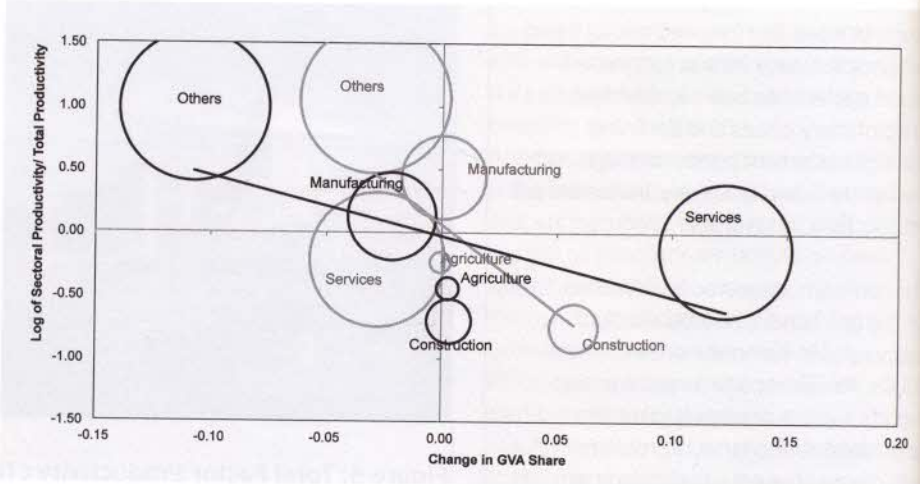
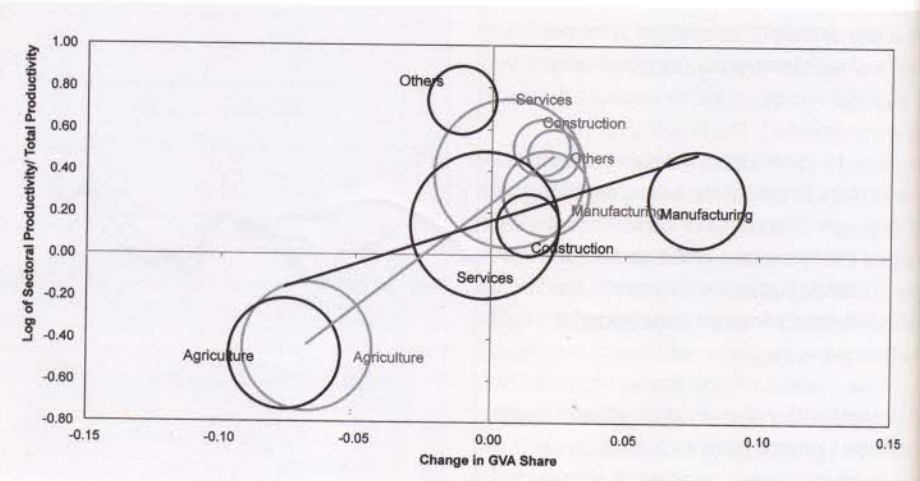


Figure 7b: Correlation between Sectoral Labor Productivity and Change in GVA Shares in Vietnam (1990–2012)



Another and more readily understood measure of productivity is labour productivity. With the use of technology and enhanced human resource capability, some activities in ASEAN have shown a labour productivity improvement; this is also known as 'within' productivity. But that improvement may not necessarily spread towards other activities ('structural' productivity). If the sectors experiencing a rise (a fall) in productivity are those that grow faster (slower) than other sectors in the economy, the improvement is economy-wide in nature. Otherwise, it confines to only an enclave of few activities, failing to diffuse to the rest of the economy. In other words, the 'within' component did well, but not the 'structural' one. What is the ASEAN achievement? It varies by country.

Figures 7a to 7g summarise the trend, where the y-axis essentially captures the growth of labour productivity and the x-axis represents the growth or the change of each sector's value added. An ideal case would generate a positive-slope line, because it implies that sectors experiencing a fast growth of productivity (high along the y-axis) are also those

Figure 7c: Correlation between Sectoral Labor Productivity and Change in GVA Shares in Malaysia (1990–2012)

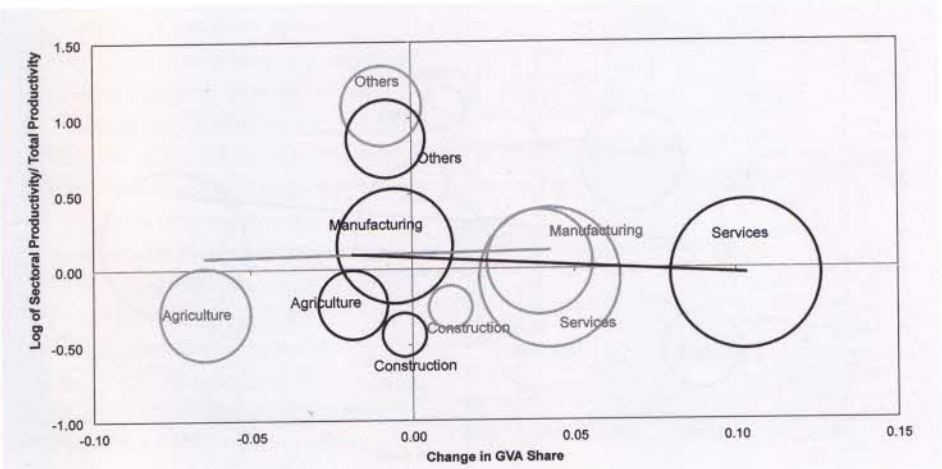
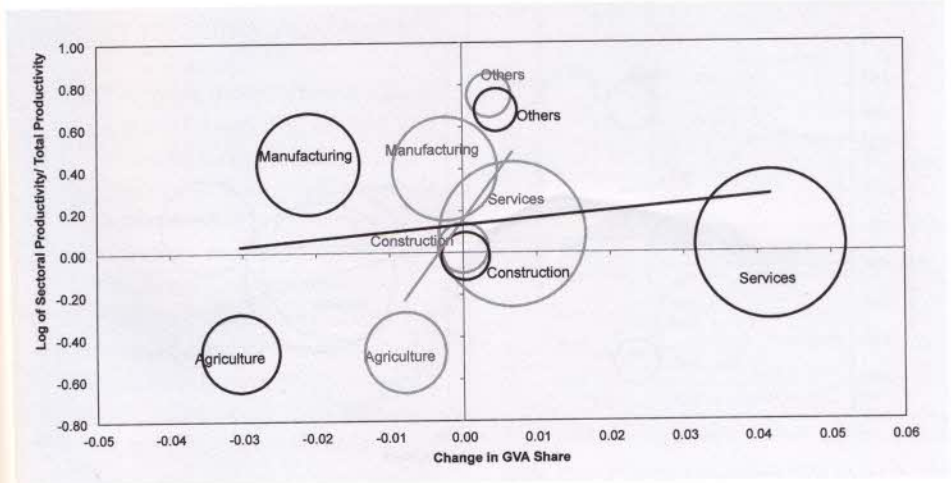


Figure 7d: Correlation between Sectoral Labor Productivity and Change in GVA Shares in Philippines (1990–2012)



expanding faster (further right along the x-axis). This is the case of economy-wide improvements. Splitting the period into two: before 1997 or pre-AFC (light-coloured lines and bubbles in Figures 7a to 7g) and after 1998 or post-AFC (dark-coloured lines and bubbles), the dynamics of labour productivity in each ASEAN member can be evaluated.

Before the AFC, Indonesia's improvement in sectoral productivity was sufficiently diffused towards the rest of the economy, leading to an economy-wide improvement of productivity (the slope of the light-coloured line in Figure 7g is positive). But the spread subsided during the post-AFC period. A similar trend is observed in Malaysia (Figure 7c). In Brunei, no productivity diffusion is observed, while in the rest of ASEAN an economy-wide improvement is evident; for example, in Vietnam the expanding manufacturing sector has a higher productivity growth than in services despite the bigger size of the latter. This is in contrast with what happened in Indonesia, where the share of manufacturing sector has declined despite the sector's higher productivity growth than in services sector (compare Figures 7b and 7g). On the one hand, the expanding sectors such as community, social and personal services did not grow well in terms of productivity, and the retail trade activities that expanded during the period were of the low productivity type (mostly the informal sector). On the other hand, an improvement in labour productivity occurred in an agricultural sector that failed to expand.

From the narrative it is clear that each member country of ASEAN has different patterns of productivity and growth, but some – including Indonesia – clearly face a challenge of how to reverse the decelerating trend of productivity and diffuse productivity improvement to the rest of the economy.

What Lies Ahead

If enhancing competitiveness and productivity is to be the focus, one should go 'back to the basics' by making improvements in education, business environment, including FDI-friendly, and using and developing better/more appropriate technologies. Targeting a high-quality education in science and maths at the secondary school level and technical training at the university level can help facilitate technology transfer and narrow the gap due to the demand and supply mismatch. Making serious efforts to build good infrastructure, nurture entrepreneurship and creativity of all classes and types, and ensure transparency and consistent enforcement of laws and regulations will facilitate the formation of industrial clusters. The latter can be a source of competitiveness and productivity by way of allowing local firms to cooperate and compete with other firms and learn new production techniques. Securing patents is also essential for R&D supported by public research institutes. The latter can also help identify what technologies most appropriate to use. Transferring patents, beyond simply creating jobs and raising production, should be an important component in FDI policy.

Finance also matters. Experience shows that the easier it is to raise funds – for

It is in manufacturing where disruptive technologies usually could flourish, allowing greater profit margins and lower costs for business.

Figure 7d: Correlation between Sectoral Labor Productivity and Change in GVA Shares in Philippines (1990–2012)

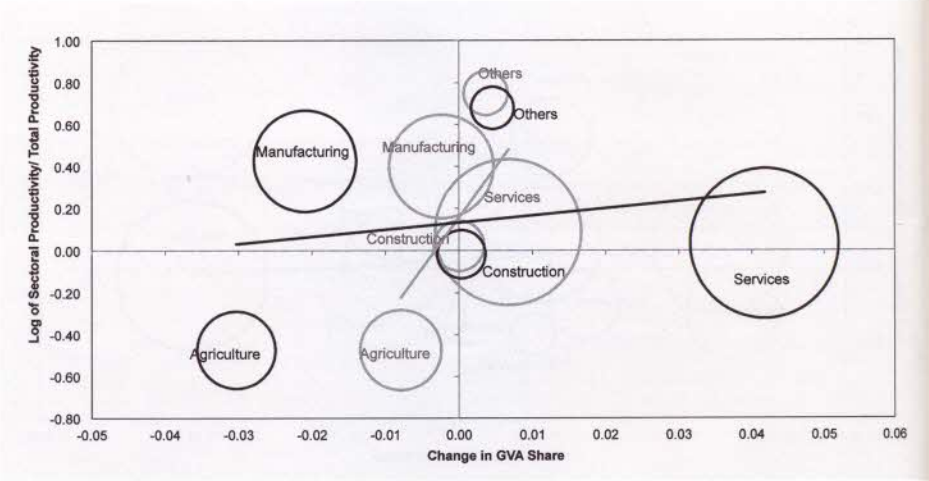
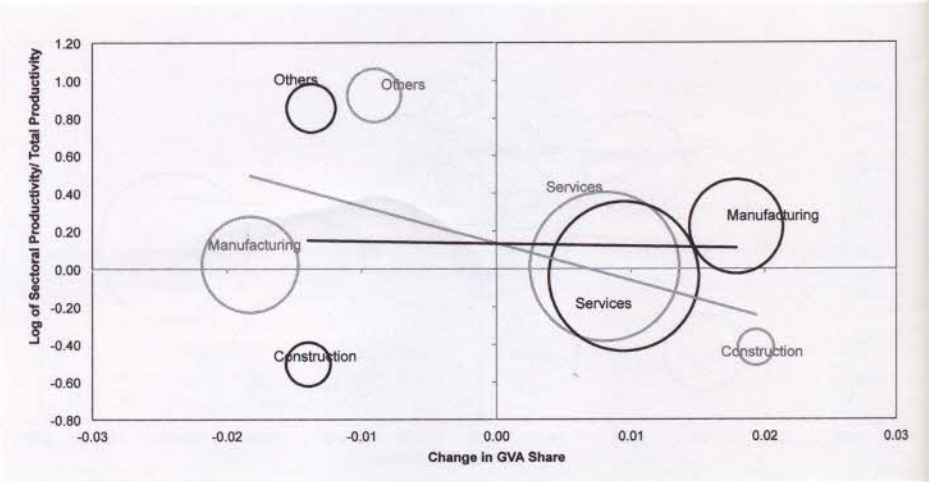


Figure 7e: Correlation between Sectoral Labor Productivity and Change in GVA Shares in Singapore (1990–2012)



example through equity or debt markets – the less difficult it is to boost productivity by allowing producers in traditional sectors to modernise and better reallocate capital. While financial markets in ASEAN members have been liberalised – albeit at varying degrees – and steadily developed through domestic policies and regional initiatives (for example, the *ASEAN+3 Asian Bond Markets Initiative* or ABMI), in some economies financial frictions remain. These frictions can cause inefficient dispersion in firms' marginal product of capital which, in turn, leads to misallocation. More importantly, they can distort entry and decisions to adopt technology critical for productivity enhancement. The costs of such productivity losses are significant because entry and technology adoption typically entails large, long-term investments with only gradual returns – thus financing them internally is difficult.

Of all sectors, manufacturing remains key to activities that likely improve productivity. It is in manufacturing where disruptive technologies usually could flourish, allowing greater profit margins and lower costs for business. The use of

big data and the Internet of Things could dramatically improve business capability in production planning and demand forecasting, for example. When this happens, firms can offer improved quality and better customer service. Indeed, while global data shows that aggregate productivity did not have a convergence pattern (no systematic tendency for economies that start with lower productivity to grow more rapidly, only in manufacturing a convergence occurred. Based on either aggregate or sub-sector data, manufacturing shows a strong tendency for unconditional convergence. This demonstrates the unmistakable strategic role manufacturing plays as a source for improving productivity. Policies that allow a stagnant or declining share of manufacturing to happen (as is the case in Indonesia; see Figure 8), should be seriously reviewed. Such a premature departure from manufacturing does not sit well with productivity improvements.

For ASEAN, where manufacturing value-added accounts for about 5 per cent of global manufacturing, the dominant activities have been in food and beverage, metals, motor vehicles, and chemicals. More harmonised rules and regulations and mutual recognition agreements aimed by the AEC offer opportunities for the region to produce productivity benefits particularly through economies of scale (estimated worth up to 20 percent of the cost base in addition to boosting demand and creating consumer surplus). The potential benefits stemmed from standardised products and pool skilled labour, and lower inventory costs by reducing the number of specialised products to keep. The latter can be significant, especially for the small and medium enterprises (SMEs).

Final words on trade-investment pattern. A recent trend that is likely to get bigger in the coming years is the rise of a 'new' type of FDI from East Asia, particularly Japan, China and Korea, in ASEAN. With the growing number of ASEAN middle class and stronger purchasing power, a new stream of FDI is likely of the domestic market-oriented type. As

Figure 7f: Correlation between Sectoral Labor Productivity and Change in GVA Shares in Thailand (1993–2012)

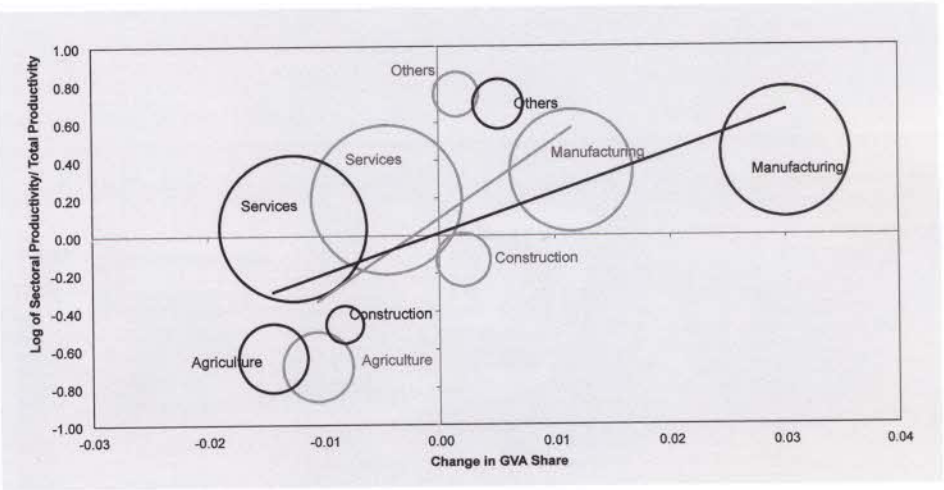
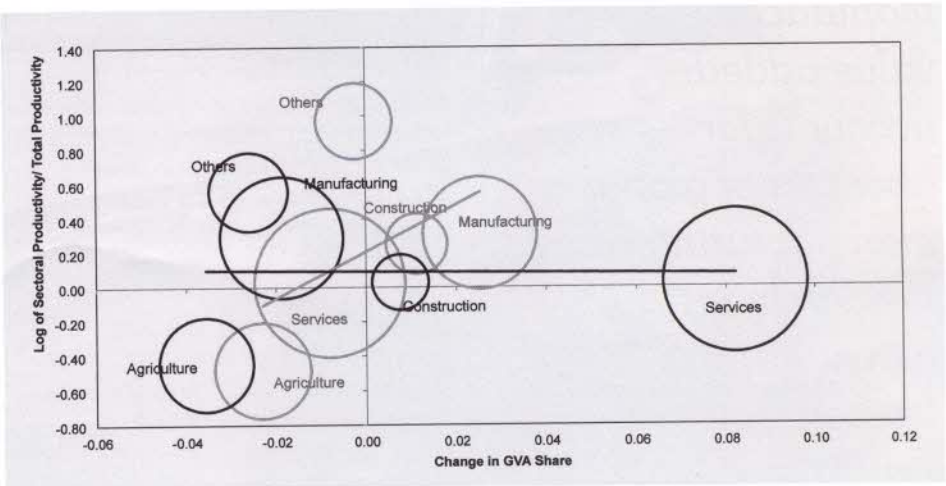
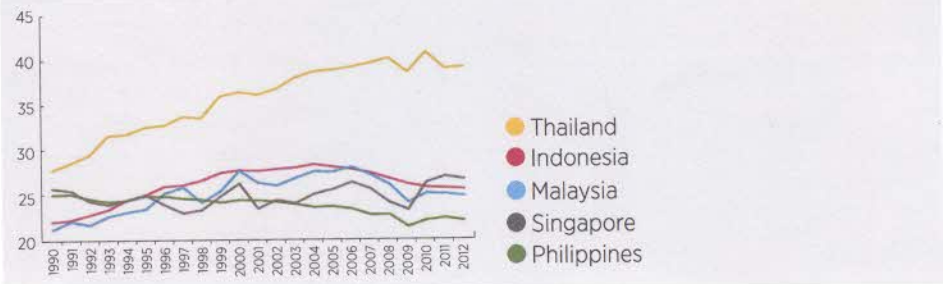


Figure 7g: Correlation between Sectoral Labor Productivity and Change in GVA Shares in Indonesia (1993–2012)



Note: Size of circle represents GVA share in: 1993 (gray bubble); 1999 (black bubble). Gray bubbles = Pre-AFC (before 1997); Black bubbles = Post-AFC (after 1998). Source: Author's calculations using data from CEIC; national sources; *World Development Indicators*, World Bank; and 'Timmer, Marcel P. and Gaaitzen J. de Vries (2009), "Structural Change and Growth Accelerations in Asia and Latin America: A New Sectoral Data Set" Cliometrica, vol 3 (issue 2) pp. 165-190.'

Figure 8: Share of Manufacturing Value-Added in Selected ASEAN Countries



For ASEAN, where manufacturing value-added accounts for about 5% of global manufacturing, the dominant activities have been in food and beverage, metals, motor vehicles, and chemicals.

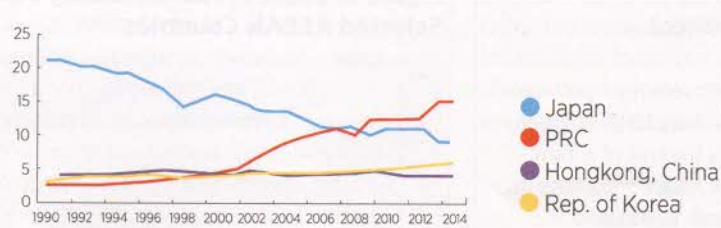
the expected stream of revenues is in local currency, most FDI will also conduct investment using local currency. To the extent the costs of production in Japan, Korea and China have increased, the production of some components required to support plants producing final goods either in those countries or in other ASEAN countries as part of the regional production network may also shift to ASEAN.

Three implications may arise: First, products from East Asia sold and consumed in ASEAN are not necessarily exported (no physical shipment) from the origin countries since they are produced in ASEAN. The declining share of Japanese exports in total ASEAN exports depicted in Figure 9 is therefore expected to continue in the coming years. Secondly, intra-ASEAN trade will be further boosted by this scheme not only in terms of size but also quality. Exports of final goods from ASEAN to East Asia may also increase. Third, a new scheme to provide access of local currency to non-ASEAN investors emerges. One of such schemes is the *ASEAN+3 Multi-Currency Bonds Issuance Framework* (AMBIF), which is an initiative under the *ASEAN+3 Bond Market Forum* (ABMF). The whole idea is to increase the access of ASEAN local currency for the purpose of financing direct investment in that currency by non-ASEAN members. Unlike in the 1980s, where most Japanese FDI in ASEAN were of the MNC and other big investors type, the new stream of FDI this time is likely to be of small and medium enterprise (SME) category. Arguably, this will pose new challenges as well as opportunities to ASEAN members.

In short, the emerging trend of FDI in local currency is an important phenomenon to watch. For ASEAN members, potential benefits can be reaped including technology-cum-productivity improvements and reduced instability of exchange rate as it lowers the dependence on foreign currency. On the other hand, new risks may arise, including greater competition faced by domestic SMEs and reduced controls of monetary authority over the use of local currency that may make the business and financial cycle less synchronised.

Is ASEAN ready to face these new challenges? What about Indonesia?

Figure 9:
Trade Share of East Asia in ASEAN Total Trade



Note: PRC = People's Republic of China. Trade share is calculated as (tij/Tiw)*100, where tij is the total trade of ASEAN with economy 'j' and Tiw is the total trade of ASEAN with the world. 2014 covers trade values from January–May.