The Difficult Art of Economic Diversification*

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Indonesia, like India, has a brand new government. Expectations are running high for the new President Joko Widodo (or Jokowi, as he is popularly known) who has promised not only to restore output growth to the high rates previously experienced before the latest downturn, but also to do so cheaply (in fiscal terms). The economic recovery is widely expected to come about through measures like ending corruption and easing the rules for doing business so as to attract new foreign investment. Meanwhile the poor are to be assisted through an expanded programme of social transfers and protection in terms of health insurance and similar measures.

How successful such a strategy will be in achieving its declared goals is yet to be seen. Yet it is important to remember that output growth per se cannot and should not be the aim, especially if it is speedily shown to be unsustainable because of reflecting boom-bust commodity or credit cycles, or if it is not associated with a sustained diversification away from primary production that is necessary for improving aggregate labour productivity and wage incomes. In this matter, there are salutary lessons to be drawn not only from other developing countries, but from Indonesia's own experience over the past three decades.

Historically Indonesia was an exporter of primary commodities, dominantly fuel as well as agricultural goods such as rubber and palm oil. In the period from 1980 to just before the East Asian crisis, however, it experienced a significant increase in the share of relatively labour-intensive manufactured goods exports. These were dominantly textiles and clothing, footwear and furniture, but there were also some "high-tech" manufactured goods such as electronic goods and components and some machinery.

As Chart 1 shows, this meant an increase in the share of manufactured goods to total merchandise exports from only 2 per cent in 1980 to more than fifty per cent just before the Asian crisis of 1997-98. That crisis affected the Indonesian economy drastically, causing massive declines in output and increases in poverty. But it also had longer term effects on the very structure of the economy, reflected not only in varying trends of savings and investment ratios but also in the composition of trade.

Thus, after a slight spurt around the year 2000, the share of manufactured goods in total merchandise exports has been declining continuously. The share fell from more than 56 per cent in 2000 to only 34 per cent in 2011. (Data are from the World Bank's World Development Indicators online.)

Chart 2 shows how the absolute rate of growth of such manufacturing exports, which had been incredibly dynamic at more than 40 per cent annual increase (in US dollar terms) in the boom period of 1986-92, slowed down considerably thereafter. In the most recent year, there has even been an absolute decline. This is true also for labour-intensive exports like textile and garments, in which Indonesia's recent poor performance cannot be blamed only on globally depressed demand, since several Asian competitors have done much better despite that.

Chart 1: The rise and fall of manufacturing export shares

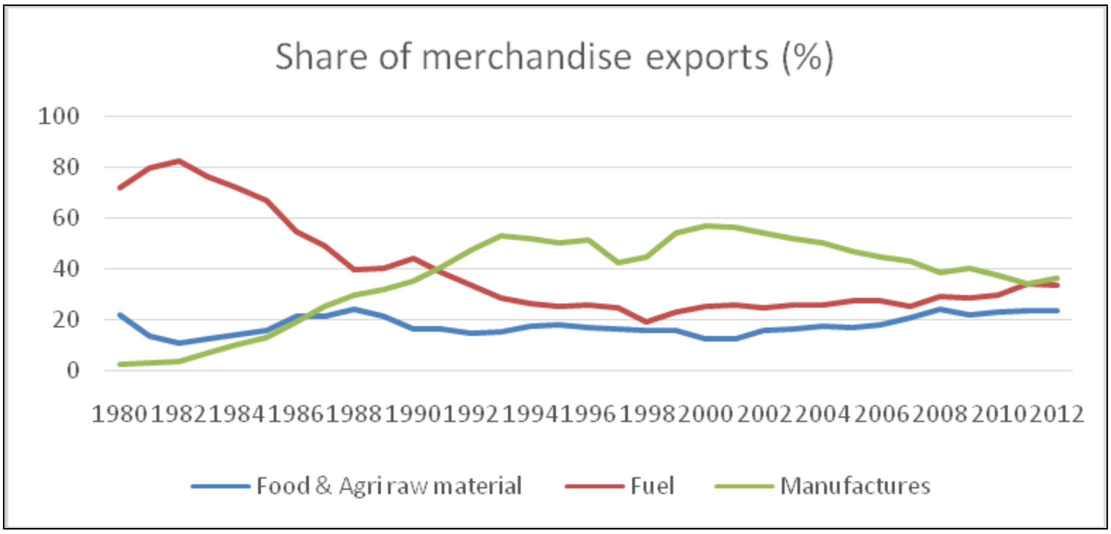


Chart 2: Boom and bust of manufacturing exports

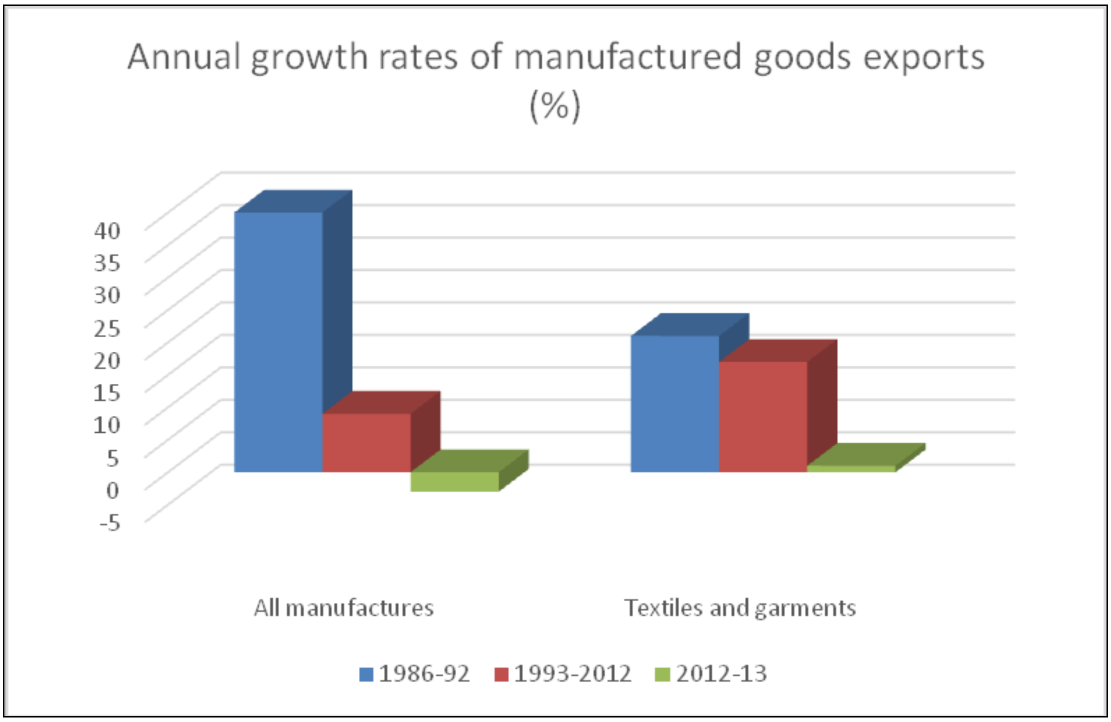
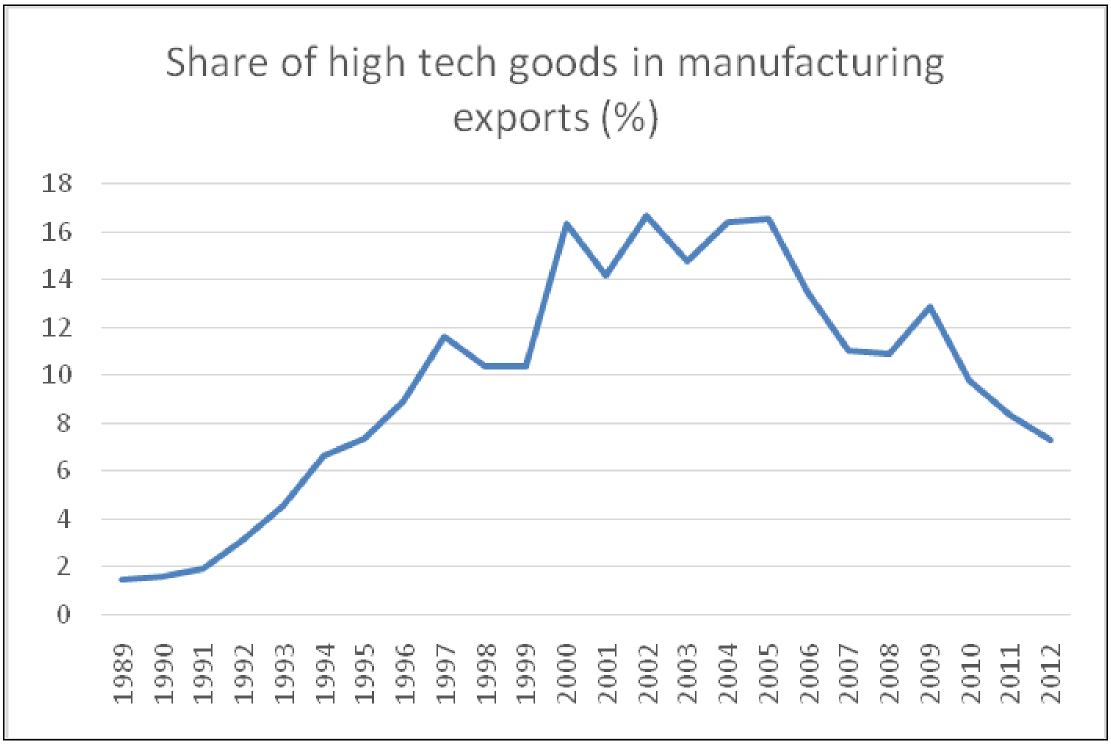


Chart 3 suggests that the relative decline of manufacturing was more serious, because it also affected the so-called "high tech" manufacturing exports, whose share of total manufacturing exports first rose until the turn of the century and then stagnated and subsequently fell. Remarkably, an economy that had seemed to achieve a significant degree of productive transformation in terms of moving away from low value-added primary production to manufacturing, relapsed back into dependence upon primary goods, albeit a slightly different set of such goods compared to earlier.

Chart 3: Even high tech export shares have fallen recently



While fuel exports had dominated the previous era, their recent expansion reflected global price rises rather than increased oil and natural gas production. Indeed, the country is now a net importer of fuel, rather than a net exporter. However, exports of palm oil and various agricultural raw materials, as well as of coal, have risen rapidly and become more important than ever. With manufacturing now accounting for only around one third of total goods exports, and high tech exports forming a dwindling share of even those, Indonesia has once again become an economy dependent on primary production.

So what happened? Three apparently unrelated processes worked to effect this trend, with two of them related to policy choices.

First, the Asian crisis led to significant financial liberalisation in the worst affected countries. Indonesia had an open capital account ever since Suharto's coup in 1966, but the extensive deregulation of domestic finance after 2008, the major offers to liberalise financial services made under the GATS and the opening up of the economy to foreign purchasers of domestic assets such as land and real estate as well as securities led eventually to capital inflows that were directed not to productive investment but to capital gains.

Second, this was then combined with the global boom in primary commodities, led by substantially increased demand from China. This created a boom in certain sectors, both mineral and agricultural. Indonesia therefore experienced a Dutch Disease of sorts, whereby the combination of capital inflows and a commodities boom generated higher real exchange rates and caused a shift in incentives away from tradeable to non-tradeable activities. This put further pressure on manufacturing production for exports and for domestic consumption.

Third, the further liberalisation of trade within the ASEAN community – and the ASEAN trade deal with China – involved additional trade liberalisation that increased the import intensity of both domestic production and consumption. Despite the fact that Indonesia has a potentially very large domestic market, domestic production of a very wide range of manufactured goods is no longer competitive or viable. Because this in turn means dynamic losses in terms of learning and productivity improvements, it becomes even harder to revive manufacturing under such conditions.

Indonesia therefore provides an object lesson for developing countries, of the difficulties in sustaining a process of economic diversification to move the economy and employment to higher value added activities. It will be interesting to see how many countries actually learn from this lesson, including Indonesia herself.

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