CAN INDONESIA COMPETE? RECOVERY FROM THE CRISIS

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ABSTRACT

In recent years, competitiveness has become more than a fashionable concept. Despite critiques of the application of this concept, some scholars have started to apply this concept on building and assessing the competitiveness of nations.

This paper presents the application of competitiveness concept, which compares the competitiveness of two Asian developing countries, Indonesia and Thailand due to those countries were hit by the financial crisis at the same time. The measurement of competitiveness uses two methods: (1) the measurement of the range of real exchange rate and export performance, and (2) the growth of GDP per capita.

Based on the real exchange rate analysis, Indonesia’s competitiveness is adequate although most measures of the real exchange rate remain below the early 1990s level. Most recent in one or two years, Indonesia shows a sound improvement in competitiveness. The export performance analysis on the other hand suggests that Indonesia needs more concern to increase the competitiveness.

The significant growth of GDP over the last two years indicates that Indonesia competitiveness has started increasing. To increase the growth level and the competitiveness level, the reform programs such as structural reforms, financial reform, tax reforms, and law reforms must support macroeconomic and microeconomic conditions.

Keyword : competitiveness, GDP per capita
1. Introduction

The Asian crisis started on July 2, 1997 when Thailand announced the floating system of bath and by January 1998, the bath had depreciated by about 113 percent. The floatation bath quickly triggered financial turmoil across East Asia with its contagion effect. Indonesia, Malaysia, Korea, and the Philippines were hit the hardest - by December 1997, their currencies were depreciated by about 75 percent.

Kaminsky, Reinhart, and Vegh (2003) call the cause of contagion effect as the “unholy trinity”: an abrupt reversal in capital inflows, surprise announcements and a leveraged common creditor. The contagion effect in Asia mainly was caused by a sudden loss of confidence of investors of short-term funds, like international bank loans, portfolio, and hedge funds. The precipitating factor was the deterioration of the balance of payments i.e., the decline in export growth, and a steep increase in current account deficits. The policy “mistake”, in retrospect, was that the monetary authorities have maintained a practically fixed exchange rate (i.e., 25 baht to a US dollar) for too long, while the current account gap was widening (Sadli, 1999).

In the late of eighties, there was investment euphoria in the emerging Asian markets. There was large capital inflow into Asia at that time where economies were growing by high single digit values and in China even by double-digit figures. Domestic bankers and large companies in Thailand borrowed money abroad because of the perceived stability of the baht. International bankers and other fund providers lost their forethought and joined the euphoria. One case in Indonesia, was Peregrine, a Hong Kong based investment firm, which lent $236 million to a Jakarta Taxi Company without collateral because of the eldest daughter of President Soeharto was connected to this company. In the ensuring crisis, Peregrine was broken.

When the crisis happened around July 1997, the investors, and the lenders rushed to take all of their funds and created a panic. Banerjee (1992) develops a model to examine the implications of decision that are influenced by what others are doing. He calls this as “herding behavior”. The massive capital outflow caused the depreciation of the currencies such as the bath, the won and the rupiah. The main difference between Indonesia and Thailand and Korea was that the Indonesian crisis triggered a political crisis, causing ultimately the fall of President Soeharto.
The massive depreciation of rupiah was followed by deficit in the country’s balance of payment, the decrease of country’s reserves, the decrease of gross domestic product, the increase of inflation rate, the increase of foreign debt, the crash of financial institutions especially banks, and a proportionate increase poverty. This condition influenced Indonesian competitiveness as the country lost its attractiveness to the investors. This paper will analyze Indonesia’s competitiveness especially after the recovery from the economic crisis compared to Thailand. Before turning to the analysis of the competitiveness of those countries, the author discusses the concepts of competitiveness of nations and the critiques about the competitiveness concept for the nation.

2. What is Competitiveness?

In recent years, competitiveness has become more than a fashionable concept. This concept is applied to firms, cities, nations, and regions. The concept of competitiveness is a result of a long history of thinking on the subject, which has helped to define the various aspects of this modern and complex concept. Among those who have contributed, one should mention (Garelli, IMD World Competitiveness Yearbook 2006):


2. David Ricardo with his law of Comparative Advantage, which already underlines how countries should compete. (see David Ricardo (1772-1823), “Principle of Political Economy and Taxation”, 1817).

3. The Marxist economists, who have highlighted the impact of sociopolitical environment on economic development, hence the communist idea that changing the political context should precede economic performance. (see Karl Marx (1818-1883), “Capital: A Critique of Political Economy”, 1867).

5. Joseph Schumpeter, who emphasized the role of the entrepreneur as a factor of competitiveness, underlying that progress is the result of disequilibria, which favor innovation and technological improvement. (see Joseph Schumpeter (1883-1950), “Capitalism, Socialism and Democracy”, 1942)

6. Alfred P. Sloan and Peter Drucker, who have further developed the concept of management as a key input factor for competitiveness. (see Alfred P. Sloan (1875-1965), “My Years at General Motors”, 1963; Peter Drucker, “The Age of Discontinuity”, 1969)


8. Nicholas Negroponte and numerous modern economists who are further refining the concept of “Knowledge” as the most recent input factor in competitiveness. (see Nicholas Negroponte, “Being Digital”, 1995).

9. Finally, Michael Porter who has tried to aggregate all these ideas into a systematic model, called the Competitiveness Diamond. (see Michael Porter, “The Competitive Advantage of Nations”, 1990).

Economics defines competitiveness as a nation’s prosperity through trade flows, monetary, fiscal and budget policies. Companies analyze competitiveness in a broader sense that is covering strategy, structure, and finance but less focused on fields like human resources, corporate culture, or consumer behavior. Garelli (2006) describes competitiveness of nations and enterprises from a more global and holistic point of view, essentially a tendency in nature to produce organized wholes, which are more than the mere sum of the component’s units (as defined by the Shorter Oxford English Dictionary). The wholeness is an important characteristic of competitiveness. Both nations and enterprises are doing something to manage a set of competencies and skills to reach prosperity for one and profit for the other.
The World Economic Forum is a not-for-profit and impartial organization under the supervision of Swiss federal government, which is tied to no political, partisan, or national interests. It is founded in 1971 as a foundation with based in Geneva, Switzerland. The World Economic Forum is committed to improving the state of the world by engaging leaders in partnerships to shape global, regional, and industry agendas. The World Economic Forum through its *Global Competitiveness Report* in fact popularized the concept of competitiveness developed by Michael Porter. The World Economic Forum (1996) defines competitiveness as the ability of a country to achieve sustained high rates of growth in GDP per capita. Through the development of its concept and methods, in 2005 The World Economic Forum redefines the competitiveness as:

“The collection of factors, policies, and institutions which determine the level of productivity of a country and that, therefore, determine the level of prosperity that can be attained by an economy”.

Jeffrey Sachs and John McArthur have developed the methodology, the *Growth Competitiveness Index* (GCI) to measure the country’s competitiveness. Based on GCI, there are three pillars for economic growth; the quality of macroeconomic environment, the state of the country’s public institutions, and the level of the technological readiness. The GCI also separates countries into three stages; factor-driven, efficiency-driven, and innovation-driven.

Besides the *Growth Competitiveness Index*, the World Economic Forum uses the *Business Competitiveness Index* to measure the competitiveness. This index focuses on the underlying microeconomic factors, which determine economics current sustainable levels of productivity and competitiveness.

In the *Global Competitiveness Report* 2005-2006, Sachs and McArthur has developed the newest methodology called the *Global Competitiveness Index* (Global CI) to measure the set of institutions, policies, and factors that set the sustainable current and medium-term level of economic prosperity. The Global CI has nine pillar; institutions, infrastructure, macro economy, health and primary education, higher education and training, market efficiency, technological readiness, business sophistication, and innovation.
Indonesia’s Competitiveness

The assessment of Indonesia’s competitiveness in this paper based on two methods; the measurement of the range of real exchange rate and export performance, and the growth of GDP per capita. The author also compares the competitiveness of Indonesia to Thailand’s competitiveness because those two countries were hit by the financial and economic crisis at the same time.

3. Real effective exchange rate indicators

The real effective exchange rate (REER) index is based on the consumer price index (CPI), the wholesale price index (WPI), and unit labor costs (ULC). The REER measures the external competitiveness of a country, which is defined by OECD (1992) as “the degree which a country can, under free trade and fair market conditions, produce goods and services which meet the test of international markets, while simultaneously maintaining and expanding the real income of its people over the long term.”

The varieties of real exchange rate indicators in figure 1 show a steady decline in Indonesia’s external competitiveness but with improvement since 2003.

Figure 1. Indonesia Real Exchange Rate Indicators, 1995-2005

Source: Information Notice System, WITS, Fund Staff Calculations.
Comparing to other crisis countries especially Thailand, Indonesia faces the worst depreciation of the real exchange rate.

4. Export performance

Indonesia’s export growth increased significantly from -12.3 percent in 2001 to 3.1 percent in 2002 and 8.4 percent in 2003. However, Indonesia’s export performance has weakened since 2000, predominantly when compared with other emerging Asian nations. Indonesia also lost export market share in major trading partners since 1999 in five of six largest export destinations (except Malaysia) and in its 15 largest export markets. In 1997-2003 Indonesia’s exports base has more narrowly concentrated with the oil and gas sector, machinery, and transport equipment sectors.

Figure 2. Indonesia Growth of Exports and Imports, 1999-2004 (%)

Source: The World Bank Group

Figure 3. Indonesia Export Performance Relatives to Asia, 1994 - 2004

Source: Direction of Trade Statistics, Fund Staff Calculations.
On the other side, Thailand’s exports showed remarkable growth from -7.1 percent in 2001 to 4.8 percent in 2002 and 18.2 percent in 2003. Growth in total export earnings in 2005 slowed to 15 percent (22 percent in 2004) but is expected to pick in 2006. The shares of the East Asia region in Thailand’s total exports rose from 28 percent to 36 percent during the recovery period.

Figure 4. Indonesian Market Share, 1994 - 2004

Source: Direction of Trade Statistics, Fund Staff Calculations.

Figure 5. Thailand Growth of Exports and Imports, 1999-2004 (%)

Figure 6. Average Shares of Thailand Exports to East Asia, and the Rest of the World in 1994 – 1996 and 2002 - 2004

Source: DOT

5. The growth of gross domestic product

One of the major criteria in the World Economic Forum for assessing a country’s competitiveness is high growth of GDP per capita. According to the Global Competitiveness Report 1998-2005, Indonesia’s competitiveness ranking stepped down from 31 in 1998 to 74 in 2005. Thailand ranking declined from 21 in 1998 to 36 in 2005 but the declining was not as dramatic as Indonesia. Based on the 2005 Global Competitiveness Report, Indonesia had poor performance for macroeconomic environment, public institution especially the corruption index, and technology index. The five major problematic factors doing business in Indonesia are inefficient government bureaucracy, inadequate supply of infrastructure, tax regulations, corruption, and inadequately educated workforce.

Indonesia’s GDP growth declined from 7.4 percent in 1996 to 4.7 percent in 1997. The immediate effect of crisis that happened in the middle of 1997 and the social riot in May 1998 caused the GDP reached the lowest point at -13.3 percent in 1998. In 1999, the growth was less than 1 percent, driven largely by a recovery of household consumption.
The economy showed good signs in 2000 by achieving 4.92 percent growth. It was supported by the peaceful general election in June 1999, which was the first democratic election since 40 years in Indonesia. Exports increased and investment was growing for the first time since the crisis by 22 percent but it was dominated by domestic investment because foreign investors still waited. The recovery in 2000 was experienced in all sectors including manufacturing (figure 8).

As the world economics slowed down in 2001, it affected the exports and the growth started decreasing again in 2001.

Figure 7. Annual Growth of GDP by Expenditure

(At 1993 constant price)

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</thead>
<tbody>
<tr>
<td>Household consumption</td>
<td>9.72</td>
<td>7.32</td>
<td>-6.17</td>
<td>4.63</td>
<td>3.53</td>
<td>5.94</td>
<td>4.73</td>
</tr>
<tr>
<td>Government consumption</td>
<td>0.65</td>
<td>0.65</td>
<td>+5.37</td>
<td>0.69</td>
<td>6.49</td>
<td>9.24</td>
<td>10.35</td>
</tr>
<tr>
<td>Gross fixed capital formation</td>
<td>14.31</td>
<td>9.27</td>
<td>-3.01</td>
<td>-18.20</td>
<td>21.52</td>
<td>3.56</td>
<td>1.93</td>
</tr>
<tr>
<td>Export of goods and services</td>
<td>7.65</td>
<td>7.60</td>
<td>11.18</td>
<td>-31.00</td>
<td>26.48</td>
<td>1.88</td>
<td>-1.34</td>
</tr>
<tr>
<td>Import of goods and services</td>
<td>6.65</td>
<td>14.72</td>
<td>-5.29</td>
<td>-40.65</td>
<td>21.52</td>
<td>3.05</td>
<td>-5.32</td>
</tr>
<tr>
<td>Gross Domestic Product</td>
<td>7.64</td>
<td>4.70</td>
<td>-13.13</td>
<td>0.79</td>
<td>4.32</td>
<td>3.44</td>
<td>3.66</td>
</tr>
</tbody>
</table>

Source: Central Board of Statistics

Figure 8. Annual Growth GDP by Industry of Origin (At 1993 constant price)

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</thead>
<tbody>
<tr>
<td>Agriculture</td>
<td>3.14</td>
<td>1.03</td>
<td>-1.33</td>
<td>2.16</td>
<td>1.89</td>
<td>0.56</td>
<td>1.74</td>
</tr>
<tr>
<td>Mining and Quarrying</td>
<td>5.30</td>
<td>2.12</td>
<td>-2.76</td>
<td>-1.62</td>
<td>5.06</td>
<td>-0.64</td>
<td>2.25</td>
</tr>
<tr>
<td>Manufacturing industry</td>
<td>11.59</td>
<td>5.25</td>
<td>-11.94</td>
<td>2.92</td>
<td>6.10</td>
<td>4.32</td>
<td>3.11</td>
</tr>
<tr>
<td>Electricity, Gas &amp; Water</td>
<td>13.62</td>
<td>12.37</td>
<td>-3.03</td>
<td>5.27</td>
<td>8.78</td>
<td>8.43</td>
<td>8.17</td>
</tr>
<tr>
<td>Construction</td>
<td>12.76</td>
<td>7.25</td>
<td>-26.44</td>
<td>-1.91</td>
<td>5.62</td>
<td>3.56</td>
<td>4.11</td>
</tr>
<tr>
<td>Trade, Hotel &amp; Rest.</td>
<td>5.16</td>
<td>5.03</td>
<td>-19.22</td>
<td>-0.56</td>
<td>5.59</td>
<td>5.18</td>
<td>3.61</td>
</tr>
<tr>
<td>Transport &amp; Comm.</td>
<td>9.63</td>
<td>7.01</td>
<td>-15.13</td>
<td>-0.75</td>
<td>9.29</td>
<td>7.51</td>
<td>7.93</td>
</tr>
<tr>
<td>Fin., Leasing &amp; Insurance</td>
<td>5.04</td>
<td>5.93</td>
<td>-26.53</td>
<td>-7.19</td>
<td>4.34</td>
<td>2.98</td>
<td>5.55</td>
</tr>
<tr>
<td>Services</td>
<td>3.49</td>
<td>3.62</td>
<td>-3.85</td>
<td>1.94</td>
<td>2.20</td>
<td>1.97</td>
<td>1.98</td>
</tr>
<tr>
<td>Gross Domestic Product</td>
<td>7.64</td>
<td>4.70</td>
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<td>0.79</td>
<td>4.32</td>
<td>3.44</td>
<td>3.66</td>
</tr>
</tbody>
</table>

Source: Central Board of Statistics
As can be seen in figure 9, the growth has been increasing since 2003 and Indonesia still does some reforms especially in fiscal reform and structural reforms.

Figure 9. Indonesia Key Economic Ratios and Long-Term Trends

<table>
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</thead>
<tbody>
<tr>
<td>GDP (average annual growth)</td>
<td>7.3</td>
<td>2.0</td>
<td>4.9</td>
<td>5.1</td>
<td>6.2</td>
</tr>
<tr>
<td>GDP per capita</td>
<td>5.5</td>
<td>0.7</td>
<td>3.5</td>
<td>3.7</td>
<td>4.7</td>
</tr>
<tr>
<td>Exports of goods and services</td>
<td>8.6</td>
<td>2.1</td>
<td>8.2</td>
<td>8.5</td>
<td>11.3</td>
</tr>
</tbody>
</table>

Source: The World Bank Group

Thailand has achieved better growth and recovered from the crisis faster than Indonesia. As can be seen in figure 13, the growth reached 6.9 percent in 2003, 6.1 percent in 2004 and in 2004-2008, this country estimated to reach 6.2 percent of GDP growth.

Figure 10. Thailand Key Economic Ratios and Long-Term Trends

<table>
<thead>
<tr>
<th></th>
<th>1994-04</th>
<th>2003</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP (in US$ billion)</td>
<td>41.0</td>
<td>144.0</td>
<td>163.5</td>
</tr>
<tr>
<td>Gross capital formation/GDP</td>
<td>20.5</td>
<td>45.8</td>
<td>25.0</td>
</tr>
<tr>
<td>Exports of goods and services/GDP</td>
<td>21.9</td>
<td>38.9</td>
<td>66.5</td>
</tr>
<tr>
<td>Gross domestic savings/GDP</td>
<td>26.2</td>
<td>36.0</td>
<td>36.0</td>
</tr>
<tr>
<td>Gross national savings/GDP</td>
<td>24.6</td>
<td>34.7</td>
<td>30.8</td>
</tr>
<tr>
<td>Current account balance/GDP</td>
<td>-5.0</td>
<td>-5.4</td>
<td>5.8</td>
</tr>
<tr>
<td>Interest payments/GDP</td>
<td>2.9</td>
<td>1.9</td>
<td>1.5</td>
</tr>
<tr>
<td>Total debt/GDP</td>
<td>35.9</td>
<td>45.3</td>
<td>36.1</td>
</tr>
<tr>
<td>Total debt services/exports</td>
<td>25.7</td>
<td>31.3</td>
<td>15.3</td>
</tr>
<tr>
<td>Present value of debt/GDP</td>
<td>..</td>
<td>..</td>
<td>32.8</td>
</tr>
<tr>
<td>Present value of debt/exports</td>
<td>..</td>
<td>..</td>
<td>52.0</td>
</tr>
</tbody>
</table>

Source: The World Bank Group

The growth in exports and private consumption has driven the recovery and Thailand’s exports performance exceeded other crisis countries.
6. Conclusions

Indonesia is the country, which suffered the worst impact of the Asian financial and economic crisis. The recovery program as formulated in IMF supported program, is built on four pillars; a strong macroeconomic framework, comprehensive strategy to restructure the financial sector, a broad range of structural reforms, and restructure corporate sector debt.

Based on the real exchange rate analysis, Indonesia’s competitiveness is adequate even though most measures of the real exchange rate remain below the early 1990s level. Most recent in one or two years, Indonesia shows a sound improvement in competitiveness. The export performance analysis on the other hand suggests that Indonesia needs more concern to increase the competitiveness.

The significant growth of GDP and GDP per capita over the last to two years indicates that Indonesia competitiveness has started increasing. To maintain the growth level at least at 6 percent and increase the competitiveness level, the reform programs including structural reforms, financial reform, tax reforms, and law reforms must support the macroeconomic and microeconomic conditions.
Bibliographies


