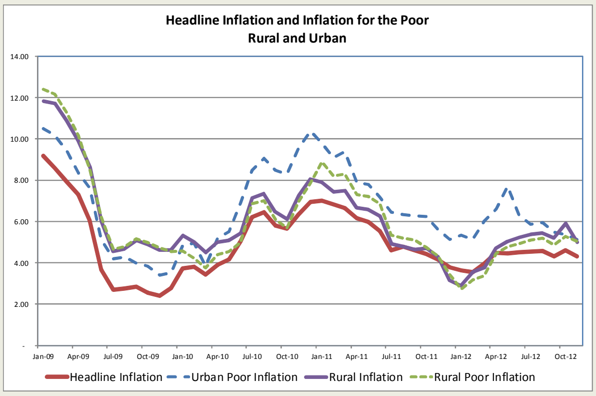
Poverty and the Economy December 2012



INFLATION

Inflation in November was low

Inflation for November 2012 was 0.07%, lower than for October. Year on year it was 4.3%. Inflation for November was the lowest for the last three years. Food prices declined by -0.13 percent in November and year to year it was 5.7%. Lower food price in November reduced inflation for the urban poor (see graph). In the rural area, November inflation was 5.01 year on year, with food price inflation of 5.4 percent.

World food prices continued to decline in November

World Food Prices[1] declined 2.2% from September to November 2012. For the year they are down 7%. All the commodity groups fell on a yearly basis with the sharpest decline for sugar and vegetable oils. If world food prices continue to fall it would have a positive impact on the poor in Indonesia because it will slow or reverse domestic food inflation.

[1] From the FAO World Food Price Index

DEVELOPMENT

World Growth: Uncertainty remains

For 2012 two of the four biggest economies had declining GDP: Europe (20% of world output) and Japan (6%). The slowdown in Europe has for the first time reached Germany. Uncertainty continues with respect to growth in the other 2 of the big 4 -the US (18%) and China (16%)- and in India (6%). A political compromise now seems more likely in the US than before the election, resulting in a more expansionary fiscal policy. That would be good news for world growth.

The most recent global GDP forecast foresees a further decline in world growth, from 3.2% in 2012 to 3% in 2013, as a result of lower growth in the US, China and India. Therefore Indonesia cannot expect a significant increase in demand for its exports that would stimulate its growth.

The Indonesian economy will outperform most countries in 2012

In 2012 Indonesia's growth will almost certainly exceed 6%. It averaged 6.3% in the first 9 months. Therefore the growth rate would have to fall to less than 5% in the fourth quarter for the average to be below 6%. Such a huge decline is highly unlikely. For most other large economies growth in 2012 was well below 6%. Most forecasts for Indonesian GDP growth in 2013 are above 6%: from the World Bank's 6.3% to the budget projection's 6.8%. At the other extreme a US think-tank forecasts a rate of only 5.2%. To make sense of such different forecasts one needs to analyze the principal constraint on growth: the balance of payments.

Growth is running up against a balance of payments constraint

Inevitably some of the increase in domestic demand in 2012 spilled over into imports, estimated to increase by $ 14 billion. Exports are estimated to decline by $ 13 billion in 2012, so the goods balance turns from surplus to small deficit. Other items in the current balance are always in deficit [e.g. services] so the balance on current account increases from minus $7 billion in 2011 to minus $33 billion in 2012. Foreign investment covered the small deficit in 2011, but falls short by $15 billion in 2012, requiring financing from Foreign Exchange Reserves.

Table 1: From Surplus to Deficit in the Balance of Payments [billion of US$]

	2010	2011	2012	2013
Exports of goods	158	203	190	190
Imports of goods	136	177	191	205
Balance on trade	22	26	-1	-15
Balance on services, income, current transfers	-25	-33	-32	-32
Net foreign private & other investment	26	13	18	18
Change in reserves	23	6	-15	-29

*For 2012 actuals for 9-10 months, estimated for 2-3 months. 2013 is a forecast assuming that growth of 6.1%, as in 2012, will require the same absolute $ 14 million increase in imports. All other items are assumed unchanged: exports, and the balance on services, income account, foreign investment etc. Note that "errors and omissions" are omitted.

In order to support a growth rate of 6.1% in 2013 imports will need to increase as they have in 2012 to support an identical growth rate. Using the conservative assumption that other variables will not change, the deficit in 2013 would almost double. Foreign borrowing and/or a decline in reserves of the order of $30 billion is not likely to be feasible, especially as foreign funds are now flowing out of Indonesia. While some estimates will undoubtedly turn out to be wrong the conclusion is reasonably clear: *continued growth of 6% or higher will require either an increase in export earnings or a further increase in foreign capital inflows or both. Either is likely to require a change in policies or acceptance of a decline in the value of the Rupiah.*

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The Impact on the Poor

There is evidence that large groups of the poor have benefited from more rapid growth in recent years. First, of the 6 million workers added to the labor force, more than 4 million found regular jobs in such formal sectors as manufacturing and construction. Second, since August of 2012 real wages of agricultural workers have stopped falling and have started to rise slightly.

The most important policy change with respect to the poor, the decision to raise the minimum wage in greater Jakarta by more than 40%, is likely to have mixed results. The increase, to Rp 2.2 million or $230 a month was justified as helping the poor. It will certainly increase the wages of those employed in larger, formal sector firms covered by minimum wage legislation whose wages are now at the minimum. But most of those benefiting from the increase are not among the poor[1] although many would be near-poor.

On the other hand, the new minimum will raise Indonesian industrial wages to those prevailing in China's Coastal areas. They would be 4 times the wage in Bangladesh and Vietnam, twice that in India and almost twice for some areas of China. Indonesia's labor intensive industries which have stagnated in the last 16 years will continue to stagnate or decline because at this wage they cannot compete in the world market. While Indonesia has advantages over some competitors in other elements of cost they are not great enough to overcome such a huge gap for labor-intensive firms competing in the world market. Therefore the number of regular formal sector jobs with a wage near the minimum will continue to grow more slowly than the labor force. Most of the poor are among the 70 million workers in the informal economy. They will find it more difficult to move to the better jobs in the formal economy. Unless labor-intensive industries are exempt, *the new minimum wage will benefit mostly the near-poor and some non-poor at the cost of the poorest 30-40% who now work in agriculture and other informal sector jobs*.

[1] The urban poverty line in 2012 was Rp 280,000, or Rp 1.4 million for a family of 5. By 2013 the poverty line might be 1.5 million. If the family had only one person earning income a minimum wage of Rp 2.2 million would be 50% above the income of the poor. Or consider a farm worker earning Rp 28,500 a day in 2013. If working 25 days a month on average, which is probably optimistic, would earn about Rp 700,000 a month, one-third of the minimum.

SPECIAL REPORT

Poverty, Food prices and Supply Shocks of Agricultural Products in Indonesia

SEADI commissioned a study on the impact of changes in food prices and of supply shocks in agricultural products on Indonesia's poor. Five scenarios are simulated representing increases in the prices of 5 important commodities. A CGE model developed by Dr. Arief Yusuf and colleagues, tries to mimic the current situation and policies in agriculture. It assumes that imports of rice will be unchanged when a domestic supply shock increases the price of rice, but that imports of poultry and vegetables will increase if domestic prices rise. In response to a shock in the world price of soybeans it is assumed that domestic production of soybeans is fixed in the short run, but domestic production of horticulture products can respond to global price changes.

The result suggests that the Indonesian poor, both urban and rural, are most vulnerable to volatility in the price of rice, Indonesia's main staple food. The poverty impact of an increase in the price of such products as soybeans (and its derivative products) is also considerable because of their relative importance for the poor. The impact of price increases will be greater for the rural than for the urban poor. An increase in the price of food tends to be regressive or inequality-increasing. Decomposition analysis suggests that the price effect is much stronger than income effect.

Policy implications from this analysis include: [i] Since the majority of Indonesian poor live in rural areas and the effect of food price volatility is more serious there, the Government needs to pay attention to any disruption in the supply of foods that are important for the rural poor, like rice and soybeans. The resulting price increase can seriously threaten poverty reduction targets. Strategies to anticipate and deal with rising prices need to be carefully devised and well-targeted to the rural poor.

[ii] In both urban and rural areas the cost of living effect of prices is more important to poverty than the income effect. For instance an increase in the price of imported horticulture products increases the income of unskilled labor by increasing employment in domestic production. However, the increase in the cost of living cannot be offset by this increase in income leaving the poor with lower real consumption. Therefore, food security policies implemented by reducing imports and resulting in higher domestic prices are likely to increase poverty. Alternative approaches to promoting food security that do not entail price increases, such as support for improvements in productivity, would be better for the poor.

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