

DEVELOPMENT

World Economy is Mixed with Substantial Risks Ahead

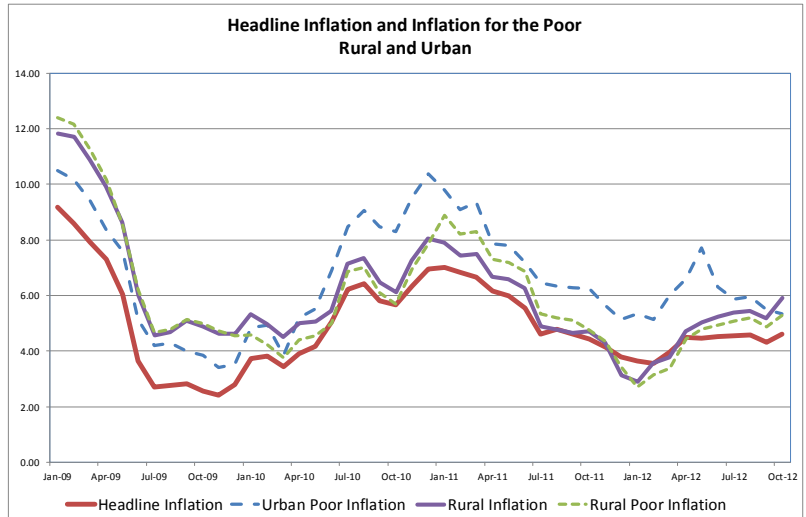
There were positive developments during October in the world economy such as the U.S. growth rate is forecast to improve to 2.5% in the fourth quarter, a percentage point higher than in the second quarter; and the slow-down in Chinese growth appears to have ended in October with both industrial production and exports up. But these are balanced by some negative developments which includes Europe has fallen into its second recession in 3 years; Japan's GDP declined in the last quarter and Indian growth estimates have been reduced further.

That world commodity prices are no longer falling supports the conclusion that the decline in the world's economic growth has stopped. However, two major risks cloud the immediate future.

- Political deadlock in the U.S. delays action dealing with the "fiscal cliff": a massive tax increase and expenditure cut by the U.S. Government in January 2013. The result could be that the U.S. with 19% of the world's GDP moves from 2% growth to a GDP decline.
- China, with 14% of world GDP, does not manage the quick resumption of growth to over 8% which now appears likely. Instead serious structural problems further slow its growth. While these risks are not considered high by the World Bank and IMF they are sufficiently great to make it wise for Indonesia builds some risk insurance into its policies.

Indonesian Economic Performance has been Stronger than Expected

Given the problems of the world economy, Indonesia has done remarkably well with growth in the third quarter at 6.2%. For the first 9 months of 2012, Indonesian growth has therefore averaged 6.3% compared to the same period in 2011, a remarkable performance in view of the substantial decline in the contribution of export earnings to growth. Growth in domestic private consumption (5% is the World Bank estimate), public consumption (8%) and investment (12%) once again compensated for declining export earnings. But there are limits to this pattern of growth because of the impact on the balance of payments (see below). Whether those limits have been reached in 2012 is an important question. Sectors which provided many "good" jobs to the poor have grown fairly rapidly year-on-year: manufacturing at 6.4%, construction at 8% and transport and communications at 10.5%. This will benefit the poor.



INFLATION

Inflation Increased Slightly in October

Inflation in October 2012 was 0.16 percent, which resulted in year-to-date inflation to 3.7 percent and year-on-year inflation of 4.6 percent. Food prices declined in October by 0.43 percent from September which resulted in lower inflation for the urban poor as depicted in the graph above. The year on year inflation for food prices was 6.5 percent. Meanwhile, in rural areas, the year on year inflation for October was 5.9 percent with the inflation of 5.7 percent for food prices.

World Food Prices Starting to Decline

After experiencing a sharp increase in early 2012, the world food price index declined slightly in October because of the decline in prices of cereals and oil/fat which offset the increase in sugar and dairy prices. However, world food inflation was still 12 percent year on year in October. The small decline in wheat prices reflects reduced trade activity, while maize values were down mostly due to slowing demand from the livestock and industrial sectors. If world food prices continue to decline, it will benefit the poor in Indonesia because it will slow domestic food inflation.

THE IMPACT ON THE POOR

Since last month's report only limited additional information has become available on the situation of the poor. The core economy remains remarkably robust given world conditions. If growth continues it will help to reduce poverty in the near term. The key challenge is maintaining competitiveness as an investment destination while the world economy recovers. So far, Indonesia is doing well on that score. Investment in 2012 is up over 2011. As a result of greater investment and consumption, employment increased substantially in construction and manufacturing. February 2012 employment in both was up by half a million workers over 2011. But with minimum wages in the Jakarta area scheduled to increase wages to the level of China and other rule changes reducing competitiveness, the outlook for labor-intensive industries is not good.

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SPECIAL REPORT BALANCE OF TRADE

Declining Exports, Rising Imports Affect Growth and the Poor

In 2011 export earnings increased by \$46 billion while in the first 9 months of 2012 they are down by almost 10 billion. For the year as whole Indonesian gross export earnings in 2012 will contribute about \$ 60 billion less to growth than they did in 2011, over 8% of GDP. Of the increase in export earnings in 2011 roughly 20% was due to quantity changes and 80% due to price changes.

The decline in exports in 2012 was due to a fall in world commodity prices resulting from the slowdown in world growth. In less than one year rubber prices dropped 26%, vegetable oil by 22% and coal by 19%.

Quantities exported of some major goods continued to increase: [i] in part because investments started last year during the period of high prices were coming into production and [ii] in part because in some commodities Indonesia remain highly profitable even at much lower prices.

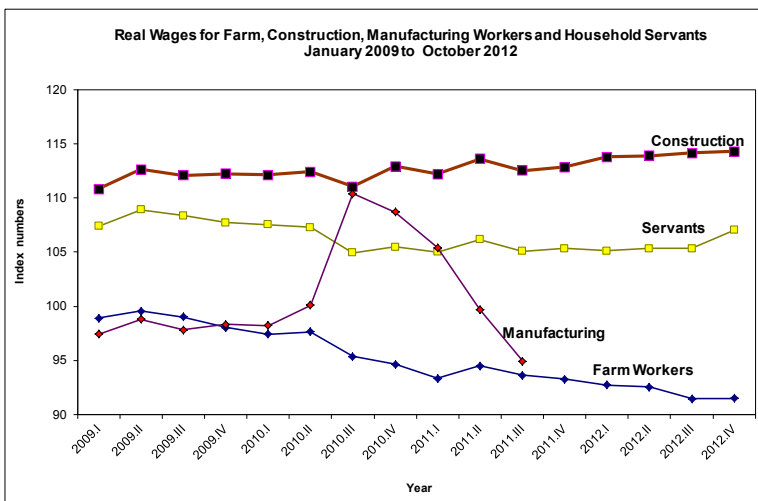
At the same time imports increased to support the substantial increase in investment and the smaller increase in consumption. Prices of some imported commodities were down, most notably cotton, but wheat, soybeans and sugar actually increased in price and the prices of investment goods did not change much. As a result the net trade in goods in 2012 was essentially in balance while it had generated a large surplus in earlier years (US\$ 35 billion in 2011 according to BI Balance of Payments data). Without that surplus Indonesia could no longer finance its deficits in services (shipping) and in income account (debt servicing). The gap was filled by an increased in foreign private investment. But that made Indonesia vulnerable to changes in the sentiments of foreign investors.

Any further decline in export earnings because quantities exported stop growing or prices fall further would increase the deficit and the difficulty of financing it. The other danger is that foreign private investment will decline if Indonesia becomes a less attractive place to invest. Given the great uncertainty in the world economy and the steps taken by some competitors to lower their costs it would be wise to adopt a more aggressive policy of expanding exports, and especially export of manufactures whose prices have held up during the recession (prices¹ for textiles, garments, furniture and footwear are down by 1%, while the prices for commodities on average are down 7%).

1. For all commodities and labor-intensive exports we calculated "unit values" – the value of exports divided by the quantity of exports. This is the same as the price received by Indonesia for a weighted average of all the commodities exported by Indonesia and the weighted average of the labor-intensive manufactures exported by Indonesia. The weights were the value of each of the goods exported by Indonesia.

Real Wages have Stopped Falling and May Even be Increasing Slightly

A low point for real wages of agricultural and construction workers and household servants occurred in August 2012. The increase since then has been so small that it cannot be seen in a graph. For servants it is 3%, for construction workers 0.5% and for farm workers it is half of that. But at least real wages have stopped falling; this is important because real wages had been falling since the second quarter of 2009 for both farm workers and household servants, by -8% and -3% respectively. This is an indication that so far the end of the commodity boom and the resulting slow-down in GDP growth has not had a negative effect on the poor. This conclusion will need to be reexamined with Susenas data on poverty incidence in late 2012 are released.



Unemployment Rate Declined Slightly in August 2012

The recent unemployment data released by BPS showed that the unemployment rate declined slightly from February to August 2012: from 7.6 million to 7.2 million people equal to a decline from 6.3 percent to 6.1 percent. However, the upcoming increase in minimum wages might increase the unemployment rate in the manufacturing sector.