Globalisation and deglobalisation: the Indonesian perspective

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Abstract

Globalisation has created new opportunities for both advanced and emerging economies. In the case of Indonesia, the country's integration with world markets has correlated positively and strongly with economic growth. Foreign direct investment has supported a shift to higher value added industries, while total factor productivity growth has also tended to benefit from globalisation. The effects on the labour market have also been positive.

However, globalisation and increasing trade openness also have unintended consequences, in that the economy becomes more susceptible to global economic and financial cycles. Supply chains between Asian countries become the pass-through channel for any global shocks to price instability, particularly those related to production costs. Meanwhile, increasing automation in some sectors, the growing skill premium, and rising employment in the informal have contributed to growing inequality.

To realise the full benefits of globalisation, domestic authorities should focus on maintaining the domestic economy's soundness and competitiveness. By improving their policy coordination and strengthening risk management, national authorities should seek to create systemic resilience in withstanding bouts of uncertainty and volatility from open economic and financial markets.

Keywords: Globalisation, trade openness, international trade.

JEL classification: F13, F15.

Globalisation is defined as integration into international capital, commodity and labour markets (Bordo (2003)). Therefore, the focus of globalisation is not only on international trade in goods and international movements of capital (including foreign investment, portfolio flows and aid), but also on cross-country migration and trade in services that are associated with labour market dynamics and skills/technology transfer. Baldwin and Martin (1999) identify two episodes of globalisation, the first starting around the mid-19th century and continuing until World War I, and the second starting after World War II and continuing today.

Determinants of globalisation

Globalisation has created new opportunities for both advanced and emerging economies. Economic globalisation in Indonesia started after the end of World War II, driven by international trade and industrialisation. Indonesia's latest trade figures show the effects of globalisation. In 2016, exports amounted to USD 144.7 billion and imports to USD 135.6 billion, resulting in a positive trade balance of USD 8.9 billion, making Indonesia the world's 26th largest exporter. The top three Indonesian exports are mineral fuels, mineral oils and products of their distillation (USD 27 billion), animal or vegetable fats and oils and their cleavage products (USD 18.3 billion), and electrical machinery and equipment and parts (USD 8.15 billion). The top three imports are machinery and mechanical appliances (USD 21 billion), mineral fuels and products of their distillation (USD 19 billion), and electrical machinery and equipment and parts (USD 15 billion). This trade performance is supported by structural transformations in agriculture as well as the manufacturing and service sectors.

From the mid-1960s to the 1980s, Indonesia was able to reap the first benefits from worldwide investment flows, knowledge exchange and rapid economic growth. During 1975–80, Indonesia's economy grew by 7.5% annually on average. Over the next five years, growth slowed to 3.7% annually. In response, the country altered its trade regime to become more outward looking. The effect was to increase the integration of Indonesia into the global economy through trade and financial flows.

The second driver of globalisation was industrialisation. In general, developing countries frequently lack the conditions to support the process of industrialisation. Capital is limited since the saving rate is still relatively low, and there are shortages of both technology and skilled human resources. This encourages the inward flow of capital, either through foreign direct investment (FDI) or the flow of funds to domestic portfolio instruments, and the flow of skilled workers (migration) from developed countries. A strategy of integrating with global value chains is also seen as part of this industrialisation agenda. As a developing country with a lower level of technology and abundant low-skill labour resources, Indonesia was able to reap the benefits of industrialisation as multinational companies moved production there.

Many believe that globalisation has a positive impact on both advanced and emerging countries. Globalisation optimises resource allocation, so that global output is higher than it would be without global economic integration. Therefore, countries will continue to expand their exposure to global markets through globalisation even if protectionism is an inevitable side effect of the recent rise in political populism. However, this effect is expected to be temporary since there is not yet any evidence of net benefits from protectionism in the global context.

Macroeconomic effects of globalisation

Globalisation has generally promoted economic growth. Using data on the economic growth of ASEAN countries between 1970 and 2008 and the KOF Index of Globalisation, Ying et al (2014) find that globalisation has increased economic growth in ASEAN countries, including Indonesia. Their results indicate that an increase in globalisation of approximately 1 percentage point lifts economic growth by 1.48%, in particular due to technological advances. A similar result was obtained by Dreher (2005), who noted that economic integration via globalisation promotes higher economic growth.

China's role in the global economy has greatly increased in the decade since the Asian financial crisis. China's ascent has been driven by its export-led growth policy since joining the WTO in 2001. Mass production of manufactured consumption goods has boosted China's economic growth and also created spillovers to neighbouring regions that provide raw materials. Indonesia, Malaysia and the Philippines are among the beneficiaries of China's high economic growth, particularly through commodities exports. Along with trade expansion, the flow of investment from China has also increased exponentially.

Trade integration as a measure of trade openness (trade as percentage of GDP) has had a positive and strong correlation with economic growth in Indonesia, particularly after the Great Financial Crisis (GFC) in 2008. Trade openness increased from 22% in the 1960s to around 60% in the 1990s, although it stabilised after the Asian crisis in 1998 and declined following the GFC to 37% in 2016. The acceleration of economic openness was accompanied by regulatory reform in trade policy focused on bolstering economic growth. Using a plant-level panel data set from the Indonesian manufacturing sector, Takii and Narjoko (2013) study the impact of globalisation through trade liberalisation on the size of plants as measured by real output. The paper finds that foreign-owned firms which participate in international activities have scale advantages.

Regarding foreign direct investment (FDI), Sjöholm (2016) documents the impact of FDI on Indonesia and finds that foreign firms generate higher value added, which in turn spills over to domestic firms' value added. Therefore, FDI promotes structural change via higher value added industry, boosting investment, tax revenues and wages. Eventually, this process should foster both economic growth and improved living standards. Thus, globalisation through FDI reduces not only the productivity gap but also the wage differential between developing and advanced economies.

In terms of total factor productivity (TFP) growth, ASEAN economies, including Indonesia, tend to perform relatively well during globalisation. Consistent with existing evidence, TFP growth in manufacturing tends to outpace that in services for most economies. The productivity growth of Asian economies, in particular of the service sector, is sometimes lower than that of the manufacturing sector (McGregor et al (2017)). Using a sample of 40 economies during the period 1995–2009, the paper found that total factor productivity (TFP) growth in Asian economies has been relatively strong compared with that of other countries. Particularly in Indonesia, most of the GDP growth was explained by the growth in the capital stock as well as the growth of education-adjusted employment.

However, globalisation and increasing trade openness have unintended consequences for emerging market economies since the economy has become more responsive to the global economic and financial cycle. Closer trade connections increase the economy's sensitivity to inflation. Recently, there has been a notable convergence of Asia-Pacific's inflation levels, particularly in terms of consumer prices, induced by an increasing share of these economies' trade in total international trade.

As domestic supply chains between Asian countries have become increasingly integrated, they have become the pass-through channel for global shocks, particularly those related to production costs. Trade intensity in Asian economies is empirically associated with the co-movement of inflation rates. Baldwin (2013) finds that a one standard deviation increase in trade intensity between two economies is associated with a roughly 3–6 percentage point increase in the correlation between the consumer price index inflation rates of the same economies. The trade intensity factor remains robust even after control variables are included.

In addition, economic growth dynamics are changing, particularly for commodity exporters. Indonesia's economic growth has moved more or less in line with China's business cycle since the beginning of the commodity boom. In Asia, China is the main importer of commodities. The positive correlation between Indonesia's and China's business cycles was more significant during the commodity boom from 2006 to 2013. China's influence is also felt in the form of capital inflows through real investment in the manufacturing, mining and services sector. A more synchronised business cycle also poses the risk of a negative spillover from any slowdown in China, which would impact not only on commodities exports from emerging markets, but also on exports of intermediate goods for manufacturing. Although China accounts for only 13% of Indonesia's total exports, it is the main market for exports of coal, palm oil and various metals, and hence the effects spread across several economic sectors.

Moreover, the surge of commodities exports in the last decade has transformed Indonesia's economic structure. Total exports from Indonesia amounted to USD 144.7 billion in 2016, which were dominated by exports of mineral fuels, mineral oils and their distillation products (USD 27 billion), as well as animal or vegetable fats and oils and their cleavage products (USD 18.3 billion). Exports of electrical machinery and equipment and parts accounted for USD 8.15 billion in 2016. Back in 1993, the share of the industrial sector was about 27%, but this had fallen to 21.4% by the last quarter of 2016. The decline in the share of manufacturing over the past 15 years is quite significant for an emerging market economy like Indonesia's that aims to attain upper middle income levels through robust industrialisation and the creation of quality jobs.

The falling share of the manufacturing sector in Indonesia's economy is also related to rising commodity prices, which have driven an appreciation of the currency and thus put pressure on the competitiveness of the industrial sector. This has reduced the incentive for the manufacturing sector to invest in improved technology, R&D and worker skills. Given insufficient skills, capacity and capability, the labour force is limited to low-skilled jobs. As a result, most of the workforce in the primary sector (agriculture and mining) is shifting to the low-skilled services sector, which has grown rapidly in line with rising domestic consumption. Unfortunately, owing to the lack of innovation and applied technology, productivity in the services sector is relatively low.

The recent episode of globalisation was a period of technological advancement. In particular, the internet has helped emerging market economies join the digital economy. The growth of e-commerce has flourished in the past two years. In Indonesia, for example, Go-jek is a technology company that focuses on providing online transportation services with plans to expand into fintech services. Innovation and increased productivity could further drive the integration of emerging market economies into the global economy.

Distributional effects of globalisation

Besides its macroeconomic effects, increased domestic economic integration with the global economy also has an impact on the labour market. Globalisation impacts positively on the labour market as working conditions have improved, especially in manufacturing. Increased integration of labour markets has also reduced the wage gap among workers in advanced and emerging market economies. Sitalaksmi et al (2007) use individual employment data to argue that the increase in export-oriented foreign direct investment influenced relative wages in the textile and apparel sector. Additionally, working conditions, proxied by workers' own assessment of their income, working facilities, medical benefits, safety considerations and transport opportunities, have improved over time in the expanding manufacturing industries as compared with agriculture.

Existing studies on the effects of Indonesian trade liberalisation show both increased firm productivity and improvements in working conditions in manufacturing. At the plant level, Amiti and Konings (2007) find that trade liberalisation affected firms' productivity via two channels: falling tariffs on imported inputs fostered learning and raised both product quality and variety, while falling output protection increased competitive pressures. Comparing the two effects, the paper argues that the gains from falling input tariffs were considerably higher. Firm productivity also has been strongly affected by FDI flows, as firms with increasing foreign ownership experienced restructuring, employment and wage growth, as well as stronger linkages to export and import markets (Arnold and Smarzynska Javorcik (2005)). However, regional autonomy, issues relating to local governance, infrastructure and uncertainties in local regulations are increasingly important as well as some programmes that promote specific locations as special economic zones to attract manufacturing investors.

The trend to automation in a number of sectors also has an impact on growing inequality. Automation in the manufacturing sector has caused job losses, especially among unskilled workers. In the trade sector, unskilled workers are also being affected by the growth of the digital economy (e-commerce), which tends to eliminate jobs. The types of job created by the digital economy are also limited to mostly higher-skilled workers. Even though jobs growth remains relatively stable, the growth of formal jobs has continued to decline after the GFC. Meanwhile the number of informal jobs has grown slightly. This is a concern since lower-quality jobs imply lower wages.

The increasing trend towards a skill premium has contributed to rising wage inequality. Globalisation has slightly increased the skill premium (wage differences between skilled and unskilled workers). Goldberg and Pavcnik (2007) found that, during globalisation, a shift in demand for skilled workers expands skill premia. Using data from medium and large Indonesian manufacturing firms covering the 2000–08 period, Takii and Narjoko (2013) find that there is a declining pattern in relative wages (skilled vs unskilled), with a slight increase in the trend towards skilled employment. They also found that plants involved with international trade and/or with foreign ownership pay higher wages to their skilled workers and employ more skilled workers compared with local and domestic-oriented plants. However, the latest research conducted by Amiti and Cameron (2012), which revealed the extent of the skill premium in the wake of globalisation, could not find any definite pattern, either between industries or over time. But a study by Suryahadi (2001) finds a fast increase in the employment of skilled labour as well as a decline in wage inequality (faster wage growth for the unskilled) in parallel with Indonesia's trade liberalisation.

Increased informal sector employment has also aggravated inequality. Since more individuals in developing countries are not employed in the formal labour market, but instead work in the informal sectors such as household businesses and family farms (Rosenzweig (1988)), thus potentially expanding wealth inequality. Goldberg and Pavcnik (2007) concluded that globalisation affects individuals through three main channels, namely, changes in labour income, changes in relative prices and consumption, and changes in household production decisions.

Policy implications

Even though it is not yet fully clear who will be the ultimate winners and the losers from globalisation, several studies have outlined which sectors and workers have benefited most to date. More educated people (skilled workers) have benefited more from integrated global trade. The same is true of the more capital and technologically intensive manufacturing sectors as compared with more labour-intensive manufacturing sectors.

For emerging market economies, globalisation brings new opportunities to increase economic growth and productivity, but also creates new challenges for authorities. Simorangkir (2006) shows that failure to anticipate trade openness has undermined the competitiveness of Indonesian products relative to foreign ones, lowering output in the medium to long term. Openness in the financial sector has increased the vulnerability of the Indonesian economy to reversals in capital flows. Trade openness and financial openness are significantly associated with fluctuations in output, exchange rates and inflation in both the very short and long run. Moreover, the benefits of globalisation do not extend equally across countries and sectors.

In order to optimise the benefits from globalisation, authorities should place the emphasis on increasing economic competitiveness. The development of both hard and soft skills is one of the key factors in creating skilled workers and fostering innovation. This type of human resources development strategy, combined with an investment policy to attract high added value and technologically intensive industries linked to global value chains, will maximise the benefits from globalisation. At the same time, increasing domestic connectivity will help to reduce gaps between regions.

Central banks can play a role in helping EMEs reap the benefits of globalisation. First, central banks must commit themselves to preserving macroeconomic stability, including price stability. By preserving macroeconomic stability, central banks help EMEs stabilise output fluctuations, which may be amplified by globalisation, as previously discussed. Second, the inflation process may also change as shocks from other countries are more easily transmitted to the domestic economy. In this case, central banks should continue anchoring inflation expectations at a level that is consistent with central bank's definition of price stability. The credibility of the central bank will reduce second-round inflationary effects and mitigate fluctuations in output and inflation. Third, central banks should encourage cross-border cooperation, for example, exchanges of information in order to paint a comprehensive picture of risks and vulnerabilities, and coordinate their actions to manage liquidity and ensure the efficient functioning of the interbank money market.

Following the Asian financial crisis, Bank Indonesia has made various efforts to strengthen the risk management and mitigation aspects of the macroeconomic and financial system. For Bank Indonesia, monetary policy is part of a constructive policy mix that takes full account of macroprudential and payment system policy considerations as well as capital flow management. This plays an important role in strengthening Indonesia's resilience against uncertainty and volatility arising from the global economy and financial markets. Bank Indonesia is also intensifying its coordination with authorities such as the Indonesia Deposit Insurance (LPS) scheme on bank resolutions and the Financial Services Authority (OJK) on systemic bank surveillance.

Bank Indonesia believes that greater regional integration will be essential to mitigate global risks. One way to reduce such risks is by complementing regional integration with a regional safety net. In general, international reserves are the central bank's first line of defense against external shocks. However, the domestic safety net alone may not be adequate in the event of major and systemic external shocks and hence support may be required from a regional safety net. Bank Indonesia has implemented measures to strengthen the international financial safety net through closer cooperation with other authorities tasked with monetary and financial system stability. These efforts have included strengthening the Regional Financial Arrangements (RFA) under the Chiang-Mai Initiative Multilateralisation (CMIM) scheme as well as cooperation in the form of bilateral swap arrangements with ASEAN partners in ASEAN+3. Such cooperation is perceived as a second line of defense against unforeseen global economic shocks. In addition to the CMIM scheme, Bank Indonesia has also established bilateral swaps with the Bank of Japan and Bank of Korea. The Bank regularly conducts readiness exercises for these facilities.

Bank Indonesia's policy responses in mitigating the risk of sudden stop in capital flows consist of preventive as well as palliative measures. The preventive measures include a macroprudential policy to counter the negative impact of capital flows on financial stability, managing short-term capital flows through regulations on foreign borrowings and FX transactions, and putting in place incentives for long-term capital flows. The palliative measures consist of liquidity support and a crisis resolution framework.

Regarding crisis prevention and resolution, the Prevention and Resolution System Crisis Law (PPKSK Law) defines the responsibilities of the institutions comprising the Financial System Stability Committee (KSSK). Bank Indonesia is responsible for the regulation and supervision of monetary, macroprudential and payment system policy. Following the implementation of the PPKSK Law, Bank Indonesia has strengthened its crisis management framework by enhancing financial system surveillance and finalising the regulations required under its PPKSK mandate.

In line with the liquidity assistance framework to support financial stability, Bank Indonesia has improved its Short-Term Liquidity Loans (PLJP) Regulation in order to help overcome short-term liquidity issues for commercial banks that may be temporarily illiquid but solvent given adequate collateral. Bank Indonesia maintains the liquidity of the banking sector by optimising its monetary operations so as to mitigate liquidity risks.

In general, the exchange rate is part of Bank Indonesia's policy mix to maintain macroeconomic stability. Therefore, the **Bank maintains the stability of the exchange rate through market operations** with a view to supporting the stability of the economy and financial system. Stabilisation policies are pursued prudently, taking into account market conditions (timing) and the adequacy of foreign exchange reserves.

External debt risks have been mitigated by Bank Indonesia's regulation on prudential principles for non-bank corporations in managing external debt. The risk from external debt is reduced by the share of long-term debt in total borrowing. As of December 2016, public sector external debt totalled USD 158.3 billion, of which a significant part is long-term external debt amounting to about USD 157 billion. Private sector long-term external debt totalled USD 117.5 billion, but short-term external debt amounted to only about USD 41.2 billion.

Meanwhile, macroprudential policy aims at maintaining the resilience of the financial system. In addition to the macroprudential regulation of banks, Bank Indonesia will strengthen its assessment and monitoring of all financial system participants, including financial service counterparties such as corporations.

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