



## Book Review: The Indonesian Economy: Trade and Industrial Policies, 1st edition

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*There are only few internationally published books with the topic of Indonesian trade and industrial policies. Written by prominent scholars and professionals, this book contributes to the literature on such topic. Critical problems pertaining to trade and industry and the related policies are discussed thoroughly, supported by comprehensive data and proper analyses.*

The book contains eleven chapters. The first chapter introduces briefly the Indonesia economy, followed by a good summary of the remaining ten chapters. Readers would get a complete picture of the book by reading the introductory chapter. The second chapter analyzes the temporal relationship between sectoral comparative advantage and aggregate capital accumulation for East and Southeast Asia countries including Indonesia and draws lesson from China's exceptional development on export specialization. Aggregate capital accumulation can explain the progression of comparative advantage—the relationship between these two variables is of inverted U-shaped. Moreover, aggregate capital accumulation is concluded better than industrial policy in affecting comparative advantage of manufacturing sectors.

The third chapter begins by describing evolution of Indonesia's trade policies during 1960-2015. Current trade policy instruments are no longer tariffs but non-tariffs measures (NTMs). The number of NTMs largely applies to textile and agri-food sectors.

Indonesia could improve its business and investment climate by improving transparency and by streamlining NTMs. This would need an independent regulatory-oversight body. Moreover, it is suggested that Indonesia needs to see trade from the point of view of the new paradigm, where production is based on production networks and global value chains. The focus should shift from protecting or favoring certain sectors to increasing customer protection and facilitating producers to grow by improving access to inputs, and to developing policies that promote human capital development, research and development, and innovation that will increase productivity.

The next chapter is on industrialization and industrial policy since 1960, and puts highlight on the democratic era after 2001. It is argued that industrial policy should not be interpreted as only government intervention in specific sectors. Key factors driving slow industrial development include macroeconomic policy environment, small and medium enterprises and firm mobility, commercial policy, governance and regulatory environment, and supply side factors as labor market, logistics, and infrastructure perspectives. The industrial policy that might be suitable for Indonesia is the one that meets the major challenge of achieving high economic growth consistent with distributional and environmental objectives. It is concluded that this should be more on 'policies for industrial progress' rather than 'industry policy', and hence the emphasis needs to be on productivity and efficiency.

The fifth chapter explains why Indonesia is left behind in the development of global value chain (GVC). Incorporation of services inputs is less pronounced in Indonesia. In key sectors such as electronics and automotive equipment, Indonesia's exports and imports skew towards final products. This might be due to several forces including the size of Indonesia's domestic market and trade policy. The country has so far maintained substantial policy restrictions affecting inward investment in services sectors, which hold back the sector from engaging in international trade. It is suggested that more liberal approach to services trade, particularly in services foreign direct investment (FDI), could promote better linkage between Indonesian firms and GVCs.

The next chapter is about development of exports analyzed from the firm-level perspective. A firm can learn from whatever technologies and information is available in the

international market, but in order to do so it must be able to access the market beforehand. It is explained that productivity is key to the persistence of exporting. Problems of infrastructure deficiency and high logistical costs are highlighted. With lower productivity and existence of these problems, the involvement of Indonesian manufacturing in the GVCs has therefore been low. This is reflected in the manufacturing exports, which are insofar narrowly based in agricultural related products. It is concluded that with investment in new machinery, textiles and garments cannot be called sunset industries yet.

The seventh chapter discusses manufacturing export competitiveness based on unit labor costs (ULC) during the commodity boom period. During this period a sharp increase in manufacturing ULC has likely to have contributed to Indonesia's manufacturing sector decline in competitiveness. It is explained that the increase in ULC is due to appreciation of Indonesia's real exchange rate, which is inevitable during a commodity boom. The surged ULC could have been moderated if labor productivity increases in order to compensate, at least partially, the real appreciation. Furthermore, it is shown that the labor productivity growth in Indonesia has been lower than that of partner countries whose real exchange rates were not affected by the commodity boom. It is also discussed that controlling inflation is necessary but not sufficient to maintain competitiveness during the commodity boom period. Improvements in labor productivity and in aspects of the investment climate are needed to mitigate the competitiveness decline, and this might require broad-based structural reforms.

Competitiveness is further discussed in the Chapter 8. Indonesia's competitiveness is determined by labor productivity and labor cost. It is explained that labor productivity has been stagnant due to the low quality of Indonesia's formal education system and the lack of a continuous skills development system. This has to be addressed without delay because the formal education remains the main source of skills production, and successful education reform would only improve labor productivity in the long run. Thus, in the short and medium run, the country needs to rely on reducing labor costs as a way to improve the competitiveness. Relatively high labor cost is related to Indonesia's rigid labor policies, including minimum wages, which have continued to increase without corresponding improvement in labor productivity. Moreover, the severance pay policy with subsequent

decisions by the Constitutional Court to prohibit outsourcing and fixed-term contracting have further increased labor costs whereas these two methods are increasingly used in other countries. It is concluded that reform is needed in this area or firms would be forced to choose between using capital and technology rather than labor or relocate to another country. Either outcome will be undesirable for Indonesia whose number of labor force is the fourth in the world.

The ninth chapter is about local content requirement (LCR), which has been used in Indonesia for the last two decades despite prohibition under WTO. LCR discourages imports, and hence reduces firms' utilization of imported inputs. It is empirically analyzed that imported intermediate inputs affect positively and significantly firms' productivity, value added, output, exports, and employment in the manufacturing sector in Indonesia. Imported intermediate inputs open the possibility of accessing foreign knowledge and technology, enabling the firms to produce higher quality and more competitive products. These imply that LCR may in fact adversely affect manufacturing firms' performance and hence competitiveness.

The next chapter explained that FDI contributes to a structural change in the economy. Because FDI increases value added and hence living standards, resources are moved from low value-added sectors to higher ones. Furthermore, it is discussed that increased value added would benefit the economy through increases in profits and higher wages which lead to firms' expansion or further investments. These would in turns lead to increases in tax revenues. The government should therefore implement policies that encourage FDI inflows by ensuring a level playing field for foreign and domestic firms, followed by improving the overall business climate which includes economic and political stability, infrastructure, and labor force skills that meet foreign MNEs requirement.

The last chapter discusses innovation in Indonesia's manufacturing and service sector. It was found that innovation activity is highly concentrated; Of all firms belong to the clusters of advanced innovators and innovation leaders, only six percent are being substantially innovative. By empirically analyzing the innovation in the sector, it was found that determinants are firm size, export activity, market structure, industry affiliation, and geographic location. Age of firms, foreign ownership, and imported inputs are surprisingly

insignificant in affecting the level of innovation. Infrastructure deficiency, limited access to finance and skilled labor, corruption, crime, and lack of economic and political stability are being major obstacles to undertaking leading innovation of the innovative firms. Addressing these obstacles would therefore be needed to foster innovation activities of the firms. Other policies to provide credits and to increase cooperation between universities and other knowledge centers and the innovating firms should also be in place.

The book thoroughly discusses critical problems facing Indonesian trade and industry and the related policies. The flow of exposition from the first to the last chapter is quite smooth, reflecting thoughtful structure. Data used in most of the chapters are sufficiently rich. Few chapters utilize statistical or econometric analyses allowing the authors to draw sharp conclusions for the chapters. Nevertheless, exposition and discussion in general are not difficult to discern, and hence readers, even with little economics background, would be able to understand. The book is therefore recommended for both academia as well as policy makers.

Although data used in the book are quite ample, some of the data series or indicators are quite old. Revealed comparative advantage indicators in East Asia for instance are presented up to 2007 and value-added related indicators of ASEAN countries being presented for the year 2011. As there exist significant events in the recent years, such as implementation of the ASEAN Economic Community (although the effectiveness of its implementation is still questionable), the industrial revolution 4.0, and the trade war between the United States and China, conclusions based on the older data might have been altered. Implications drawn on the basis of those data or analysis should therefore be referred to with cautions.

Finally, readers would find it be helpful if the book contains a concluding chapter stressing main conclusions or policy implications regarding trade and industrial policies for the time being in Indonesia. In addition, differing conclusions in different chapters, such as the importance of imported input in determining firms' productivity, value added etc. in the ninth chapter vs. the insignificant effect of imported inputs in affecting the level of innovation in the last chapter could be addressed accordingly.

Overall, this book discusses important issues and policies regarding trade and industrial policies in Indonesia. It covers export specialization, industrialization, global value chain, competitiveness, foreign direct investment, innovation, and the related policies, presented in easy to follow exposition. It is very hard to draw general conclusion out of the eleven chapters. I would conclude that trade and industrial policies should enable firms to enhance their competitiveness by removing distorted intervening policies, creating conducive business climate which attract foreign direct investment with technology and quality intermediate inputs to flow in, improving skills and quality of human resource, and urging firms to be innovate.

To broaden perspectives on the Indonesian trade and industrial aspects, complementary readings by Khor and Mitra (2013) on trade and employment in Asian countries; Tan et al. (2019) on competitiveness analysis, exchange rates and exports; Cattaneo et al. (2010) on global value chains in post-crisis; and Ginting et al. (2018) on productivity and quality jobs are suggested.

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