JC Economics: A Level Revision

Macroeconomics CSQ

Economic Development in Indonesia and South Korea

Table 1: Gross Domestic Product per capita (at 2018 US$ constant prices) for Indonesia and South Korea, selected years

	2000	2005	2010	2015	2018
Indonesia	781	1263	3122	3331	3893
South Korea	11948	18640	22087	27105	21363

Source: World Bank

Table 2: Indonesia's Selected Economic Indicators, 2015 – 2018

	2015	2016	2017	2018
Real Economic Growth (%)	4.9	5.0	5.1	5.2
Unemployment (%)	4.5	4.3	4.2	4.5
Change in General Price Levels (%)	6.4	3.5	3.8	3.3
Net Exports in goods and services (current US$billion)	7.7	9.5	11.8	-8.7

Source: World Bank

Extract 4: Opportunities and Challenges for Indonesia's burgeoning middle class

Indonesia is the world's fourth largest consumer market, trailing only China, India, and the United States. The economy is now worth US$900 billion per annum, fuelling a large consumer base, second to none in South East Asia, and a burgeoning middle class and retail sector to match drawing in significant capital investment from domestic and international sources.

Key factors driving Indonesia's explosive growth include its strikingly young population with 60% of its people below 30 years of age, expanding at a rate of 2.9 million a year. It is one of the fastest- growing consumer markets in the world, undergoing a rapid period of urbanisation which is expected to reach 71% of the total population by 2030, fuelled by a rise in incomes and a consumerist lifestyle. It is thus essential that any company wishing to operate there interpret and understand the characteristics of the Indonesian domestic market and its needs. Equally critical is being conscious of the considerable challenges for companies seeking to capture a share of this large commercial opportunity, including its fragmented geography, spread across 6,000 inhabited islands, and the heterogeneous nature of its people.

Indonesia is not Jakarta (the capital city), nor is it Java (the most important island); Indonesia is a complex country composed of many villages, smaller towns and cities who can only be served via proper operations and distribution networks. Indonesians have a strong preference for trusted local brands and take particular, even nationalistic, pride in supporting local businesses. The perception of being "Indonesian" has a strong bearing on purchasing decisions. Compounding the regional disparities are the logistical challenges inherent by extending supply chains across a country that remains poorly served due to insufficient transport infrastructure which are usually dominated by domestic firms with the long-established connections.

Source: FDISpotlight (accessed 24 July 2020)

Extract 5: Two Sides of Economic Success

Indonesia's air quality has deteriorated from among the cleanest in the world to one of the most polluted over the past two decades, shaving five years from life expectancy in some regions, researchers say.

The study by the Energy Policy Institute at the University of Chicago says an increase in coal- fired power stations, burning of land for plantation agriculture and rising car ownership are responsible for the worsening pollution in the world's fourth-most populous country. Sustained high concentrations of particulate matter in the air people breath will cut 2.3 years from lifespans in Jakarta. Indonesia's annual dry season fires were particularly disastrous in 2015, burning 2.6 million hectares of land and spreading health-damaging haze across Indonesia, Singapore, southern Thailand and Malaysia. The World Bank estimated the fires cost Indonesia $16 billion and a study estimated the haze hastened 100,000 deaths in the region.

Citing the experience of cities such as London, Osaka and Los Angeles in reducing disastrous air pollution and China's more recent progress, the researchers said Indonesia's pollution problem is "solvable" through stricter regulation and stronger enforcement, which is sorely missing now.

Meanwhile, a World Bank report in 2015 rang alarm bells for Indonesia. Despite managing to more than halve its poverty rate since 1999, inequality has been rising fast since 2000. That’s because the richest 20% have enjoyed much higher growth in incomes and consumption than others. World Bank estimates reveal that Indonesia’s Gini index increased from 0.30 in the 1990s to 0.41 in 2015. Indonesia’s consumer class has grown stronger thanks to two decades of economic growth. Their incomes are rising as their high educational qualifications meet the increasing demand for skilled workers. On the other side, Indonesia is largely still an agrarian country with a low-skilled manufacturing sector. A significant number of people with lower education struggle to find productive employment. They are trapped in low-paying jobs. Some work in farming and fisheries in rural areas, others work in the informal sectors – market coolies, domestic workers, drivers, etc. As their wages increase more slowly than for skilled workers, the income gap widens.

Indonesia also faces different income gaps between different provinces, ranging from the richer Jakarta metropolitan area to the poorer agriculture-based Sumatra and Sulawesi islands.

Source: Associated Press, 29 March 2019 and The Conversation, 28 August 2018

Extract 6: Can Asian countries learn from South Korea?
The "middle–income trap", in general terms, are middle–income countries which have lost their competitiveness against other low-wage economies but at the same time are unable to compete against developed economies to transition to high-income countries. As Ejaz Ghani from the World Bank says, it is a "development stage that characterizes countries that are squeezed between low- wage producers and highly skilled and fast-moving innovators." Typically, its real GDP per capita would remain in the region of US$3,000 to US$10,000. Certainly, many developing countries have enjoyed the benefits of transitioning, some rapidly, from a low-income country to a middle–income country but only a handful of countries have seemed to manage to escape the middle–income trap. This is a sad situation, where the GDP of a country can possibly decrease if it remains in the middle- income level for a very long time and has little hope of seeing it reach high–income in the near future.

South Korea began its economic take-off from 1960s to 1980s, during which rapid economic growth was fuelled mainly by investment and exports. Beyond a certain threshold, more focus had been shifted to the quality rather than the quantity of growth. Today, South Korea's firms such as Samsung, Hyundai and LG are among the world leaders in capital-intensive manufacturing in areas such as consumer electronics, biotechnology and alternative energy.

For countries to leave the middle–income trap, encouraging private investment and innovation, high levels of efficient government system and leadership, and highly educated workforce must be achieved. These are areas that South Korea has certainly achieved which developing middle-income countries can emulate. Considering the rather similar conditions most of these Asian countries stuck in a middle–income trap have with South Korea's initial economic development experience, the country offers important lessons on how to fill those gaps.

Source: Daniel Kasenda, Global Development Network (accessed 12 July 2020)

Questions

(a) With reference to Table 1, explain why real GDP per capita in US$ might not be a good indicator to compare material wellbeing of an average person living in South Korea to another living in Indonesia and suggest a more appropriate indicator. [3]

(b) Explain whether the net exports indicator could help you to conclude that Indonesia is an open economy. [2]

(c) Using information from Extract 4, explain why would a rational foreign retailer make the decision to invest in Indonesia. [3]

(d) Extract 6 mentions that 'the GDP of a country can possibly decrease if it remains in the middle-income level for a very long time'.

Explain how the above would impact on unemployment and net exports of Indonesia as shown in Table 2. [4]

(e) Discuss the extent to which economic growth is beneficial to the standard of living in Indonesia. [8]

(f) Given Indonesia's burgeoning middle class, discuss whether Indonesia could escape the middle-income trap by following the example of South Korea. [10]

[Total:30 marks]

Suggested Answers

(a) With reference to Table 1, explain why real GDP per capita in US$ might not be a good indicator to compare material wellbeing of an average person living in South Korea to another living in Indonesia and suggest a more appropriate indicator. [3]

In table 1, real GDP per capita (US$) of S.Korea is more than 4-5 times of Indonesia's. It suggests that the average South Korean has the purchasing power 4-5 times more than an average Indonesian based on the indicator.

However, real GDP per capita in US$ is derived by converting the real GDP per capita denominated in domestic currency using the market exchange rate will pose problems as market exchange rate is subjected to currency manipulation or attacks leading to the indicator to over/under estimate the material well-being of an average citizen compared to another country.

It also does not account for the difference in cost of living between an average person in S.Korea and Indonesia. A basket of goods can cost much lower in Indonesia hence it is possible that an average person in Indonesia can consume more goods and services compared to an average person in S.Korea.

The use of Real GDP per capita using PPP would be more appropriate.

(b) Explain whether the net exports indicator could help you to conclude that Indonesia is an open economy. [2]

The data on net exports does not give a conclusion if Indonesia is an open economy.

In the Table 2, Net exports is X-M. which gives the absolute value in terms of US$. It does not give a proportion to GDP.

Even so, exports and imports figures separately are unknown. To know where Indonesia is an open economy, it should be the proportion of total trade to GDP [(X+M)/GDP] or at least it should be mentioned that the proportion of exports or proportion of imports separately are unknown.

(c) Using information from Extract 4, explain why would a rational foreign retailer make the decision to invest in Indonesia. [3]

If expected benefits of investment outweigh the costs of investment, this would increase the chances of investing in Indonesia.

<u>Evidence of benefits of investment</u>
Strong demand as a result of 'young and expanding population, rising income, growing taste & preference for consumer goods'.

Indonesians have a 'strong bias towards local goods' which may lead PED which is inelastic for local goods. Foreign goods could be seen as weaker substitutes. Thus the demand for foreign goods could be low.

Evidence of costs of investment
Possible high cost of transportation due ‘fragmented geographically and poor infrastructure network’

Indonesians have a ‘strong bias towards local goods’ which may result in high barriers to entry for the foreign retailer. The cost of establishing the foreign brand in the local Indonesian market could be high.

In the final assessment, a foreign retailer after weighing the benefits and costs, made the rational decision to expect the benefit is greater than cost, would still make the decision to invest.

(d) Extract 6 mentions that ‘the GDP of a country can possibly decrease if it remains in the middle-income level for a very long time’.

Explain how the above would impact on unemployment and net exports of Indonesia as shown in Table 2. [4]

The middle-income trap may lead to a decrease in GDP. This may lead to Real GDP Growth to be negative.

With negative economic growth (or a recession), Demand for goods and services falls, firms experience a build-up of inventory and will cut production as a result. Fewer workers are demanded leading to higher retrenchment. Cyclical unemployment may start to rise leading to higher than 4.5% per year.

Net exports may improve due to fall in demand of imports as a result of negative economic growth (positive YED of imports). The net exports figures shown in Table 2
may improve to be less of a deficit or even turning into a surplus.

(e) Discuss the extent to which economic growth is beneficial to the standard of living in Indonesia. [8]

Introduction
- Define Standard of Living (SOL): Standard of living refers to the level of well-being or welfare enjoyed by an average person or resident of a country. Conceptually, the overall standard of living measures the material plus non-material well-being of the economy.

Main Body
Thesis – How higher economic growth improves SOL of Indonesians
With higher economic growth, an average household would expect higher income. With greater purchasing power they can buy more goods and services for consumption. This would lead to higher material SOL.

Evidence in the extract 1. “*a rise in incomes and a consumerist lifestyle – it one of the fastest-growing consumer markets in the world*”

Anti-Thesis – How EG does not improve SOL and/or worsens SOL
Although economic growth could help to improve the ability of Indonesians to consume and hence raising the material aspect, non-material aspect may in fact not taken into consideration when examining only economic

<u>1. Environmental issues and weak government enforcement In Extract 2,</u>
"increase in coal-fired power stations, burning of land for plantation agriculture and rising car ownership are responsible for the worsening pollution". "Life expectancy are decreasing"

As a result of fueling economic growth, energy production and land-clearing results in negative externalities in production such as environmental pollution. With high income levels, higher ownership of cars results in negative externalities of consumption which leads to harmful emissions. As a result, the third parties such as the residents in surrounding affected areas suffer which led to lower life expectancy.

"Indonesia's pollution problem is "solvable" through stricter regulation and stronger enforcement, which are sorely missing now."

While there exist policies that could resolve the issues related to negative externalities, the government failed to enact regulations with sufficient severity due partially to information failure. There is also a need for stronger enforcement of the policies, failing which could result in the issues of negative externalities persisting in the Indonesian economy.

<u>2. Income inequality and immobility – Not everyone benefited equally from economic growth.</u>
"Indonesia's Gini index increased from 0.30 in the 1990s to 0.41 in 2015."

The Gini coefficient is a measure of the inequality of a distribution, with a value of 0 expressing total equality and a value of 1 representing maximal inequality. It is commonly used as a measure of the inequality of income. Indonesia's income inequality had worsened as the coefficient value increased while the real GDP per capita in Table 1, had also increased by about 400% from the year 2000 to 2015. This clearly demonstrated the growing inequality in Indonesia.

"different income gaps between different provinces, ranging from the richer Jakarta metropolitan area to the poorer agriculture-based Sumatra and Sulawesi islands."

This difference in income is also evident across the different provinces and economic activities. It could be due to geographical immobility where it is difficult to relocate to another area. Likewise, occupational immobility could also be present when farmers in rural Indonesia are not able to possess necessary skills to bring them a lucrative living in Metropolitan Jakarta.

<u>Conclusion</u>
Changes in material SOL are concentrated in the hands of few people. Majority are not able to enjoy the fruits of economic growth resulting in high income inequality. Non-material SOL aspects in terms of pollution are deteriorating throughout the country due to weak government enforcement. Majority may face both a stagnant material SOL and worsening non-material SOL.

(f) Given Indonesia's burgeoning middle class, discuss whether Indonesia could escape the middle-income trap by following the example of South Korea. [10]

Introduction

Indonesia's strong economic growth in the past three decades was largely due to demand-side changes. It was useful to bring the level of economic development up to a certain stage. When it reached the middle-income category it would find itself extremely difficult to achieve further growth. South Korea is a good example of an economy that focused on the supply-side changes which Indonesia could emulate.

Main Body

Indonesia's burgeoning middle class and middle-income trap

Burgeoning middle class – high consumption drives AD. It will increase GDP but may face limitations of AS not increasing sufficiently.

Middle-income trap – income stagnates or declines due to increased wages which makes the economy less competitive against low wage economies, at the same time it is not able to move up the value chain to compete against more developed economies.

How did South Korea solve the middle income trap?

Indonesia may need to emulate South Korea's factors as in Extract 3 that led them to escape the middle income trap.

- Encouraging private investment and innovation (link to capital investment and increase in both AD and AS) – helps to seek out new growth sectors
- High levels of efficient government system and leadership (strong facilitator of FOP)
- Highly educated workforce (link to quality of FOP and AS) – if quality of workforce improves hence raising the productivity of workers > the increase in wages, the economy will remain competitive against other economies

However, Indonesia is plagued with issues

Extract 1: "a country that remains poorly served due to insufficient transport infrastructure which are usually dominated by domestic firms with the long- established connections."

Extract 1:" Indonesians have a strong preference for trusted local brands and take particular, even nationalistic, pride in supporting local businesses. The perception of being "Indonesian" has a strong bearing on purchasing decisions."

Extract 2: "However, Indonesia is largely still an agrarian country with a low-skilled manufacturing sector"

Indonesia may find difficulty in attracting investments especially foreign investment who might not invest in high capital-intensive industries due to low expected rate of return and high barriers to entry

Weak government enforcement especially in environmental protectionism or inefficiencies given "insufficient transport infrastructure which are usually dominated by domestic firms with the long-established connections."

In Extract 2, "significant number of people with lower education struggle to find productive employment"

"They are trapped in low-paying jobs. Some work in farming and fisheries in rural areas, others work in the informal sectors – market coolies, domestic workers, drivers, etc."

Difficulties to raise skill-set through training as the lack of basic education would hamper the success of the policy. In addition, there may also be no willingness on the part of workers to go for training if they are already struggling to find productive employment in the first place. The informal sectors in which they are employed will most likely not be paying them if they take time off to go for training. Hence, the policy may work, only if the training provides a stipend for them to be able to maintain basic consumption during training period.

<u>Conclusion</u>
Although Indonesia has a fast growing middle-income population which can provide a large consumer base to attract investments and growth, it may not be the case. The burgeoning middle class could provide impetus in terms of aggregate demand but South Korea's experiences focused on changes in the aggregate supply.

Given South Korea's positive experience, Indonesia could aim to implement the policies to shift the economy out of the middle-income trap but faces substantial hurdles. Indonesia would find it difficult to solve some of the most limiting issue/s which it faces currently. It is lacking good governance, quality infrastructure and basic education. It can only attract investments if there is good infrastructure and skilled workforce, and with investments, jobs will be created and there can be growth. Indonesia's unique geography and culture of the country presents a significant challenge to investors and hence growth. These are the factors that were critical for South Korea but lacking in the current Indonesia.