Lessening Pressure on Trade Protectionism by Diversifying Exports

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History has shown us that protectionism and beggar-thy-neighbor policies were key factors in bringing down the global economy into the Great Depression in the 1930s. We do not want to repeat a similar mistake again. So at the onset of the global financial crisis, G-20 leaders called on each other to refrain from raising new barriers to investment and trade. This commitment has been reaffirmed in almost every G-20 meeting following the Washington meeting in November 2008. Fortunately, so far there has been no significant increase in trade barriers like what had happened during the Great Depression of the 1930s.

The global financial crisis was associated with a trade collapse, which affected many countries in the world. It is natural that a collapse in the trading system combined with acute macroeconomic instability led policymakers to question the relevance of an export-led growth strategy. Given the magnitude and impact of the trade collapse, protectionism has become an obvious concern, especially when the global recovery is still underway.

As for Indonesia, many believe that its relatively insulated economy is the reason why it has performed relatively better than other economies during the global financial crisis (Basri and Rahardja, 2010). This then brings to the surface the question of whether an export-led growth strategy is still relevant, bearing in mind that what saved Indonesia from the dreadful effects of the global financial crisis was its domestic economy. This is not only specific to Indonesia because data shows that many countries that are supported more by their domestic economies are proven to have a better performance compared to countries that are extremely dependant on exports during the global financial crisis. This phenomenon has led to lively discussions among commentators, politicians and some policymakers in Indonesia about the importance of relying less on exports and focusing more on the domestic market. Often the advice given to Indonesian policymakers from these discussions is to pay less attention to the "openness" to trade and investment and instead concentrate more on protecting the domestic economy against external volatility. This experience is influencing these groups to embrace somewhat more nationalistic or protectionist views for a new reason. As often captured by print media, there seems to be a thinking that Indonesia should limit openness and integration with the global economy to prevent itself from being dragged down by the global economic slump. This view adds to the existing view that openness exposes Indonesian firms to unfair competition. Political pressures against more openness sometimes influences policymakers to implement more inward looking policies and to rely less on exports. So what is the relevance of a strategy of facilitating exports and openness to economic growth?

Amidst that debate, a study by Basri and Rahardja (2010) indicates that exports are in fact an important source of Indonesia's economic growth. Exports have a large effect in supporting economic growth, albeit less stable compared to domestic demand. Therefore, a strategy safeguarding a balance between the domestic economy and global orientation, such as becoming a part of a production network and promoting export-oriented growth, must become a part of the development strategy of the national economy. Strengthening domestic demand can be done without resorting to protectionist policies. The study by Basri and Rahardja

(2010) also shows the strong link between exports and strength in the domestic economy. They argue that it is likely that commodity exports play an important role in driving consumption in Indonesia. The economic activities in resources-rich provinces increased as a result of the commodity boom that had occurred in the previous years. This development was reflected by relatively high credit growth in resource-rich provinces several years ago. The growth of third party funds in commodity-producing regions also experienced a slow increase. This fact strengthens the argument that the economy in resource-rich provinces improved as a result of the commodity boom; and during the crisis period, residents in those areas were capable of making use of their accumulated savings to support their consumption during the global financial crisis. In addition, services exports played an important role because surprisingly strong exports in tourism, creative designs and workers' remittances are likely to have direct links with private consumption.

With that evidence, an inward looking strategy is not the right choice. This is also true for the countries that do not have a large domestic market like Singapore. Thus, a strategy to facilitate exports will provide relevant results for the Indonesian economy or countries with small domestic markets. If a strategy facilitating exports is still relevant for Indonesia, will that strategy be able to reduce volatility in Indonesia's economic growth?

A study by Haddad, Lim and Saborowski (2010) shows striking results of a positive connection between export concentration and the total effect of openness on volatility. The more concentrated exports are, the higher the total effect of openness on volatility is. The implication is that the effect of growth volatility as a result of the choice of an export-led growth strategy in the economy would diminish through export diversification. This study provides an exit road for Indonesia to still safeguard an export-led growth strategy as long as an export diversification policy is carried out. Therefore, it is very important to examine the experience of export diversification in Indonesia.

Basri and Rahardja (forthcoming) show that Indonesia can still do more to diversify its exports. It is true that the reform package on trade liberalization in the 1980s dramatically increased Indonesia's export product diversification. A set of policies that reduced barriers to entry, improved trade facilitation and reduced bureaucratic inefficiencies unlocked business opportunities in Indonesia's non-oil sectors. As a result, Indonesia became one of the platforms for a footloose manufacturing industry. The process was also accompanied by a global quota arrangement on textiles and clothing, measures discouraging exports of raw agriculture commodities and relatively low global commodity prices that made exporting manufactured products more attractive than exporting commodities. Our findings also suggest that Indonesia has increased exports of existing products to some new markets, which is part of the extensive margin. However, we also find that extensive margins driven by the discovery of new products and exports to new markets are still quite low.

Basri and Rahardja (forthcoming) show that about 71 percent of the increase in Indonesia's exports from 1990-2008 was due to growth of the same set of products sold to the same markets. Exports of existing products to new markets only comprised 2.9 percent of the increase in total exports between 1990 and 2008. Finally, there seems to be very little discovery in Indonesia's exports. Exports of new products, either to existing or to new markets, contributed only 2 percent of the increase in total exports in that period. The limited capacity and effective public institutions to facilitate R&D and new exporters could limit incentives of manufacturers to engage in new product discovery. As a consequence, Indonesia has depended more on exports of old products to existing markets as the main driver of export growth.

Recent efforts to diversify exports in markets and products have been increasingly more challenging. Competitiveness issues are constraining Indonesian manufacturers and limiting their returns as they face an increasingly competitive global market. Booming commodity prices and the appreciation of the rupiah's real exchange rate have increased the opportunity costs from investing outside of the commodity-related businesses and lowered the margins for manufacturers to compete globally. Interestingly, declining performance of Indonesia's manufactured exports also coincides with the appreciation in the real exchange rate and rising exports of resource-based commodities. The increased price of commodities raises export revenues and increases pressure for real appreciation of the rupiah. Meanwhile, the increase in the price of commodities could also have increased factors of production intensively used in commodity sectors, such as labor and capital, squeezing profitability in traditional manufacturing sectors that are facing competitive world prices and the strengthening rupiah. In addition, the threat of a "currency war" may complicate the situation. The loose monetary policies and measures of advanced economies prop up the carry trade and consequently lead investors to buy assets in emerging economies, thereby creating pressure on exchange rate appreciation which may hamper Indonesia's efforts on export diversification and may trigger protectionist pressures.

Indonesia's past experience and dependence on oil commodities reminds us that there are risks in its economy. Therefore, in the future Indonesia has to issue policies to diversify exports. There are several policies to be carried out, such as development improvements in the financial sector, improvements in the logistics system or connectivity, reduction in dependency toward primary exports, safeguarding competitiveness from exchange rates (preventing Dutch disease), improvements in R&D and the quality of products, increasing the role of the services sector as well as improvements in promotion and marketing. If these policies are smoothly implemented, Indonesia will maintain an export-led growth strategy while also supporting domestic consumption. Ultimately, export-dependant countries can still safeguard an export-led growth strategy as long as an export diversification policy is carried out. This export diversification strategy will also help to ease the pressure on protectionism.