

PROJECTING THE LONG-RUN IMPACT OF AN ECONOMIC REFORM

The case of the Indonesian Omnibus Law

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01

POLICY ISSUES



Investment climate needs improvement

- Complicated regulation (Surianta and Patunru 2021, Negara and Hutchinson 2020)
- Increased protectionism (Lindblad 2015, Patunru and Rahardja 2015, Patunru 2018, Hill 2018)
- Less flexible labour market (Coxhead 2014, Manning 2014)

High risk premium

- Less efficient investment (figure 1)
- Increasing 10-Y bond yield gap with the U.S. (figure 2)

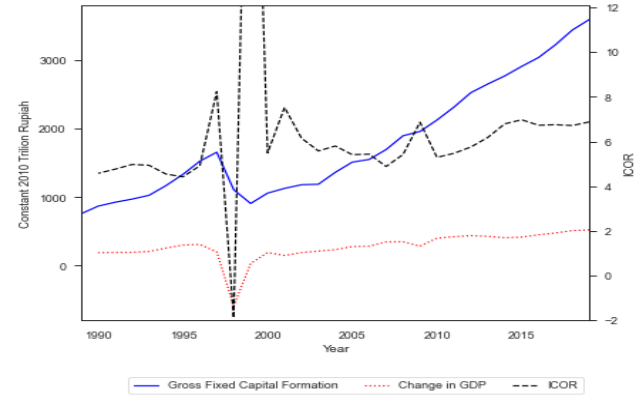


Figure 1. Incremental Capital Output Ratio, Indonesia, 1980-2020

Source: World Development Indicators

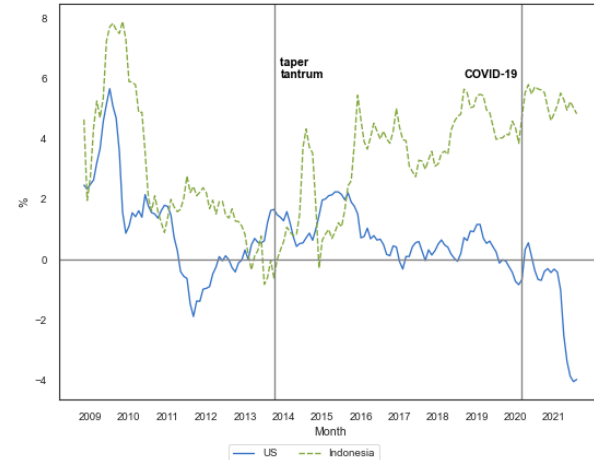


Figure 3. inflation adjusted 10-Year Bond rate, Indonesia and the U.S.

Source: Author calculation, Bank Indonesia, Indonesian statistic agency, Indonesia Bond Pricing Agency, Federal Reserve of US, IMF via CEIC

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The Omnibus Law

An economic reform in sight (Temenggung et al. 2021)

- Law No.11/2020 on Job Creation.
- A controversial law in the middle of pandemic. Revokes 76 other “law” level regulation in just one law.

Improvement in starting a business:

- Risk-based assessment, where “low risk” requires less permit than “high risk”.
- ‘Silent is consent’ approach, more control for central government.

Sovereign Wealth Fund (SWF):

- Managed by a new institution, funded by Government debt and asset selloff.
- Guaranteed by the government against loss
- Already received co-investment commitment from various countries.

Reduced labour market rigidity:

- Reduction in severance pay
 - Allows for economic fluctuation in the minimum wage calculation
- Unemployment benefit and training fund
- Higher coverage of outsourcing

Better (?) trade administration:

- A new, automatic, data driven licensing system called “Neraca Komoditas”.



Contradictory policy

- Continuous trend toward trade reducing policies (Patunru and Rahardja 2015, Patunru 2018)
- A policy to reduce imports by 35% in 2022 (Yu 2020, Gareta and Liman 2021)
- If one aims to increase FDI, expect an increase in CAD.

Bad experience with CAD

- Long spell of CAD prior to Asian Financial Crisis (AFC) (figure 4)
- Avoiding CAD was among policy advice after AFC (Stiglitz 1999)
- Positive current account was cited as the reason why the impact of GFC and the 2013 reduction of asset purchases by rich countries' central bank was mild (Siregar and Wihardja 2015, Doraisami 2014, Basri and Siregar 2009, Basri 2017)

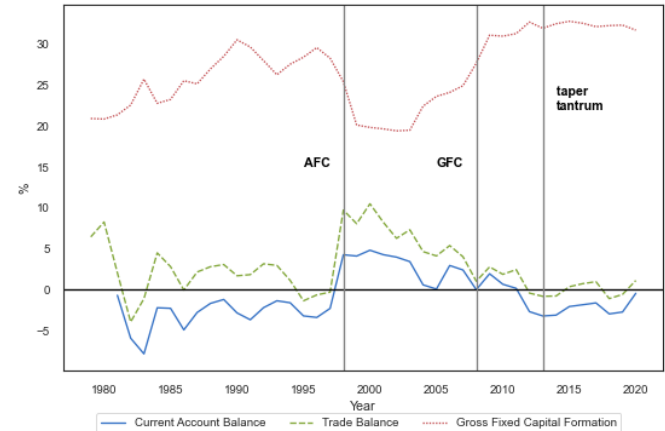


Figure 4. Current Account Balance, Trade Balance, and Gross Fixed Capital Formation, % of GDP, 1980-2020
Source: World Development Indicators

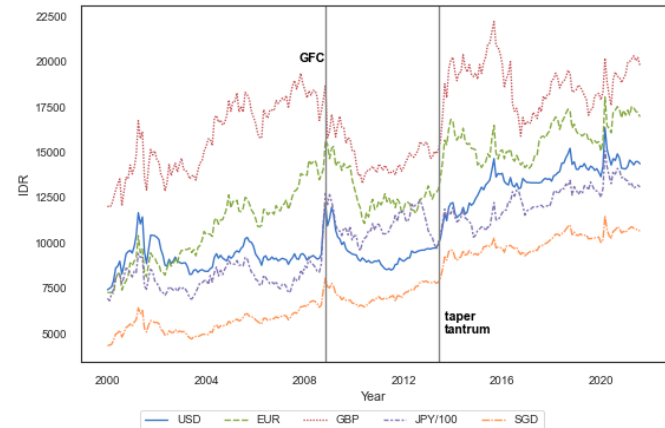


Figure 5. Indonesian rupiah against important currencies, 2000-2020
Source: Bank Indonesia



Some key take-aways

- The Omnibus Law could be Indonesia's long awaited economic reform.
 - The law tries to attract FDI with a significant improvement in business climate.
 - In the short-run, expect an increase in CAD.
- Pairing it with import substitution may reduce the reform's potential.
 - Import substitution emerge from bad past experiences.
 - But it could undermine the efficiency of capital accumulation.



02

SIMULATION SETTING



Gdyn-FS

GTAP (Hertel and Tsigas 1999, Corong et al 2017)

- Multi-sector, multi-region, CGE model with representative agents.
- Solved in (linear) first difference.
- Relatively highly disaggregated sector is useful.

GDyn (Ianchovina and Walmsley 2012)

- Adds recursive dynamics with adaptive expectation investment.
- Capital moves across region via a global trust.
- Asset ownership and domestic-foreign capital transfer.

GDyn-FS (Gretton 2021)

- Adds level-adjustment to the adaptive expectation investment.
- Gives (DELETE:more) stable long-run results.



Key equations on investment treatment

Capital accumulation variable and rate of returns

- There are 3 interest rates which are equal in the long run
- Actual rate of return dictates expected rate of return.
- Capital accumulates as long as there is discrepancy between expected rate of return and target rate of return.

Target rate of return

- Target rate of return is a fixed, long run variable that varies between countries.
- Reflects required rate of return.
- Difference of target rate of return between countries is the risk premium.

GDyn-FS:

$$\begin{aligned} erg_rorg_r &= LAMBRORGE_r \times (rorgt_r - rorge_r) \\ &+ \left(100 \times LAMBRORGE_r^2 \times \log \left(\frac{RORGT_r}{RORGE_r} \right) \right) \end{aligned}$$

In the long run:

$$\begin{aligned} rorgt_r &= rorge_r = rorga_r = 0 \\ RORGT_r &= RORGE_r = RORGROSS_r \end{aligned}$$



Policy scenarios

Target rate of return scenario

- Indonesia's required rate of return is well above the US in GTAP 10 database.
- The Omnibus Law potentially reduces cost of doing business.
- This can be reflected as reduced required rate of return.
- A reduction of 100 basis points of target rate of return is applied with 2 year phase (2022-2023, 50 bps each).

Trade policy scenarios

- Scenario 1: Automatic licensing and trade agreements may improve trade.
 - More open represented by a reduction of ad-valorem equivalent by 10%, phased in 2 years (2022-2023).
- Scenario 2 :increased protectionism
 - More restrictive represented by a reduction of import by 35% applied in 2022.

Country	Target rate of return	
	Pre-shock	Post-shock
Indonesia	15.5	14.5
US	7.3	7.3

	Reduced Target rate of return	Trade Policy
Scenario 1	Yes	No change
Scenario 2	Yes	More open
Scenario 3	No	More restrictive



Baseline and database

Baseline creation

- Baseline serves as a counterfactual as well as reference point.
- GTAP 10 database is used, with 2014 as a reference year.
- We follow baseline from Chappuis and Walmsley (2011) and Gretton (2021).

Baseline calibration

- 2 Parts of GDP growth baseline:
 - 2015-2026: World Economic Outlook, October 2021
 - 2027-2050: CEPII
- Population growth, unskilled labour growth and skilled labour growth are sourced from CEPII.

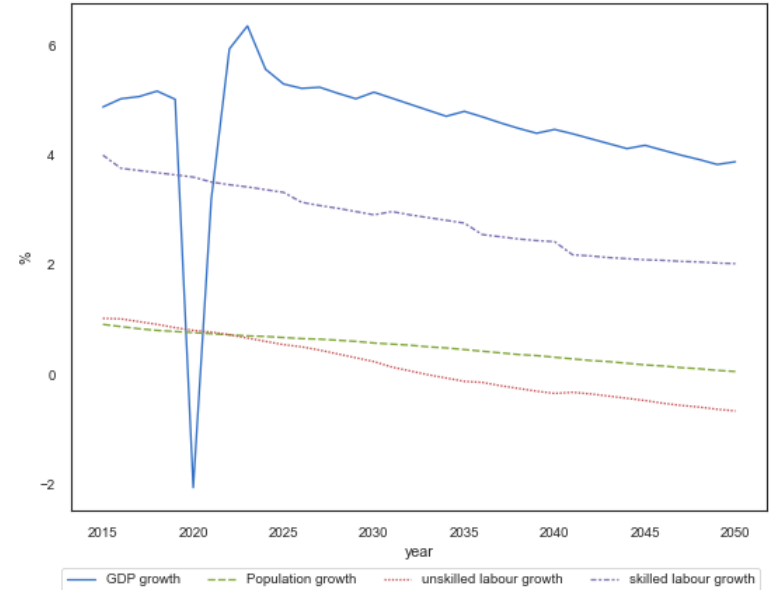


Figure 10. Baseline projection of Indonesia

Source: Author calculation, GTAP 10 Database, Chappuis and Walmsley (2011)



03

RESULTS



3 scenario results

Panel a:

- For scenario 1 and 2, difference in GDP is increasing before transitioning towards new long-run in mid-2030.
 - GDP are higher in the long-run compared to baseline.
- Scenario 3 sees smaller GDP compared to baseline.

Panel b:

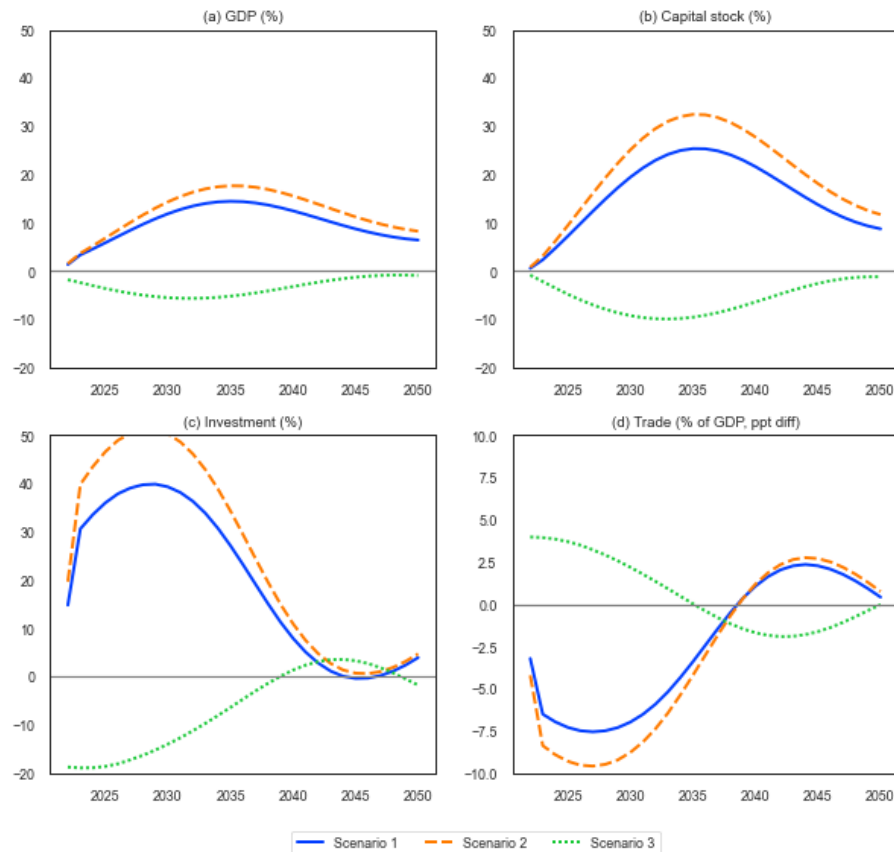
- Results in panel a follows difference in capital stock.

Panel c:

- Higher investment in the short run for scenario 1 and 2.
- In the long run, investment is not so different compared to the baseline.
- In scenario 3, investment reduced significantly in the short run, albeit no change in country risk assumed

Panel d:

- Scenario 3 sees a significant increase on trade balance in the short run, but not in the long run.
- The opposite is true for other 2 scenarios.



Results from scenario 2

- Panel a: Rate of return jumped immediately, periods are not long enough for convergence.
- Panel b: Imports jumped, which suggests the importance of imported goods for investment efficiency.
- Imports slow down in the longer-term, while exports grow.
- Panel c and d: wages and real consumption boom in the medium-term, permanently higher in the long-term.
- Panel e: Foreign-owned asset is high during the peak, but reduced dramatically.
- In the long run, foreign-owned asset is smaller than the baseline.
- Panel f: Net primary transfer dramatically smaller than the baseline in the long run

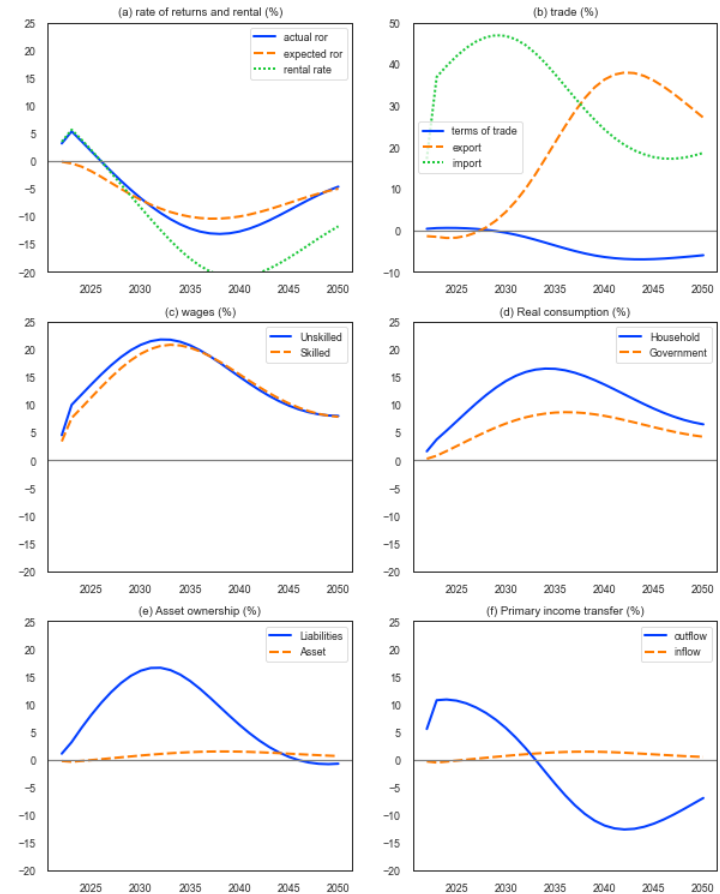


Figure 12. Deviation from baseline of scenario 2 on selected indicators, 2022-2050

Source: Authors' simulation



Industry results

Figure 13 shows results from 2022, 2026, 2031 and 2050

- Construction shows a significantly higher GDP during the investment phase.
 - During the investment phase, imports peak.
 - In the long run, the size is similar to the baseline.
- Textiles and wearing apparel shows significantly higher GDP and real exports.
 - Interestingly, Indonesia applied safeguard tariffs in this sector in 2020 and 2021.
- Primary sector's GDP is not too different compared to the baseline.
 - Imports are much higher.

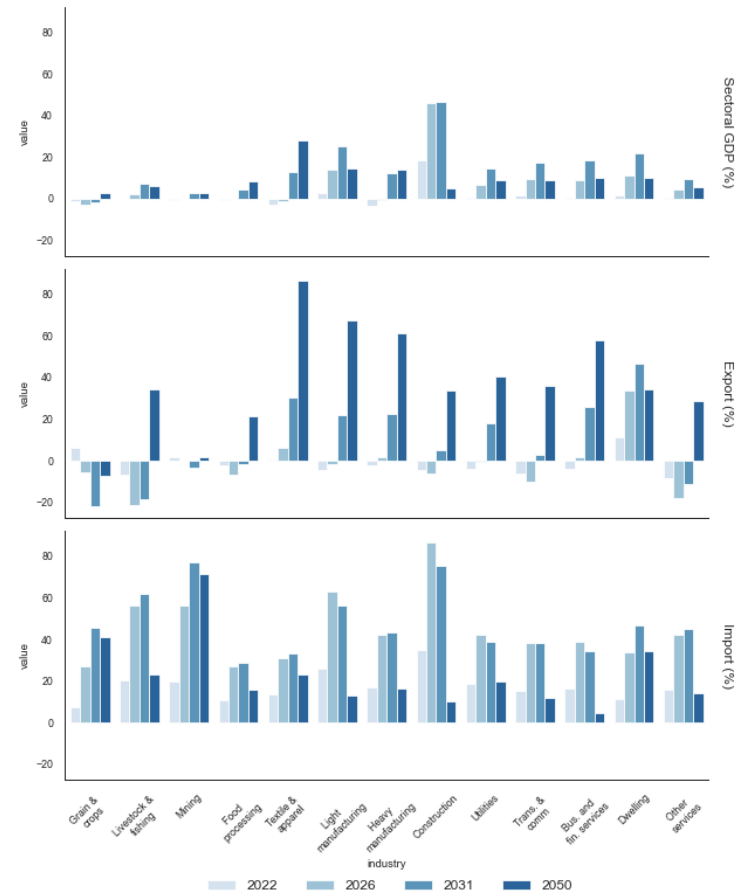


Figure 13. Deviation from baseline of scenario 3 on selected indicators per sector
Source: Authors simulation



04

DISCUSSION & CONCLUSION



Discussion & Conclusion

Much needed reform

- The Omnibus Law covers many areas traditionally hard to implement legislatively.
- If implemented successfully, it would potentially bring positive long-term impact to the economy.
- The law is still controversial and possibly still hard to implement practically.
- Evaluation on each area is needed, especially on investment.

Financial trade vs goods trade

- Inefficient foreign investment leads to CAD resistance.
- Protectionism attracts rent seeker which leads to pressure on net primary income.
- Distorting goods trade is not the best way to counter this.
- Imported capital and intermediate inputs are needed for efficient investment and competitive tradable goods.



THANK YOU

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