POVERTY AND THE ECONOMY February 2012

SUMMING UP

The global economic situation has two key aspects:

1. International institutions now project that the global economy will expand between 2 to 4 percent in 2012, and that the advanced economies will grow more modestly at 1.5 to 1.9 percent. Given this scenario, it is likely that the global economy will rely on the emerging markets in China and Asia to pull out of the recession.
2. The economic crisis may affect Indonesia through two main channels: trade and financial. On the trade front, Indonesia's exports are currently facing a considerable threat as the three big markets for Indonesian exports—the US, Japan and the EU (accounting for 37.4 percent of Indonesia's total exports)—reduce their imports. On the financial front, foreign investors have accumulated $24.2 billion in government bonds in Asia. Some Asian countries, including Indonesia, are now quite sensitive to the possible sudden liquidation of sovereign debt by foreign investors.

The review of poverty change in Indonesia, 1990 to 2011, has five important findings:

1. When changes in poverty in Indonesia are examined using 3 different poverty lines—national poverty line and two international poverty lines—the results are identical, namely, that poverty has fallen quite substantially in Indonesia over the last 21 years, 1990 to 2011.
2. The best three-year period for poverty reduction in Indonesia was right after the crisis years, that is, during 1999-2002. During that three-year period the headcount index of poverty fell by an average of at least 6.3 percent per year.
3. It is also possible to examine changes in poverty in Indonesia using the "growth elasticity of poverty," which measures how much poverty declines in percentage terms with a given percentage rise in economic growth (GDP per capita). Over the last 21 years, the average growth elasticity of poverty in Indonesia is between (-0.68) and (-1.24), meaning that a 10 percent increase in economic growth reduces poverty in Indonesia by 6.8 to 12.4 percent.
4. According to the growth elasticity of poverty, the two best three-year periods for poverty reduction in Indonesia were the years right after the crisis, that is, during 1999–2002 and 2002–2005.
5. On the whole, average annual economic growth in Indonesia has been strong (3.4 percent GDP per capita per year) over the last 21 years, and this economic growth has been very important to poverty reduction in Indonesia.

The Global Condition

Turmoil continued to roil the world economy in the last quarter of 2011. In Europe the debt crisis began to affect the drivers of EU economic growth: Germany and France. In coming months, lagging domestic growth in these advanced European countries is likely to have a large impact on household consumption. In the United States the economy has not shown any significant improvement, with the level of unemployment claims still high and real wage growth still low. In 2012 the US economy is projected by the International Monetary Fund (IMF) to grow by only 2 percent. By contrast, Japan has shown a fairly strong recovery from the crisis, with a 5.6 percent rate of growth for the third quarter 2011.

International institutions now project that the global economy will expand between 2 to 4 percent in 2012, and that the advanced economies will grow more modestly at 1.5 to 1.9 percent. Given this scenario, it is likely that the global economy will rely on the emerging markets in China and Asia to pull out of the recession.

The IMF now estimates that world trade volume will only grow 5.8 percent in 2012, in contrast with 12.8 percent growth in 2010. Advanced economies will lead the drop in trade volume with 6 percent declines in both import and export growth since 2010.

Transmission of the Global Crisis

The economic crisis is now spreading to developing countries, like Indonesia, through trade, financing and remittances channels. Indonesia needs to focus on two of these channels. First is the trade channel. Indonesia's exports are currently facing a considerable threat as the three big markets for Indonesian exports—the US, Japan and the EU (accounting for 37.4 percent of Indonesia's total exports)—reduce their imports. The second channel is the financial one. It is possible that the present global crisis might lead to (1) a repatriation of funds from overseas and, (2) a flight from risky assets. The first development would lead to a net outflow of funds from Indonesia, and the second development would imply a movement away from riskier assets in Indonesia towards the US, Japan, Hong Kong and Singapore.

With respect to trade channels, since Indonesian exports are dominated by primary commodities and extractive industries,

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Indonesia is quite sensitive to external shocks. The Indonesian Ministry of Trade currently projects that the value of Indonesian exports will increase by 10 percent in 2012. However, this projection is very much dependent on international commodity prices. A large slump in international prices could significantly reduce the value of Indonesian exports.

With respect to financial channels, since the year 2000, investors from advanced countries have accumulated substantial financial holdings in Asian markets. For example, foreign holding of government bonds in Asia has reached IDR 214 trillion ($24.2 billion), or 31 percent of total available funds. As a result, some Asian countries, like Indonesia, are now very sensitive to the sudden liquidation of sovereign debt by foreign investors. As the economic crisis continues to tighten up credit markets in Europe, it is possible that troubled European banks will reduce the supply of credit to Asia. This would increase the risk of a financial meltdown in Indonesia, if there are strong negative investor sentiments.

The Economic Crisis and the Poor in Indonesia

In developing countries like Indonesia, the poor will initially be relatively isolated from the first shocks of the growing economic crisis because their income is heavily dependent on domestic-related employment. However, the new middle class in Indonesia is likely to feel the first effects of the crisis if traditional exports to other countries begin to slow down and consumption credit starts to contract. Specifically, it is possible that middle class workers in the formal sectors of the economy might face employment cutbacks, with the largest impact being on those employed in export-oriented industries. If this happens, members of the lower tier middle class, who cannot afford to be unemployed, will be pushed into the less productive informal sectors of the economy. If these developments occur, output per unit labor for urban workers in Indonesia will shrink, and per capita incomes will fall.

The Poor in Indonesia: Lessons Learned from 2008/2009

To some extent, the story of how Indonesia responded to the decline in the world economy in 2008/09 offers lessons for today. In 2008/09 per capita expenditures for both the middle class and the poor declined, the proportion of self-employed workers increased, and unemployment for younger workers rose sharply.

The latter finding is particularly relevant because it shows that young people tend to suffer disproportionately during an economic crisis. Young workers with little job tenure are typically among the first to be laid off, and young (first-time) job-seekers have to compete against a rising pool of more experienced (and recently unemployed) workers.

Policy Implications for Indonesia

In order to withstand the current crisis, the Indonesian economy must continue to create jobs to absorb those workers who might be released from contracting sectors of the economy, like export-based industries. To ensure jobs for the middle class, the government needs to invest in infrastructure to ensure better connectivity in inter-regional trade. Indonesia's low rate of inflation in 2011, 3.79 percent, needs to be sustained in order to protect the purchasing power of formal and informal workers. Bank Indonesia has projected the inflation level in 2012 to be around 4.5 percent, but what really matters to the poor is volatility in the price of rice because they spend about one-quarter of their total expenditures on this one single food item.

In the past, such as the 1997/98 crisis, large increases in the price of rice have had a devastating impact on the poor.

The Poor and Poverty Change in Indonesia, 1990 to 2011

Over the years various poverty lines have been used to examine changes in the number of the poor in Indonesia. One of the more important of these poverty lines is the "national poverty line" set by the Central Statistical Agency, Badan Pusat Statistik (BPS) on the basis of a consumption bundle including both food and non-food goods. In September 2011 the national poverty line set by BPS was 263,594 rupiah per person per month (about $29.28 per person per month)[1] and 12.4 percent of the population was considered poor.

However, some have criticized the "national poverty line" in Indonesia, claiming that it is set too low (about $0.95 per person per day) and therefore "underestimates" the number of the poor in Indonesia. For this reason, in examining changes in poverty in Indonesia it is useful to use other "international poverty lines." These international poverty lines include the consumption of both food and non-food goods and are set at either $1.25 per person per day or $2.00 per person per day.

Table 1 analyzes changes in the poverty headcount measure in Indonesia over the last 21 years (1990 to 2011) using these three different poverty lines, that is, the national poverty line and the two international poverty lines. The results are instructive. No matter what the choice of poverty line, poverty has fallen in Indonesia over the last 21 years. The headcount index of poverty measuring the percentage of the poor in Indonesia fell in 14 of the 19 three-year time periods shown in Table 1. Moreover, over the entire 21-year period, each of the different poverty lines shows an average annual decline of over 2 percent in poverty. Regardless of the poverty line being used, poverty fell and fell rather substantially in Indonesia over the period 1990 to 2011.

[1] The average exchange rate for 2011 was $1.00 = Rupiah 9,000.

Table 1. Change in Poverty Headcount Index in Indonesia, 1990–2011

Years	Annual % Change in GDP per capita, PPP (constant 2005 $)[1]	Using National Poverty Line for Indonesia[2]	Using International Poverty Line of $1.25 per person per day PPP[1]	Using International Poverty Line of $2.00 per person per day PPP[2]
1990–1993	6.06	-3.20	0.08	-0.01
1993–1996	6.28	-6.11	-7.27	-3.08
1996–1999	-4.16	9.96	3.21	1.93
1999–2002	2.99	-8.04	-14.99	-6.36
2002–2005	3.87	-4.21	-9.01	-7.04
2005–2008	4.79	-1.27	0.35	-0.14
2008–2011	4.25	-7.07	NA	NA
Average (3-Year)	3.44	-2.85	-4.60	-2.45

[1]PPP (Purchasing Power Parity) exchange rates are used to ensure comparability of international poverty lines across countries.

[2]In 1996 Badan Pusat Statistik (BPS) "revised" the national poverty line for Indonesia, making it impossible to compare pre-1996 and post-1996 figures.

Disaggregating the rate of poverty reduction by time period in Table 1 shows that the worst three-year period for poverty change was during the crisis years of 1996-99, when poverty actually increased in Indonesia. According to Timmer (2005), poverty increased during this period because of a 300 percent increase in rice prices between 1997 and 1998.[2] By contrast, Table 1 shows that the best three-year period for poverty reduction occurred right after the crisis years, that is, during 1999-2002. During that three-year period each of the poverty lines shows poverty falling by an average of at least 6.3 percent per year. As rice prices fell, and economic opportunities for the poor rose, poverty fell quite dramatically during 1999–2002.

It is also possible to analyze the rate of poverty change in Indonesia using the "growth elasticity of poverty." The growth elasticity of poverty measures how much poverty declines in percentage terms with a given percentage rise in economic growth (GDP per capita).

Table 2 analyzes changes in the growth elasticity of poverty in Indonesia using the same three poverty lines and over the same 21-year time period as Table 1. The results are quite similar to the previous table. No matter what the choice of poverty line, the growth elasticity of poverty shows that as GDP per capita in Indonesia increased, poverty fell. In other words, economic growth as measured by changes in GDP per capita is good for the poor in Indonesia. Over the entire 21-year period, the average growth elasticity of poverty ranges between (-0.68) and (-1.24). This means that, on average, a 10 percent increase in GDP per capita reduces the headcount index of poverty in Indonesia by between 6.8 and 12.4 percent. These average values for the growth elasticity of poverty are similar to the value (-1.0) reported for East Asia and Pacific by Besley and Burgess (2003).[3]

In Table 2 it is interesting to note that the best three-year period for poverty reduction was right after the crisis years, that is, 1999 to 2002. The average growth elasticities of poverty for that three-year period are the highest for each of the poverty lines, ranging from (-2.13) to (-5.01). This finding is identical to Table 1. Table 2 also shows that the second-best three-year period for poverty reduction was 2002–2005. In that three-year period the average growth elasticities of poverty ranged from (-1.09) to (-2.32).

Table 2. Change in Growth Elasticity of Poverty in Indonesia, 1990–2011

Years	Annual % Change in GDP per capita, PPP (constant2005 $)[1]	Using National Poverty Line for Indonesia[2]	Using International Poverty Line of $1.25 per person per day PPP[1]	Using International Poverty Line of $2.00 per person per day PPP[2]
1990–1993	6.06	-0.53	0.01	-0.01
1993–1996	6.28	-0.97	-1.15	-0.49
1996–1999	-4.16	2.39	0.94	0.46
1999–2002	2.99	-2.69	-5.01	-2.13
2002–2005	3.87	-1.09	-2.32	-1.82
2005–2008	4.79	-0.26	0.07	-0.03
2008–2011	4.25	-1.66	NA	NA
Average (3-Year)	3.44	-0.68	-1.24	-0.67

[2]Timmer, Peter, 2005, "Operationalizing Pro-Poor Growth Country Study for the World Bank: Indonesia. Unpublished manuscript. Center for Global Development, Washington, DC.

[3]Besley, Timothy and Robin Burgess, 2003, "Halving Global Poverty." Journal of Economic Perspectives. Vol 17 no. 3, pp. 3-22.

Poverty Change and Policy Implications for Indonesia

In 2012 the Government of Indonesia predicts that annual aggregate real GDP growth will be 6.5 percent. With population growing at 1.1 percent per year, the preceding calculations suggest that the growth elasticity of poverty for 2012 will be about (-0.46). In other words, using the national poverty line, the headcount index of poverty in Indonesia will fall from 12.4 to about 11.8 percent in 2012. This will be the lowest rate of poverty recorded for Indonesia since 1996.

The preceding calculations show that one of the keys to poverty reduction in Indonesia has been strong economic growth. Over the past 21 years, average annual GDP per capita growth has been high (3.4 percent) and this has significantly reduced the level of poverty in Indonesia.

To continue this strong rate of poverty reduction, policymakers in Indonesia should pay attention to three issues. First, they need to maintain macroeconomic stability by ensuring low inflation and a stable and competitive exchange rate. Research by the World Bank (2005) shows that countries with fewer macroeconomic shocks experience faster economic growth and higher rates of poverty reduction.[4] Second, policymakers should keep the poor connected to opportunities for economic growth. Since the majority of the poor (60 percent) in Indonesia work in agriculture, this means that improved rural roads, rural credit and opportunities for formal sector employment are essential to keeping the poor connected to growth. Finally, policymakers must continue to invest in the human capital of the poor. There continues to be a need to raise the educational levels of the poor, so that more of them can complete secondary school. In both rural and urban areas, completion of junior and secondary school is closely associated with lower levels of poverty.

[4] World Bank, 2005, "Pro-Poor Growth in the 1990s: Lessons and Insight from 14 Countries," Washington, DC.

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