SECTOR ASSESSMENT (SUMMARY): INDUSTRY AND TRADE

1. Higher foreign direct investment (FDI), better trade competitiveness, and improved productivity are needed to boost Indonesia’s economic growth. The country’s economy has not sufficiently diversified away from primary commodities, and technological adoption has been limited. Indonesia’s labor productivity remains lower than other countries, hindering its potential to become a higher-income country. This sector assessment defines the core development problem, identifies the key development constraints, and summarizes the government’s strategy for overcoming these constraints.

   1. Sector Performance, Problems, and Opportunities

2. FDI has played an important role in Indonesia’s economic development but can be improved to support further growth. In the Association of Southeast Asian Nations (ASEAN), Indonesia has been a key FDI destination. ASEAN and other Asian economies contributed more than 90% of FDI inflows to Indonesia. In 2021, FDI inflows to Indonesia were $20.1 billion, lower than Singapore ($99.1 billion) but higher than other ASEAN countries such as Viet Nam ($15.7 billion), Malaysia ($11.6 billion), and Thailand ($11.4 billion). FDI in Indonesia increased by 8% in 2022 due to robust investment in manufacturing, transportation, storage, communication, mining, and the digital economy. Investment in electric vehicles is increasing and receiving strong interest from foreign investors. Although Indonesia’s investment policies have developed, the FDI share of gross domestic product (GDP) declined from 2.0% in 2010 to 1.8% in 2021. Foreign investors have been reluctant to invest in Indonesia because of its complex business environment, FDI restrictions, and entry conditions. The government has liberalized foreign investment regimes, but Indonesia remains one of the most restrictive countries for FDI. This is important because FDI is essential for economic growth, and restriction policies impede investment.

3. Indonesia must enhance its global competitiveness. While global trade increased by 5.0% from 1980 to 2020, Indonesia’s exports of goods and services rose by 2.5%. Goods and services exports accounted for 18.6% of the country’s GDP in 2019 and 17.3% in 2020 but improved to 21.6% of GDP in 2021 following the approval of subprogram 1—still only about half its share in 2000 (41.0%). By comparison, exports of goods and services from Malaysia, Thailand, and the Philippines expanded by more than 12% from 1980 to 2020. Indonesia’s share of trade relative to GDP peaked at 96.0% in 1998, shrank to 33.0% in 2020, but rebounded to 40.4% by 2021 after the approval of subprogram 1. Improved trade competitiveness will be paramount in accelerating Indonesia’s economic growth. The Global Competitiveness Index ranked Indonesia 50 of 141 countries in 2019. In Indonesia, 19.6 days are required to start a business, higher than in Viet Nam (17.0 days), Malaysia (13.5 days), and Thailand (4.5 days). This must be addressed because a better business climate is important for growth.

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1 ASEAN Secretariat. 2022. ASEAN Investment Report. Jakarta.
4. Export performance is vulnerable to external shocks, and trade policies have been inward looking. During the coronavirus disease pandemic, international trade was a positive economic contributor. Indonesia maintained trade surpluses for 32 consecutive months since May 2020. Export performance benefits from rising prices of commodities, such as coal, palm oil, and nickel.\(^8\) Commodities contributed about 59% of Indonesia’s exports in 2022.\(^9\) With its exports concentrated in resource-intensive industries, Indonesia has the lowest sophistication compared to peer countries.\(^10\) The significant contribution of commodities to Indonesia’s export will make the country vulnerable to commodity price volatility and resource curse.\(^11\) Through increases in nontariff measures (NTMs), Indonesia’s trade policies have become more inward looking. Based on World Integrated Trade Solution data, imports to Indonesia have a coverage of 69%, higher than in Viet Nam (38%), Malaysia (55%), and Thailand (31%). NTMs are applied to nearly 90% of all imported consumer goods, imposing a burden on Indonesian businesses.\(^12\) NTMs shorten the life span of businesses by making them less competitive\(^13\) and undermine productivity and job growth.\(^14\)

5. Inadequate productivity of firms to support broad-based growth because most firms in Indonesia are micro and small-sized. The low productivity of Indonesian companies has led to the country’s weak export performance and foreign investment. Pro-competitive policies and openness to trade lead to more efficient firms.\(^15\) For example, an increase in openness to trade will increase productivity.\(^16\) In 2019, more than 99% of manufacturing firms in Indonesia were micro, small, and medium-sized enterprises (MSMEs), accounting for nearly two-thirds of manufacturing employment (footnote 2). However, large firms accounted for 79.9% of manufacturing value-added, followed by 9.4% for medium-sized firms, 5.1% for small firms, and 5.6% for micro firms. Consequently, the productivity of labor, as measured by industry value-added per worker, is lower in Indonesia than in other countries in the region. Labor productivity can be attributed to better economic complexity, higher FDI, and increased manufacturing exports.\(^17\) However, low productivity and limited exposure to global value chains make Indonesian businesses less likely to adopt new technologies and innovate than companies in the region.\(^18\) MSMEs are also more likely to struggle to comply with NTM requirements because of a lack of information or capacity.\(^19\) Indonesia’s manufacturing sector has a large proportion of small firms and only a small number of medium-sized firms transitioning into large firms. Since 1990, especially after the Asian financial crisis, Indonesia has seen limited change in company sizes, with most small firms remaining small.\(^20\) Low-wage, labor-based microenterprises dominate the economic landscape and are concentrated in non-tradable sectors with lower-than-average

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incomes, which indicates unproductive operations. Sectors with higher productivity pay higher wages, but a minority of Indonesian workers are employed in these sectors. Boosting the productivity of businesses in Indonesia is vital for broad-based, productivity-driven growth.

6. **Development constraints.** Three development constraints have been identified and remain relevant to subprogram 2: (i) the business environment is not conducive to investment, (ii) hard and soft infrastructure barriers inhibit trade, and (iii) small firms have difficulty growing and upgrading their operations.

7. **Business environment is not conducive to investment.** The high additional costs imposed on businesses by Indonesia’s regulatory systems have hindered investment. The main impediments to starting and operating a business in Indonesia are poor coordination within and between government agencies, overregulation by multiple agencies, and the requirement of business licenses by multiple layers of government. Many local governments are unable to increase investment because of inadequate state capacity, insufficient coordination with regional and national governments, and a lack of incentives. The Organisation for Economic Co-operation and Development (OECD) reported that Indonesia was one of 68 middle-income countries with severe and increasing FDI restrictions; Indonesia’s score on its FDI Regulatory Restrictiveness Index rose from 0.317 in 2010 to 0.347 in 2021.

8. **Hard and soft infrastructure barriers to trade.** The cost of logistics in Indonesia, equivalent to 23.9% of GDP in 2019, remains significantly higher than in its Southeast Asian neighbors, such as Viet Nam (20.8%), and other Asian countries, such as India (13.0%), Republic of Korea (9.5%), and Singapore (9.5%). Indonesia’s high logistics costs impede broad-based growth. Logistics costs, including for transport, warehousing, and inventory, constitute about 25% of manufacturing sales, compared with 15% in Thailand and 13% in Malaysia. These costs are mostly associated with the need to maintain high inventory levels because of unpredictable and unreliable logistics chains. Because businesses do not trust the capability of local logistics service providers, about two-thirds of Indonesian manufacturers have in-house logistics services instead of outsourcing them. Foreign companies are unable to transport goods between Indonesian ports because of regulatory barriers, severely restricting competition in the logistics subsector. Rising logistics and regulatory compliance costs have made Indonesia less competitive in producing labor-intensive manufactured goods for export (e.g., textiles, garments, and footwear). Participation in cross-border networks requires open trade and investment policies, highly efficient logistics infrastructure, and competitive labor inputs—all areas where Indonesia lags its regional peers.

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21 Based on the 2016 census and labor force survey, up to 23 million of the 26.7 million companies in Indonesia are self-employed, on temporary contracts, doing unpaid work, or working for family.
26 M. Horridge et al. 2016. Improving Indonesia’s Domestic Connectivity: An Inter-regional CGE Analysis. ADB Papers on Indonesia: Jakarta.
9. **Difficulty growing and upgrading operations.** Support for MSMEs is not coordinated nationally because of insufficient aggregated and disaggregated data. As a result, MSMEs are unable to fully benefit from government services. Under the Job Creation Law (2020), the government has supported the growth of MSMEs, including those owned by women. However, they remain underdeveloped, have low productivity, and lack access to the government services required to participate in global value chains and attract FDI. Indonesia does not have a consolidated database of MSMEs capable of using sex-disaggregated data to report on women-owned businesses (WOB).

2. **Government Strategy**

10. **Reform opportunity.** Recognizing the constraints on growth, the government has launched ambitious structural reforms. Indonesia’s National Medium-Term Development Plan, 2020–2024 aims to achieve faster and more inclusive economic growth. The government targets annual real GDP growth of 6.2%–6.5% by 2024, leading to a reduction in poverty incidence to 6.0%–7.0% (from 9.2% in 2019). The government projects real fixed investment will grow from 4.5% in 2019 to 6.6%–7.0% per year in 2024, with real exports forecast to rebound from a 0.9% contraction in 2019 to 4.7%–4.9% growth per year in 2024. Policies to achieve these objectives include boosting foreign and domestic private investment, deregulating investment procedures, and harmonizing licensing regulations. The government plans to improve Indonesia’s logistics performance index score from 3.1 in 2019 to 3.5 in 2024. The government has been developing a national logistics ecosystem and an integrated national single window to reduce the barriers to exports and imports of goods, and to strengthen the effectiveness of trade agreements.31

11. **Structural reforms to improve the investment and business climate.** In October 2020, Indonesia’s Parliament approved the Job Creation Law, which amended 78 laws to improve the investment and business climate.32 The government launched the online single-submission, risk-based approach (OSS-RBA) in August 2021 as part of its commitment under the Job Creation Law to streamline business licensing procedures. The technical licensing from related ministries and the online single submission system at the subnational level have been integrated into the OSS-RBA. As a result, 3.4 million businesses have been approved under OSS-RBA since August 2021.33 The export process has been simplified, as mandated by the Job Creation Law, by introducing automatic approval for goods exporters. A new priority investment list, which offers investment incentives such as tax reductions and import duty exemptions for capital goods, has also been introduced.

12. **Prioritized support for micro, small, and medium-sized enterprises.** The government has prioritized improving the productivity of enterprises. The National Medium-Term Development Plan aims to increase the contribution of MSMEs to GDP from 57.2% in 2019 to 65.0% in 2024 and expand access to formal credit for 30.8% of MSMEs. To reach these targets, the government will support increases in (i) business partnerships between MSMEs; (ii) business capacity and access to finance for entrepreneurs; (iii) capacity, reach, and collaborative innovation; (iv) new business opportunities and startups; and (v) the value-added of social enterprises. The government will also extend support and encourage MSMEs to export goods and services.

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31 Based on Ministry of Finance Letter No. S-78/MK.012/2023. Through the operation of the integrated single window and national logistics ecosystem, the dwell time (the time a vessel or vehicle e.g. truck or plane spends at a port or facility discharging or loading cargo) was reduced to 2.9 days in 2022.

32 Based on the recent update from Coordinating Ministry for Economic Affairs in February 2023.

33 Based on Ministry of Investment’s presentation during the fact-finding mission on 10 March 2023.
3. ADB’s Reform Experience and Assistance Program

13. **Knowledge and policy engagement.** Informed by flagship knowledge work on Indonesia’s growth potential by the Asian Development Bank (ADB) and policy dialogue, the program supports the government’s economy-wide reforms aimed at achieving faster, more inclusive, and sustainable growth. ADB provided technical assistance to support the implementation of various government regulations, including by sharing international experiences and best practices. Support for policy actions included (i) reviewing the challenges in implementing the OSS-RBA and investment promotion, (ii) analyzing parcel-based land valuation, and (iii) strengthening competitiveness of the government procurement framework. The program also reflects dialogue with academia, think tanks, and civil society. It will continue to provide regular knowledge inputs and support policy dialogue and partnerships with stakeholders.

14. **Support for investment climate reforms.** ADB has been engaged in reforms targeting the investment climate in Indonesia since 2013. Through its development policy support programs, ADB provided parallel cofinancing for World Bank development policy loans to support investment climate improvements. The Stepping Up Investment for Growth Acceleration Program promoted a more predictable and open business environment and helped improve the framework for private sector participation in infrastructure. To complement the economy-wide reforms, ADB is also supporting financial inclusion, the energy sector, human capital development, state-owned enterprises, and domestic resource mobilization.

15. **One ADB engagement.** Opening opportunities for domestic and foreign private investments will help accelerate the economic recovery from the pandemic. Guided by the framework of the country partnership strategy for Indonesia, 2020–2024, the program will capitalize on the One ADB approach. ADB’s engagement in structural reforms targeting the investment climate benefit from close collaboration between sovereign and nonsovereign operations to ensure that private sector perspectives are incorporated, while exploring the downstream potential for nonsovereign investments.

16. **Development partner support.** Development partners support government reforms to the investment and business climate. The World Bank and OECD support capacity development for regulatory good practice. Australia provides support through its Indonesia Infrastructure Initiative Facility and Prospera (a grant-funded partnership between Australia’s Department of Foreign Affairs and Trade and Indonesia’s Coordinating Ministry for Economic Affairs). The European Union provides trade-related technical assistance and a policy dialogue fund to support policy loans. The Government of Canada supports improvements to the local investment climate and enhancements to regional economic development.

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**HCD** = Boosting Productively through Human Capital Development Program.
**PIFIP** = Promoting Innovative Financial Inclusion Program.

Legend:  
- **Supported Under This Program**  
- **Supported Under Other ADB Programs**