SUMMARY OF INDONESIA’S ECONOMIC ANALYSIS

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ECONOMIC ANALYSIS (SUMMARY)

A. Country Background

1. Economic growth. Indonesia’s economic growth averaged 5.8% over the last decade (Figure 1). However, GDP growth has decelerated gradually since peaking at 6.5% in 2011 to 5.1% in 2014, its slowest since 2009. The more recent economic slowdown was partly policy driven, as the government acted to restrain domestic demand to rein in the current account deficit and inflation. The slowdown was sharper than anticipated as exports continued to shrink due to prolonged weak commodity prices. Private consumption continued to be a stable source of growth supported by Indonesia’s growing middle income class. The contribution of public spending was modest as the government’s fiscal space was eroded by untargeted subsidy spending. Investment picked up strongly and returned to the pre-Asian financial crisis level of 33% of gross domestic product (GDP) in 2012, but its contribution weakened over 2013–2014 as growth prospects softened.

2. Sources of growth by sector. On the production side, mirroring the dominant contribution of consumption from the demand side, growth was mostly driven by the non-tradable services sector. Services contributed on average 3.4% per year to growth from 2005–2014. The telecommunication and transport sectors continued to record double digit growth. The financial sector, trade, hotels and restaurants, and other services also expanded strongly, supported by the growing middle income bracket and rapid urbanization. The agriculture sector benefited from a commodities boom as Indonesia is a major producer of rubber and palm oil. However, due to a lackluster performance of other food products, the sector’s growth was far below the national average, contributing just 0.5% to annual GDP growth. The oil and gas sector has been a drag on growth for many years; on average it contracted by 1.3% per year over the last decade because of aging oilfields and declining investment.

3. Manufacturing remained subdued in the first half of the last decade, but started to pick up pace from 2010. The sector’s growth averaged 1.2% over the last decade, contributing to less than one-third of GDP growth. Despite an appreciation of the real exchange rate in the first half of the last decade due to the commodities boom, manufacturing output expanded modestly, supported by a labor surplus in West Java and East Java, where most manufacturing industries are located. In the second half of the decade, foreign direct investment (FDI) in the sector rose markedly to $15.8 billion in 2014 from only $3.3 billion in 2010. Manufacturing’s share of total FDI grew to 55.4% from 20.6% over the same period. Robust domestic demand drove higher investment in basic metals, food, chemicals, and automotive parts. The manufacturing sector’s contribution to the trade deficit, through imports of intermediate goods, has also declined, indicating that increased investment and rupiah depreciation have stimulated import substitution through domestic goods.

4. Employment. The services sector’s rapid growth saw its share of GDP increase to 41% in 2014 from 37% in 2009. The sector became the key source of employment, creating 14.2 million jobs in the last decade, accounting for about 80% of new jobs. The industry sector, with its modest performance, contributed only 7.1 million new jobs, including 4.4 million in manufacturing. The agriculture sector lost 900,000 jobs in the last decade but still absorbed about 35% of the country’s workforce. Most new jobs were generated in urban areas—a
reflection of the country’s rising urbanization. Total urban employment has gradually overtaken rural employment, and jobs in urban areas have been growing faster than the working age population since 2008. However, the majority of jobs created are in the informal sector, which offers minimum job security.

5. **Progress in productivity.** Productivity improvement has been very sluggish. Much of the country’s workforce remains in the agriculture sector, where overall productivity is low, despite growth in palm oil, rubber, and other estate crops that have received large investments. Most workers entering the services sector in 2014 were absorbed by low–end services, with 36% taking jobs in community, social, and personal services, and 48% in wholesale and retail trade, and hotels and restaurants. Productivity in the transport, communication and financial intermediation subsectors improved markedly, but they, along with warehousing and other business services, absorbed only 16% of workers. Productivity in the manufacturing sector stagnated but was three times higher than average productivity in the services sector. Productivity of workers in mining, oil, and gas also declined with recent downturn in investment (Figure 4).

6. **Poverty reduction.** The poverty level declined to 11% in 2014 from 16.8% in 2004, partly due to economic growth and job creation in the services sector in urban areas. Nonetheless, poverty reduction has slowed since 2012, falling only about 0.5% annually, the slowest decline in the past decade. While poverty has officially declined, 27% of the population lives just above the poverty line and these 65 million people are highly susceptible to sliding back into poverty. With about 60% of the workforce employed in the informal sector, the risk of falling back into poverty remains high. On average, over half of the poor each year were not poor the previous year.¹

7. **Rising income inequality.** Indonesia’s sustained economic growth of the last decade has not been shared equally. Income inequality measured by the Gini coefficient has been rising steadily, reaching .41 by 2013. The speed of the increase in income inequality has raised concerns. Indonesia’s poor have experienced much slower income growth than the wealthiest income groups. While the commodities boom helped reduce poverty, it has also fueled inequality. Rising commodity prices resulted in a rise in corporate wealth. Furthermore, affluent property owners, many in metropolitan areas, disproportionately benefited from the sharp rise in land prices over the past decade. The rapid rise in income for the rich contrasts sharply with sluggish growth in real wages of the poor. Government spending has generally helped to reduce inequality, but in some cases, such as fuel subsidies, it exacerbated income inequality. Heavy spending on fuel subsidies was essentially a transfer that disproportionately benefited rich households. A World Bank study found that about 40% of fuel subsidy benefits went to the richest 10% of households, and less than 1% to the poorest 10%. In addition, the poor receive disproportionately less from infrastructure because they live in areas that often have the most difficulty in accessing basic services.

8. **Millennium Development Goals progress.** Indonesia made steady progress on several Millennium Development Goals (MDGs) over the past decade. The country has achieved four MDGs, namely: access to primary education, gender equality and empowerment of women, reducing child mortality, and developing a global partnership for development. The

¹ See Poverty Assessment (available in the list of linked documents)
under–five mortality rate declined steadily from 82 deaths per 1,000 live births in 1990 to 32 deaths per 1,000 live births in 2011, putting Indonesia on track to meet the MDG requiring a two–thirds reduction in under–five mortality between 1990 and 2015. The country is also on track to reduce the prevalence of underweight children under five, currently estimated at around 18%. However, Indonesia is behind on another health–related goal, the maternal mortality ratio, which is estimated at 220 deaths per 100,000 live births, well above the MDG target of 102 deaths per 100,000 live births by 2015. Sustainable access to safe drinking water and basic sanitation is also lagging behind.

9. **Economic vulnerability.** Indonesia has been vulnerable to volatility in global financial markets because of its relatively open capital account and a large foreign presence in its stock market (55% of holdings) and bond market (38% of holdings). The domestic bond market is still shallow at 13.4% of GDP, compared to 34.8% in the Philippines and 67.5% in Thailand. Indonesia’s vulnerability has been amplified by increased dependence on commodity exports over the past decade. A prolonged decline in commodity prices has put significant pressure on the current account and growth. Prudent macroeconomic management, increased international reserves, and a more flexible exchange rate have improved resilience to external financial shocks. However, a lasting solution to the current vulnerability lies on the supply side. The economy needs consistent and comprehensive structural reforms to sustain wider improvement in productivity, better infrastructure to improve competitiveness, and a deeper and more inclusive financial market to enhance market stability.

B. **Economic Assessment and Outlook**

10. The government aims to achieve sustained higher growth and job creation, while reducing inequality in the next five years. Factors that could help Indonesia to achieve these goals include demographic transition, rapid urbanization, increased integration with economies in the region, and a potential advantage in labor–intensive exports on the back of rising labor costs in the People’s Republic of China. However, there are risks of a further slowdown in long–term growth. Softening commodity prices have reduced the country’s exports by 8.3% annually in the last three years. At the same time, the period of easy global liquidity, which supported large capital inflow into the country, will soon end as the US Federal Reserve normalizes its monetary policy. To counter these challenges, Indonesia will need to rely more on productivity improvement to support its overall growth. This will require closing the infrastructure gap and the skills gap to boost productivity in key sectors, including manufacturing, agriculture, and high–end services. Cross–cutting structural reforms are also needed to provide an enabling environment for productivity improvement and to ensure that prosperity is shared more widely.

11. **Closing the infrastructure gap.** Underinvestment in infrastructure has impeded Indonesia’s growth over the past decade. One of the main constraints faced by manufacturing firms is logistics problems. Indonesia is also struggling to meet rising demand for power. These problems are symptoms of low infrastructure spending over the past decade. Government expenditure on infrastructure averaged less than 2% to 3% of GDP over 2000–2014, compared to about 6% before the Asian financial crisis, and about one–third of what regional peers have invested.² Low government infrastructure spending is partly due to funding constraints, as well as poor spending choices and constraints on public sector borrowing. At the subnational level,

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most local government spending is allocated for personnel and other non–capital expenditure. This trend will change with the recent cutting of fuel subsidies. Improving fiscal transfers with stronger links to development will help to address infrastructure shortages at the local level. However, addressing the infrastructure gap requires reforms beyond financing. These include capacity improvement to plan and prepare projects, increasing private sector participation, making public–private partnerships deliver, and accelerating land acquisition.

12. **Closing the skills gap.** Indonesia compares unfavorably with other Southeast Asian middle–income economies in the skills of its workers. Fewer than 10% of the country’s workers possess a tertiary degree, compared with 29% in the Philippines and 17% in Thailand. A large number of tertiary–educated individuals work in low–skilled occupations, which suggests that despite holding degrees, they lack the right skills. Companies in Indonesia are finding it increasingly difficult to recruit suitable candidates for professional and management positions. To meet future growth demand, the country will need to improve the quality of its workforce. McKinsey estimates that demand for semi–skilled and skilled workers may rise from 55 million in 2012 to 113 million by 2030, and that Indonesia will face a shortage of 9 million workers educated to secondary and tertiary levels. Over the longer term, the government will need to improve the quality of basic education to build a stronger base of cognitive skills necessary to acquire the higher–level skills needed by the workforce. But to address current constraints in the short term, improving the relevance of vocational and tertiary education to meet market needs is imperative. Existing training institutions should be enabled to deliver relevant training and specific skills needed by higher value–added sectors such as manufacturing and higher–end services. Recent data shows that Indonesia’s gross tertiary enrollment ratio has climbed to 31%, compared to 28% in the Philippines and 51% in Thailand.

13. **Attracting needed investment.** The country has made considerable progress in attracting investment in the last decade, but significant challenges remain. Helped by an earlier reform to introduce Investment Law in 2007 and the commodity boom after, investment expanded rapidly from 2010 to bring it back to the pre–Asian financial crisis level of 33% of gross domestic product (GDP) in 2012. Supported by the country’s good medium-term growth potential, a number of reputable surveys put Indonesia as one of the top three investment destinations. However, significant challenges remain as companies still find many impediments to starting and operating a business in Indonesia. According to the latest World Bank Doing Business report, these impediments include poor coordination within and between government agencies, over-regulation by multiple agencies, and cumbersome business license process. The country plans to cut red tape further through recent introduction of the One–Stop Service Facility, but the progress at the local levels across the country is still mixed. A systematic mechanism needs to be established to simplify and remove inconsistent and overlapping regulations at various levels. Recently, the government issued a number of new investment incentives to support new sector and exports. These incentives, where needed, need to be non–distorting and transparent. In addition, the Negative Investment List last revised in 2014 has

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provided transparency, but it needs to be continuously reviewed to ensure it meets the country’s future needs for higher growth.

14. **Expanding the manufacturing sector.** Indonesia needs to create a greater diversity of exports to reduce dependence on primary commodities. International experience suggests that manufactured exports are much less volatile than commodity exports. The manufacturing sector has regained growth since 2010 and recent depreciation of the rupiah has supported initial recovery of manufactured exports amid continued negative growth of commodity exports. Indonesia should take advantage of increased integration with economies in the region and the rising labor costs in the PRC. In addition to closing infrastructure and skills gaps and improving investment climate discussed above, in the medium–term, the government needs coherent policies to develop a better system to help the sector move up the value chain. These would need to include policies to (i) deepen manufacturing agglomeration areas and clusters, (ii) promote more predictable productivity–based wage increases to benefit workers and employers, (iii) limit tax incentives for activities that will provide positive externalities to manufacturing, and (iv) accelerate improvement in the quality of human capital and research and development.

15. **Improving agriculture sector productivity.** Agriculture accounts for 14.4% of GDP, but it is the country’s second–largest employer, absorbing 35% the labor force. Government efforts to foster rice self–sufficiency and to promote tree crop development for export have been a boon to rural incomes, employment, and poverty reduction. The sector currently faces several challenges. Although budget funding to the sector has increased, a large proportion of it has been allocated to fertilizer, seed, and other agro–input subsidies for food crop production, which has not been well targeted. Public investment in rural infrastructure and agricultural support services has fallen to exceptionally low levels, resulting in a deterioration of rural roads, irrigation systems, research and development, disease control, and extension services. Poor rural connectivity has contributed to inefficiencies in agricultural marketing, with loss rates for perishable crops estimated to be as high as 40%–50%. Shifting public spending from input subsidies to rural infrastructure and agricultural support services can have a positive effect on productivity in the long run. Shifting land resources out of low–value food crops and into higher–value cash crops, and increasing smallholder yields, could contribute $95 billion in added value to the sector by 2030. Higher spending on agriculture research and development, accelerated privatization of irrigation systems, greater use of information and communication technology–assisted agricultural extension, improved access to rural finance, more coordinated spatial planning for land use, and accelerated registration and land titling are among the measures that McKinsey suggests could help to boost smallholder yields.

16. **Deepen the financial market.** Access to credit is a significant constraint to private sector activity in Indonesia, particularly for micro– and small businesses. The financial sector is dominated by banks (78% of assets) and its claims to the private sector stand at only 35%, compared to well over 100% for Malaysia, Thailand, and Singapore. At the end of 2014, stock market capitalization was just 50% of GDP, compared to 160% in Malaysia. Both the money market and the foreign exchange market are thin, with limited use of swaps and options. Deeper financial markets are needed to mobilize savings to fund investments and to meet business

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transaction needs. While the banking sector is sound and well regulated, substantial efforts are needed to develop the money market, the foreign exchange market, and the capital market. A deeper financial sector will help provide more suitable and longer term financing for infrastructure, while improving the country’s resilience to external financial shocks. The emergence of e–banking, e–money, and peer–to–peer banking should improve financial inclusion, but raises new regulatory and oversight challenges.10

17. **Improve services delivery.** Since the adoption of decentralization in 2001, subnational governments have been given increased responsibilities in delivering basic public services, including to the poor. To support these increased responsibilities, the central government has transferred nearly a half of the state budget (net subsidies and interest payments) to subnational governments. Available indicators suggest that the quality of services provided by most subnational governments remains problematic. Addressing service delivery at subnational level is also crucial to reducing income inequality, as the majority of Indonesia’s poor live in rural areas. Perverse incentives in the current transfer system have encouraged increased spending on salaries and administration at the expense of spending on basic public services. Therefore, the current transfer arrangements will need to be revisited to increase the proportion of local governments’ budgets linked to the delivery of key basic services such as infrastructure, education, and health. At the same time, subnational governments need to be made more accountable for results.

![Figure 1. Contribution to GDP growth: demand (2000=100)](image1)

![Figure 2. GDP share by sectors](image2)

![Figure 3. Employment share by sectors](image3)

![Figure 4. Labor productivity differences across sectors*](image4)

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10 IMF. 2013. *Staff Report for the 2013 Article IV Consultation.* Washington D.C.
Source: World Development Indicators, the World Bank

*) Sector labor productivity (real terms) compared with labor productivity in agriculture
Source: Indonesia: avoiding the trap: the World Bank (2014)