INDONESIA'S JOKOWI TO COMMENCE SECOND TERM: CHALLENGES OF BECOMING A LEADING ECONOMY BY 2045

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SUMMARY

- Although Indonesian President Joko Widodo's first term in office has showed significant achievements in infrastructure development, it has failed to fulfill its campaign pledge to "achieve 7% economic growth." In recent years, Indonesia's economic growth rate has slowed down to around 5%, with youth unemployment rate remaining high.

- The Joko administration aims to boost economic growth through revitalization of the manufacturing industries, though given the limited presence of local enterprises with strength in capital-intensive industries that generate high added value, attracting foreign investors will be the key. Expectations are especially high for Japanese investors that have industrial technologies and business management capabilities, for example in the automotive and chemical industries which the Indonesian government has identified as priority sectors.

- In order to attract foreign investors, including from Japan, Indonesia will need to: (1) further improve its infrastructure, (2) promote deregulation, and (3) increase labor productivity. However, reforms in some of these areas will likely face strong opposition of vested interests who are intending to maintain the status quo.

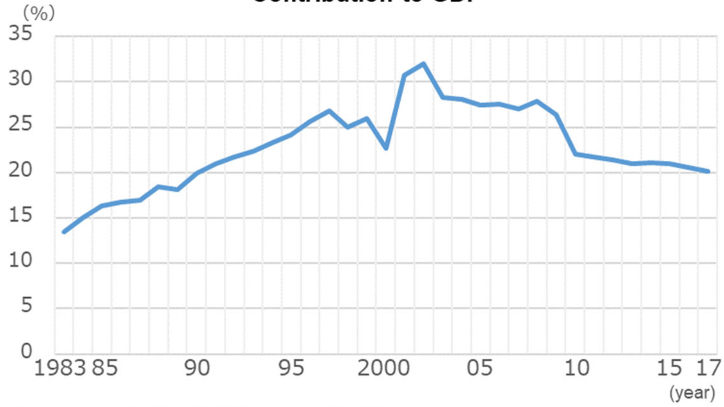
CHALLENGES FOR THE INDONESIAN ECONOMY

Indonesian President Joko Widodo (Jokowi) was re-elected in the April 2019 Indonesian presidential election. In his second term, the Jokowi aims to further upgrade the country's industrial structures, in addition to continuing its pursuit of infrastructure development from the first term.[1] In 2018, the Jokowi administration announced the "Making Indonesia 4.0" roadmap designed to promote export-competitive manufacturing industries, centered on food and beverages, textiles and apparel, automotive products, electronics, and chemicals, and to boost net exports to a level representing a 10% contribution to GDP.[2] Indonesia has also drawn up an ambitious development blueprint, "Indonesia 2045", to achieve GDP per capita of more than US$20,000 and become the world's fifth-largest economy by 2045, when Indonesia will mark her 100th anniversary of independence. Upgrading the country's industrial structures is one of the major challenges to achieving these targets.[3]

[1] See President Jokowi's campaign manifesto, *Meneruskan Jalan Perubahan Untuk Indonesia Maju*.
[2] Indonesia's Ministry of Industry (2018), *Making Indonesia 4.0*.
[3] See Indonesia's Ministry of National Development Planning/National Development Planning Agency (Bappenas) (2018), *Indonesia 2045: Berdaulat, Maju, Adil dan Makmur*. In an interview with a Japanese newspaper, Jokowi said Indonesia will become the fourth largest economy in the world by 2045. See "Indonesia Daitouryo: Keizaikibo Yonjuugo-nen ni Sekai Yon-I (Indonesia's President aims to turn the country into the fourth biggest economy by 2045" *Nihon Keizai Shimbun*, 20 June, 2019.

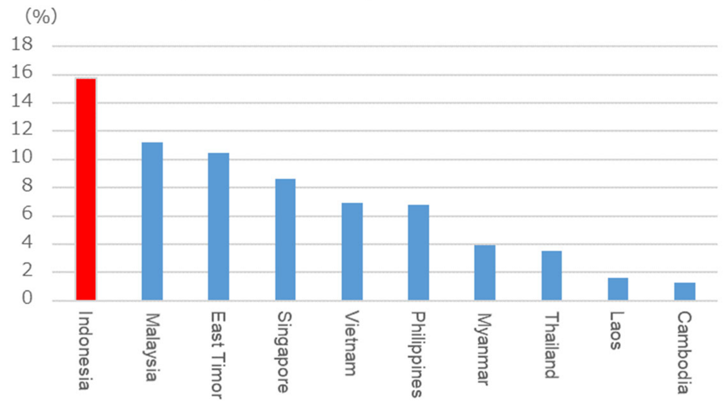
Indonesia's economy will likely continues to grow steadily, but its growth rate has slowed down in recent years. At the outset of his first term in 2014, Jokowi pledged to achieve economic growth of 7%, but growth has instead hovered around 5%. The decline of the manufacturing sector has often been pointed out as one of the primary factors that account for the slowing growth.[4] While commodity exports and private consumption have continued to remain primary sources of economic growth, Indonesia has been experiencing premature "de-industrialization", a process where the performance of manufacturing industry declines well before a sufficient level of industrial development has been achieved (Fig. 1). In this context, sources of employment have not increased, and the youth unemployment rate[5] in Indonesia remains the worst among ASEAN countries (Fig. 2).

Figure 1: Indonesian Manufacturing Industry's Contribution to GDP



Source: Compiled by MGSSI based on World Bank data

Figure 2: Youth unemployment rate (15–24 years old) in ASEAN countries



Source: Compiled by MGSSI based on World Bank data

From the perspective of macroeconomic management as well, the growth of export industries is a pressing matter. Indonesia has had a current account deficit since 2012, but it showed a bigger deficit in 2018 as the trade balance turned into a deficit, which then led to a depreciation of its currency. As a result, the value of Indonesia's currency temporarily stagnated at around the level reached during the 1997 Asian financial crisis (1 dollar = over 15,000 rupiah), and it was argued that the weak economy could constitute the biggest weakness of Jokowi, who was campaigning for re-election at that time.[6] The government now aims to vitalize export-manufacturing industries that can generate foreign currency to improve the trade balance and thereby the current account balance.

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[4] See for example Resosudarmo, B. P. and Abdurohman (2018), "Is Being Stuck With a Five Percent Growth Rate a New Normal for Indonesia?," *Bulletin of Indonesian Economic Studies*, vol. 54, no. 2, pp. 141-164.
[5] Population of 15–24 year olds.
[6] See for example "Indonesia's President Suddenly Looks Vulnerable," *The Wall Street Journal*, October 17, 2018.

STRUCTURAL FACTORS BEHIND SLOWDOWN OF INDUSTRIAL DEVELOPMENT

A look back on Indonesia's history shows that the slowdown in the industrialization process coincided with the era of "democratization" that followed the collapse of the Suharto regime (1968-98) (Fig. 1). The main factors behind the de-industrialization process in the post-Suharto period[7] were: (1) changes in the structure of governance facilitated by democratization, (2) the arrival of a commodity boom, and (3) expansion of economic relations with China.

1. Changes in the structure of governance

The Suharto regime promoted aggressive government-driven development of the heavy industries. While Suharto's industrialization policies were often criticized for having nurtured non-competitive domestic industries, creating a fertile ground for corruption, collusions and nepotism, there have also been a few successful examples, including the automotive sector, where Japanese investments helped create an internationally competitive industry with an ability to provide significant manufacturing export revenues. As the government embarked on import substitution industrialization from the 1970s, various initiatives to forcefully promote local production, such as import restrictions on finished vehicles and mandates for local procurement, were implemented. The government also encouraged technology transfers from Japanese manufacturers through joint venture partnerships. These initiatives proved effective, and Indonesia's automobile industry became export competitive.

Following the fall of the Suharto regime in 1998, which was driven partly by public resentment against corruption collusion and nepotism centered on the Suharto family and is cronies, state interventions in the market came to be viewed largely in a negative light.[8] Meanwhile, political power became decentralized from the executive to the legislative body, and from the central to regional governments, making it more difficult for the central government to effectively coordinate and implement coherent industrial policies. The development of competitive capital-intensive industries, a critical component of Indonesia's development plan, requires government support to facilitate large-scale and long-term investments. However, as economic activity has been left largely to market forces in the post-Suharto era, the majority of local business players in Indonesia has shifted their focus to capturing growing domestic demand through the strengthening of the consumer business, most notably retail, financial, and real estate services.[9] As the contribution of the manufacturing industries to the Indonesian economy has been on a decreasing trend, the government rightly refocused on the importance of industrial development. This process began under the previous Yudhoyono administration, and the Joko administration is following this trend.

2. Arrival of the commodity boom

The commodity boom, which arrived in the first half of the 2000s, constituted another factor behind the slowdown of Indonesia's industrial development. It is worth remembering that, in the late Suharto era, one could observe the country's major conglomerate operating in capital-intensive industries, such as the cement, automobiles, and petrochemicals sectors (e.g. the Salim Group, Astra Group, Bimantara Group, Damas Group, and others). However, as commodity prices began to rise, many companies shifted their focus to more lucrative agribusiness (e.g. palm oil production) and mining (e.g. coal). Against this backdrop, Indonesia became the largest exporter of palm oil in 2006 by overtaking Malaysia. Although some Indonesian companies still continue to produce automotive, such as those belonging to the Astra and Salim groups, it should be noted that many companies in the manufacturing sector are involved with labor-intensive products, including food, textiles, and tobacco, or

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[7] After the resignation of President Suharto in 1998, Indonesia was governed by the administrations of B.J. Habibi (1998–1999), Abdurrahman Wahid (1999–2001), Megawati Sukarnoputri (2001–2004), and Susilo Bambang Yudhoyono (2004–2014). President Joko took office in 2014.

[8] Y. Sato (2011), *Keizai Taikoku Indoneshia (Economic Power, Indonesia)*, Chukoshinsho.

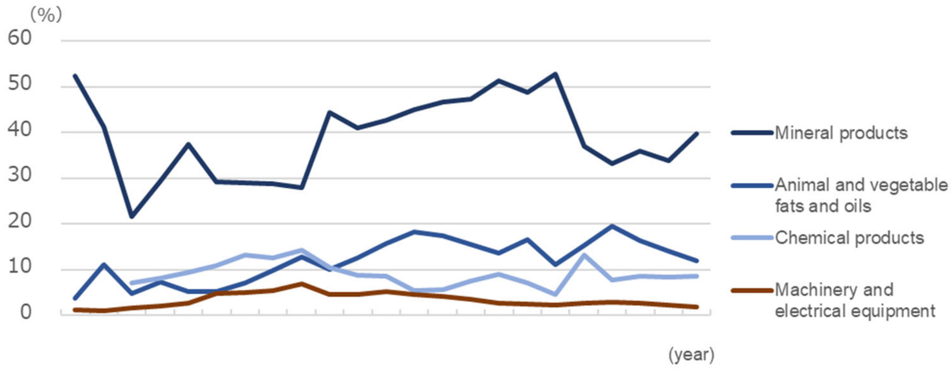
[9] See for example H. Shimato (2018), "Leading Companies in ASEAN (Indonesia, Thailand, Malaysia)", *Mitsui & Co. Global Strategic Studies Institute Monthly Report*.

natural resource-based products, such as plywood and paper/pulp production.[10] There are few local companies with strength in the capital-intensive industries, which are the targets of the government's industrial development initiatives.

3. Expansion of economic relations with China

Providing further impetus to the withdrawal of private capital from the manufacturing industry has been the expansion of vertical trade relations with China. Under the Suharto regime, which was built on the pillars of anti-Communism, Indonesia-China relations were characterised by mutual hostility and suspicion. The relations began to improve since the 1990s, which was further facilitated by the fall of the Suahrto regime. After the agreement for the ASEAN–China Free Trade Area (ACFTA) went into effect in 2010, economic relations expanded further as Indonesia formed a relationship with China for exporting natural resources and importing industrial products (Fig. 3).[11] As they came to be exposed to fierce competition with cheap Chinese imports, Indonesian firms accelerated the shift in focus to the agribusiness, mining, and newly emerging service industries. As a percentage of total exports to China, Indonesia's exports of animal and vegetable fats and oils, as well as mineral products to China, have approximately doubled in the past 20 years. Meanwhile, exports of capital-intensive industrial products to China have not increased, and instead, imports of such products from China have increased (machinery imports from China as a percentage of total imports from China has nearly doubled).

Figure 3: Indonesia's Exports to China
(as a percentage of total exports of each product category)



Source: Compiled by MGSSI based on UN Comtrade data

To sum up, instead of developing major domestic enterprises with strong competitiveness in the manufacturing sector, approximately 90% of Indonesian manufacturers have become micro-enterprises with weak competitiveness, and approximately half of those companies are engaged in industries that create relatively low added value, such as the food processing and textile industries.[12] Here lies the motive behind the Joko administration's determination to promote the revitalization of manufacturing by attracting foreign investors. At the same time, however, as economic nationalism has prevailed historically in Indonesia, some resistance is anticipated against the reliance on foreign capital to stimulate the economy. It is therefore expected that the Jokowi government will likely be mindful of taking a balanced approach by, say, simultaneously exploring the use of state-owned enterprises.[13] This could lead to more opportunities for foreign investors, including Japanese companies, to work with Indonesian SOEs to help the latter increase operational efficiency or develop new businesses (including the development of downstream industries).

[10] Y. Sato (2011), op. cit. and Asian Development Bank (2019), *Policies to Support the Development of Indonesia's Manufacturing Sector During 2020-2024*, (Manila: Asian Development Bank).

[11] Fukuoka, Y. and Verico, K. (2016) "Indonesia-China Economic Relations in the Twenty-First Century: Opportunities and Challenges" in Kim. Y. C. (ed.) Chinese Global Production Networks in ASEAN (London: Springer), pp. 53-75.

[12] Asian Development Bank (2019), op. cit.

[13] For example, the state-operated oil and gas company Pertamina is working to strengthen its downstream sector, such as by constructing refineries and petrochemical plants.

DIFFICULTIES OF ATTRACTING FOREIGN CAPITAL

The priority areas under the "Making Indonesia 4.0" roadmap include not only the labor-intensive industries for food & beverages and textiles & apparel but also capital-intensive industries, such as those for automotive, electronics, and chemical products. To realize the roadmap, the Jokowi government has proposed various initiatives (Fig. 4), through which to increase the economic growth rate by 1-2%, create 10 million new jobs, and boost manufacturing to account for over 25% of the country's GDP. President Jokowi emphasizes the importance of developing downstream industries, particularly in natural resource processing industries.[14] At the same time, the president has also expressed his intention to promote regional economic development by diversifying manufacturing investment from the island of Java, where investment has been concentrated, to the outer islands. Meanwhile, Minister of Industry Airlangga Hartarto has been aggressively campaigning to attract foreign investment in Indonesia's electric vehicle industries, by emphasizing the country's advantage as a major producer of cobalt and nickel required for EV batteries, and its standing as one of the largest automobile market in the region.

Figure 4: Key Initiatives for "Making Indonesia 4.0"

1	Develop domestic upstream industry: Reduce dependence on import of the raw materials and critical parts.
2	Redesign industrial zones: Develop a comprehensive and cross-industrial roadmap for industrial parks.
3	Embrace sustainability: Adopt clean technologies, EVs, biofuels, renewable energy, etc.
4	Empower SMEs: Provide e-commerce and technology support.
5	Develop digital platforms: Promote cloud solutions, data centers, information security, broadband services, etc.
6	Attract foreign investment: Attract top global manufacturers, accelerate technology transfers.
7	Upgrade human capital: Redesign education curriculum to be in line with industry 4.0 trends. Create professional talent mobility program.
8	Develop innovation ecosystem: Establish innovation centers, protect intellectual property, and promote industry-academia collaboration.
9	Incentivize technology investment: Introduce subsidies and tax exemption for technology adoption and support funding.
10	Reoptimize regulations and policies: Build more coherent regulations and policies by cross-ministry collaborations.

Source: JETRO

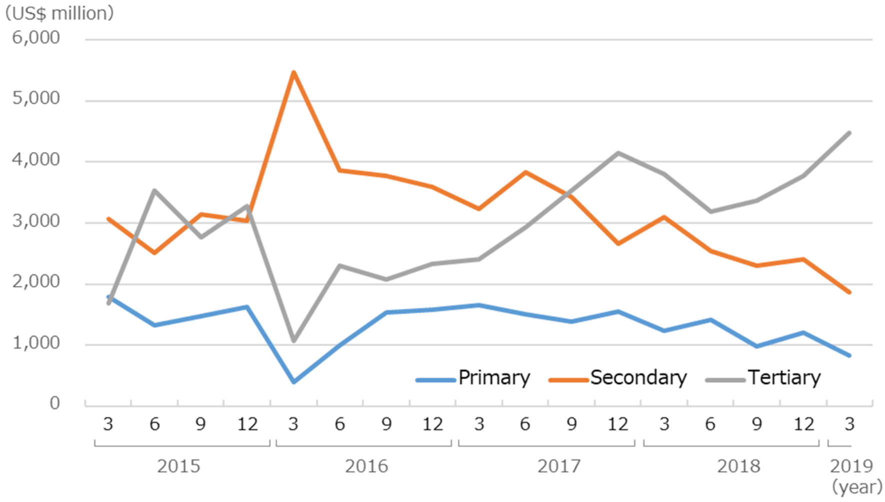
Indonesia has high expectations of Japan to upgrade its industrial structures. A good illustration of this is the "Project 2045"[15] which was announced in 2018 to commemorate the 60th anniversary of Japan–Indonesia diplomatic relations, and highlight ways in which the two countries could cooperate in the priority areas of "Making Indonesia 4.0." The report also indicates that Indonesia expects investment from Japan to serve as a catalyst for technology advancements and enhancement of project operations, as well as help widen Indonesia's participation in global supply chains. At present, Japanese companies are pushing forward with the construction of petrochemical plants and implementation of EV pilot programs, etc., but overall foreign direct investment in Indonesia's manufacturing sector is on a downward trend (Fig. 5). Jokowi's first term in office has produced visible results in infrastructure development and has also promoted deregulation, such as simplifying investment licensing procedures. However, Indonesia's deep-rooted protectionism and weak labor productivity growth appear to have diluted the attractiveness of the country's manufacturing industry as an investment destination.[16]

[14] Effective from January 2017, the Indonesian government banned the export of unprocessed minerals, in principle, and has been supporting the construction of domestic refineries.

[15] The report presents the vision of the nation looking toward 2045, which will mark the 100th anniversary of Indonesia's founding, and a summary of the state of bilateral cooperation needed to realize that vision.

[16] In the Doing Business rankings by the World Bank, Indonesia's position rose from 114th in 2014, to 72nd in 2018. However, it then ranked 73rd in 2019, fueling observations that the country's reforms have stagnated. Also, in a survey conducted by the Japan Bank for International Cooperation (JBIC) in which Japanese manufacturing companies were queried about their business destination plans over the medium term, Indonesia dropped from 2nd in 2016, to 5th in 2017.

Figure 5 Foreign Direct Investment in Indonesia (by industry)



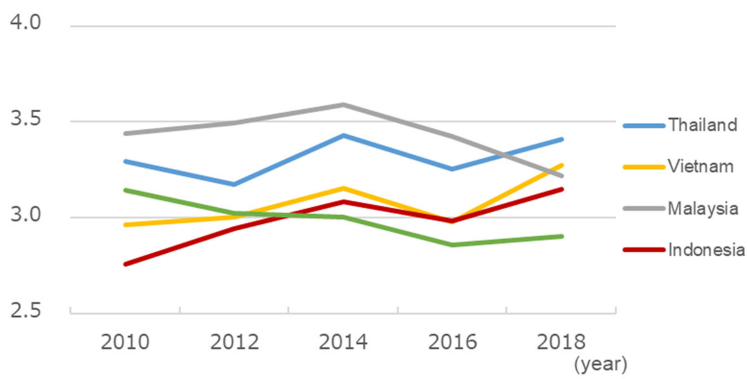
Source: Compiled by MGSSI based on CEIC data

Against this backdrop, Jokowi's second term is expected to focus on initiatives for further deregulation and human resource development, in addition to the acceleration of infrastructure development. At the same time, however, these are areas where strong political opposition is likely to emerge from those with an interest in maintaining the status quo.

1. Infrastructure development

One of the major obstacles to industrialization in Indonesia is the high cost of logistics, which is caused by the lack of infrastructure and amounts to more than 20% of GDP. The government has set a goal to reduce this cost to 8% of GDP by 2045, which would put it on a par with developed countries.[17] As discussed earlier, the first Jokowi administration aggressively pursued infrastructure development has produced significant results. However, a look at the World Bank's Logistics Performance Index (LPI)[18] and other data suggests there is still considerable room for infrastructure development in Indonesia compared to neighboring ASEAN countries (Fig. 6). In the 2019 budget, however, the growth in the infrastructure development budget has slowed down due to increases in subsidies, civil servants' pay and benefits to poor households, a not-so-subtle attempt to win over voters ahead of the April 2019 presidential and general elections (Fig. 7). In order to secure a large budget for infrastructure development, it is necessary to reduce fuel subsidies and other allowances, though the public is strongly opposed to such moves. Therefore, the question of whether Jokowi will be able to steer Indonesia onto a path of infrastructure drive once again will become one of the first points of interest as his second term commences.

Figure 6: Comparison of LPI for ASEAN Countries

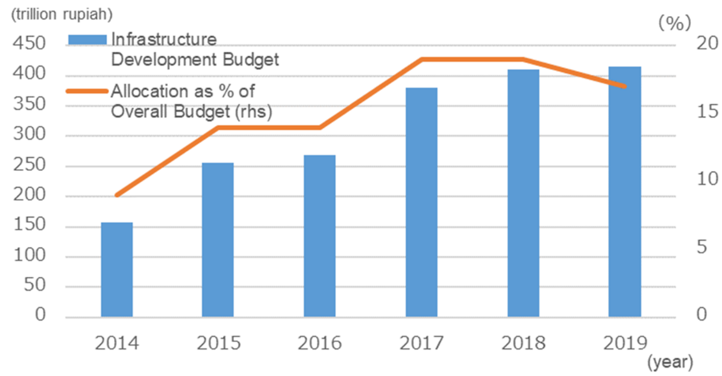


Source: Compiled by MGSSI based on World Bank data

[17] Indonesia's Ministry of National Development Planning/National Development Planning Agency (Bappenas), 2018, op. cit. *Indonesia 2045.*

[18] An indicator of the logistics performance of each country, announced by the World Bank once every two years.

Figure 7: Indonesia's Infrastructure Budget

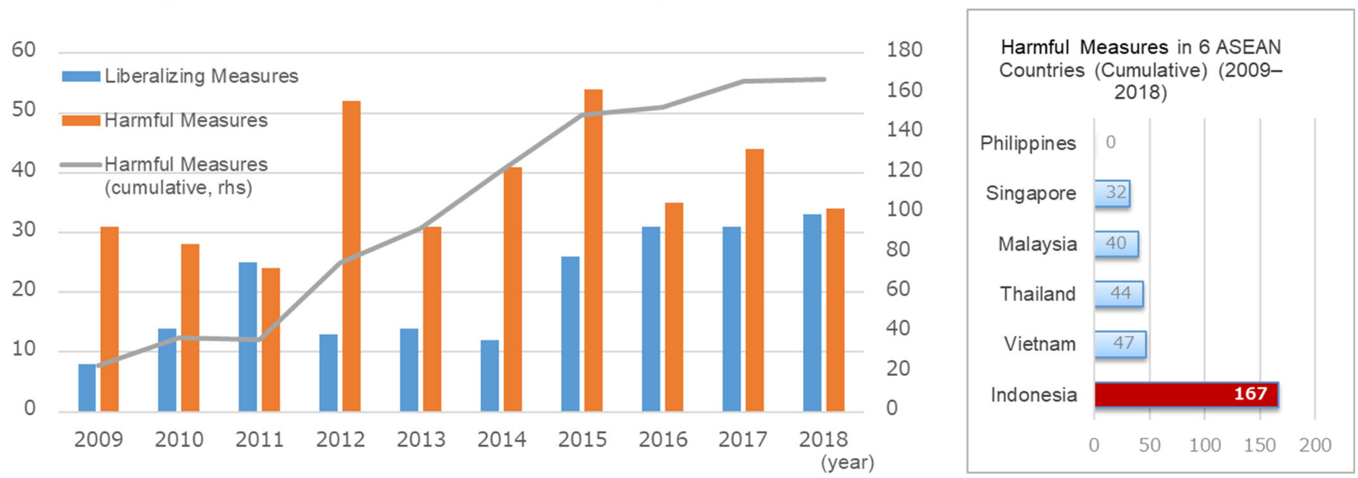


Source: Compiled by MGSSI based on Indonesian Ministry of Finance data

2. Promotion of deregulation

Becoming a part of the global supply chain is essential for developing export-competitive manufacturing industries. To that end, an open trade policy and preferential treatments for foreign investment are needed. Still, an increase in protectionist measures has been seen in recent years in Southeast Asian countries, mainly in the form of non-tariff barriers, but this tendency is particularly strong in Indonesia (Fig. 8), and this is creating barriers for the import of raw materials and parts for foreign manufacturers.[19] Problems have also been pointed out regarding foreign investment incentives. For example, the existence of minimum capitalization and minimum investment requirements has become an obstacle to the entry of foreign small and medium sized enterprises that would make up the supporting industries. Behind this is a sense of caution against foreign capital among Indonesian businesses, which often manifests itself in the form of protectionist pressures through parliament and other state institutions. Last but not least, the continued failure to reform Indonesia's rigid labor market – addressing the over-protection of formal sector workers – constitutes yet another obstacle to attracting further foreign direct investment in the manufacturing sector.

Figure 8: Indonesia's Harmful and Liberalizing measures



Note: Harmful measures (cumulative) indicates the total number of harmful measures (restrictions on trade, investment, other areas) excluding the number of measures contributing to liberalization.
Source: Compiled by MGSSI based on Global Trade Alert data

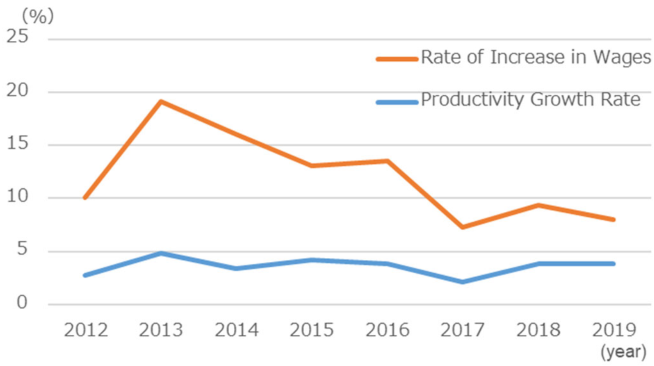
Considering the continued presence of deep-rooted protectionism in Indonesia, the possibility of wide-sweeping deregulation in the near future is unlikely. Still, after a comfortable victory in the April 2019 election, there are expectations that the second Jokowi administration improves the business environment, even on an incremental basis.

[19] According to the "2018 JETRO Survey on Business Conditions of Japanese Companies in Asia and Oceania," 222 Japanese companies (64.9%) out of 342 Japanese companies in Indonesia surveyed responded that there are "non-tariff measures that obstruct business in Indonesia," which was higher than the ASEAN average (43.0%).

3. Improvement in labor productivity

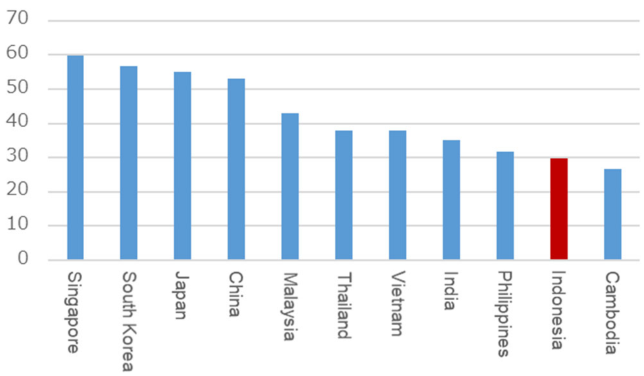
Finally, Indonesia has been facing serious productivity problems because the improvement in labor productivity has not kept pace with rising labor costs (Fig. 9). As other emerging countries are making the most of relatively low labor costs to build themselves up into manufacturing hubs, Indonesia is stuck between a rock and a hard place, facing competition with both highly productive countries and low labor-cost countries at the same time. The country's level of innovation is inferior to that of neighboring countries that have attained a level of development similar to Indonesia's and with which it competes to attract foreign capital, such as Thailand and Vietnam (Fig. 10).[20] Although the Joko administration aims to improve productivity of the manufacturing sector through the use of AI and IoT, this is an ambitious plan for Indonesia, where science education has traditionally been weak, and there is an overwhelming shortage of engineers needed for design and maintenance of production lines.[21]

Figure 9: Rates of Increase in Indonesia's Labor Productivity and Minimum Wage



Source: Compiled by MGSSI based on ILO/CEIC data

Figure 10: Innovation Index for Countries in Asia



Source: Compiled by MGSSI based on WIPO data

It has been pointed out that there is a need to shift the focus of education policy from the expansion of primary and secondary education to the improvement of the quality of higher and vocational education in order to improve productivity.[22] President Joko has expressed expectations for the "import" of Australian higher

[20] According to the OECD's Programme for International Student Assessment (PISA) survey conducted in 2015 (the survey of 15-year-old students is carried out every three years), 42% of students in Indonesia failed to acquire the "key knowledge and skills that are essential for full participation in modern societies" in all subjects covered by the survey (reading comprehension, mathematical literacy, and scientific literacy), trailing far behind Singapore (4.8%), Vietnam (4.5%), Malaysia (25.0%) and Thailand (35.8%).

[21] According to a study by McKinsey & Company, the number of science graduates per population of 1,000 in Indonesia is 0.8, less than China (3.4) and India (2.0). McKinsey & Company, "The Digital Archipelago: How Online Commerce is Driving Indonesia's Economic Development," August 2018, p. 57.

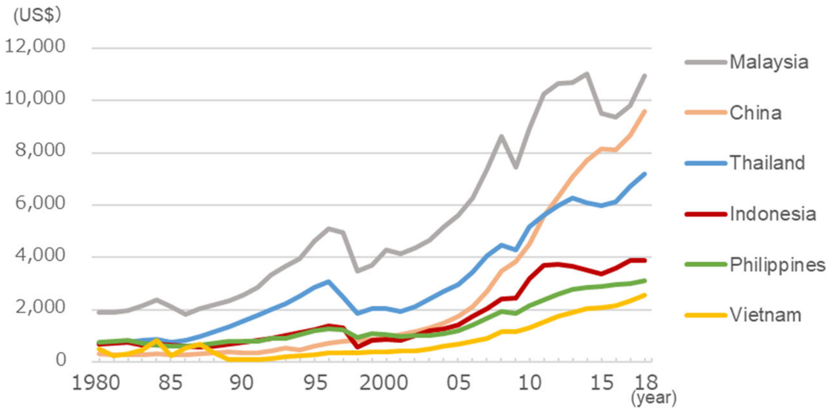
[22] Kuncoro, A. (2018), "Trends in the Manufacturing Sector Under the Jokowi Presidency: Legacies of Past Administrations," *Journal of Southeast Asian Economies*, vol. 35, no. 3, pp. 402-424.

education institutions and Japanese technical colleges. It should be noted, however, that Indonesia's educational institutions, whose performance have been undermined by corruption and nepotism, would be reluctant to accommodate such changes that would expose them to greater competition. Despite repeated calls for reforms to date, it still remains unclear as to what extent these concepts can be put into practice considering potential backlash from those who have benefitted from the current system and are thus hesitant to any meaningful reforms.[23]

OUTLOOK FOR INDONESIAN ECONOMY LACKS OPTIMISM

In recent years, Indonesia has attracted attention as a huge consumer market, and there is even an inclination to regard it as "the second China" for e-commerce, for example.[24] Although economic growth has slowed to the 5% level, the country is still an attractive market because it is expected to continue to achieve solid growth going forward. At the same time, however, the prospects of future growth should be carefully assessed. Growth in Indonesia's GDP per capita is sluggish as the upper-income groups living around Jakarta are the ones who primarily benefit from economic expansion, while those living in outer islands are being left behind. In the first half of the 2010s, when Indonesia began to attract attention as a huge consumer market, there was a strong sense of optimism for the future growth in consumption in the country, though this expectation has been unmet. Given that higher economic growth was seen in China and other Asian countries when their GDP per capita was at the same level as it is now in Indonesia, it is hard to shake off the sense that the slowdown in Indonesia's growth rate is too fast (Fig. 11).

Figure 11: Trend of GDP Per Capita in Asian Countries



Source: Compiled by MGSSI based on IMF data

For Indonesia to achieve sustainable economic expansion and to increase income level, the government needs to bolster the regional economy, not just the areas near Jakarta. The Joko administration wants to raise income levels of those living in outer islands by strengthening manufacturing and diversifying investment to outside of Java island. The Asian Development Bank (ADB) points out that "it will be very difficult to become a high-income economy without achieving substantially higher levels of industrialization",[25] emphasizing a close relationship between the development of the manufacturing industry and GDP growth. In addition, the ADB, while appreciating that "Making Indonesia 4.0" provides "a timely opportunity for Indonesia's manufacturing sector to boost productivity and enhance competitiveness in the export market",[26] argues that it is imperative for the Indonesian government to translate this initiative into immediate policy action. In order to enhance Indonesia's attractiveness as a global manufacturing hub and give the country a competitive edge for attracting foreign capital over its neighbors, President Jokowi is expected to leverage the political capital gained through his re-

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23 Rosser, A. (2018), "Beyond Access: Making Indonesia's Education System Work," *Lowy Institute Analysis*, Feb 2018.
24 McKinsey & Company (2018), op. cit.
25 ADB (2019), op. cit., p. 11.
26 ADB (2019), op. cit., p. 113.

election to accelerate infrastructure development, and promote initiatives for deregulation and higher education reform.

In this regard, the experience of the previous Yudhoyono administration (2004-2014) is worth recalling. Former president Yudhyono was re-elected in 2009 in a landslide victory, raising an expectation for ambitious reform in his second term, though due to his preoccupation with prioritizing political stability over structural reform that could potentially disturb his coalition allies, his presidency was characterized more by stagnation than by significant changes. Some observers express concern that the Joko administration could follow a similar path.[27] To assess the prospect of his second administration, the points to watch for now will be the selection of Cabinet members (whether President Jokowi will be able to appoint technocrats instead of partisan party politicians for strategic positions which are critical to the government's economic management) and the preparation of the budget for the next fiscal year (whether President Joko will be able to cut back on pork-barrel spending). As Indonesia's demographic dividend will run out in the 2030s, an effective growth strategy must be launched before that. President Joko won re-election in April to serve another five-year term, but in the second half of the term, political parties will begin preparing for the next presidential election in 2024, and Joko is likely to become virtually a lame duck. As such, the success or failure of his administration will be determined within the 1-2 years after Joko's inauguration, meaning he does not have much time left to push through with his initiatives for Indonesia.

[27] "Indonesian President Faces Economic Hurdles," *Financial Times*, May 21, 2019.