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Indonesia Needs Greater Appetite for Future Economic Reforms

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Key Points

- More reforms will be needed if Indonesia is to boost economic growth and attract much-needed investment, especially in infrastructure.
- There has been some progress in introducing economic reforms, but the effect has been stifled by the implementation of protectionist measures.
- The upcoming presidential election could also undermine some of that progress, especially if economic nationalism becomes a prominent campaign platform.
- The reform process is likely to remain slow and stilted for the foreseeable future.
- Significant opportunities for businesses and investors remain, however, especially in high population centres where strong growth is expected in the middle-income class.

Summary

The upcoming presidential election has seen both current President Joko "Jokowi" Widodo and contender Prabowo Subianto place economic policy under the spotlight. Rather than focusing on economic reforms, however, as Jokowi did in the 2014 poll, both have shifted their focus towards the safeguarding of national resources. In considering that more nationalist focus, this paper will look at the current state of the Indonesian economy and the

progress of economic reforms to date. Possible opportunities for Australian businesses and investors will also be identified.

Analysis

The Current Economic Climate

Securing more trade and investment is vital to the future of Indonesia. According to Jim Yong Kim, President of the World Bank, that investment needs to come soon so that Indonesia can 'reach high-income status before the working-age population, relative to the rest of the population, starts to shrink by 2030.' If it is to achieve sustained long-term economic growth, Indonesia will need approximately $1.6 trillion in investment by 2030.

Much of that investment is needed in the infrastructure sector. Currently, government expenditure on infrastructure sits at approximately thirty per cent of the amount required. As a result, the current state of infrastructure in Indonesia is generally poor, which imposes some significant costs on the economy. The Australian Department of Foreign Affairs and Trade (DFAT) outlined some of those consequences in a 2015 report:

> **Transport:** Travel speeds on arterial roads are among the worst in East Asia, with longer journey times contributing to high logistics costs of around 24 per cent of GDP [$269 billion in 2016].
>
> **Water:** Eighteen per cent of the population lacks access to improved water, while 80 per cent lacks access to piped water.
>
> **Sanitation:** Ninety-eight per cent of the population lacks access to sewerage systems (including in Jakarta), resulting in severe economic costs to families.
>
> **Electricity:** Many regions continue to suffer from load-shedding; in Papua, only 30 per cent of the population are connected to the grid.
>
> **Internet Access:** Indonesia has only around 1.2 fixed broadband connections per 100 persons, as compared with 8.4 in Malaysia and 5.0 in Vietnam.[1]

While some of those areas have seen improvement, the World Bank also estimates that sub-par infrastructure has equated to a loss of one per cent of GDP growth per annum over the past ten years. This equates to a loss of between $90 billion and $100 billion over the past decade.[2]

Inadequate infrastructure is not an issue for Indonesia alone and is a problem across much of South-East Asia. To help attract investment in the infrastructure sector, the Indonesian Government must continue to implement reforms. Currently, private investors make up only a small fraction of overall investment in Indonesia's infrastructure. That is partly due to a

[1] Department of Foreign Affairs and Trade, 'Indonesia Infrastructure Programme (2016-26): Investment Concept (Revised)', Australian Government: Canberra, November 2015, p. 5.
[2] *Ibid.*

poor investment climate, which imposes obstacles that dissuade many potential investors and causes others to postpone or even cancel their investment plans. Some of those obstacles include: changing and inconsistent regulations, lengthy licensing procedures and high logistics costs due to poor infrastructure. Addressing those concerns is vital if Indonesia is to attract much-needed investment.

There is also an argument for Indonesia to open up its economy in other ways. The country enjoys a wealth of natural resources, including oil, gas, coal and minerals, but has been reluctant to explore and extract many of those deposits efficiently. This hesitancy is due to government policies that lean towards "resource nationalism". Since 2009, that policy line has seen the introduction of such policies as export bans and foreign ownership caps. While those changes have had some positive impacts, such as bolstering domestic service providers, they have also pressured investors into supporting state-led projects. According to the Lowy Institute, 'successful resource exploitation necessitates some degree of economic openness. That is required to access export markets, as well as to attract investors (usually foreign) to obtain necessary capital and technology.'

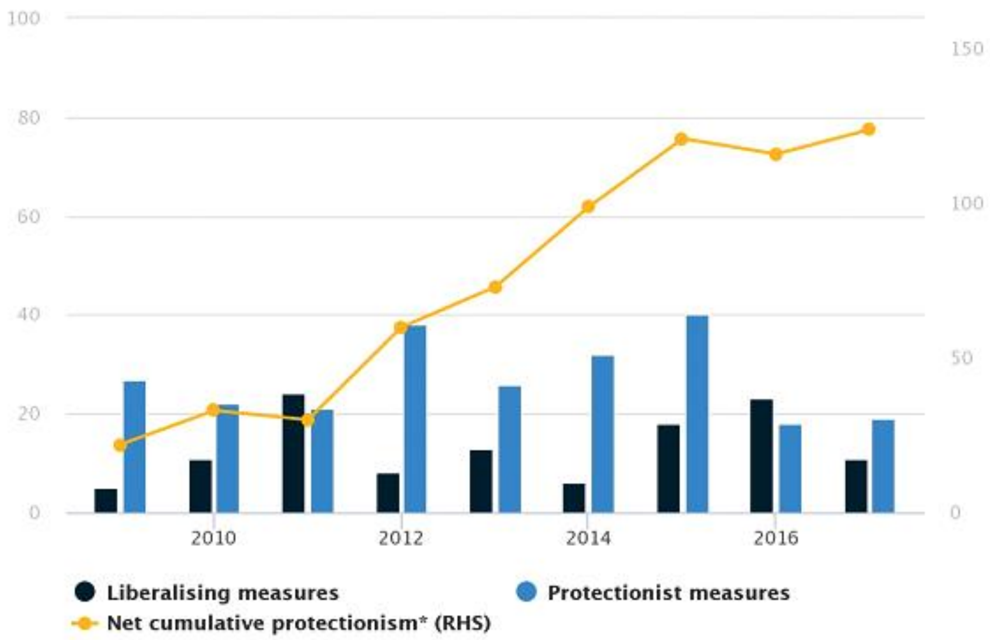
Indonesia is also working to transform its export industries from being dominated by raw commodity exports by producing and exporting more manufactured goods. According to a report by the World Bank Office in Jakarta, growth in exports and employment in the manufacturing sector has been overwhelmingly driven by foreign direct investment. Recently, growth in that sector has strengthened considerably, although challenges remain, such as rising wages, workforce skill levels and the availability of raw materials. It is also not certain that the recent spurt of growth is sustainable. Appropriately adjusting and reforming the regulatory environment and continuing to work towards keeping the sector attractive for investors will be vitally important for the future prospects of Indonesian exporters.

Progress of Reforms

There are conflicting messages about Indonesia's progress with reforms. During the initial years of the Jokowi Administration, there was a major focus on economic reform, which was designed to open the country to greater levels of trade and investment. Protectionist measures, often advocated by members of the political élite, have, however, stymied that progress. As a result, the overall level of protectionism in Indonesia's economic policy has begun to plateau, rather than decline (see Figure 1). Additionally, many of the deregulation packages released by the Jokowi Administration have been criticised for being overly vague and poorly implemented.[3] Overall, there has been some progress at face value, such as the bettering of its position on the World Bank's "Ease of Doing Business Rankings", but little has been done to alleviate the concerns and problems faced by those on the ground.

[3] Oxford Business Group, 'The Report: Indonesia 2018', p. 70.

Figure 1: Protectionism Still Elevated Despite Reforms



Source: Lowy Institute

At the same time, however, the reforms that have been put into place do appear to have made a significant impact on incoming investment levels. President Widodo has implemented sixteen reform packages so far; the most recent in August 2017. While they may have been vague and even poorly implemented, some of those reforms are reported to have had a positive impact on foreign direct investment inflows. At the end of 2015, after the first two packages were introduced, the Indonesian Investment Co-ordinating Board (*Badan Koordinasi Penanaman Modal*, or BKPM), reported that foreign direct investment, measured in rupiah, had increased by 19.2 per cent compared to the previous year. Recent statistics also show similar levels of growth. The first quarter of 2018 saw year-on-year growth at 12.4%.

Future Prospects

With the 2019 presidential election looming, it seems unlikely that there will be much appetite for further reforms in the short-term. That is primarily due to the fact that, in the current political atmosphere, a reformist agenda does not appear to be a popular campaign platform. The rupiah has recently slumped to its lowest value in twenty years and, despite stable – if sometimes modest – economic growth, economic nationalism has become the primary campaign focus. Speaking to Bloomberg, Bill Sullivan, the Senior Foreign Counsel for Jakarta-based law firm Christian Teo and Partners, noted that 'Nationalist rhetoric is definitely a "vote getter" in Indonesia, where foreign investment is viewed by most people as either a bad thing or, at least, a necessary evil that must be strictly controlled'.

Soon after declaring his candidacy, Jokowi told his supporters that he would 'safeguard our national resources', adding that his policies to nationalise oil and gas assets are proof of his commitment to Indonesia's sovereignty. For Prabowo Subianto, the sole challenger to Jokowi, protecting Indonesia's natural resources from foreign entities was already high on his agenda when he stood at the 2014 presidential election. As noted by Marcus Mietzner, of the Australian National University, Prabowo's campaign is likely to 'focus on ultra-nationalist themes: sell-out to China, invasion of foreign workers, evil imports, predatory investors… These are classic Prabowo themes anyway, but they will become even more pronounced this time.'

Once the election is over, the most likely outcome for economic reform will probably be the status quo. Even if Jokowi wins the election and shifts his focus away from economic nationalism and back to more liberal economic policies, he will still lack control over the will of the political élites who tend to favour protectionist policies. Prabowo, on the other hand, who tends to favour economic nationalism more than Jokowi, appears able to wield more influence over those élites, but is less likely to be amenable to liberal reforms.

Looking to the longer-term, it is difficult to see exactly where the Indonesian economy is headed. As an oft-cited report by PricewaterhouseCoopers has speculated, Indonesia is projected to become the world's fourth-largest economy in terms of GDP by 2050.[4] That depends to a very real extent on the actions that the Indonesian Government takes today and how economic growth is balanced with economic stability.

If Indonesia does become the fourth-largest economy by 2050, it is likely – if not essential – that many of the required reforms would have already been put in place. Such a scenario seems difficult to envision in the current environment, given that progress has so far been slow and hampered by opposing ideologies. The divisive atmosphere of Indonesian politics today will do little to help steer the country along a pathway of reform in the future. Given the right leadership, however, a pragmatic approach to reforms could certainly put Indonesia on track.

Opportunities for Australia

Despite the setbacks outlined above, there are still significant prospects for Australian investment and business in Indonesia. High-demand areas that provide the best opportunities for Australian businesses and investors include: consumer goods and services; education and training services; knowledge-based industries; and technology. Most of those opportunities will be focused in high population centres, where there is already a growing middle class. Jakarta, for example, is predicted to become the world's most populous megacity by 2030, bringing with it a large market of consumers with a growing need for more goods and services.

At the same time, there is likely to be a deficit in skills, due to a lack of existing training and education facilities. Finance Minister, Sri Mulyani Indrawati, has recognised that issue and has actively pushed for the government to invest in human capital, to increase the skill set of

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[4] PwC, 'The Long View: How Will the Global Economic Order Change by 2050?', February 2017, p. 7.

the Indonesian workforce. While the skills deficit may be an obstacle for some businesses, it can also provide opportunities for investment in the education and training sectors.

Conclusion

Reforms are a vital component of Indonesia's future economic growth. While there has been some progress in reforming the economy in recent years, a lack of will among major political players has seen progress stifled by the introduction of protectionist measures. Today, the divisive political climate in Indonesia does not seem to be conducive to a steady stream of liberalising measures.

There is, however, an urgent need for reforms to attract investment into the economy, especially in the infrastructure sector. In the longer-term, though, the Indonesian Government is likely to recognise that need and should continue to push for reforms, although the actual progress may be slow and inconsistent.

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