Indonesia: Economic Developments and Future Prospects

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Key Points

- The Indonesian economy continues to show strong growth, with predictions that it could become the world’s fourth-largest by 2050.
- The country’s growing middle class has the potential to be a significant future driver of the economy.
- Investment is desperately needed to improve infrastructure, which is vital to achieving future growth.
- Good progress has been made in introducing reforms to help small businesses but much less has been done to aid larger companies looking to invest in Indonesia.

Summary

Indonesia is the largest economy in terms of Gross Domestic Product in South-East Asia and, as a member of the G-20, is a significant emerging market in the world economy. Although predicted to become the world’s fourth-largest economy by 2050, there are a number of challenges that will need to be overcome if that lofty target is to be reached. Sluggish global trade and subdued international growth, especially in China, is a particular current constraint, and the Widodo Administration needs to do more to make the Indonesian business environment more attractive to foreign investors, whose funding is necessary if the country’s infrastructure inadequacies are to be addressed.
Analysis

Macroeconomic Settings and Obstacles to Growth

Gross Domestic Product growth rates remain strong at approximately five per cent; the economy grew by 0.2 per cent over 2015, although it has slowed from 6.2 per cent in 2011. This places Indonesia comfortably among the other Association of South-East Asian Nations (ASEAN) countries, with average growth across member states sitting at approximately 4.8 per cent. Maintaining a GDP growth rate of between five and six per cent will see Indonesian GDP double every fifteen years, thus putting the country on track to become the fourth-largest economy by 2050, as measured by nominal GDP. Inflation rates remain low at 3.3 per cent at the end of the fourth quarter of 2016, compared to the annual inflation rate of 6.4 per cent seen in 2015. The Indonesian inflation rate remains higher than its neighbours, however, with the average rate across ASEAN being around 2.3 per cent. Annual unemployment rates have also fallen from 6.2 per cent in 2015 to 5.5 per cent in 2017, the lowest since 1998. The poverty rate continues to decline as well, having fallen approximately six per cent in the past ten years down to 10.7 per cent in 2016. The drop in the poverty rate may now be beginning to stagnate, with rural poverty increasing by 0.2 per cent since 2014. Overall, Indonesia has continued to make good economic progress and its economy remains the largest in South-East Asia in terms of GDP. It is the world’s tenth-largest economy in purchasing power parity terms.

Looking ahead, the World Bank, in its latest quarterly report for Indonesia, outlined the following potential obstacles for growth in 2017: continued global policy uncertainty and financial volatility, sluggish global trade and subdued growth in advanced economies, and the ongoing deceleration of the Chinese economy.1 Global policy uncertainty caused by high-profile events such as the September 11 attacks has been linked to international growth and has spiked again due to more recent events including the European immigration crisis, Brexit and increased US-Russia tensions. According to a paper published by Global Trade Watch, ‘a rise in economic policy uncertainty reduces trade by reducing GDP growth. In a less-certain environment, firms may choose to postpone investment decisions, consumers may cut back spending, and banks may increase the cost of finance’. In Indonesia, the US election resulted in a three per cent depreciation in the value of the rupiah.

Sluggish global trade and subdued international growth, especially in China, could pose problems for Indonesia as it looks to expand its global trade and seek more foreign investment. Specifically, in the case of China, the World Bank estimates that a one percentage point decline in China’s GDP growth rate could reduce GDP growth in Indonesia by 0.4 percentage points after two years.2 The primary area affected by this is bilateral trade. As seen in Figure 1, exports, especially coal, to China have fallen significantly. Specifically, the net worth of coal exports to China in 2015 was $1.8 billion less than the

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average over the previous ten years. While declining coal prices did have an impact on the net worth of trade, the net weight of coal exports to China fell from approximately 53 million tonnes in 2013 to a low of 37 million tonnes in 2015. In overall trade terms, the percentage of exports as a component of Indonesian GDP has fallen from 41 per cent in 2000 to 21 per cent in 2015, significantly less than in Singapore and Malaysia, where exports make up 176 and 71 per cent of GDP, respectively. While the actual monetary value of Indonesian exports almost tripled over the entire period between 2000 and 2015, it has in fact declined since 2011.

![Indonesian Exports to China](image)

**Figure 1:** Based on statistics from the United Nations Comtrade Database.

*Key Economic Sectors*

The highest-performing sector in the Indonesian economy is manufacturing, which accounted for 20.51 per cent of GDP in 2016. Within this sector, the food and beverage industry constitutes thirty per cent of manufacturing GDP and six per cent of total GDP. The only secondary sector that is larger than the food and beverage industry is wholesale and retail trade, which makes up 10.49 per cent of GDP. The dominance of these sectors is primarily due to Indonesia’s large population and, particularly, its expanding middle class. This is likely to also be the case in the longer term as Indonesia continues to show strong growth and the number of people living in poverty steadily declines.

The fastest-growing sectors over the past three years have been rail, land and air transport services, electricity, and food and beverage. The rapid growth of transport services can be attributed to government backing for the industry and strong investment. As the Indonesian Government presses ahead with plans to expand the tourism sector, transport services can be expected to benefit in the medium- to long-term future. Growth in the electricity sector is primarily due to the ambition of President Joko “Jokowi” Widodo for the national grid to generate an additional 35,000 megawatts of electricity generation capacity by 2019. Weaker than expected growth, however, has forced Jokowi to re-evaluate that target.
The only sectors to have contracted since 2014 are the oil, gas, metal and coal mining industries, coal and gas refineries and the rubber and plastics industries. The mining industries have declined significantly in the past three years, averaging reductions of between ten and 25 per cent. This is primarily due to a ban on unprocessed mineral ores that came into effect in 2014, significant drops in oil and gas prices and declining coal exports. The future of oil, gas and coal mining in Indonesia is not helped by a lack of new major oil projects, insufficient investment in gas and the decline in demand for coal. Metal mining, on the other hand, is expected to recover as Jokowi considers lifting the ban on exports, although mining companies, which had been forced to develop refinery facilities at considerable expense, may not be altogether pleased if the ban is subsequently lifted.

The sectors that employ the highest number of local workers are agriculture (38.3 million), followed by wholesale trade, retail trade, restaurants and hotels (28.5 million), community, social and personal services (19.8 million) and the manufacturing industry (16 million). Employment numbers in the agriculture sector have fallen over the past few years, however, even as the sector’s contribution GDP continues to grow (Figure 3). This has contributed to the slowness of the fall in the unemployment rate, which fell by 0.6 per cent during the period 2012-16, compared to a drop of 2.5 per cent from 2007 to 2011. Shrinking employment in the agricultural sector, however, has been offset by the growth in the sectors mentioned previously, which have collectively created over ten million new jobs since 2011. Growth in these sectors can again be credited to the growing middle class, whose rising prosperity will continue to drive the Indonesian economy in the years ahead.
Foreign Investment

During the initial years of the Jokowi Administration, there was a major focus on economic reform to open the country to more trade and investment. Since then, however, the commitment to that focus has diminished immensely, with the government having little new investment to show for it. Despite declaring Indonesia “open for business”, foreign direct investment (FDI) inflows have largely plateaued since Joko took office, increasing by only...
1.2 per cent ($460 million). This is primarily due to declining investment in the mining sector, previously the most popular destination for foreign investment in Indonesia, but which has now fallen by 43 per cent ($2.75 billion) since 2013. In addition to mining bans, external factors, such as demand, are also responsible for the lack of investment in this particular sector. This can be seen when comparing the sharp decline of foreign investment in the Indonesian mining sector – which is dominated by coal mining – with the corresponding decline in coal imports across Asia. India and China, which together account for 42.3 per cent of Indonesian coal exports, have both made efforts to reduce their dependence on coal imports, with an accompanying effect on investment in the Indonesian mining sector, as shown in Figure 4 (above).

Perhaps the area most in need of investment is infrastructure. According to a report by the Asian Development Bank, Indonesia needs approximately $1.6 trillion in investment if it is to meet its investment needs by 2030. Currently, investment in Indonesian infrastructure is only thirty per cent of what is actually needed. The Australian Department of Foreign Affairs and Trade (DFAT) has outlined the consequences of that lack of infrastructure:

**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, while in Papua, only 30 per cent of the population is connected.

**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.³

As further noted by DFAT, the World Bank has also estimated that sub-par infrastructure due to a lack of investment has equated to a loss of one per cent of GDP growth per annum over the past ten years, equating to a loss of between $90 billion and $100 billion over the past decade. Securing the investment to upgrade its infrastructure should be the primary focus of the Indonesian Government for the near future. This need for investment, however, is true for the entire Asian region, not just for Indonesia, or even South-East Asia generally. The South-East Asian region in particular, will need $4.2 trillion in investment between 2016 and 2030 if it is to maintain its growth momentum, eradicate poverty and respond to the demands imposed by climate change.⁴ This clearly places Indonesia in competition with its

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neighbours in securing investment, and Jakarta will need to do more to make Indonesia a more attractive environment for potential investors. It should also be noted that more could be done to encourage Australian businesses to invest in Indonesia. In 2016, Australia invested only $228 million in the Indonesian economy, representing only 0.012 per cent of the total $2.1 trillion worth of Australian outward investment.

**Business and Investment Environment**

To open up Indonesia to more investors, Jokowi must continue to reform the country’s business environment, which is riddled with instances of corruption and excessive bureaucracy. There has been good progress so far, at least in regard to small businesses, as noted by the World Bank. According to the report, *Doing Business 2017: Equal Opportunity for All*, Indonesia is ranked among the top ten countries that have most improved the ease of conducting business. Specifically, in the past two years, the Indonesian authorities have made it easier to start a small business by cutting red tape and reducing the time taken to register a business, the introduction of an online system for filing tax returns and paying health contributions, together with improved access to electricity. The reforms, however, do not necessarily benefit the large foreign investors that the Indonesian economy needs and do not necessarily reflect any progress on that count.

One of Indonesia’s largest infrastructure projects, the Jakarta-Bandung high-speed railway, continues to be plagued with problems and delays. As reported in the *Strategic Weekly Analysis*, on 29 September 2015, China won the bid over Japan and France to build the railway. The initial bidding process was messy. After the bidders had already spent years developing proposals for the project, the Indonesian Government announced that it was instead looking at building a medium-speed railway, and called for the bidders to draw up new proposals. In response, China again proposed a high-speed link but this time without requesting any financial guarantees or assistance from Jakarta, which accepted the proposal. Japan was understandably upset at the turn of events, having spent ten years and approximately $4 million on a feasibility study for the project. Construction has only recently begun and the project has been beset by such issues as land clearance, funding shortages and environmental concerns. The efficiency and transparency of the Indonesian business environment will certainly need to be improved if more foreign companies are to be enticed to invest in large infrastructure projects.

**Conclusion**

Indonesia is showing strong growth despite external pressures on the economy, such as sluggish global growth and global policy and political uncertainty. Looking ahead, the Indonesian Government will need to facilitate the expansion of the middle class while continuing to make progress in reducing the national poverty rate. If it can continue to grow at the rates forecast, the middle class will continue to be a strong driver of economic growth for the foreseeable future. That domestic growth could, in turn, aid Indonesia in becoming more resilient to the external factors that can negatively affect important sectors of the

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economy, such as coal mining. Opening up the country to more foreign investment will help to develop the much-needed infrastructure that will be instrumental in future growth. Predictions that Indonesia will become the world’s fourth-largest economy by 2050 are ambitious, but do hold merit providing that economic conditions do not severely deteriorate and that the government takes the necessary steps to aid, rather than hamper, economic growth.

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