For Indonesia’s Economic Future, The Next Five Years Will Be Decisive
By Wijayanto Samirin

Indonesia’s growth story has only in recent years captured the imagination of the global business community. Add to that the recent election of a reformist outsider as president, and the optimism about Indonesia’s economy is understandable.

But, as Wijayanto Samirin argues, the country must address pressing challenges, most notably better infrastructure, to realize its potential. The next five years will be critical.

Indonesia has most of the factors it needs to prosper. But despite the encouraging economic progress of the last decade, the $1 trillion economy still performs well below its potential. Inadequate infrastructure is one of the largest hindrances, in addition to policy uncertainty and the lack of high-caliber human capital. Improving infrastructure is the major medium-term challenge for President Joko Widodo’s new government if it is to ensure that progress continues.

Recently, Paramadina Public Policy Institute, the think-tank with which I work, conducted a focus group discussion in Jakarta. Senior executives from 25 multinational firms attended the event where policy recommendations for the government to promote more foreign direct investment (FDI) were discussed. Coincidently, as we were discussing infrastructure issues, the lights in the five-star hotel meeting venue went out. While outages are a recent phenomenon in Jakarta, they happen almost daily outside Java Island. It was a good object lesson for our discussion.

Electricity is only one infrastructure issue on a long list. For example, just moving from one place to another in Jakarta is a tough undertaking. The traffic is daunting, and getting worse. In 2010, cars in the city moved at an average of 18 km per hour; by 2014, that had declined to only slightly above 10 km per hour. According to a study by the Japan International Co-operation Agency (JICA), there will be total gridlock in Jakarta in the foreseeable future without significant improvement.

In cities such as Wellington, Los Angeles and Singapore, having five meetings a day is normal. In Jakarta, even three is a great achievement.

Indonesia’s airports are also congested. Despite capacity expansion, terminals are overflowing with passengers and runways with airplanes. For instance, Soekarno-Hatta International Airport in Jakarta has a designed capacity of 22 million passengers per year, but serves more than 50 million passengers now. The government is expanding it, so that by 2016 the airport will be able to handle 62 million passengers. Unfortunately, actual passenger numbers will have reached 65 million by that time. In addition, flight delays are becoming more common, because of the long queue for airplanes waiting to take off or land.

HIGH-COST ECONOMY, SUB-OPTIMAL GROWTH

Over the last decade, the economy has grown by an average of 5.3 percent per annum. Indonesia’s encouraging economic performance has triggered a growing demand for infrastructure. Unfortunately, this phenomenon has not been accompanied by adequate growth on the supply side, creating a high-cost economy.

Nowadays, many businesses have to invest in private back-up generators, in case of electricity blackouts. Extra investments such as these increase business costs. The final impact is higher costs for consumers, smaller profits for businesses and lower tax revenues for the government. Private electricity generation is only one of a long list of cases where poor infrastructure adds to the cost of doing business in Indonesia.

The lack of infrastructure also has made logistics costs in Indonesia among the highest in the region (see chart 1). It is so inefficient that the cost to transport locally grown oranges from Medan in North Sumatra to Jakarta (around 2,000 km) is more expensive than it is to transport them from the US or China to Jakarta. As a result, farmers from across Indonesia are losing the opportunity to enjoy the growing domestic market. Oranges are not unique; other commodities and goods face a similar situation.

High logistics costs have also made it difficult for Indonesian products to compete in the global market. In 2011, logistics costs in Indonesia accounted for the equivalent of 24.6 percent of gross domestic product (GDP). Instead of decreasing, it has increased to around 27 percent in 2014. This trend may continue in the future if the government fails to make serious improvements.

High logistics costs also have an indirect impact. Producers transfer the increased costs to consumers by raising prices. This triggers supply-side inflation. In response, the central bank, Bank Indonesia, raises its reference interest rate, triggering lending rate increases. This improper contractionist monetary policy creates a higher cost of funds, further eroding economic competitiveness.

TOO LITTLE, TOO LATE

The Asian financial crisis of 1997-1998 was a turning point for the Indonesian economy. The calamity shifted Indonesia’s economic struc-
A recent World Economic Forum Global Competitiveness Index showed that Indonesia’s infrastructure competitiveness ranks 56th out of 150 countries in the survey (see chart 2). It is slightly below Thailand and China and significantly worse than Singapore and Malaysia.

In response to the poor infrastructure, the government of former President Susilo Bambang Yudhoyono (2009-2014) launched the Master Plan for Acceleration and Expansion of Indonesia’s Economic Development (MP3EI), an initiative to speed up economic growth with an emphasis on infrastructure development. Sadly, after almost four years of tireless effort, MP3EI has failed to reach its goal.

UNLOCKING GREAT POTENTIAL

Despite setbacks, Indonesia is a country of the future. Its large population of about 250 million means a huge labor force and a growing consumer market. The McKinsey Institute forecasts that under an optimistic scenario, by 2030 Indonesia will be the seventh-largest economy in the world and have a middle class of some 135 million people eagerly seeking out globally produced goods and services. It also has a relatively young demographic, which also means continuing economic dynamism. It is rich in natural resources including oil, natural gas, coal, copper, tin, iron and timber.

From a political point of view, Indonesia’s democracy is maturing, vibrant and stable. The policy-making process remains complicated, but it is moving in the right direction. What’s more, it is located in Southeast Asia, a peaceful region of 600 million people that boasts impressive economic growth. In short, Indonesia has a complete recipe to grow and to prosper.

Despite all of this potential, prosperity will be a distant reality without proper policy, notably improving infrastructure quality to promote economic efficiency and competitiveness. The more the country delays its infrastructure development, the more opportunity cost that it will have to bear in the form of economic underperformance. Over the last five years, the rate of GDP growth has declined from 6.4 percent in 2011 to around 5.1 percent in 2014. The decrease was triggered in part by external factors such as the decline in global commodity prices and slower growth in China and Japan. However, internal factors are playing a more significant role. These include the lack of efficient infrastructure, policy uncertainty and government indecisiveness.

Interestingly, the lack of adequate infrastructure is actually a two-edged sword. It is a challenge, but also at the same time an opportunity. Even with current infrastructure, the economy is still able to grow at more than 5 percent, which means that better infrastructure will mean higher GDP growth in the future. In addition, it also means great opportunities for investors in infrastructure-related businesses.

NARROW WINDOW OF OPPORTUNITY

As mentioned earlier, demography is another encouraging story for Indonesia. Its median age is 28, much younger than its peers in the region. In addition, the country’s fertility rate of 2.3 is slightly higher than the replacement rate of 2.1. It means that for the foreseeable future, Indonesia will be able to avoid the problem that many other countries have with an aging population, which in turn is an opportunity to boost economic productivity. In fact, Indonesia’s dependency ratio — the percentage of the young and elderly to the working age population — is low and will keep decreasing over the next decade (see figure 1).

But the demographic bonus will not last forever. There is a natural force, triggered by economic and technological advancement, in which the fertility rate tends to decrease and life expectancy tends to rise; consequently, the dependency ratio will increase at some point in the future. The World Bank has forecast that by 2025-2030, Indonesia will reach the turning point. If the economy fails to grow at 8 percent per annum in

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**FIGURE 1 DEMOGRAPHY BONUS: INDONESIA’S DEPENDENCY RATIO 1970-2050**

Source: World Bank, with minor adjustment by author
the next decade, Indonesia will find it tough to reach the status of a high-income economy.

The opportunity is there, but the window of opportunity narrows just 10 to 15 years from now. Indonesia is racing against time. Improving infrastructure to promote higher GDP growth is a crucial factor to determine the future of Indonesia. This will ultimately determine whether the country will be stuck in the middle-income trap or will be able to surpass it.

THE DECISIVE NEXT FIVE YEARS

President Joko Widodo, known to all as Jokowi, and Vice President Jusuf Kalla came into office in October after a very dramatic election. Jokowi rose from being a small city mayor to president of the nation in less than a decade, a historic event for Indonesia. The two leaders face a crucial five-year period. The trust level of the public is currently very high, but so too are expectations.

The new government targets GDP growth of 5.8 percent for 2015 and hopes to achieve annual growth above 7 percent before 2019. Such a goal requires several pre-conditions, including efficient and reliable infrastructure, vast investment in many sectors and efficient and proper allocation of the state budget. Promoting reliable infrastructure has always been the government’s main priority. In the past, it failed to carry the goal forward; why will this government be successful in the future?

Jokowi and Kalla, who both have entrepreneurial backgrounds, are men of action. They are masters at making complicated things simple without oversimplifying them, an essential skill to lead Indonesia effectively. Both are ready to adopt unpopular but essential policies and they promise a long list of policy reforms. Their bold decision shortly after taking office to raise fuel prices and thereby reduce government subsidies will save the government $15 billion per year, and is a great showcase for the consistency of their rhetoric and their actions.

With the recent cut in fuel and energy subsidies, as well as a serious effort to optimize government tax revenues, Jokowi and Kalla will have enough resources to realize their infrastructure ambitions, including reducing logistics costs by 5 percent per year to match the level of Thailand in the next five years. Other major infrastructure plans include building 35 gigawatts of new electricity generating capacity, building railway tracks and toll roads across Indonesia’s major islands, improving the efficiency of sea transportation and expanding the irrigation system, which includes building almost 50 new dams.

Jokowi and Kalla understand that the government cannot achieve all of this alone; they need support from the private sector. Fortunately, the private sector and international donors have shown a strong initial interest in participating in various infrastructure projects. This is in part the result of Indonesia’s great potential, as well as the government’s decisiveness and clear plan.

The next five years will be an exciting time for Indonesians. It is a make or break period. It is too early to conclude whether the new administration will succeed. However, what has been done during the first two months in office is very encouraging. Indonesia has a huge chance to be able to enter the club of high-income nations. Insya Allah, it will happen during our lifetime.

Wijayanto Samirin is a vice rector of Paramadina University. He is also the Co-Founder and Managing Director of Paramadina Public Policy Institute. He is a former investment banker and hedge-fund manager. He currently serves as Economic Advisor to the Vice President of Indonesia. He can be reached at wijayanto@paramadina.ac.id.