

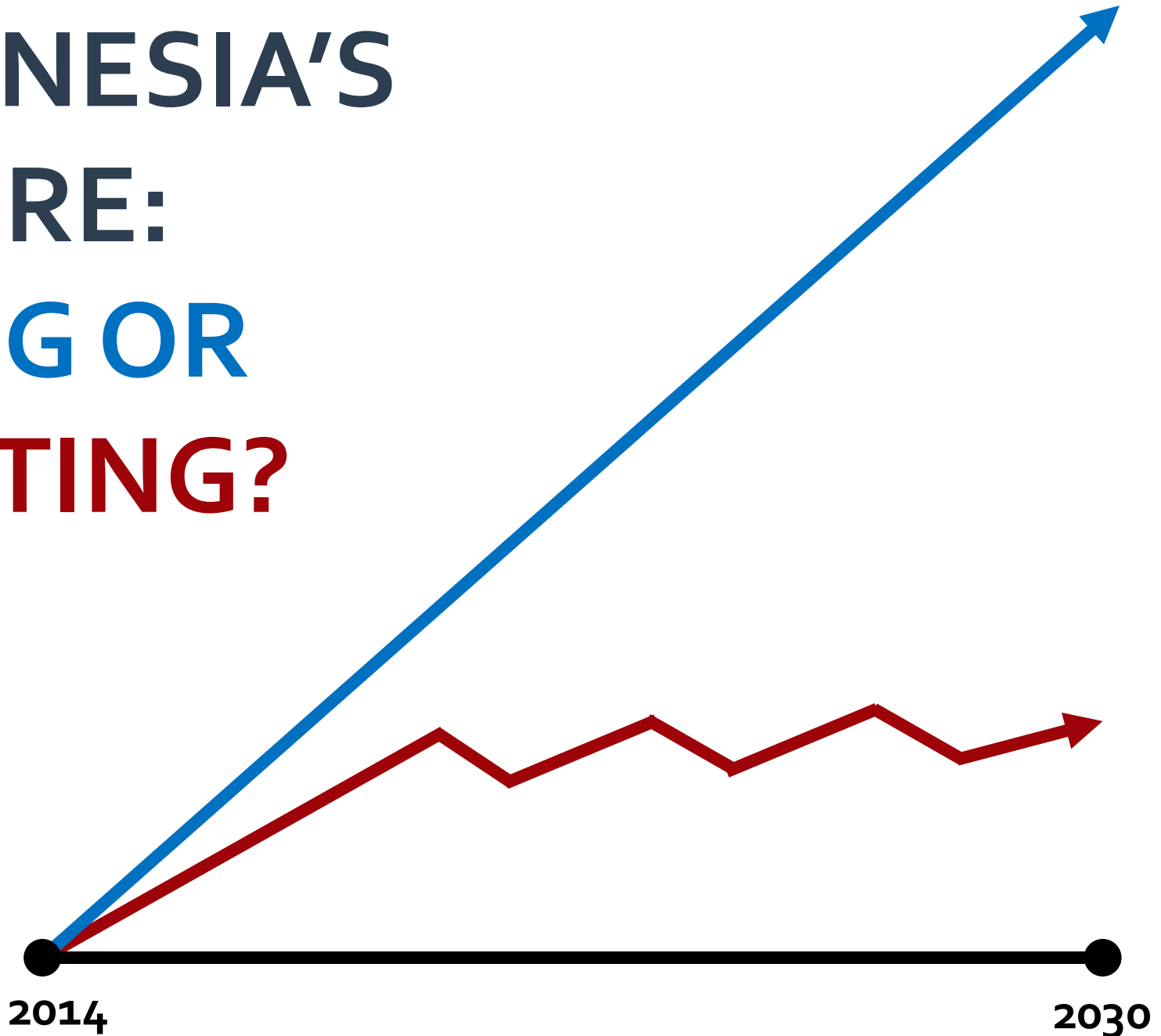


INDONESIA: AVOIDING THE TRAP

Ndiamé Diop, Lead Economist (Indonesia)



INDONESIA'S FUTURE: RISING OR FLOATING?



DOMESTIC MEGATRENDS CAN HELP GROWTH

DEMOGRAPHICS

**RAPID
URBANIZATION**

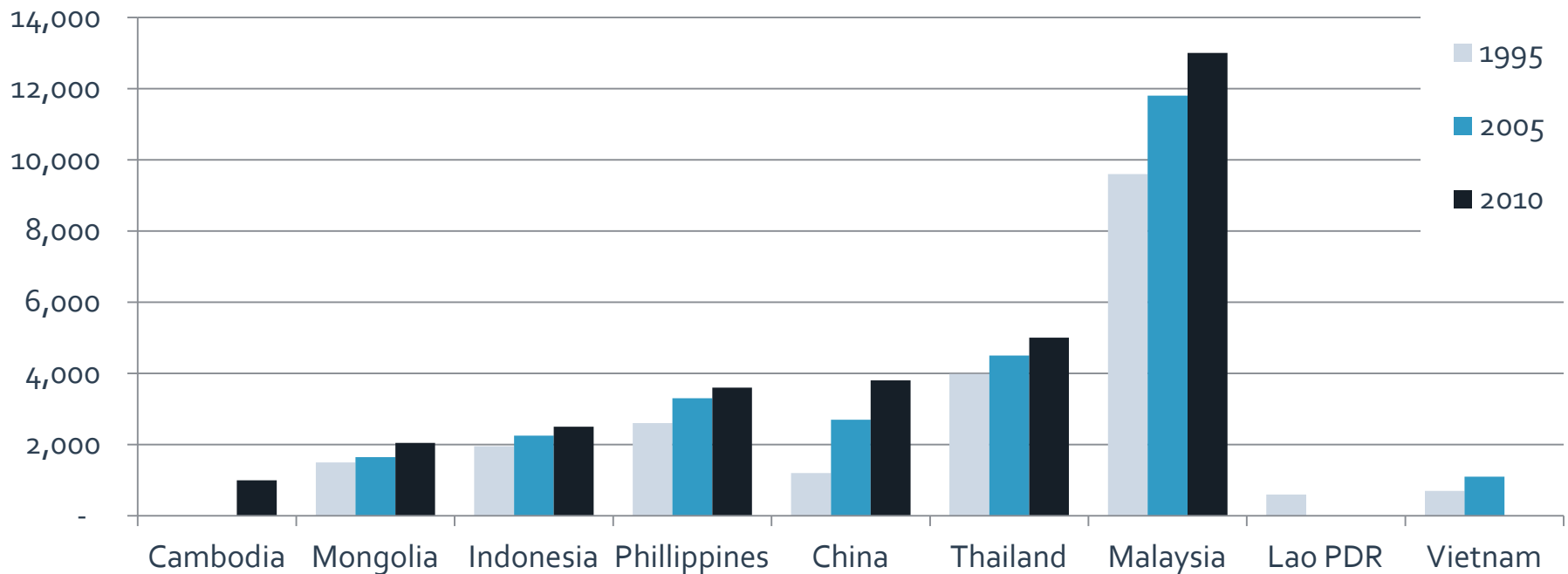
**RISING MIDDLE
CLASS**



BUT LABOR PRODUCTIVITY LAGS...

92% of differences in income per capita around the world can be explained by differences in labor productivity.

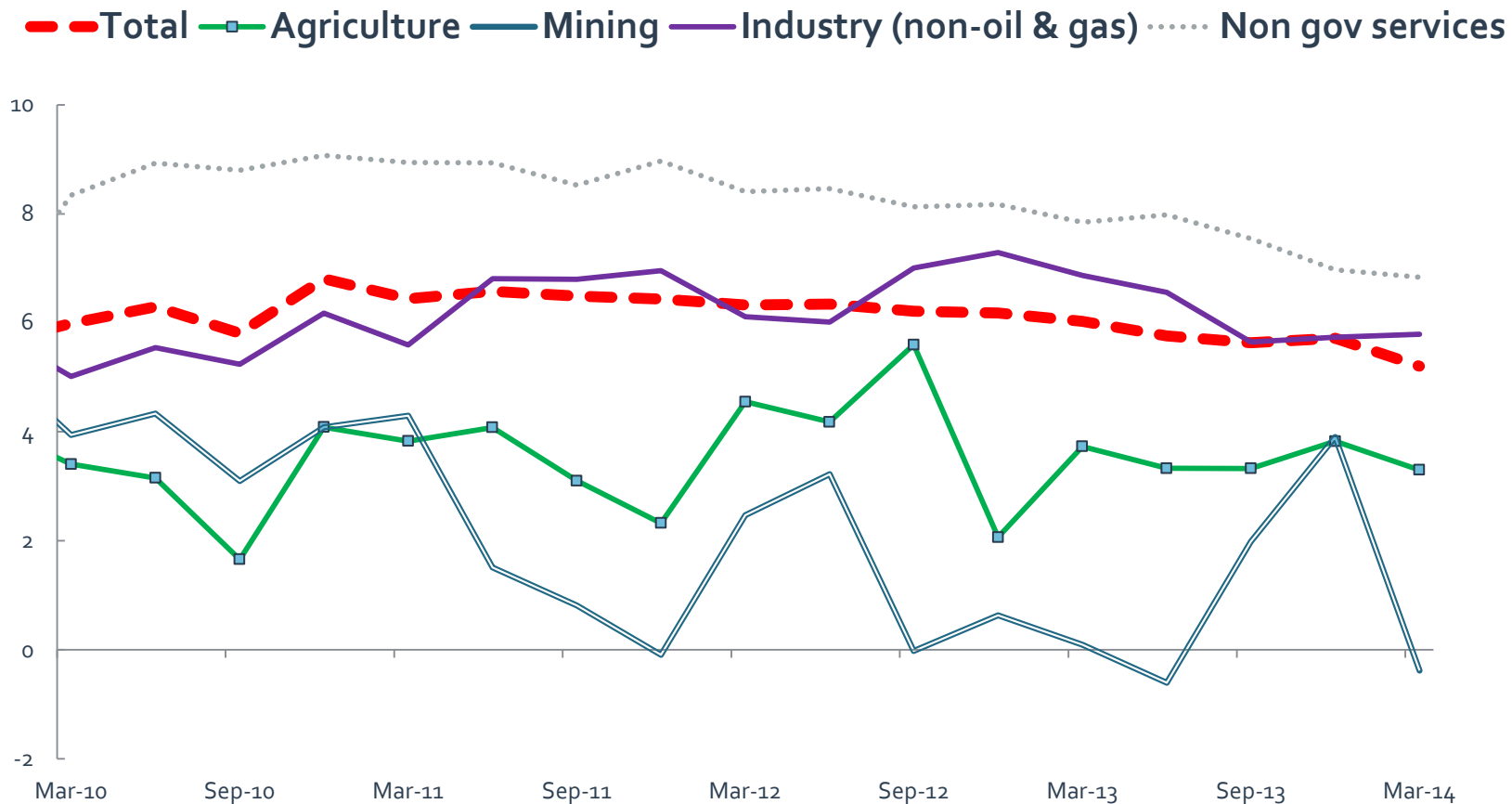
Value Added per Worker (2005 PPP\$)



...AND COMPETITIVENESS CHALLENGES REMAIN

- **Seven of Indonesia's top 10 export products are commodities**
- **Indonesia under-exports in manufacturing**
 - Half of ASEAN population but only 15% of manufacturing exports
 - Thailand: 15% ASEAN population and 34% of exports
- **There is a need to develop intermediate industries but this requires a lot of expertise and capital**
- **Despite remarkable increase, FDI inflows lower than in ASEAN peers**
 - FDI inflows to Indonesia: 1.9% of GDP
 - FDI inflows to Vietnam 5% of GDP; Average Middle Income in ASEAN: 3.3% of GDP

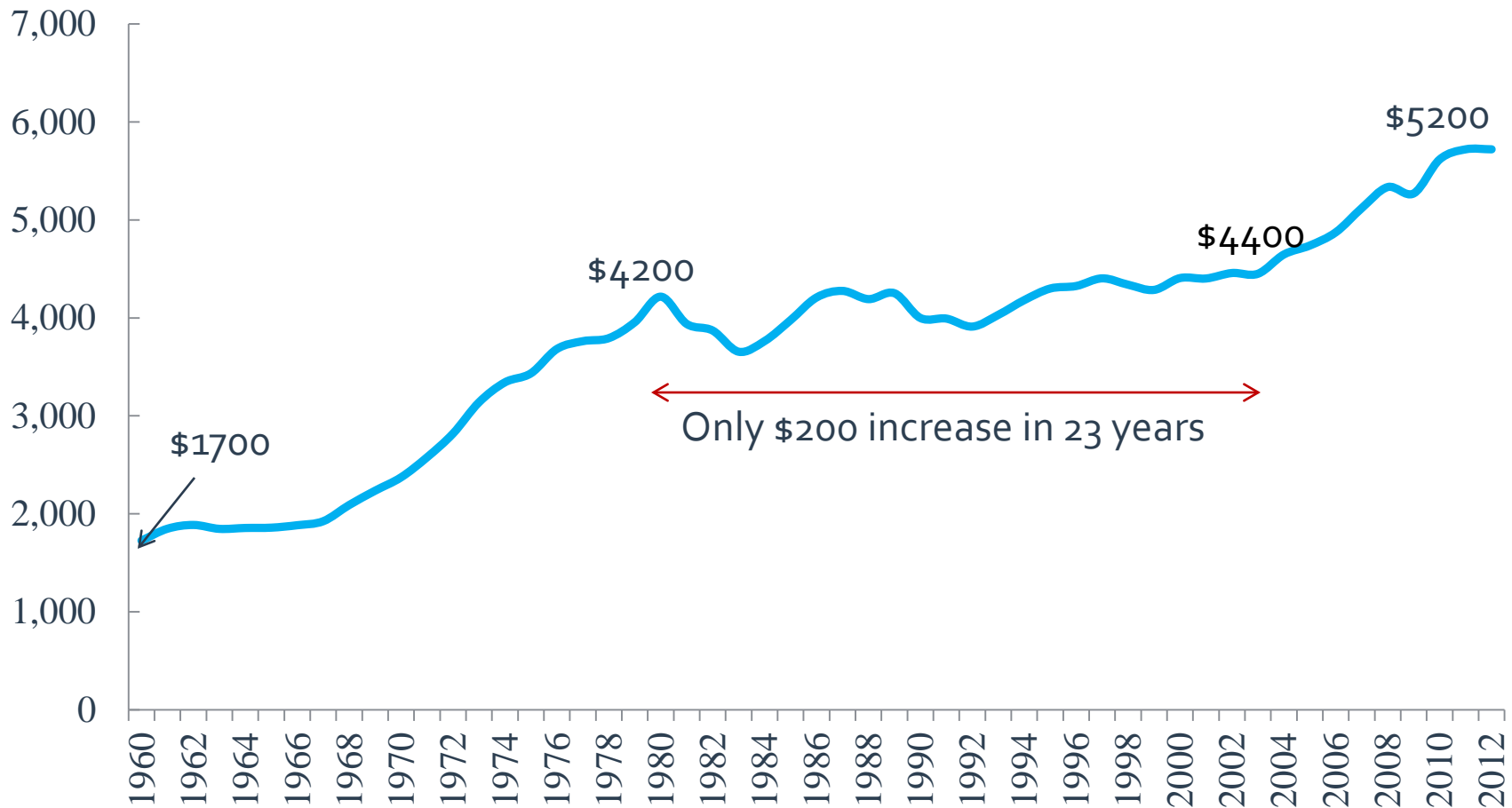
HOW TO AVOID A PROLONGED SLOWDOWN? ...and revive growth to above 6%



NOT A TRIVIAL QUESTION: BRAZIL IN 1980-2004; FLOATED AFTER STRONG GROWTH

Per capita GDP constant 2005 USD

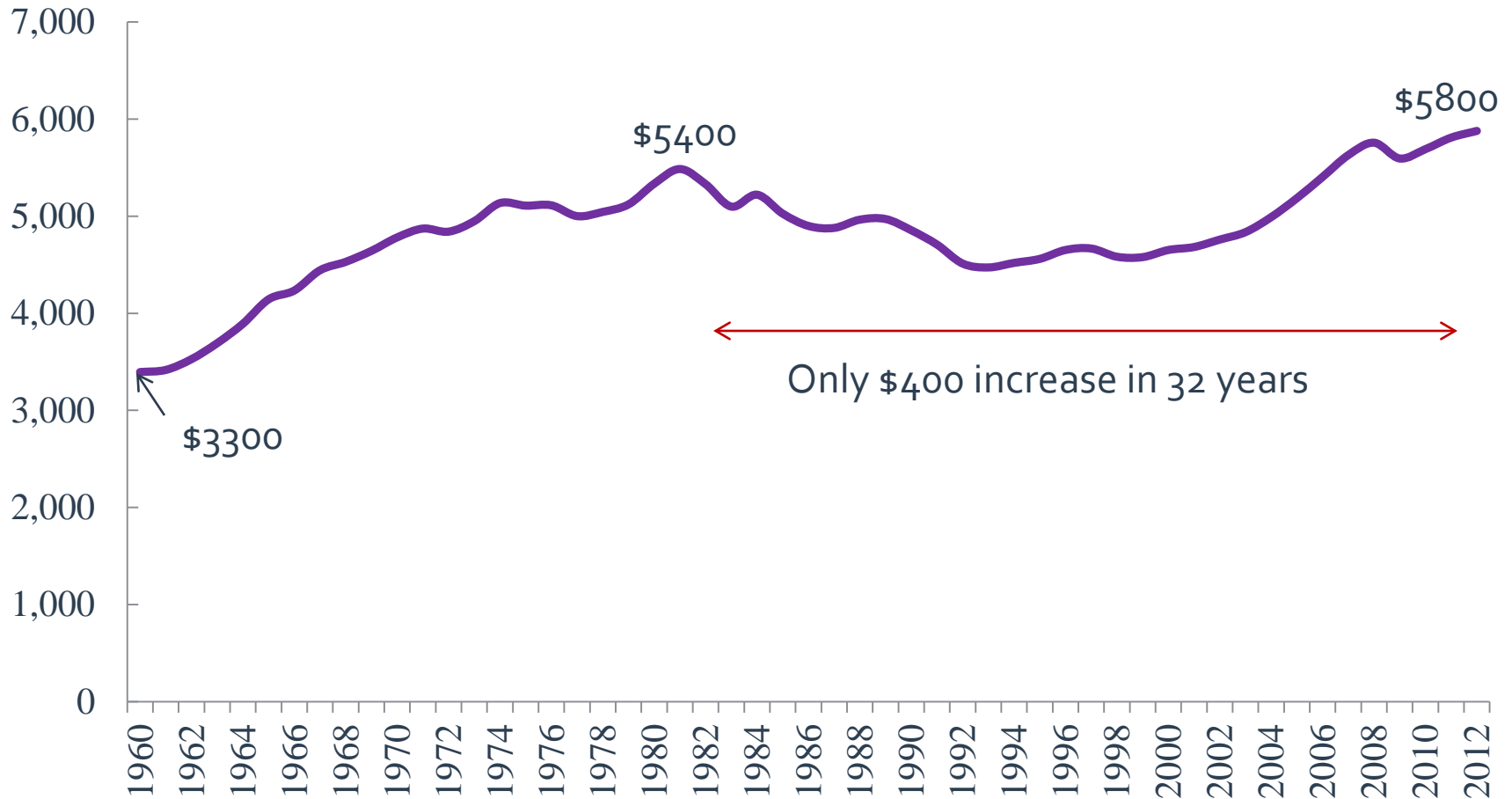
Brazil



SOUTH AFRICA IN 1980-2004; FLOATED AFTER STRONG GROWTH

Per capita GDP constant 2005 USD

South Africa



REFORMS FOR HIGH QUALITY GROWTH, ABOVE 6%

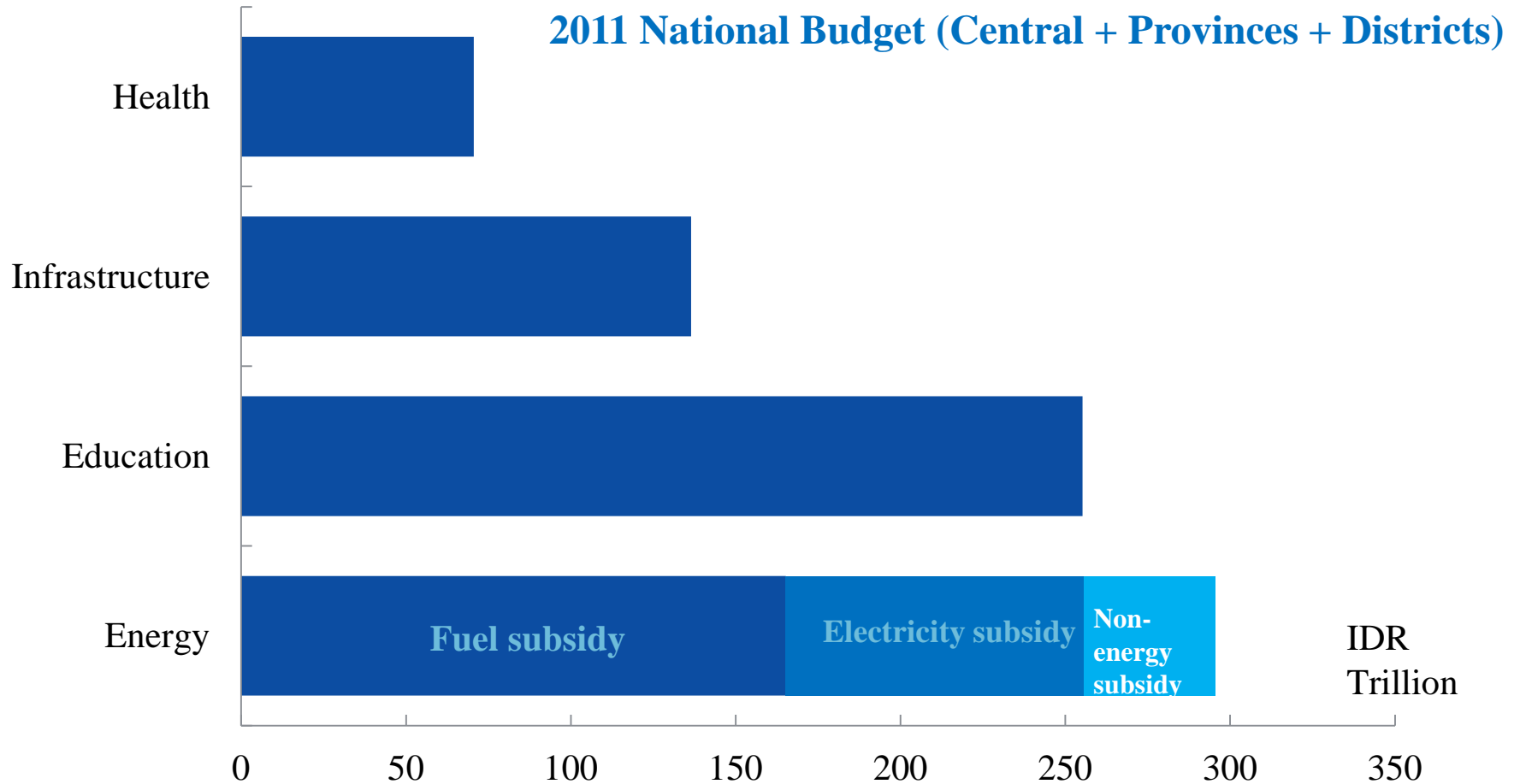
REDIRECT PUBLIC SPENDING TO KEY DEVELOPMENT PRIORITIES

SUPPLY-SIDE REVOLUTION

REFORMS TO IMPROVE LIVING STANDARDS FOR ALL

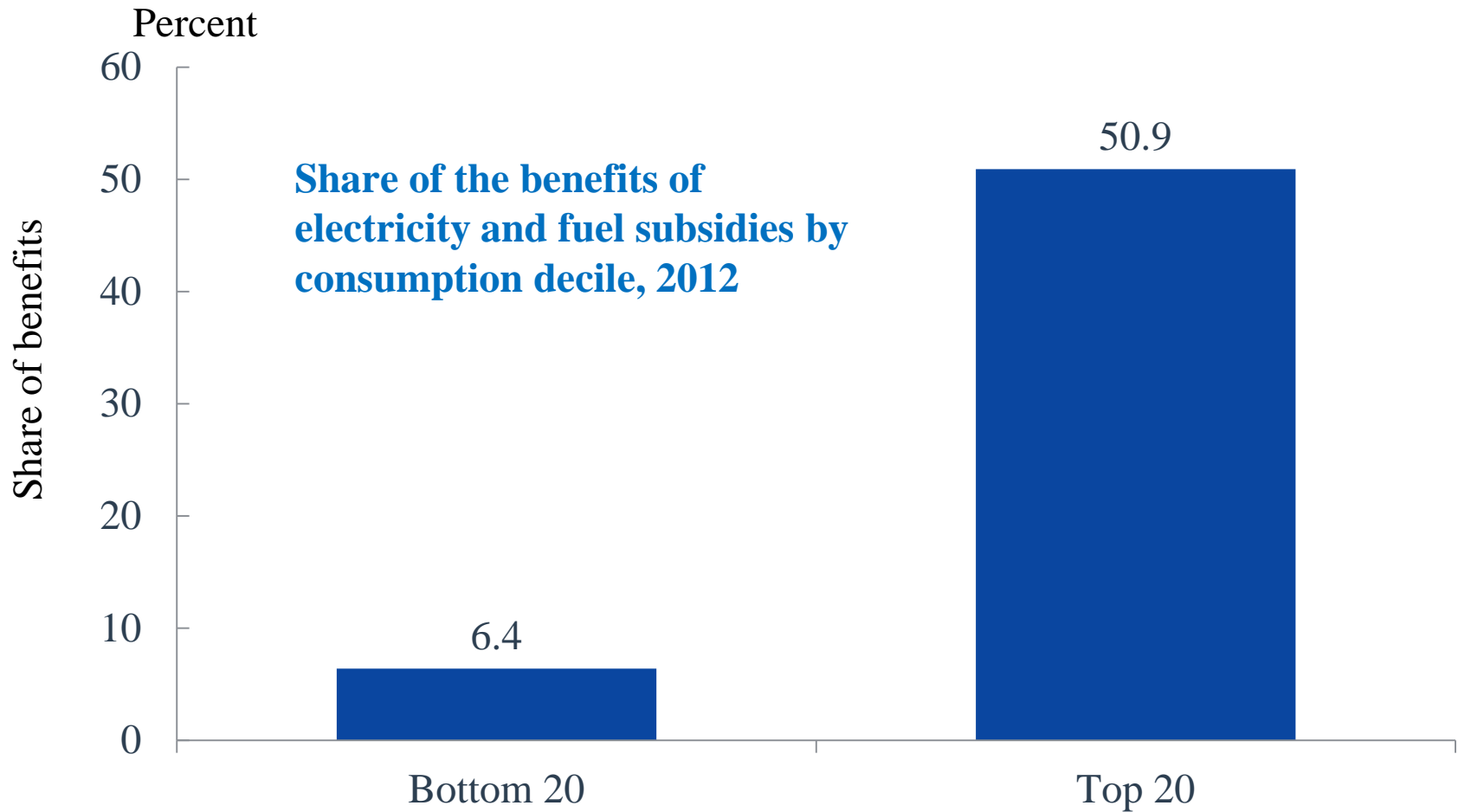
IMPLEMENTATION

1. REDIRECT PUBLIC SPENDING



Source: 2012 CENTRAL GOVERNMENT BUDGET and
WB staff calculation

THAT'S A FAIR THING TO DO



Source: Susenas, World Bank staff calculations

2. SUPPLY-SIDE REVOLUTION

**CLOSE
INFRASTRUCTURE GAP**



**CLOSE SKILLS
GAP**

**MAKE
MARKETS
WORK FOR
ALL**

INFRASTRUCTURE GAPS HURT PRODUCTIVITY, COMPETITIVENESS AND GROWTH

- Road length grew only by **35%** in the last 10 years while vehicle growth was **300%**.
 - Ports' capacity: Jakarta's Tanjung Priok (75% trade): **6 million TEUs/year**; Singapore: **30 million TEUs/year**
 - Improved piped water to premises: Indonesia: **36%**; Malaysia: **99%**
 - Doubling of power demand in 7 years: Huge investments needed to boost supply
-
- ✓ Indonesia has lost about 1 percentage point of growth due to infrastructure gap
 - ✓ Given dynamism of domestic demand, supply bottlenecks = lost growth opportunities
 - ✓ Closing the gap is crucial for attaining higher productivity, competitiveness and growth

REFORM OPTIONS

1. Boost public sector spending from 2.5 % of GDP to **4.5 %** by 2019
2. Improve **efficiency and quality of public investment**, and coordination
3. **Tackle land** acquisition (implementation of new law)
4. Leverage **private sector financing**

SKILLS GAPS HURT PRODUCTIVITY, COMPETITIVENESS AND GROWTH

- More Indonesians have higher degrees, **but skills gaps remain**:
 - **Mismatched employment**: 50 % of senior secondary and 15 % of tertiary education graduates work in unskilled positions
 - **Unhappy employers**: 70 % of manufacturers say 'very difficult' to fill skilled positions
50 percent of senior secondary and 15 percent of tertiary education graduates find work in unskilled positions
- Only about **5%** of labor force receive formal on-the-job **training**
- ✓ The of many sectors rests in large part on improving availability of skills rapidly
- ✓ With ASEAN integration, risk of losing the best and not being competitive in the middle

REFORM OPTIONS

1. Strengthen the credibility of the **quality assurance system**; channel funds only to accredited institutions
2. Create **more training centers** to deliver relevant training and specific skills in higher value-added, strategic sectors
3. Support **linkages** between education institutions and employers
4. Improve **basic education**, starting with early childhood education

MARKET DYSFUNCTIONS HURT PRODUCTIVITY, COMPETITIVENESS AND GROWTH

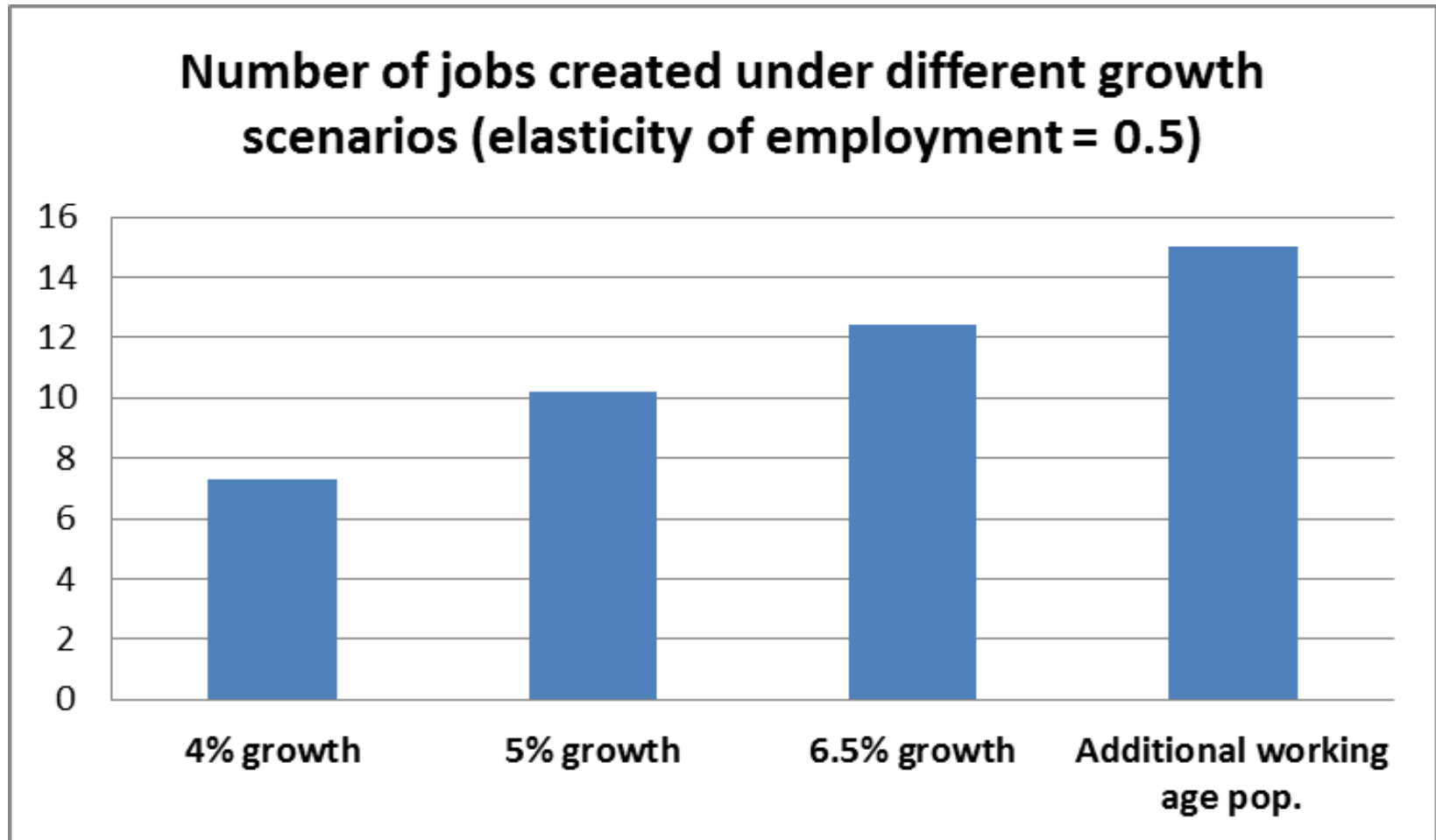
- **Product markets.** Not well-prepared sector-specific regulations expose the economy to rent-seeking activities, create uncertainty and send mixed signals.
- **Labor market.** High severance pay and uncertain minimum wage setting mechanisms yield lose-lose outcomes.
- **Financial market.** Financing of the private sector (credit to private sector) is among lowest in ASEAN (firms retain cash for future use or borrow at high costs)
- **Land market.** Access to land is a big constraint for infrastructure development and industrial expansion.

REFORM OPTIONS

1. Product markets:
 1. **Regulatory consistency** and less uncertain business environment
 2. Continue simplification of investment procedures, including licensing
2. Labor market:
 1. **Revision of severance pay** provisions of the labor law
 2. Adoption a **new minimum wage setting formula** based cost of living and inflation
3. Financial market:
 1. Financial **inclusion** and legal infrastructure

THE GROWTH-ENHANCING REFORMS HAVE HIGH EMPLOYMENT PAYOFF!

The difference between growing by 6.5% and 4% = millions of jobs!



3. REFORMS TO IMPROVE LIVING STANDARDS FOR ALL

**LOCAL SERVICE
DELIVERED TO ALL**

(health, waste management,
water, sanitation)

**ENHANCED
SOCIAL
PROTECTION**



**IMPROVED
MANAGEMENT
OF NATURAL RISKS**

GOVERNANCE MATTERS FOR LOCAL SERVICE DELIVERY

More money does not improve access/quality...

without good local governance

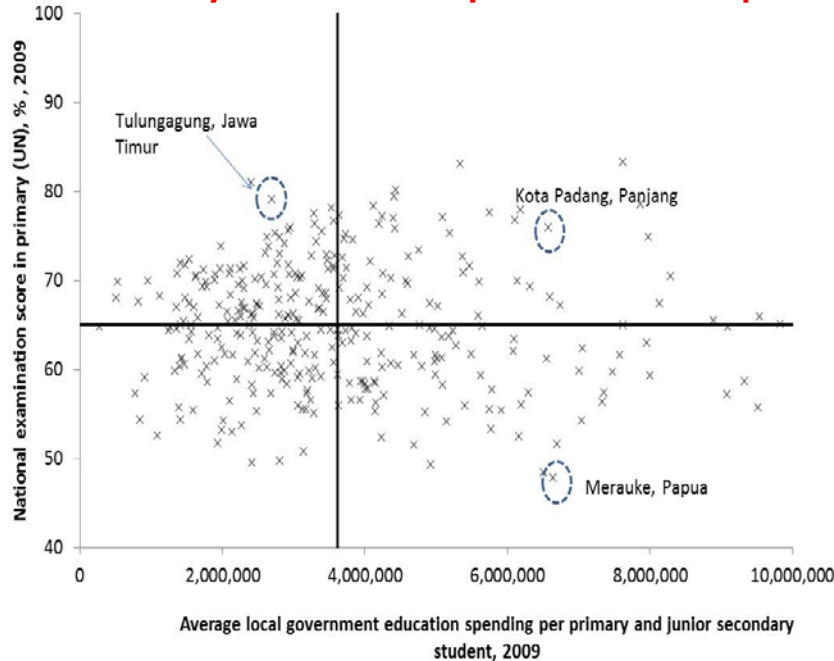
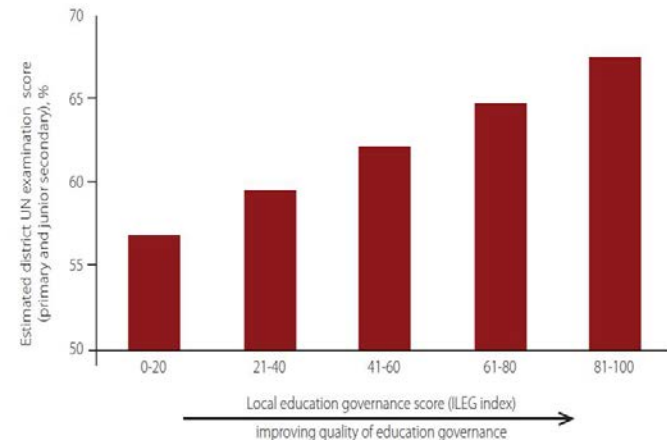


Figure 0.4 Higher quality local education governance is associated with better education performance



Note: The results presented here show the estimated relationship between the ILEG index and the UN examination score having controlled for other factors that could determine district examination scores (e.g. poverty levels). See Appendix 4, Table 1 for the full results. Source: Indonesian local education governance survey, 2009 and 2012

REFORM OPTIONS

1. Hold sub-nat. governments accountable to **results**
2. **Reward** those that perform well (performance-based transfers)
3. Provide **technical support** to sub-nat. gov. on public finance management
4. **Inform** the public about use of public resources in localities

MANY PEOPLE HAVE NO SOCIAL PROTECTION



REFORM OPTIONS

1. Strengthen **existing** social assistance programs (some work well, others no)
2. New programs covering the **elderly, the disabled and the near-poor**
3. Improve **integration** of different assistance programs and **targeting**
4. **Sound implementation** in social security reform

NATURAL RISKS THREATEN POVERTY REDUCTION



REFORM OPTIONS

1. A national program on **hazardous micro-zoning** to incorporate resilience into site design and construction standards
2. A **financing framework** for infrastructure development that incentivizes investment with built-in resilience
3. A national program on **urban upgrading** and **ecosystem rehabilitation**

4. MEET IMPLEMENTATION CHALLENGES

- A stronger Center of Government to manage the policy process and resolve policy conflicts
- Streamlined bureaucracy for enhanced accountability
- More strategic management of human resources across the public administration
- Better planning and budgeting procedures to deliver improved results with public spending
- Stronger accountability for service delivery at the local level

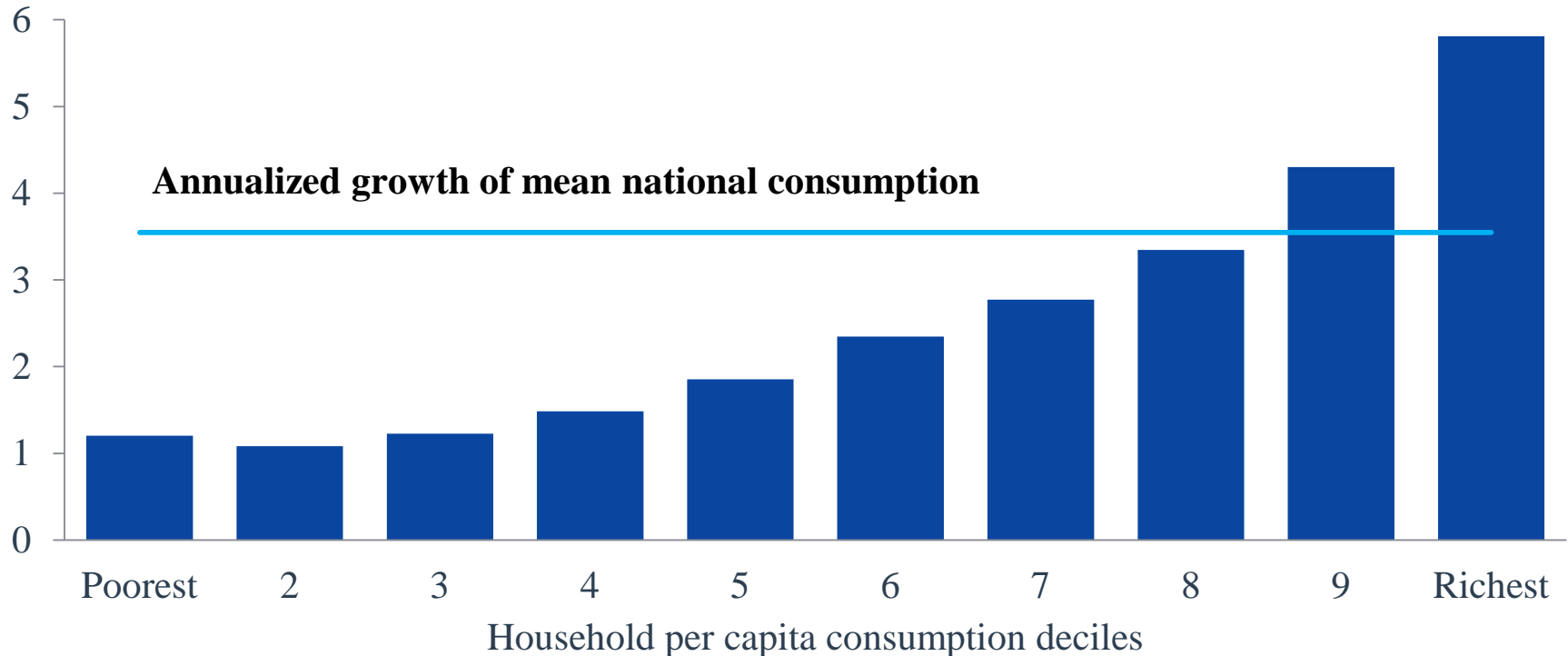
OPTIONS EXIST TO FINANCE REFORMS

<p>1. Phase out fuel subsidy for premium and diesel over 5 years</p>	<p>Phasing out fuel subsidies would free up 2 percent of GDP by 2019.</p>
<p>2. Temper growth in central and subnational personnel spending</p>	<p>1.4 percent of GDP can be secured if central and subnational personnel spending could be tempered to grow in line with inflation rather than at 5 to 8 percent above inflation in recent years.</p>
<p>3. Increase tax revenues by improving tax administration and increasing tobacco excise tax</p>	<p>Tax administration measures could increase revenues by nearly 1.5 percent of GDP per year by 2019, while increasing excise tax on tobacco to 70 percent would increase revenues by 0.5 percent of GDP per year by 2019.</p>

THE STAKES ARE HIGH: INDONESIA WANTS TO REDUCE INEQUALITY AND POVERTY

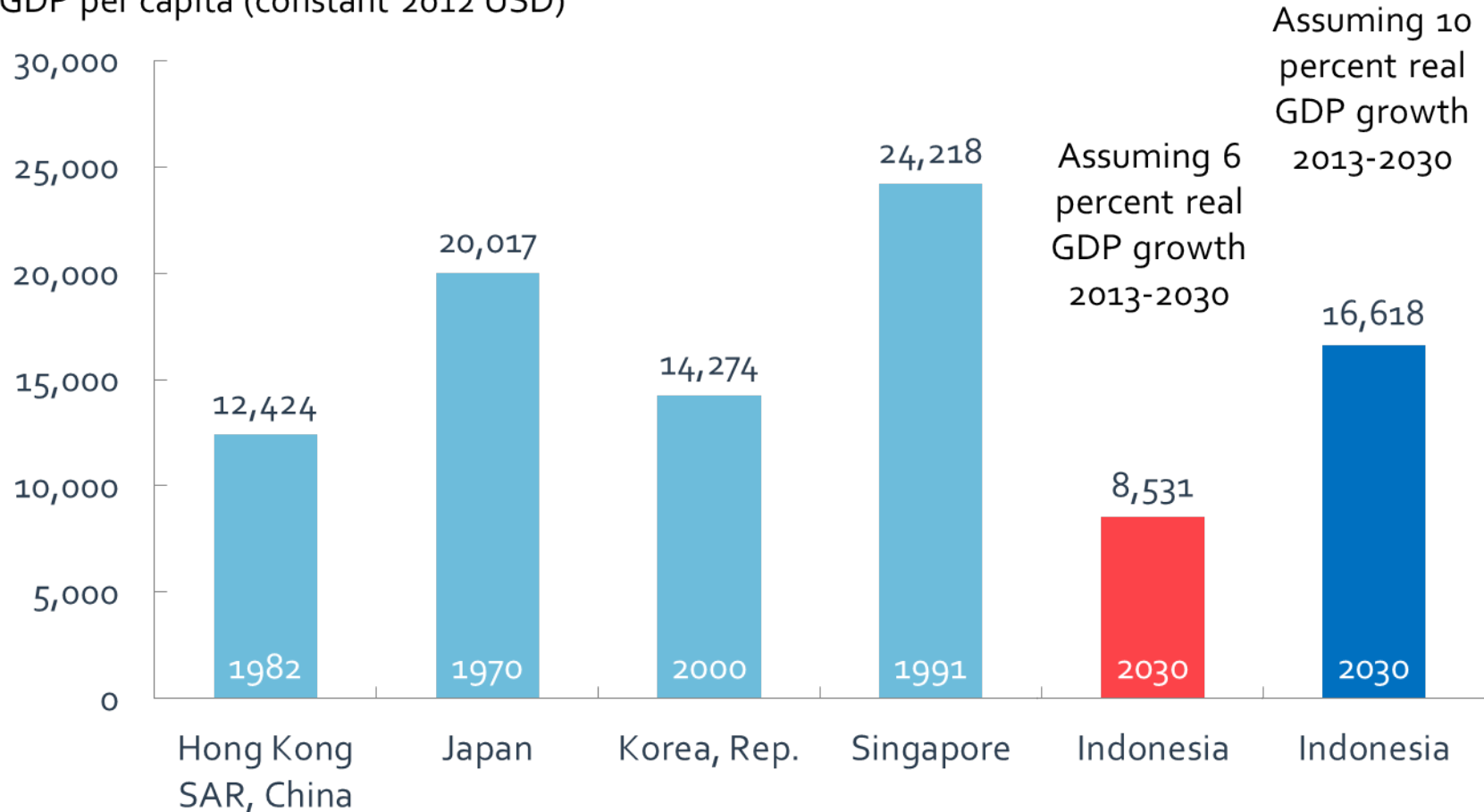
The poor and vulnerable did not benefit from past growth as well as the rich

Average real consumption growth, 2003 - 2013



INDONESIA IS AT A CROSSROADS

GDP per capita (constant 2012 USD)



Indonesia can get rich before growing old, with serious reforms!

...CAN DO IT!

- **A solid track record of good macroeconomic management**
 - Fiscal prudence (deficit capped at 3% of GDP);
 - Crisis management and response (1997 and 2009)
 - Good macro management leading to low volatility of growth despite dependence on natural resource
- **Structural reform agenda well-known**
- **A good neighborhood:** East Asia = the most dynamic region in the world (market opportunity and investment dynamism)
- **The country's own forces:** a dynamic, tech-savvy youth, formidable economic, cultural and geographical diversity, a rising middle class and a stable democracy.
- With **consistent** reforms, Indonesia can avoid the trap!