

Indonesia's prosperity challenge



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Generating prosperity: challenges and opportunities

The international experience: “middle income trap” risk

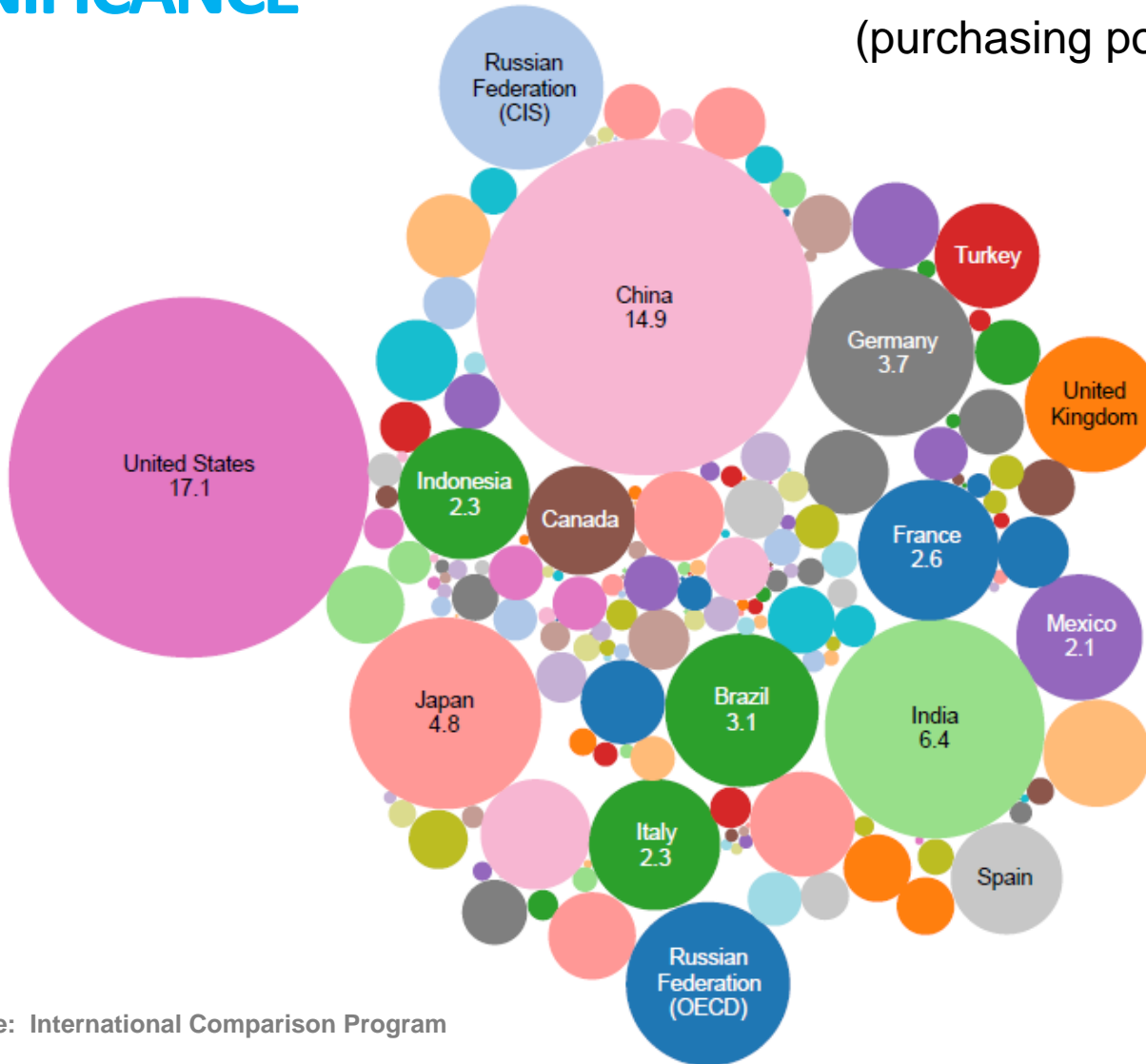
Lifting sustainable growth: a deep reform agenda

THE IMPERATIVE OF GENERATING PROSPERITY...

- **Sustained generation of prosperity is a pre-condition for Indonesia achieving its development objectives as we look ahead to the next five years and beyond**
 - Can the Indonesian economy deliver on its potential and more than **double the income of the average Indonesian** by 2030 to over USD 7000?
 - Can enough **quality jobs** be created for the **30 million young Indonesians** entering the working population between 2015 and 2030?
 - Can growth rates support the generation of sufficient fiscal resources to enhance **public services** and strengthen **social protection**?
- And even if the growth is achieved, will it be **inclusive** and **sustainable**?

...WITH NOT ONLY NATIONAL, BUT GLOBAL, SIGNIFICANCE

Share of global expenditure
(purchasing power parity-adjusted,
2011)



Source: International Comparison Program

INDONESIA HAS ALL THE INGREDIENTS TO MEET THIS CHALLENGE...

Global scale



Endowments

Powerful domestic drivers of growth

- Demographics
- Urbanization

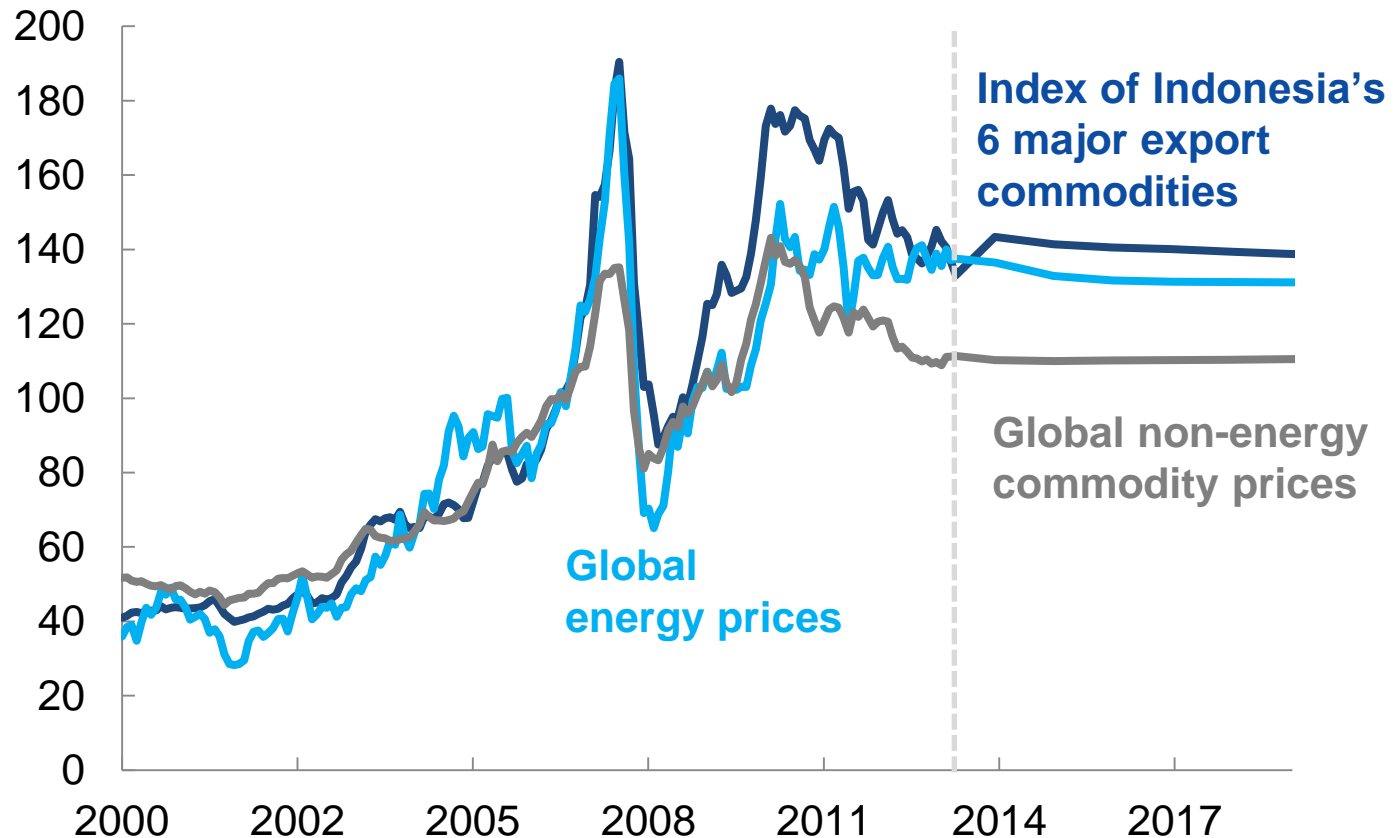
...WITHIN A CHANGING INTERNATIONAL CONTEXT

- Indonesia is located in a **DYNAMIC REGION** which offers large opportunities to boost investments through various channels
 - The global economic center of gravity is shifting east but the regional reform context matters
- But, **GLOBAL COMMODITY PRICES AND FINANCING CONDITIONS** are set to be less supportive



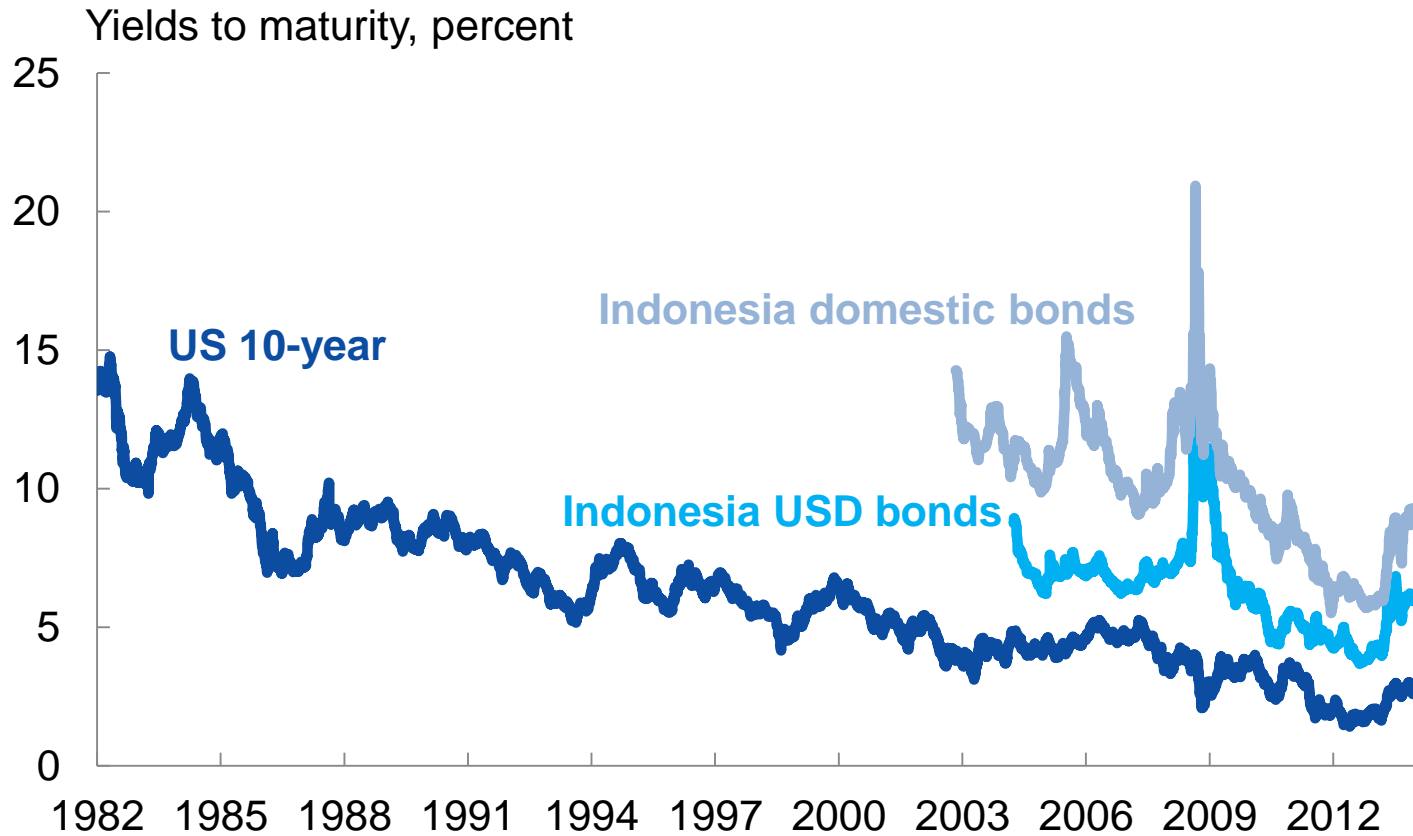
THE OUTLOOK FOR GLOBAL COMMODITY PRICES IS FLAT...

USD commodity price index, 2007=100



Source: World Bank

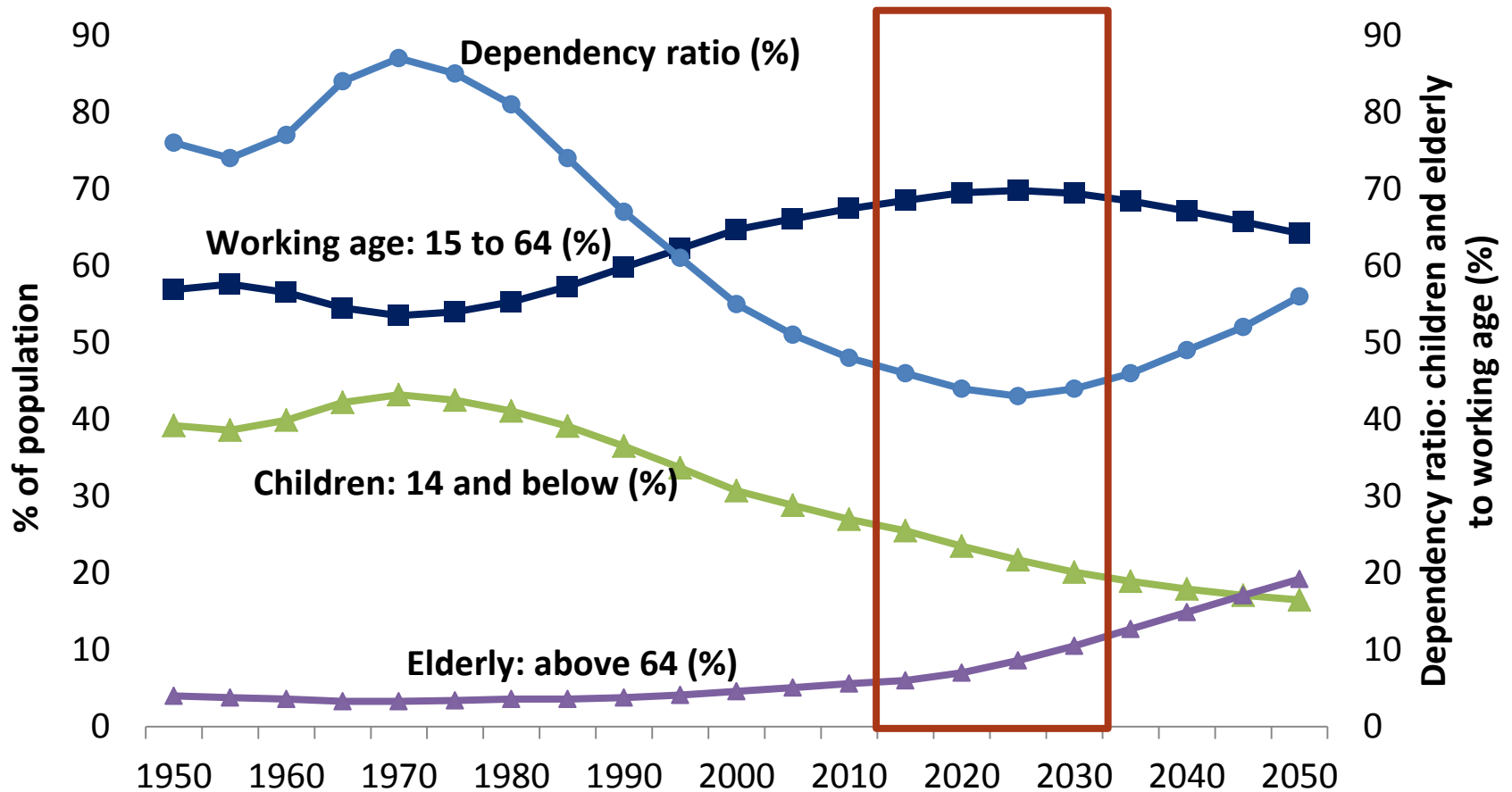
... AND THE COST OF FINANCING HAS MOVED UP



Source: JP Morgan

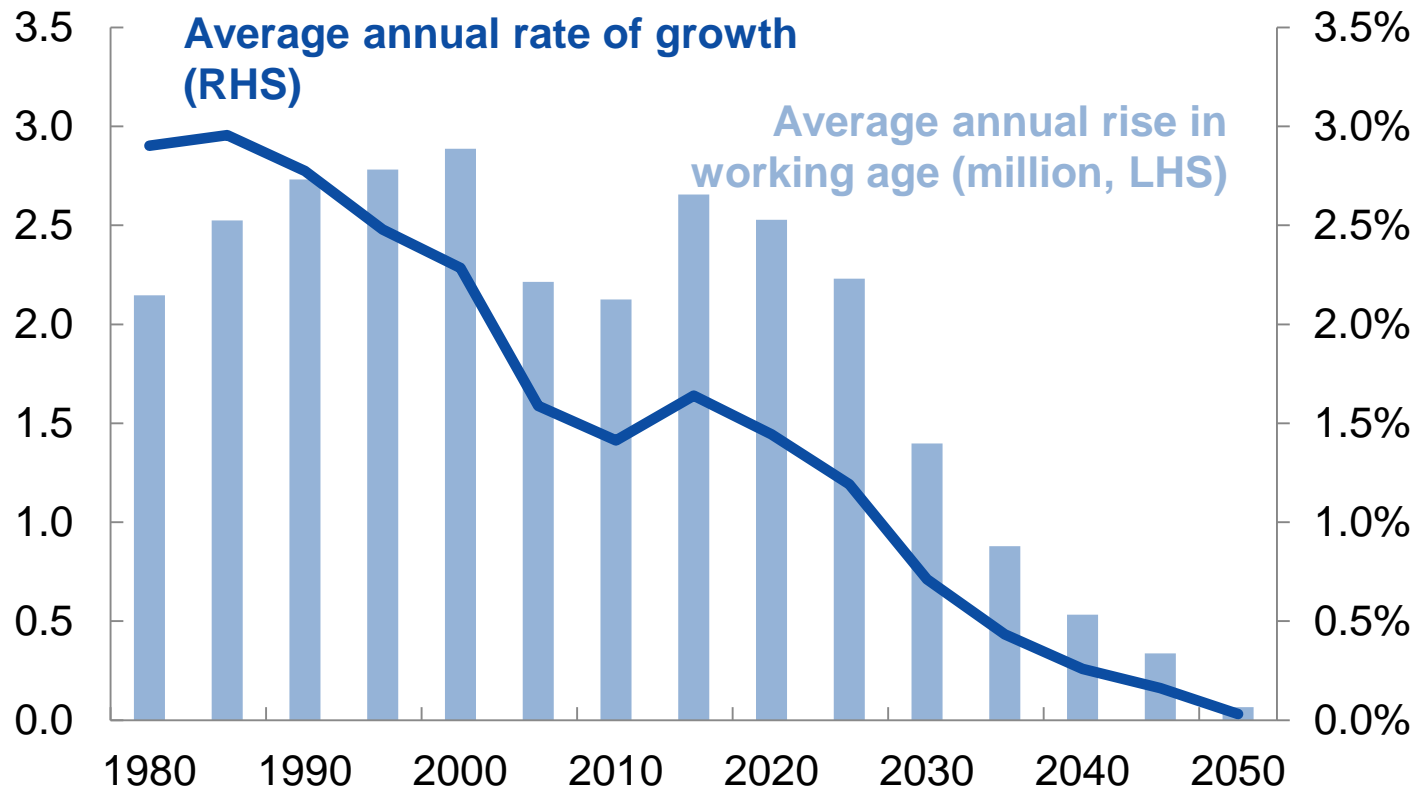
TURNING TO THE DOMESTIC DRIVERS OF GROWTH IN TERMS OF DEMOGRAPHICS...

- **Opportunity:** Favorable dependency ratio for the next 16 years



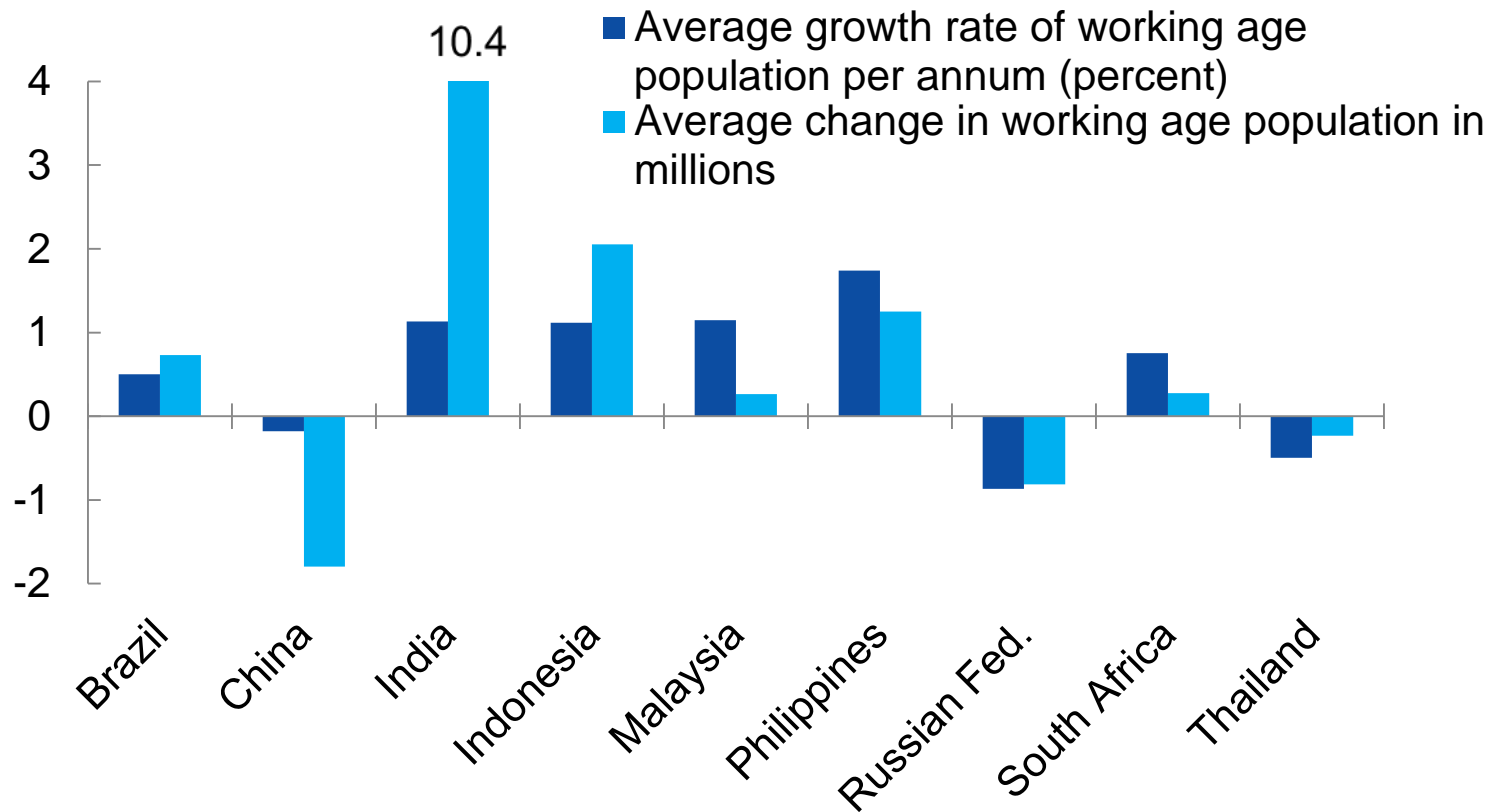
...BUT REALIZING THE POTENTIAL DEMOGRAPHIC DIVIDEND DEPENDS UPON QUALITY JOB CREATION...

- **Challenge of job creation:** Between 2015 and 2030, the population of working age is projected to increase by 30 million in Indonesia or around 2 million per year. Absorbing them requires high growth.



...WITH THE SCALE OF THE CHALLENGE, AND OPPORTUNITY, RELATIVELY HIGH VERSUS PEERS

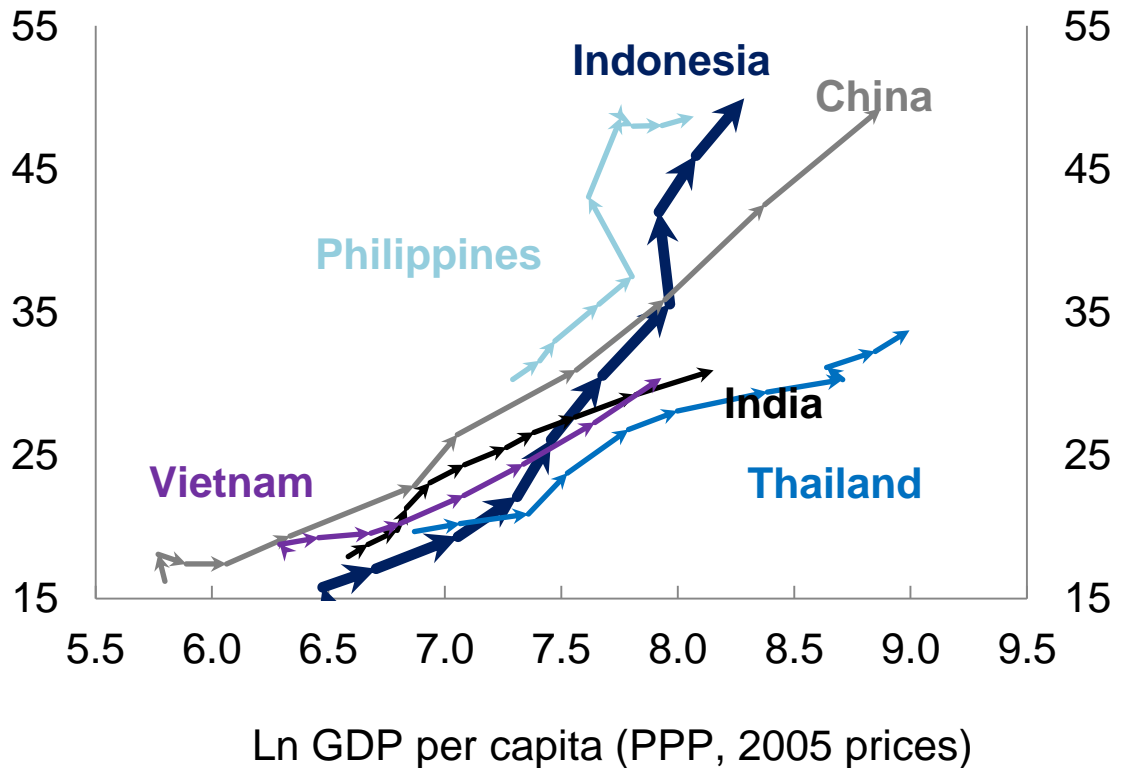
- Between 2015 and 2030 Indonesia's increase in working age population in absolute terms and in growth rates is projected to be relatively high



INDONESIA IS ALSO EXPERIENCING A RAPID RATE OF URBANIZATION...

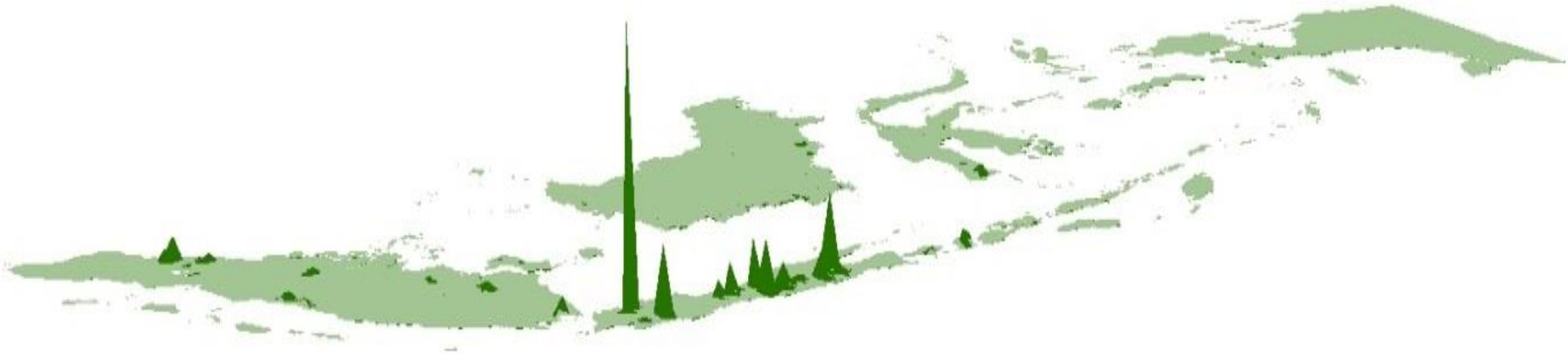
- In 1970 17% of Indonesians lived in cities, in 2011 it was 51% and by 2025 it is expected to be 68%

Urban population share, percent



...BRINGING POTENTIAL AGGLOMERATION AND SCALE ECONOMIES BUT ALSO CONGESTION EFFECTS

- Firms located in agglomeration areas enjoy 30% higher TFP relative to those located outside agglomeration areas.
- Firms locating in districts with a higher presence of existing firms tended to enjoy subsequent TFP growth



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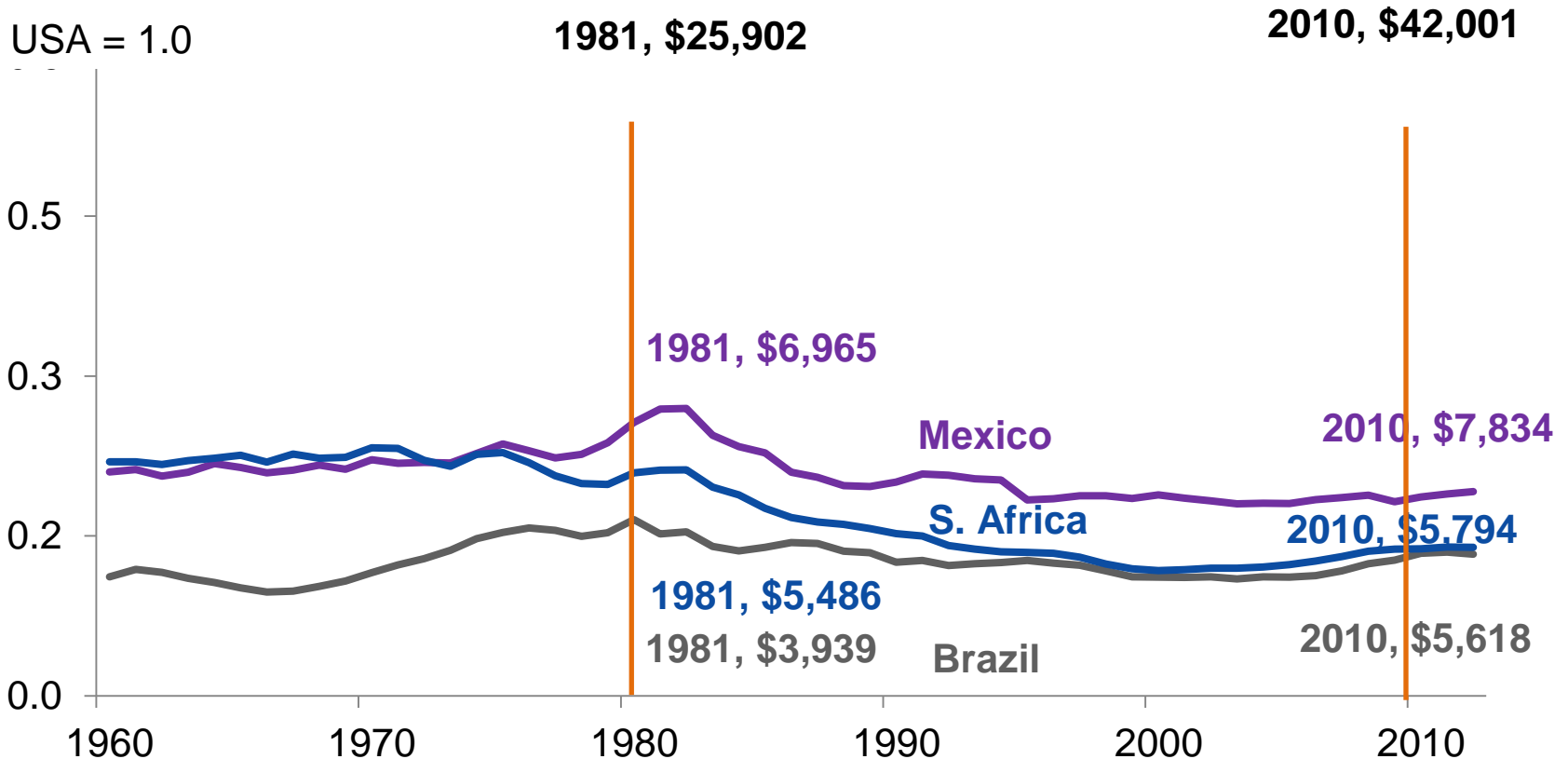
Generating prosperity: challenges and opportunities

The international experience: “middle income trap” risk

Lifting sustainable growth: a deep reform agenda

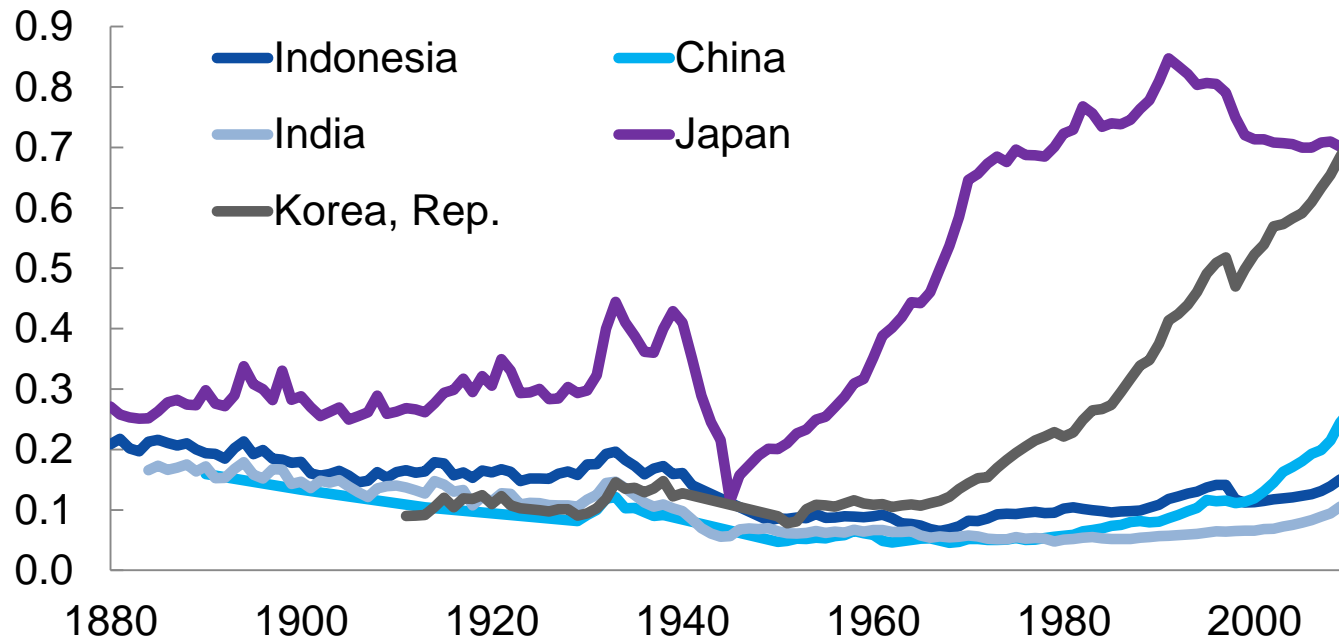
INTERNATIONAL EXPERIENCE OVER RECENT DECADES SHOWS THAT CATCHING UP IS DIFFICULT...

Ratio to US GDP per capita (2005 constant PPP Dollars)



...EVEN OVER LONGER HORIZONS AS WELL...

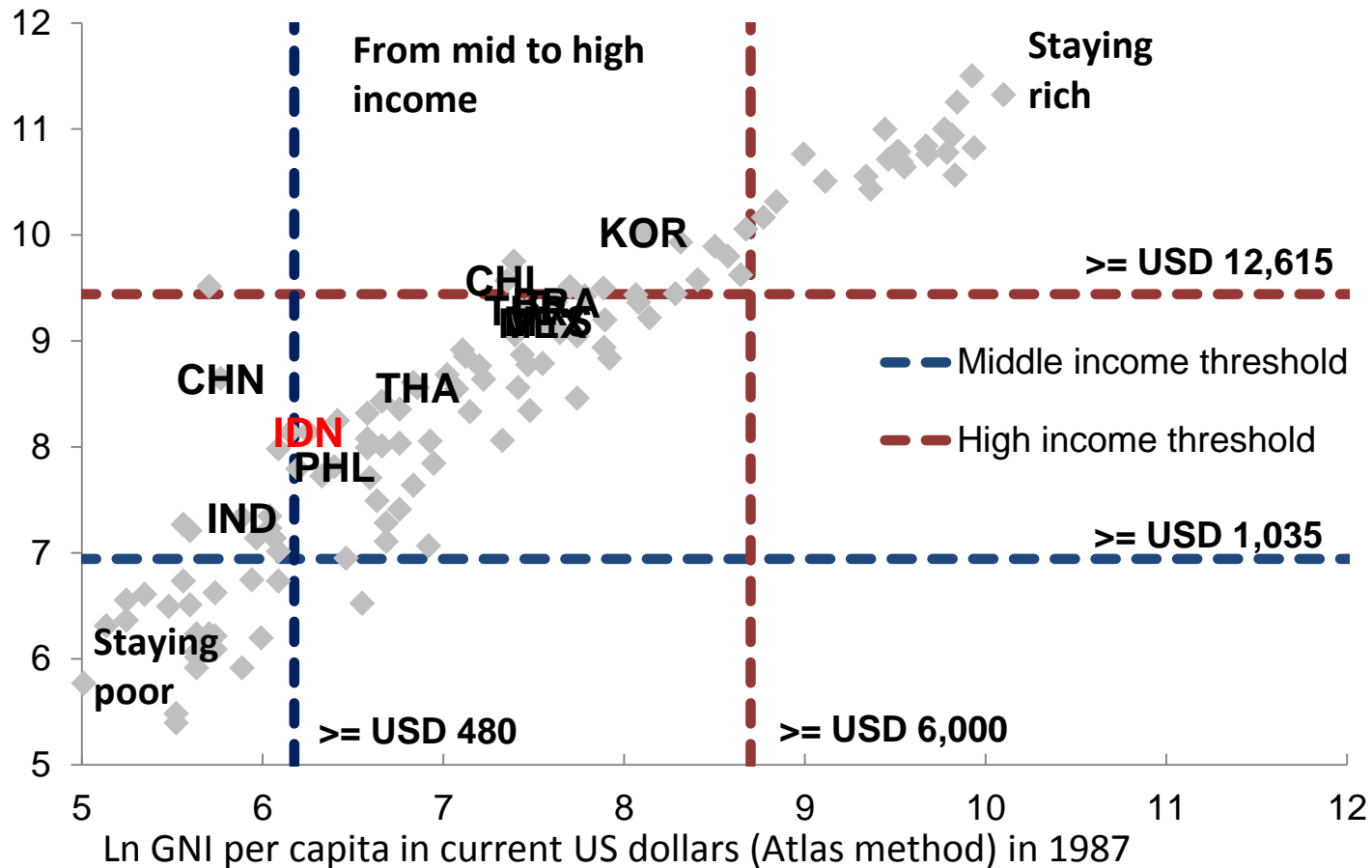
Real PPP GDP per capita
relative to US



...RAISING SCOPE FOR A “MIDDLE INCOME TRAP”

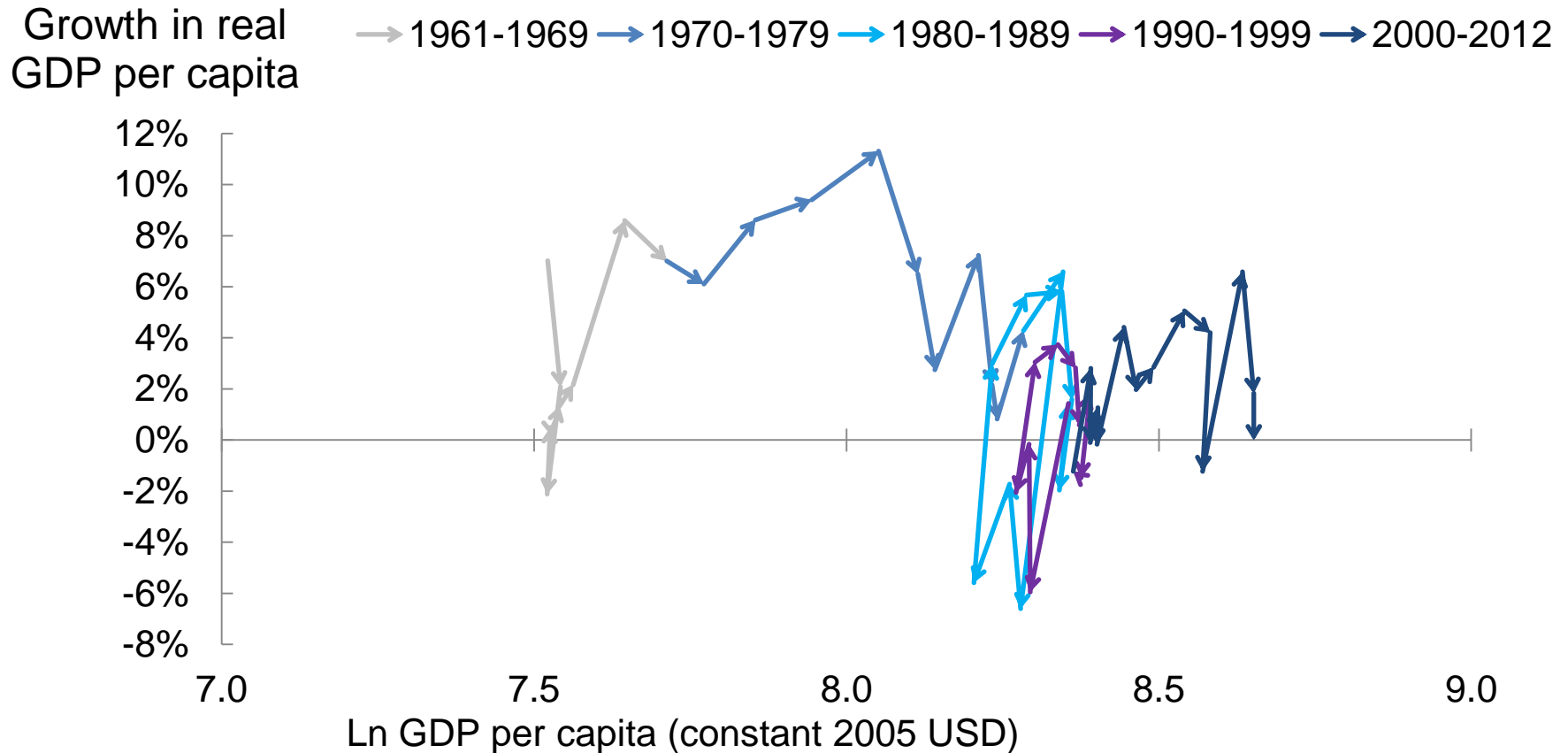
- There is a risk that generation of prosperity can stall as a country's income rises BUT this is not a certainty

Ln GNI per capita in current US dollars (Atlas method) in 2012



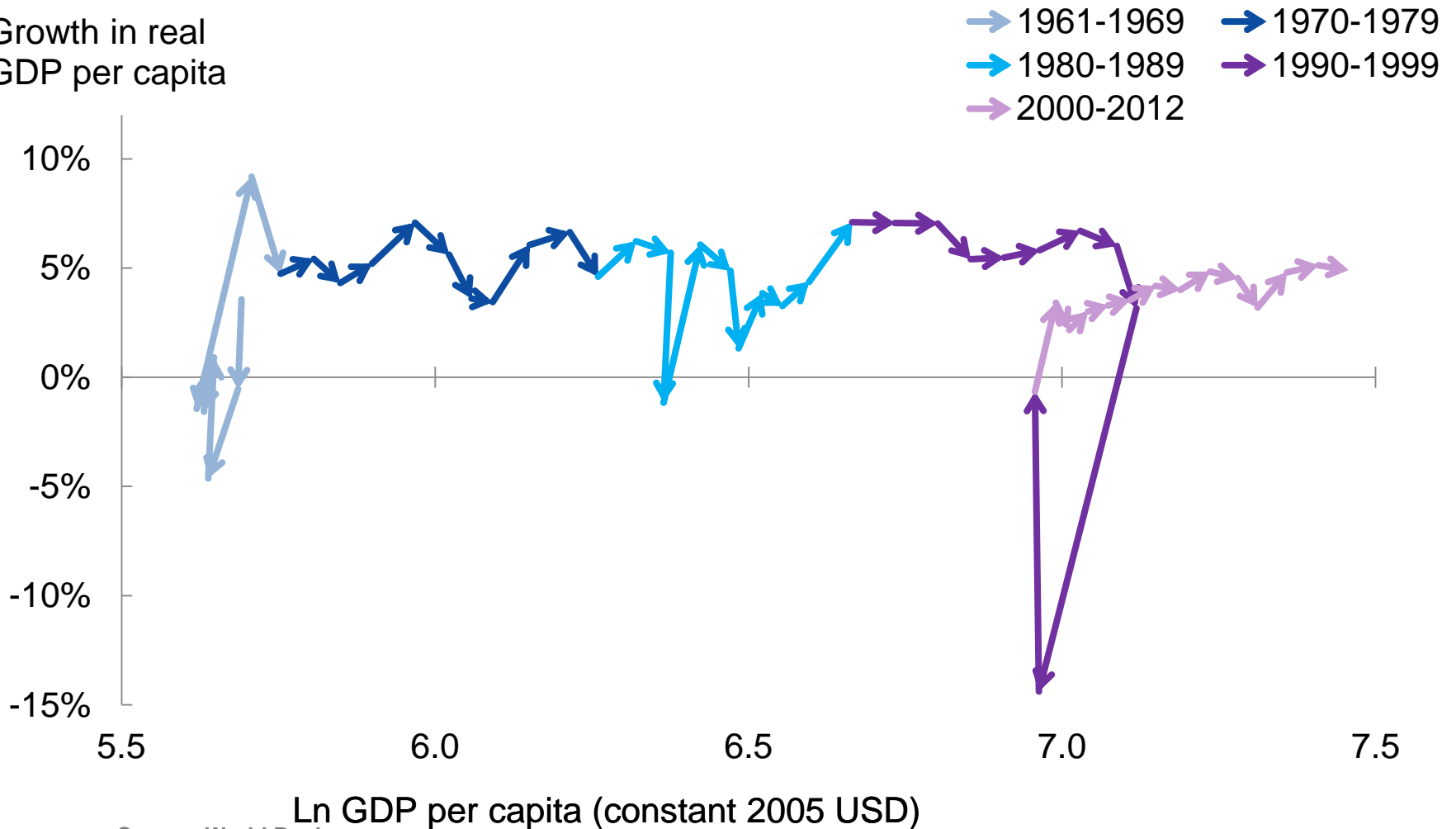
WITH MACRO FISCAL MANAGEMENT AN IMPORTANT DETERMINANT OF SUCCESS IN SUSTAINING GROWTH

➤ Brazil's boom, bust cycles and the progress in income growth



INDONESIA IS ON THE RIGHT TRACK FROM A MACRO STABILITY PERSPECTIVE...

Growth in real GDP per capita



Source: World Bank

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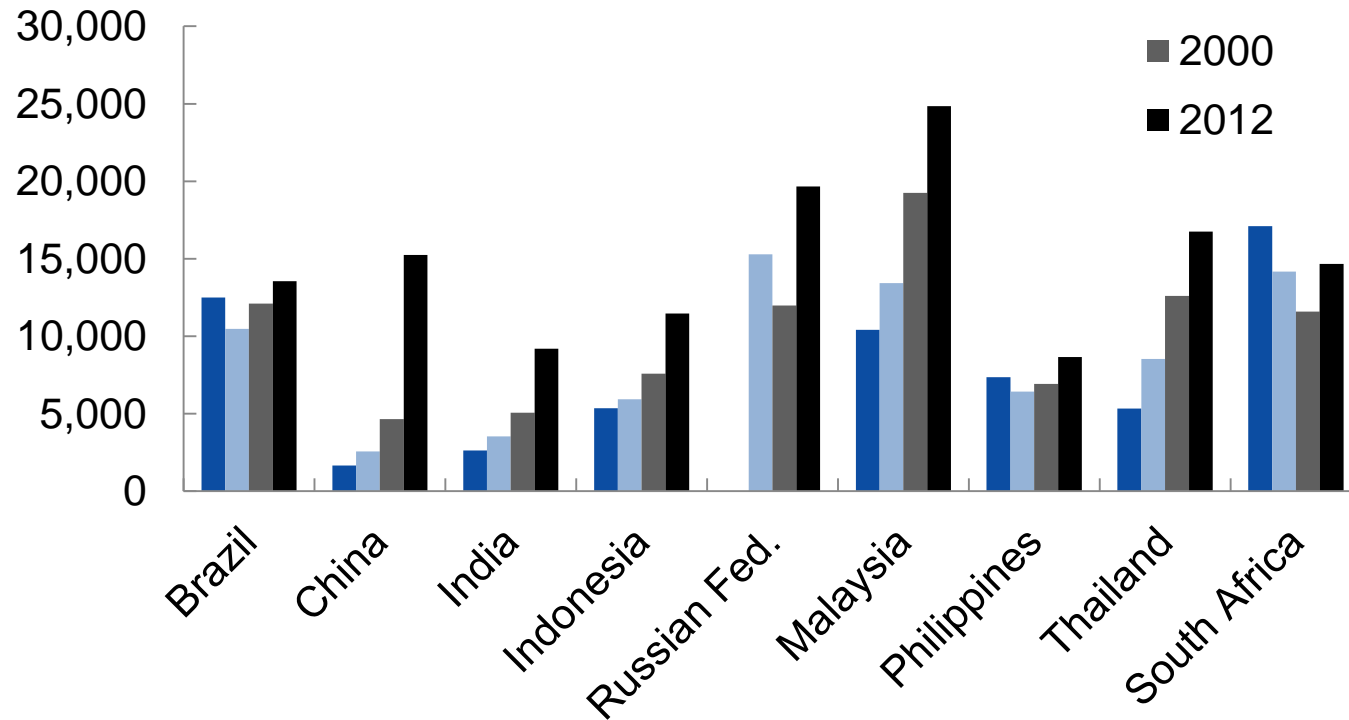
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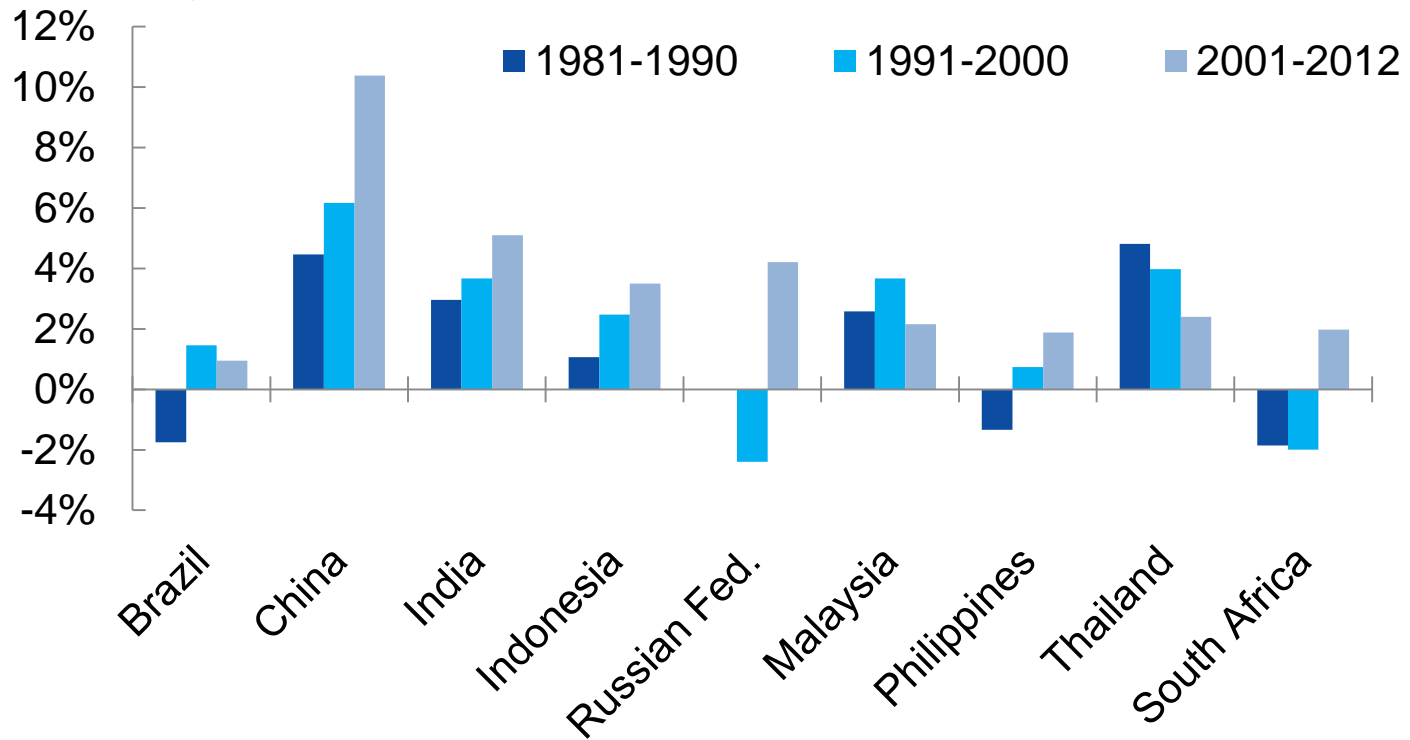
THERE IS A LARGE SCOPE FOR CATCH UP IN THE LEVEL OF PRODUCTIVITY IN INDONESIA...

Value added per person employed
(constant 1990 PPP)



...AND IN MOVING LABOR PRODUCTIVITY GROWTH RATES HIGHER

Average growth rate of value added per person employed (constant 1990 PPP)



THE GOOD NEWS: MOVEMENTS IN LABOR INTO MORE PRODUCTIVE SECTORS CAN PLAY A BIG ROLE

Labor productivity (VA per worker annual average, in million IDR)

Detail sector	1990-1996	2000-2003	2005-2008	2009-2012
Agriculture	5.2	5.6	6.5	7.7
Mining and Quarrying	229.1	261.7	174.5	138.7
Manufacture	30.5	35.3	43.1	43.7
Electricity, Gas, and Water	26.1	76.2	66.3	78.4
Construction	25.8	21.1	23.5	25.7
Wholesale, Trade, Rest	15.2	13.6	16.6	18.4
Transport & Communication	17.3	15.9	23.0	42.7
Finance	194.2	120.3	133.7	113.1
Public Service	10.8	13.5	15.2	14.2

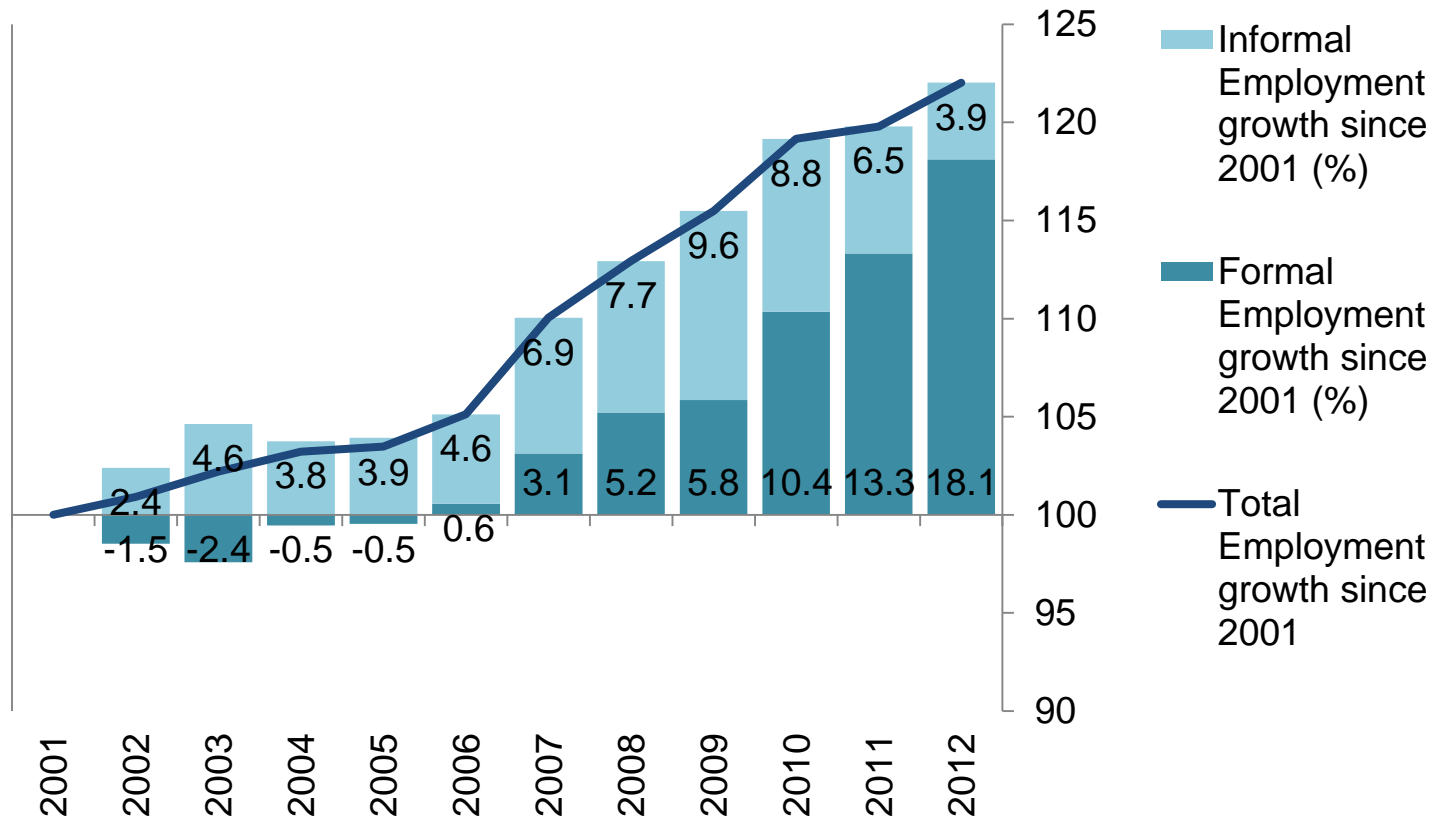
THE GOOD NEWS: MOVEMENTS IN LABOR INTO MORE PRODUCTIVE SECTORS CAN PLAY A BIG ROLE

Sector productivity relativity to agriculture (agriculture =1)

Detail sector	1990-1996	2000-2003	2005-2008	2009-2012
Agriculture	1.0	1.0	1.0	1.0
Mining and Quarrying	43.6	46.8	26.7	18.0
Manufacture	5.8	6.3	6.6	5.7
Electricity, Gas, and Water	5.0	13.6	10.1	10.2
Construction	4.9	3.8	3.6	3.3
Wholesale, Trade, Rest	2.9	2.4	2.5	2.4
Transport & Communication	3.3	2.8	3.5	5.5
Finance	37.0	21.5	20.5	14.6
Public Service	2.1	2.4	2.3	1.8

ALTHOUGH RECENTLY MUCH EMPLOYMENT GROWTH HAS BEEN IN THE INFORMAL SECTORS...

Decomposition of employment growth in Indonesia: formal vs. informal sector
(Employment in 2001=100)



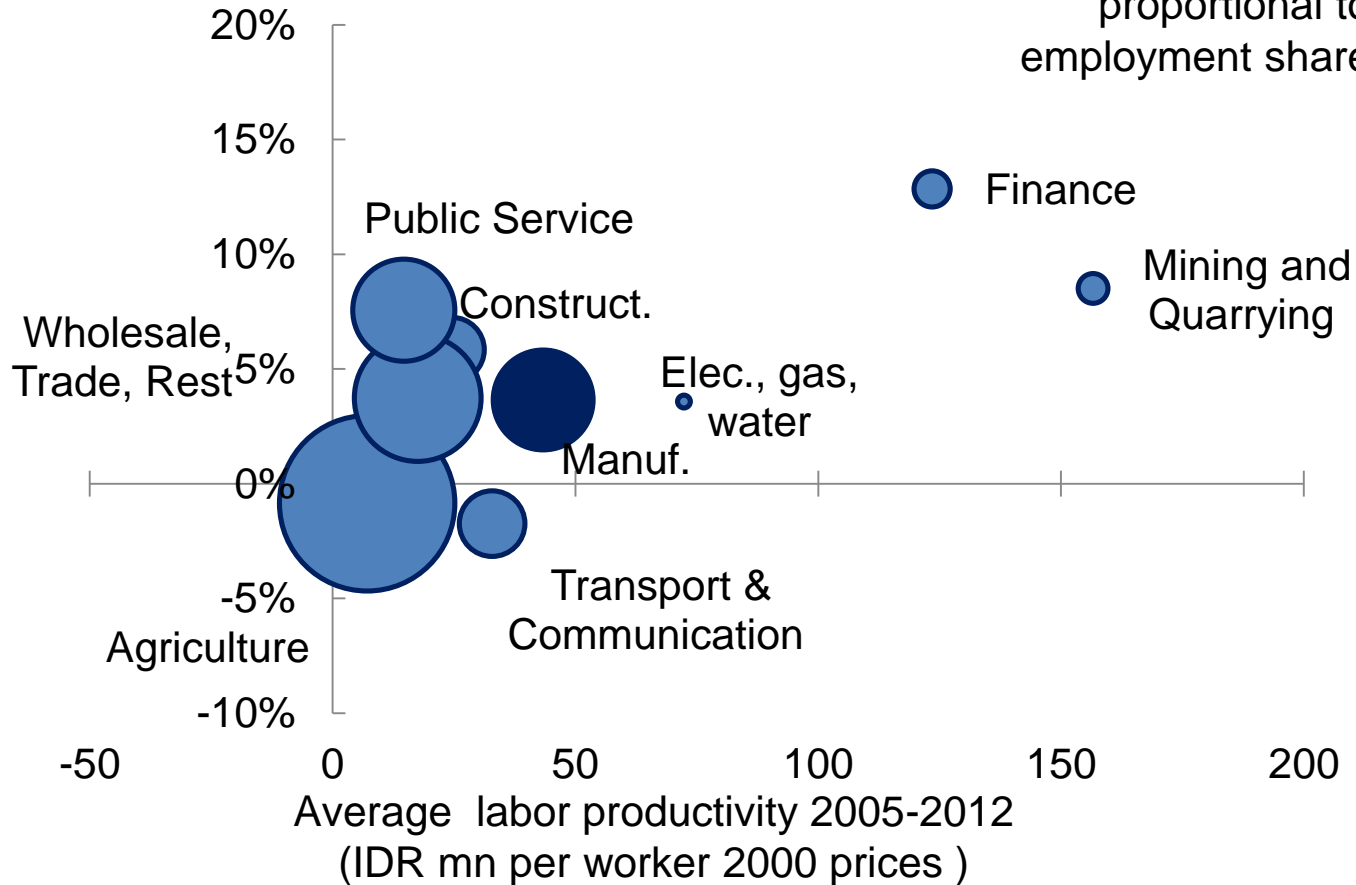
Source: Sakernas

...WHICH HAVE LOWER AVERAGE LABOR PRODUCTIVITY

PRODUCTIVITY

Average employment growth, 2005-2012

Bubble size proportional to employment share



SO, WHAT ARE THE INGREDIENTS OF A PRODUCTIVITY-DRIVEN GROWTH STRATEGY?

THE CHALLENGE –harnessing Indonesia’s potential to generate shared prosperity, through **fast productivity-driven economic growth** with **inclusiveness**

- **Structural policies to boost prosperity:**
 - Closing the infrastructure gap
 - Closing the skills gap
 - Enhancing the functioning of markets
- **Complementary areas (to support generation as well as sharing of prosperity)**
 - Service delivery for all
 - Social protection
 - Natural disaster risk management
- **Foundational pre-requisites:**
 - Macro-fiscal management and managing shocks
 - Implementation

CLOSING THE INFRASTRUCTURE GAP ...

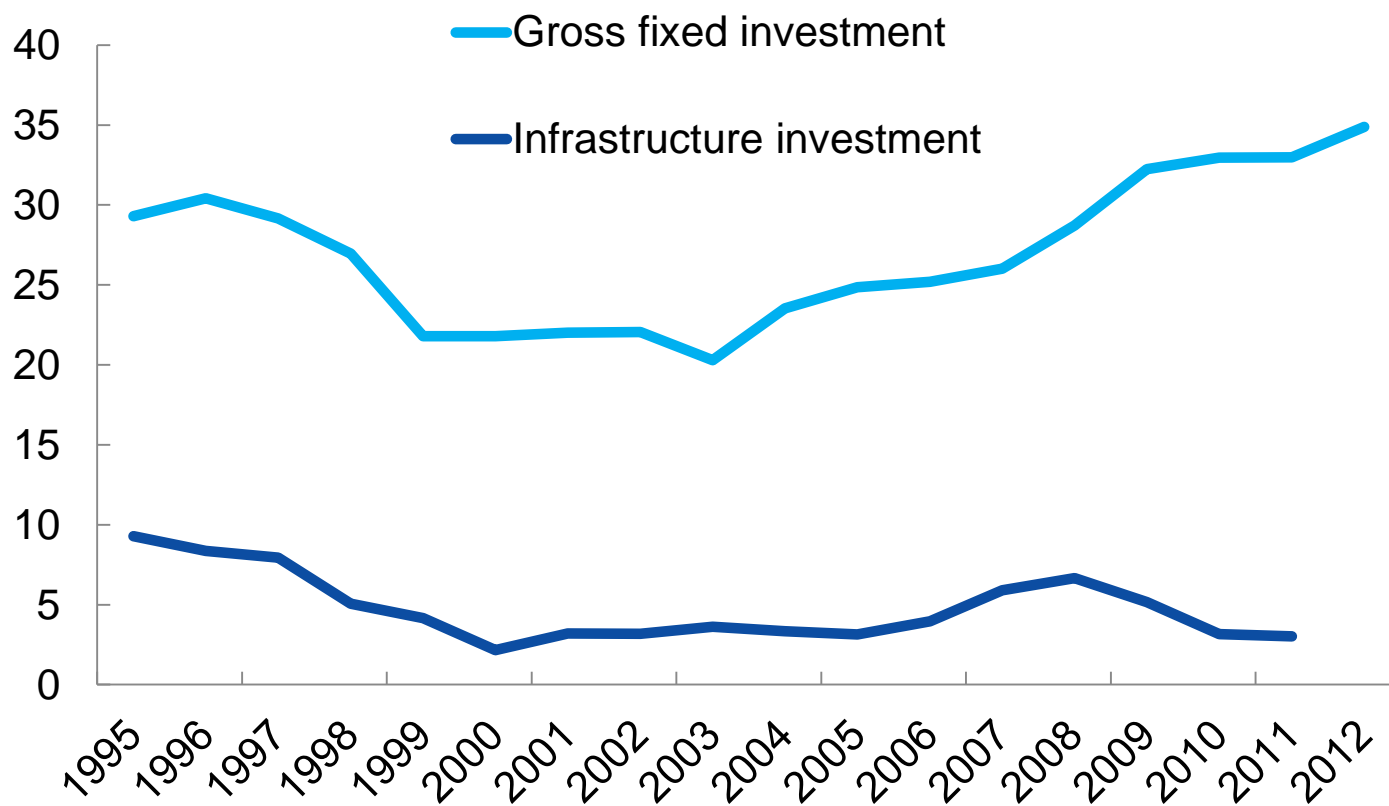
Indonesia's infrastructure's weaknesses are well-recognized

- **Weaknesses in infrastructure services are impeding domestic and international competitiveness and the population's access to services**
 - Road length grew by 35% in the last 10 years while vehicle growth was 300%. Rail accounts for only 1% of passenger traffic, mass transport accounts just 2% of modal share and the Jakarta bus rapid transit system operates at only 25% capacity, heightening congestion. Ports are close to saturation. Power demand doubled in the last 7 years requiring US\$ 10 billion in new investments each year.



...INFRASTRUCTURE INVESTMENT HAS LAGGED THE RECOVERY IN OVERALL INVESTMENT...

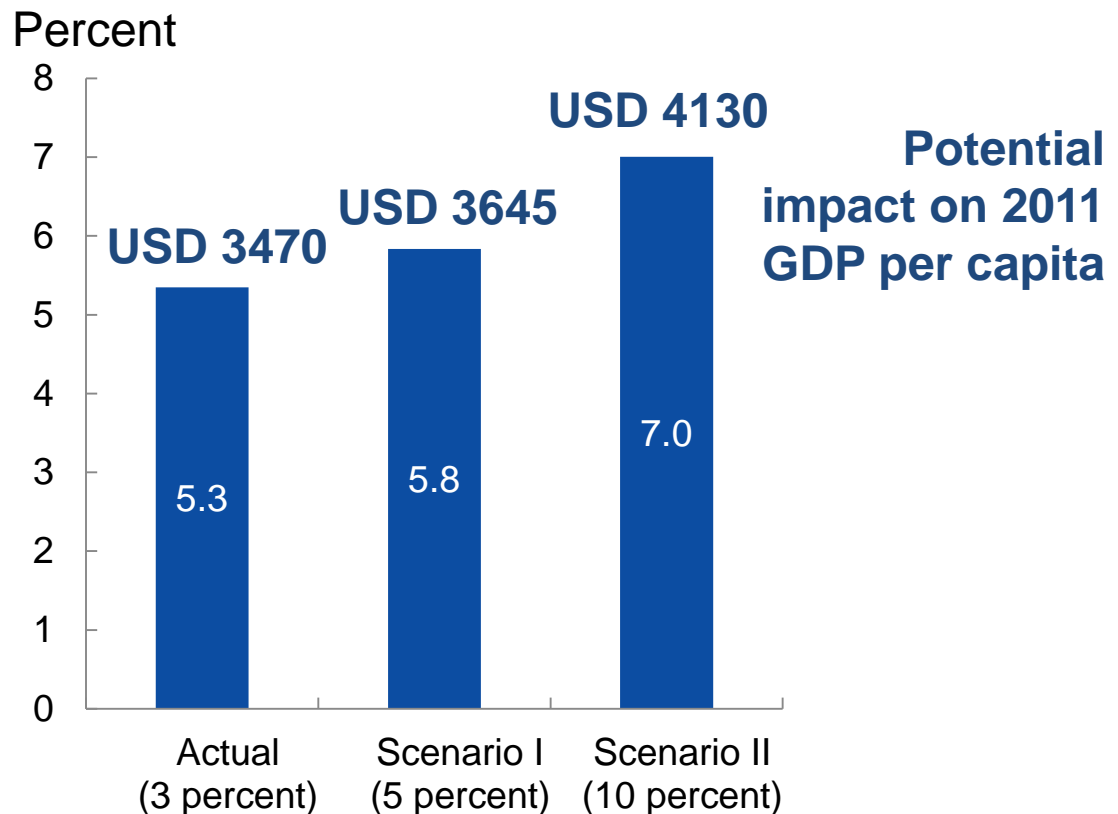
Share of GDP, percent



MEETING THE INFRASTRUCTURE CHALLENGE COULD BRING SIZEABLE GROWTH BENEFITS

- **The drop in infrastructure investment after 1997/1998** resulted in estimated infrastructure capital stock growth of only 3 percent per year over 2001 to 2011
- **Boosting the level and quality of infrastructure investment would have a material positive growth impact** and support improved access to services

Average real GDP growth over 2001-11 under different scenarios for the growth in the infrastructure capital stock:



CLOSING THE INFRASTRUCTURE GAP - POLICY OPTIONS

1. Mobilizing **FUNDING FOR INFRASTRUCTURE DEVELOPMENT**
 - **Continuing to increase budget allocation at central and local government levels - but it's not all about the money** - focus on efficiency and on improving the quality of *public* investment management
 - **Leverage private sector financing** through delivering on potential of strengthened framework for PPP schemes
2. Improved **INFRASTRUCTURE PLANNING AND COORDINATION** processes, e.g. by integrating national, regional and sectoral plans
3. Addressing **LAND ACQUISITION COMPLEXITIES** and delivering on the expectations of improved clarity and transparency from the 2012 Land Acquisition Law and Presidential Regulation

CLOSING THE SKILLS GAP IN THE LABOR FORCE...

To harness the demographic dividend there is a need to ensure that the labor force has the right skills to support a move toward higher productivity growth

- **Despite increasing education attainment (the number of Indonesians with tertiary education may double over the next 10 years) there are concerns over whether these better educated workers have the right skills**
- **50 percent of senior secondary and 15 percent of tertiary education graduates find work in unskilled positions**
- **Almost 70 percent of employers in manufacturing reported finding it 'very difficult' to fill skilled professional-level positions (engineers and similar)**
- **On-the-job training is rare (only 5% of labor force have received formal training)**

...REQUIRING MOVES TO A SKILLS DEVELOPMENT AGENDA

Gradually shift from ensuring greater access to education to a skills development agenda, targeting both those enrolled in schools and those already employed:

1. Improve the **QUALITY OF BASIC EDUCATION**, starting with early childhood education (but this would have a long-term impact...)
2. Improving the **RELEVANCE OF FEEDERS INTO THE LABOR MARKET** (technical and vocational education, and tertiary education)
 - Address information gaps on labor market trends and quality of institutions
 - Improve institutional performance
3. Upgrading **THE SKILLS OF THE EXISTING LABOR FORCE**
 - Increase funding for skills upgrading, but ensure resources used strategically. Developing a credible quality assurance system and channeling funds only to accredited institutions is a first step. Provide targeted services to hard-to-employ segments of the population

IMPROVING THE FUNCTION OF FACTOR MARKETS

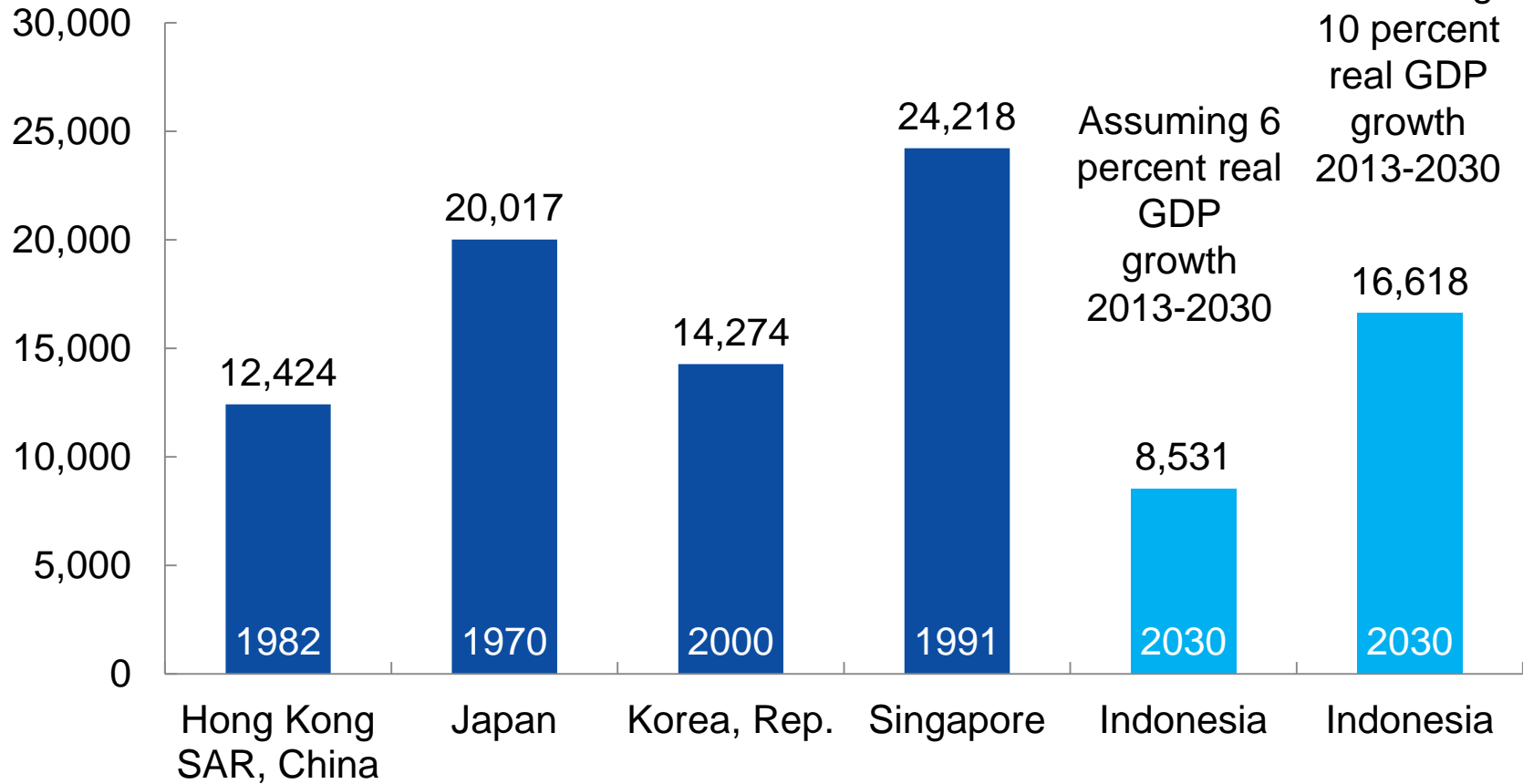
A SET OF MULTIFACETED CHALLENGES INCLUDING:

1. Supporting **FINANCIAL MARKET DEVELOPMENT AND ACCESS**
2. Enhancing the **QUALITY, CONSISTENCY AND CERTAINTY** around the **REGULATORY AND INVESTMENT CLIMATE**
3. Well-functioning **LABOR MARKETS**

THE POTENTIAL PRODUCTIVITY, GROWTH AND DEVELOPMENT PAY-OFFS FROM SUCH REFORMS ARE SIGNIFICANT BUT THE CHALLENGE IS IN THE IMPLEMENTATION

A FINAL MOTIVATING THOUGHT: WILL INDONESIA GET OLD BEFORE IT GETS RICH?

GDP per capita (constant 2012 USD)



Indonesia's prosperity challenge



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