Improving Indonesia’s Competitiveness

Presentation to President Susilo Bambang Yudhoyono

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Agenda for the Second Term

- Improving **macroeconomic** foundations
  - Intensify the fight against corruption
- Upgrading the **business environment**
- **Clusters** development
- **Provincial** economic development
- Economic coordination with **neighboring countries**
- National **economic strategy**
- **Organizing for competitiveness**
Prosperity Performance
Lower and Middle Income Countries

PPP-adjusted GDP per Capita, 2008 ($USD)

Growth of Real GDP per Capita (PPP-adjusted), CAGR, 2001 to 2008

Source: EIU (2009), authors calculations
Unemployment Performance
Middle and Lower Income Countries

Unemployment Rate, 2008

Change of Unemployment Rate in Percentage Points, 1999-2008

Note: In some cases, 1999 data was unavailable, so latest data used.
Source: EIU (2009)
Export Performance
Middle and Lower Income Countries

Exports of Goods and Services (% of GDP), 2008

Export Performance
Middle and Lower Income Countries

Change in Exports of Goods and Services (% of GDP), 2004 to 2008

Source: EIU (2008), authors’ analysis
Indonesia Exports By Type of Industry
Excluding Oil and Gas Industry

Note: Excluding Oil and Gas cluster
Source: UNComTrade, WTO (2008)
Inbound Foreign Investment Performance
Stocks and Flows, Selected Middle and Lower Income Countries

Inward FDI Stocks as % of GDP, Average 2003 - 2007

FDI Inflows as % of Gross Fixed Capital Formation, Average 2003 - 2007

Inbound Foreign Investment Performance Flows, Selected Countries

Inward FDI Flows, % of GDP

Ranked by Inward FDI Flows (% of GDP), 2007

- Russia
- Brazil
- China
- India
- Indonesia
Innovative Output, Selected Countries

Average U.S. patents per 1 million population, 2004-2008


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Indonesian Competitiveness in 2009

- **Solid growth** rates over the medium term
- The impact of the global crisis has been comparably **modest**
- **Political stability** has improved significantly
- The achievements of the first term have laid a good **foundation for rapid progress**

**HOWEVER**

- Indonesia’s prosperity **remains low**, and prosperity growth rates have only been **average relative to regional peers**
- Indonesia’s **limited integration into the global economy** has provided shelter but greatly limits Indonesia’s long-term growth prospects
- Indonesia continues to face **significant competitive weaknesses**

- The second term is the time to move to a more **ambitious economic strategy** which will place Indonesia on a higher growth path
What is Competitiveness?

• Competitiveness is the **productivity** with which a nation uses its human, capital, and natural resources.
  
  – Productivity **sets the sustainable standard of living** (wages, returns on capital, returns on natural resources)
  
  – It is not **what** industries a nation competes in that matters for prosperity, but **how productively** it competes in those industries
  
  – Productivity in a national economy arises from a **combination of domestic and foreign firms**
  
  – The productivity of “**local**” or **domestic industries** is fundamental to competitiveness, not just that of export industries
  
• Only **competitive** businesses can create sustainable jobs and attractive wages

• Nations compete to offer the **most productive environment for business**

• The public and private sectors play **different but interrelated roles** in creating a productive economy
Determinants of Competitiveness

- Natural endowments alone are **not enough** to support a high standard of living
- **Macroeconomic competitiveness** creates the potential for productivity
- Productivity ultimately depends on improving the **microeconomic capability** of the economy and the **sophistication of local competition**
Indonesia’s Macroeconomic Competitiveness

- Indonesia has made significant progress solidifying and improving political institutions
- Macroeconomic policy is solid, but stable fiscal balances are partly due to the inability to execute planned spending, especially at the provincial level
- Decentralization of authority to the provinces is an important step in a large, spread out country such as Indonesia, but better policy coordination and implementation is needed
- There has been some progress in reducing corruption, but this remains a central obstacle to further improvements in competitiveness
- Indonesia performs relatively well in some aspects of basic human development, but has not improved its position significantly over time
Corruption Perception Index, 2007

Note: Ranks only countries available in both years (91 countries total)
Source: Global Corruption Report, 2008
Indonesia’s Macroeconomic Competitiveness
Action Priorities

• Sustain progress in improving the *stability of the political system* and the battle against *terrorism*

• Intensify the *fight against corruption*

• Sustain the focus on *stable government finances*, while enabling more effective execution of *public sector investments*

• Create and implement a clear strategy for improving *education* and *health care*, especially the quality of delivery

• Improve the effectiveness of *policies to ameliorate poverty*, for example, through a social safety net instead of broad consumption subsidies

• Continue strengthening the *legal system*
Microeconomic Competitiveness: Improving the Business Environment

Context for Firm Strategy and Rivalry

- Vigorous local competition
  - Openness to foreign competition
  - Competition laws
- Local rules and incentives encouraging productivity and investment
  - e.g., incentives for investment, intellectual property protection, corporate governance standards

Factor (Input) Conditions

- Access to high quality business inputs
  - Human resources
  - Capital availability
  - Physical infrastructure
  - Administrative infrastructure (e.g., registration, permitting, transparency)
  - Scientific and technological infrastructure

Demand Conditions

- Demanding and sophisticated local customers and needs
  - e.g., strict quality, safety, and environmental standards
  - Consumer protection laws

Related and Supporting Industries

- Availability of suppliers and supporting industries

- Many things matter for competitiveness
- Successful economic development is a process of successive upgrading, in which the business environment improves to enable increasingly sophisticated ways of competing
Ease of Doing Business
Indonesia, 2009

Median Ranking, Asia and Pacific Region

Indonesia’s per capita GDP rank: 101

Indonesia’s Business Environment
Critical Strengths and Weaknesses

**STRENGTHS**
- Solid basic skills and a large available workforce
- Promising reforms of rules and regulations affecting business
  - Top Asian reformer in 2010 World Bank Doing Business ranking
- Solid financial system
- Greater formal opening of the economy to trade and investment
  - New Investment Law passed in 2007
- Wide array of potential clusters, especially in natural resources-related fields

**WEAKNESSES**
- Weak logistical and communication infrastructure
- Unreliable electricity supply
- Labor market rigidity
- Regulations and customs procedures remain complex
- Limited depth in the financial system
- Weak educational quality
- Legal system uncertainty for investors, especially at the provincial level
- Dominance of large business groups and state-owned enterprises
- Weak cluster collaboration and development
- Lack of advanced skills
- Weak science and technology system
Indonesian Business Environment

Action Priorities

• Continue progress on regulatory reforms
• Improve logistical infrastructure
• Improve communications infrastructure
• Improve the quality of electricity supply
• Reduce rigidities in the labor market
• Reform customs procedures and continue the process of opening to international trade and investment
• Increase domestic competition, including limits on dominant domestic market positions
• Create stronger institutions to disseminate management best practices and support the adoption of new technologies
Microeconomic Competitiveness: Cluster Development
Tourism Cluster in Cairns, Australia

Public Relations & Market Research Services
Food Suppliers
Property Services
Maintenance Services
Travel agents
Tour operators
Restaurants
Attractions and Activities e.g., theme parks, casinos, sports
Hotels
Airlines, Cruise Ships
Local retail, health care, and other services
Local Transportation
Souvenirs, Duty Free
Banks, Foreign Exchange
Government agencies e.g. Australian Tourism Commission, Great Barrier Reef Authority
Educational Institutions e.g. James Cook University, Cairns College of TAFE
Industry Groups e.g. Queensland Tourism Industry Council

Sources: HBS student team research (2003) - Peter Tynan, Chai McConnell, Alexandra West, Jean Hayden
Chilean Wine Cluster

Related and Supported Industries

- Irrigation technology
- Grapestock
- Fertilizer, pesticides, herbicides
- Grape harvesting equipment

Government
(trade promotion offices, implementation of standards, export/import/FDI policies)

Growers / vineyards

Winery / processing facilities

Educational, research, and trade organization

- Specialized financing
- Barrels
- Bottles
- Plasctics / Tetrapacks
- Corks
- Labels
- Public relations and advertising
- Specialized publications
- Export promotion

Related and Supported Industries

- Agriculture Cluster
- Food Cluster
- Tourism Cluster
- Pisco Cluster

Clusters as a Tool For Economic Policy

• A forum for collaboration between the private sector, trade associations, government, educational, and research institutions
• Brings together firms of all sizes, including SME’s
• Creates a mechanism for constructive business-government dialog
• A tool to identify problems and action recommendations
• A vehicle for investments that strengthen multiple firms/institutions simultaneously
• Fosters greater competition rather than distorting the market
Clusters and Policy Implementation

- Clusters provide a framework for implementing public policy and organizing public-private collaboration to enhance competitiveness.

- Clusters:
  - Education and Workforce Training
  - Management Training
  - Business Attraction
  - Export Promotion
  - Market Information and Disclosure
  - Physical Infrastructure
  - Science and Technology Investments (e.g., centers, university departments, technology transfer)
  - Standard setting and quality initiatives
  - Environmental Stewardship
  - Natural Resource Protection
Indonesian Clusters

• Indonesia has potential strengths in a wide array of clusters, including agriculture, tourism, forest products, coal, oil and gas, and forms of mining
Indonesia’s National Cluster Export Portfolio
1997 to 2007

Indonesia’s world export market share, 2007

Indonesian Clusters

- Indonesia has **potential strengths** in a wide array of clusters, including agriculture, tourism, forest products, coal, oil and gas, and forms of mining.

- Indonesia’s emerging clusters are heavily based on the country’s abundant **natural endowments**, with few activities in related and supporting industries.

- The **National Industrial Policy** approved in 2008 identifies priority sectors, but there is no effective cluster development effort.

- Existing cluster related efforts suffer from **weak coordination** across ministries and agencies.
Share of World Exports by Cluster
Indonesia, 2007

Note: Clusters with overlapping borders have at least 20% overlap (by number of industries) in both directions.
Indonesian Clusters

Action Priorities

• Adopt cluster development as a central approach for organizing the government’s business development efforts

• Utilize cluster initiatives as a tool to engage the private sector in more effective collaboration with government at the national and regional level

• Use clusters to organize export promotion and FDI attraction
Geographic Influences on Competitiveness

- Neighboring Countries
- Nation
- Regions and Cities
Specialization by Traded Clusters
U.S. States, 2006

**Oregon**
- Agricultural Products
- Prefabricated Enclosures
- Forest Products
- Analytical Instruments

**Maine**
- Forest Products
- Aerospace Engines
- Communications Equipment
- Hospitality and Tourism

**Mississippi**
- Furniture
- Fishing and Fishing Products
- Power Generation and Transmission
- Motor Driven Products

**Oregon**
- Agricultural Products
- Prefabricated Enclosures
- Furniture
- Forest Products

**Kentucky**
- Automotive
- Plastics
- Construction Materials
- Transportation and Logistics

**Alaska**
- Fishing and Fishing Products
- Power Generation and Transmission
- Heavy Construction Services
- Hospitality and Tourism

**South Carolina**
- Textiles
- Forest Products
- Automotive
- Production Technology

**South Dakota**
- Heavy Machinery
- Sporting, Recreational and Children's Goods
- Financial Services
- Processed Food

**Colorado**
- Oil and Gas Products and Services
- Medical Devices
- Aerospace Vehicles and Defense Entertainment

**Nevada**
- Leather and Related Products
- Heavy Construction Services
- Hospitality and Tourism
- Transportation and Logistics

**Idaho**
- Agricultural Products
- Information Technology
- Prefabricated Enclosures
- Furniture

**Illinois**
- Biopharmaceuticals
- Lighting and Electrical Equipment
- Heavy Machinery
- Metal Manufacturing

**Arizona**
- Textile
- Forest Products

Indonesia’s provinces are **geographically dispersed** and **culturally diverse**.

Indonesia’s population is becoming increasingly **urban**.

Weak **infrastructure** has limited internal trade and specialization and made it difficult to access Indonesia’s large national market.

Decentralization in government has led initially to **inefficiency** and **corruption**.
Indonesia’s Provinces
Divergent Performance

GDP per Capita, 2007
(Constant Market Prices, 2000, Million Rupiah)

Growth of GDP per Capita (Constant Market Prices, 2000), CAGR 2003 to 2007

Weighted Indonesian Average: Rp9.41
Weighted Indonesian Average: 4.82%

Note: Since population only available for 2000, population held constant when calculating per capita levels.
Indonesian Provinces
Action Priorities

• Strengthen logistical and communications infrastructure linking the provinces to expand trade, encourage economic specialization, and open internal competition

• Reduce internal administrative and policy barriers to inter-provincial trade and investment

• Improve the capabilities of provincial governments to improve policy formulation and implementation, and to reduce corruption

• Support provinces in creating distinctive economic strategies

• Create rules that limit destructive competition among provinces for investments, such as large subsidies

• Create a structure and incentives to align and harmonize national and provincial policies
Geographic Influences on Competitiveness

- Neighboring Countries
- Nation
- Regions and Cities
Economic Integration with Neighboring Countries
South East Asia

- Economic coordination among neighboring countries can significantly enhance competitiveness
Economic Strategy For Cross-National Regions

Traditional View
• Regions as free trade zones

Emerging View
• Regional strategy as a powerful tool to enhance competitiveness across countries
  – Expand trade and investment within the region
  – Attract more foreign investment to the region
  – Capture synergies in improving the business environment
  – Accelerate the rate of domestic policy improvement
  – Enhance interest and investment in the region by the international community
Economic Coordination Among Neighbors
Capturing Synergies

Factor (Input) Conditions

- Improving regional transportation infrastructure
- Enhancing regional communications and connectivity
- Creating an efficient energy network
- Linking financial markets
- Harmonizing administrative requirements for businesses
- Opening the movement of students for higher education

Context for Strategy and Rivalry

- Eliminating trade and investment barriers within the region
- Simplifying and harmonizing cross-border regulations and paperwork
- Coordinating anti-monopoly and fair competition policies

Demand Conditions

- Harmonizing environmental standards
- Harmonizing product safety standards
- Establishing reciprocal consumer protection laws
- Opening government procurement within the region

Related and Supporting Industries

- Facilitating cross-border cluster upgrading, e.g.
  - Tourism
  - Agribusiness
  - Transport & Logistics
  - Business services

Macroeconomic Competitiveness

- Coordinating programs to improve public safety
- Coordinating macro-economic policies

Regional Strategy & Governance

- Creating a regional strategy and marketing program
- Sharing best practices in government operations
- Creating regional institutions
  - Dispute resolution mechanisms
  - Regional development bank
- Developing a regional position with international organizations
Indonesia and ASEAN

• ASEAN has set ambitious **policy goals** but there is limited **implementation**
• ASEAN’s agenda is focused on a **reciprocal trade liberalization**, rather than **upgrading regional competitiveness**
• ASEAN is moving **too slowly** towards greater **economic integration**

• Indonesia has played a largely **passive role** in ASEAN
• Indonesian firms have been **slow** to penetrate regional markets
• Indonesia can be a **leading force** in driving ASEAN forward
Developing an Indonesian Economic Strategy

National Value Proposition

- What is the unique competitive position of Indonesia given its location, legacy, endowments, and potential strengths?
- What is Indonesia’s value proposition for business?
- In what clusters can Indonesia excel?
- What role can Indonesia play in its region?

Developing Unique Strengths

- What are the key strengths that Indonesia must build upon?

Addressing Crucial Constraints

- What weaknesses must be addressed to achieve parity with peer countries?

- An economic strategy requires rigorous prioritization and sequencing
Toward an Indonesian Economic Strategy

Unique Strengths

- Significant natural resources
- Pluralistic, diverse society increasingly embracing democratic principles
- Creative and energetic workforce
- Large domestic market with a growing number of urban consumers
- Complex geography with thousands of islands and long distances
- A central location in Asia, with proximity to numerous foreign markets

Implications

- Political and Legal Stability
- Human Development
- Infrastructure
- Regulatory Reforms
- Trade, investment and Regional integration
- Cluster Development
- Government Effectiveness and Organization
Organizing for Competitiveness

• Sustained improvements in competitiveness require coordination among many parts of government
  – Across different ministries to align all the policies that affect clusters or aspects of competitiveness
  – Across geographic levels of government

• Improving competitiveness requires collaboration with the private sector
  – Public-private dialogue to identify competitiveness priorities and implement solutions

• While Indonesia has made progress on advancing competitiveness policies at the national level, policy coordination within government with the private sector remains a challenge
Organizing for Competitiveness

Action priorities for Indonesia

• Create a **strategy unit** in the Office of the President

• Strengthen the **coordinating structure** within the national government

• Create a public-private **National Council on Competitiveness** to build consensus on an overall economic strategy and track implementation

• Foster **Provincial Competitiveness Councils** to drive consensus on provincial plans, involving representatives from both public and private sector and participation by the national government
Agenda for the Second Term

- Improving **macroeconomic** foundations
  - Intensify the fight against corruption

- Upgrading the **business environment**

- **Clusters** development

- **Provincial** economic development

- Economic coordination with neighboring countries

- National **economic strategy**

- **Organizing for competitiveness**