

Raising Indonesia's Competitiveness

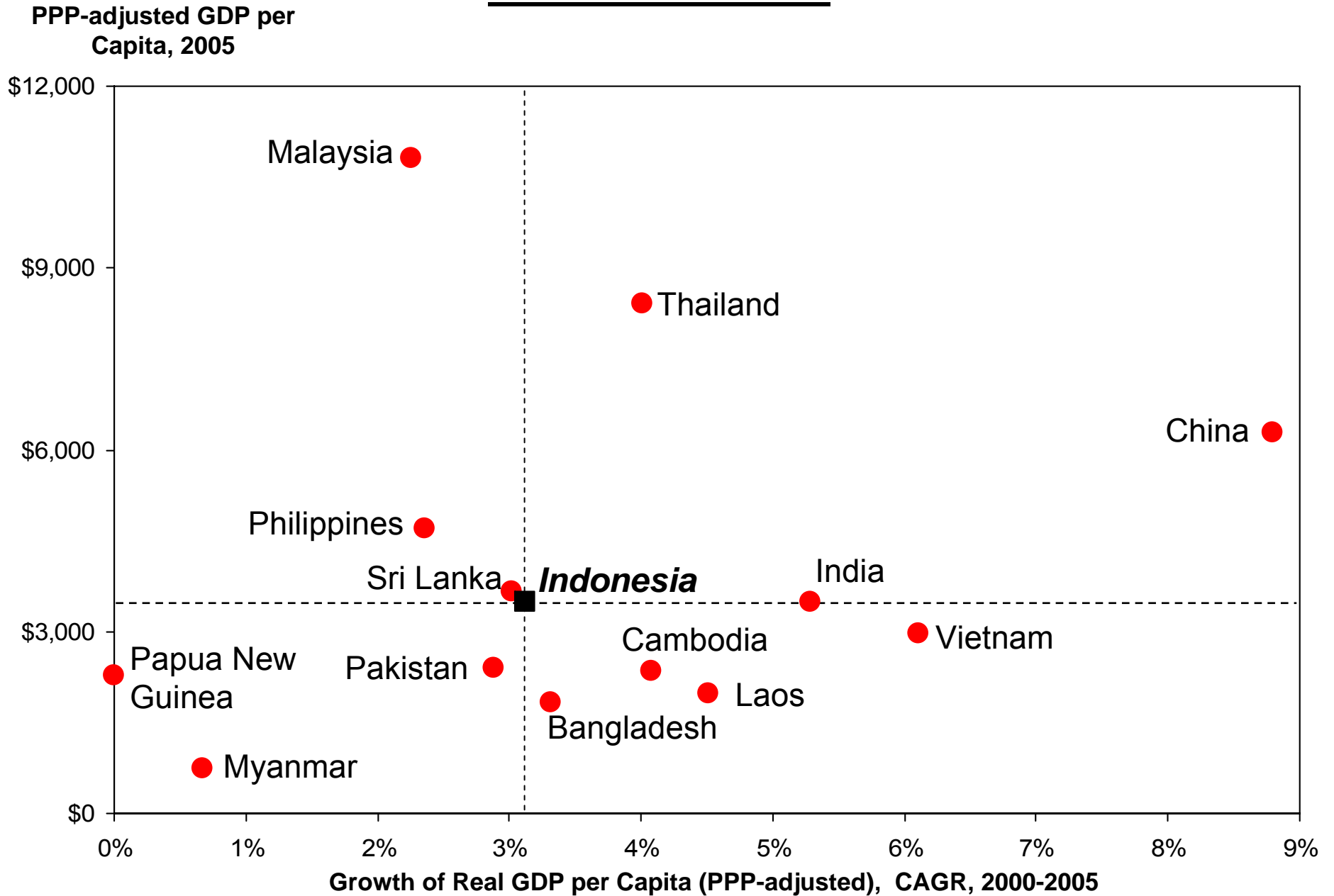
Prof. Michael E. Porter
Harvard Business School

Jakarta, Indonesia
28 November 2006

This presentation draws on ideas from Professor Porter's books and articles, in particular, "Building the Microeconomic Foundations of Prosperity," in *The Global Competitiveness Report 2006-07* (World Economic Forum, 2006); "Clusters and the New Competitive Agenda for Companies and Governments," in *On Competition* (Harvard Business School Press, 1998); *Clusters of Innovation Initiative* (www.compete.org), a joint effort of the Council on Competitiveness, Monitor Group, and ongoing research. No part of this publication may be reproduced, stored in a retrieval system, or transmitted in any form or by any means—electronic, mechanical, photocopying, recording, or otherwise—without the permission of the author

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Prosperity Performance Selected Countries



Source: EIU (2006), authors' calculations

Trends in the Global Economy

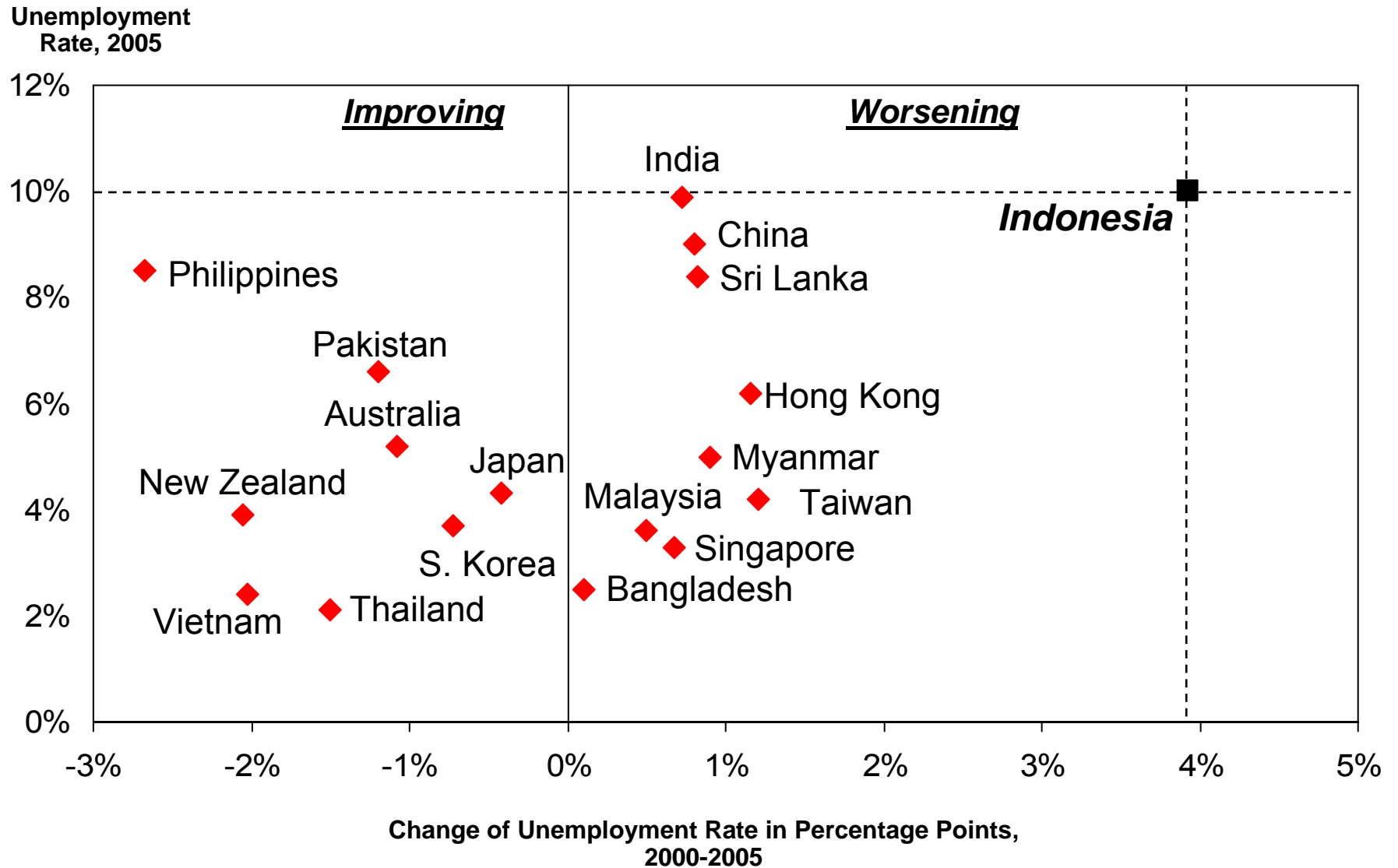
- Globalization of **markets**
- Globalization of **value chains**
- Globalization of **knowledge**
- **Innovation** and **skill** an increasing share of value added
- **Services** an increasing share of value added



- Competitiveness depends on **productivity**
- The bar for competitiveness is **rising**
- Competitiveness in the global economy is a **positive-sum game**

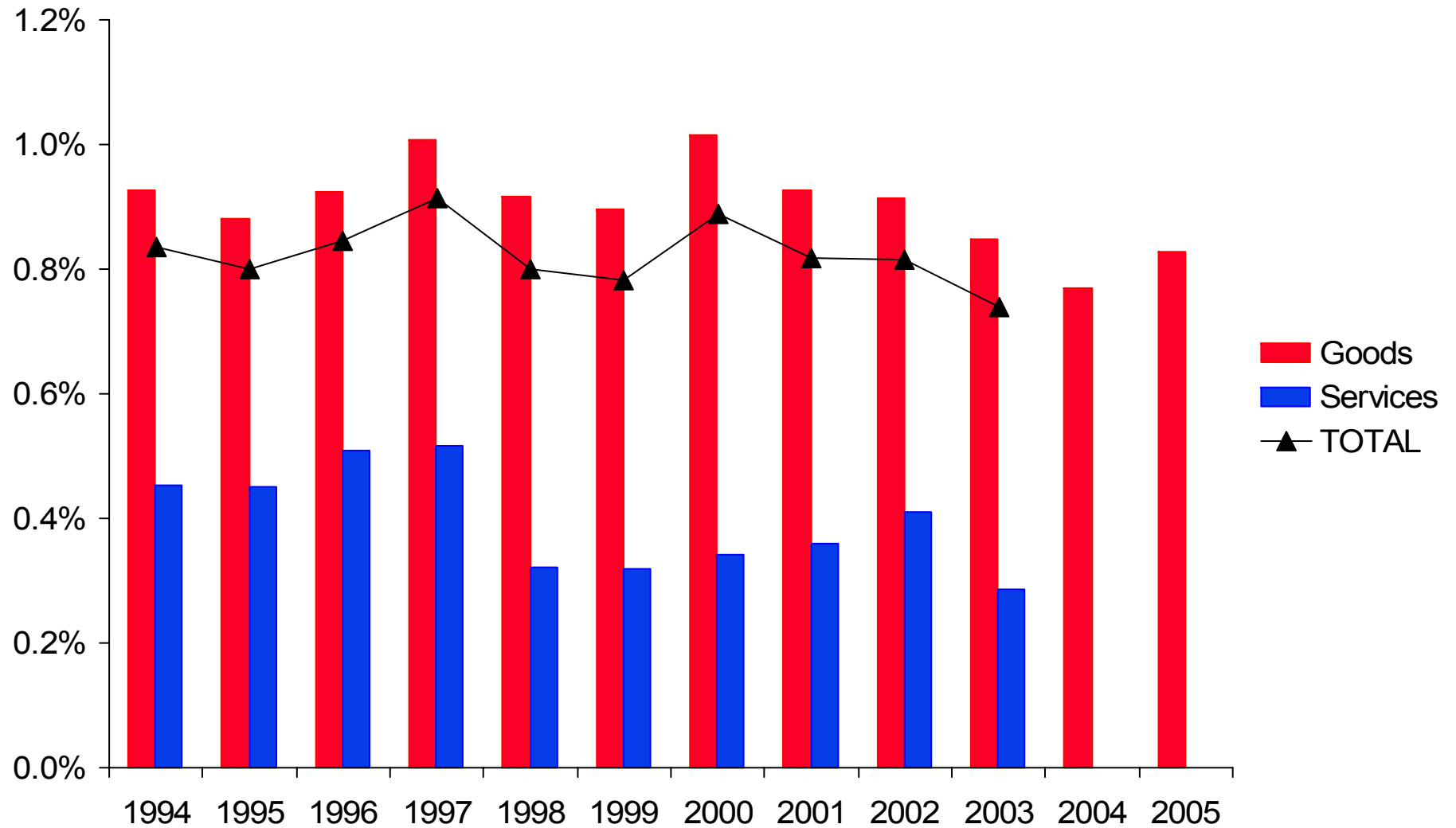
Unemployment Performance

Selected Developing Countries



Indonesia Export Share Trends

World Export Market Share



Note: Services data not available for 2004 and 2005.

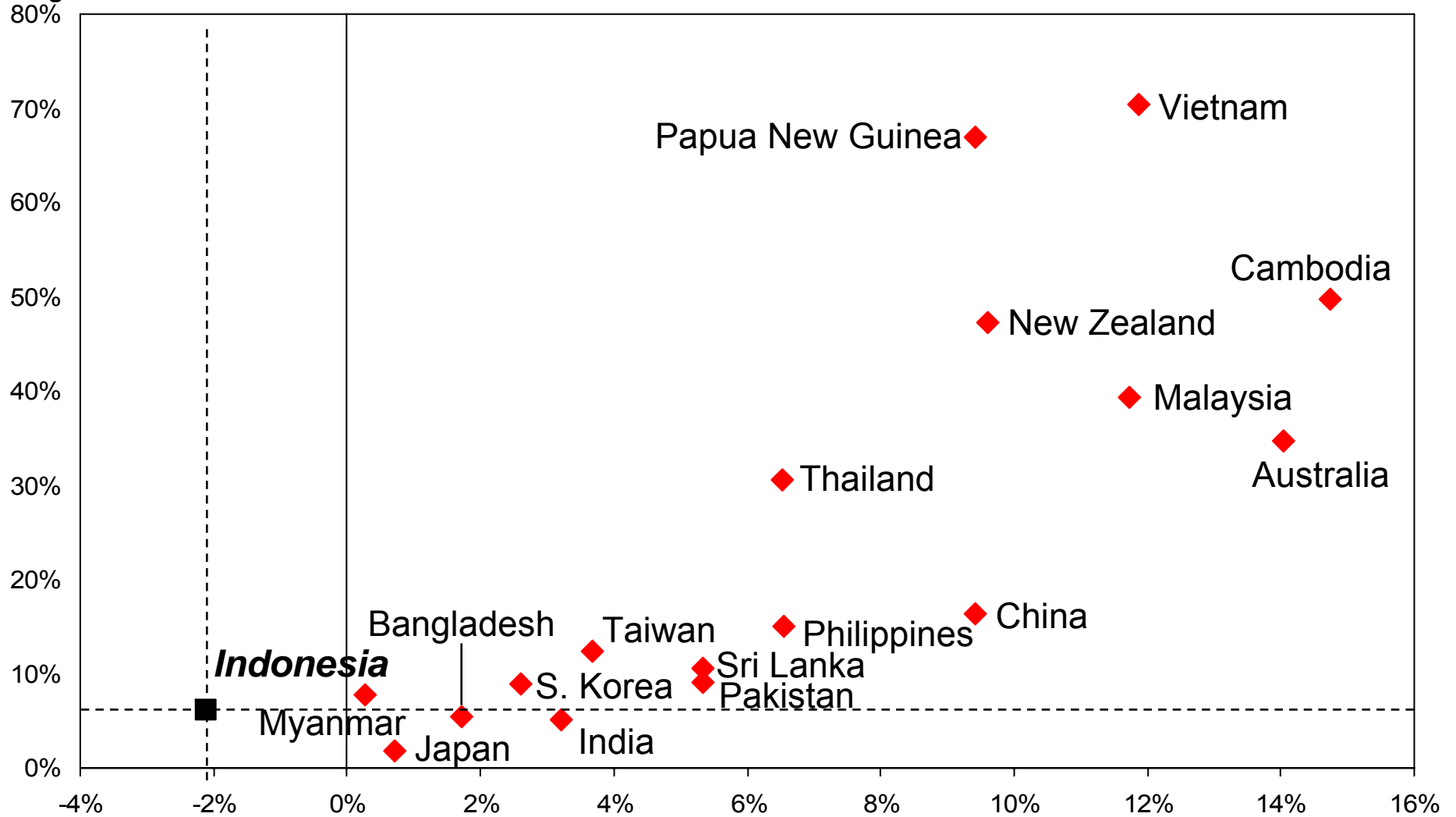
Source: WTO (2005)

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Foreign Investment Stocks and Flows

Selected Countries

Stock of FDI as a % of GDP,
Average 2001-2004



FDI Inflows as a % of Gross Fixed Capital Formation,
Average 2001-2004

Indonesian Economy in 2006

- Stable **growth** since the 1998 Asian crisis
- Prosperity growth is positive, but only **average** among Asian peers
- **Unemployment** remains a crucial problem
- World export market share is on a **downward trend**
- Foreign direct investment inflows are **disappointing**



- Economic outcomes are **acceptable**, but Indonesia is **underperforming its potential**
- The government's reforms have so far had **limited visible impact** on the performance of the economy

Indonesia's Challenging Economic Legacy

- Normal challenges of an emerging economy
- Natural catastrophes (Tsunami, SARS)
- Large population and huge geographic spread
- Strong regional loyalties
- Significant natural resources that generate revenue without the need for productivity
- Maturing political process and lack of well-established government, business, and social institutions
- Legacy of corruption and inefficient, poorly governed state-owned companies
- Terrorism

What is Competitiveness?

- Competitiveness is determined by the **productivity** (value per unit of input) with which a nation or a region uses its human, capital, and natural resources. Productivity sets a nation's or region's standard of living (wages, returns on capital, returns on natural resources)
 - Productivity depends both on the **value** of products and services (e.g. uniqueness, quality) as well as the **efficiency** with which they are produced.
 - It is not **what** industries a nation or region competes in that matters for prosperity, but **how** firms compete in those industries
 - Productivity in a nation or region is a reflection of what both domestic and foreign firms **choose to do in that location**. The location of ownership is secondary for national prosperity.
 - The productivity of **“local”** industries is fundamental to competitiveness, not just that of traded industries
 - Devaluation and revaluation do **not** make a country more or less “competitive”



- Nations and regions compete in offering the **most productive environment** for business
- The public and private sectors should play **different but interrelated roles** in creating a productive economy

Determinants of Competitiveness

Macroeconomic, Political, Legal, and Social Context

Microeconomic Foundations

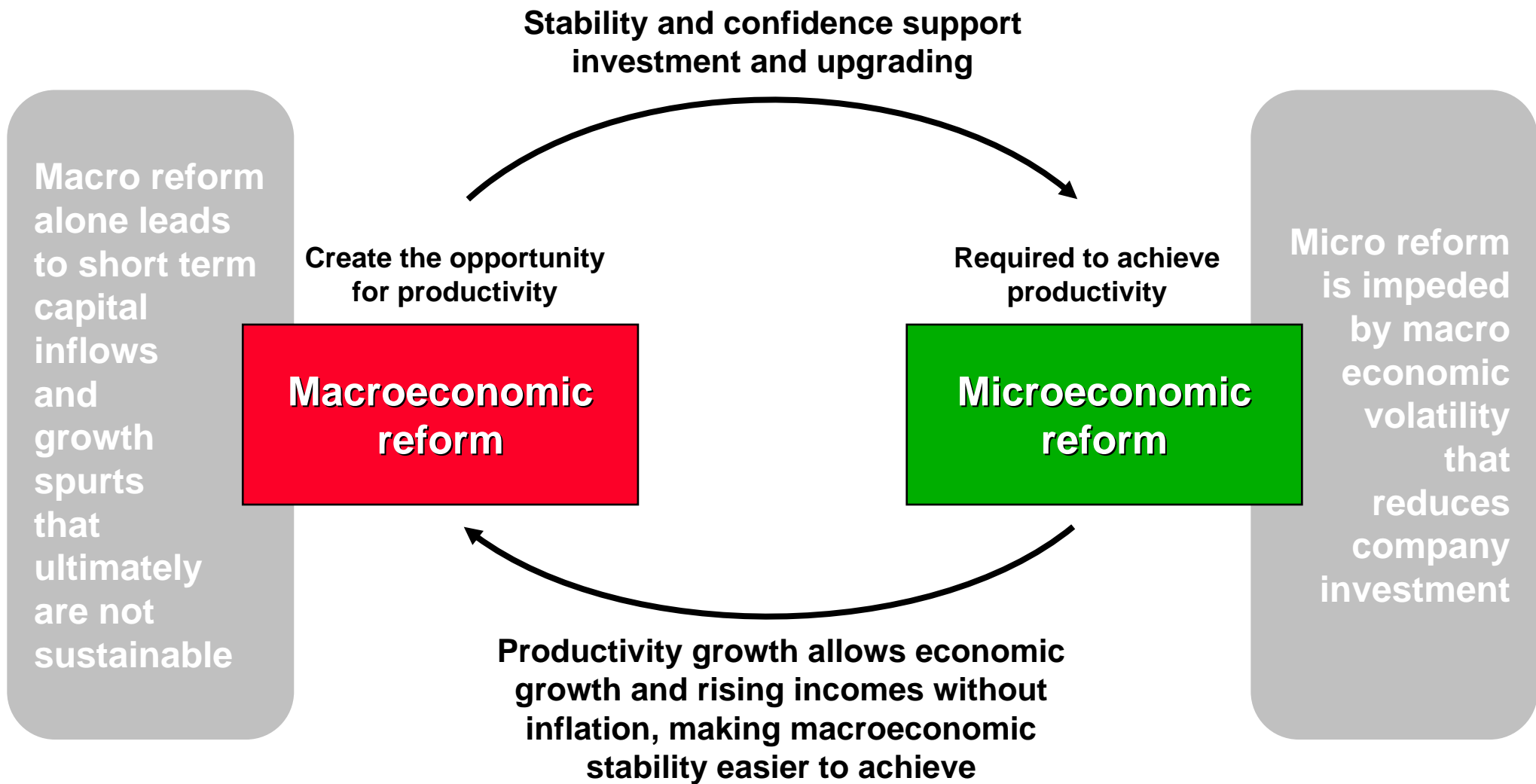
The Sophistication
of Company
Operations and
Strategy



The Quality of the
Microeconomic
Business
Environment

- A sound macroeconomic, political, legal, and social context creates the potential for competitiveness, **but is not sufficient**
- Only **firms** can create wealth, not government

Integration of Macro- and Microeconomic Reforms



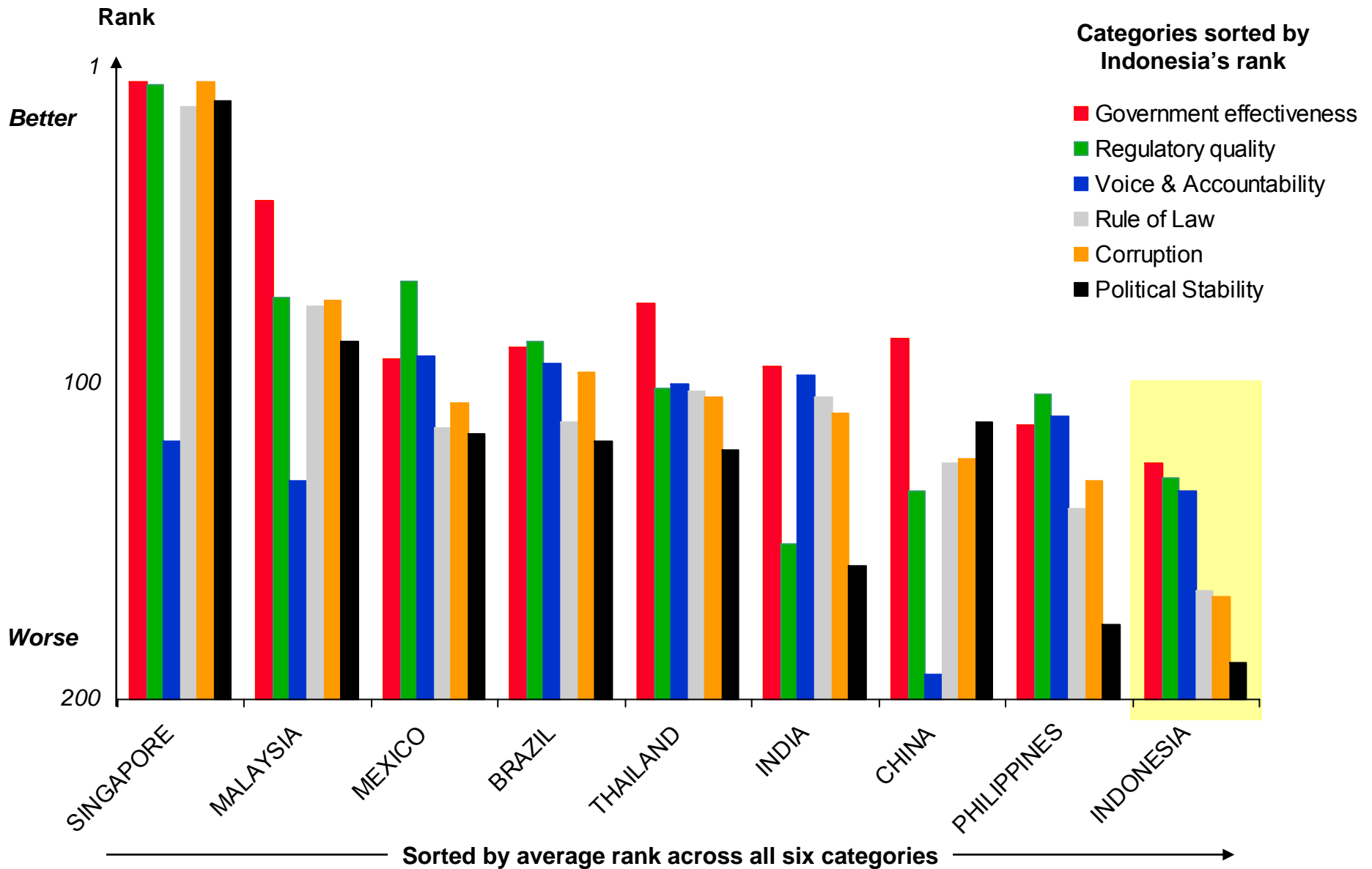
Indonesian Context

Work in Process

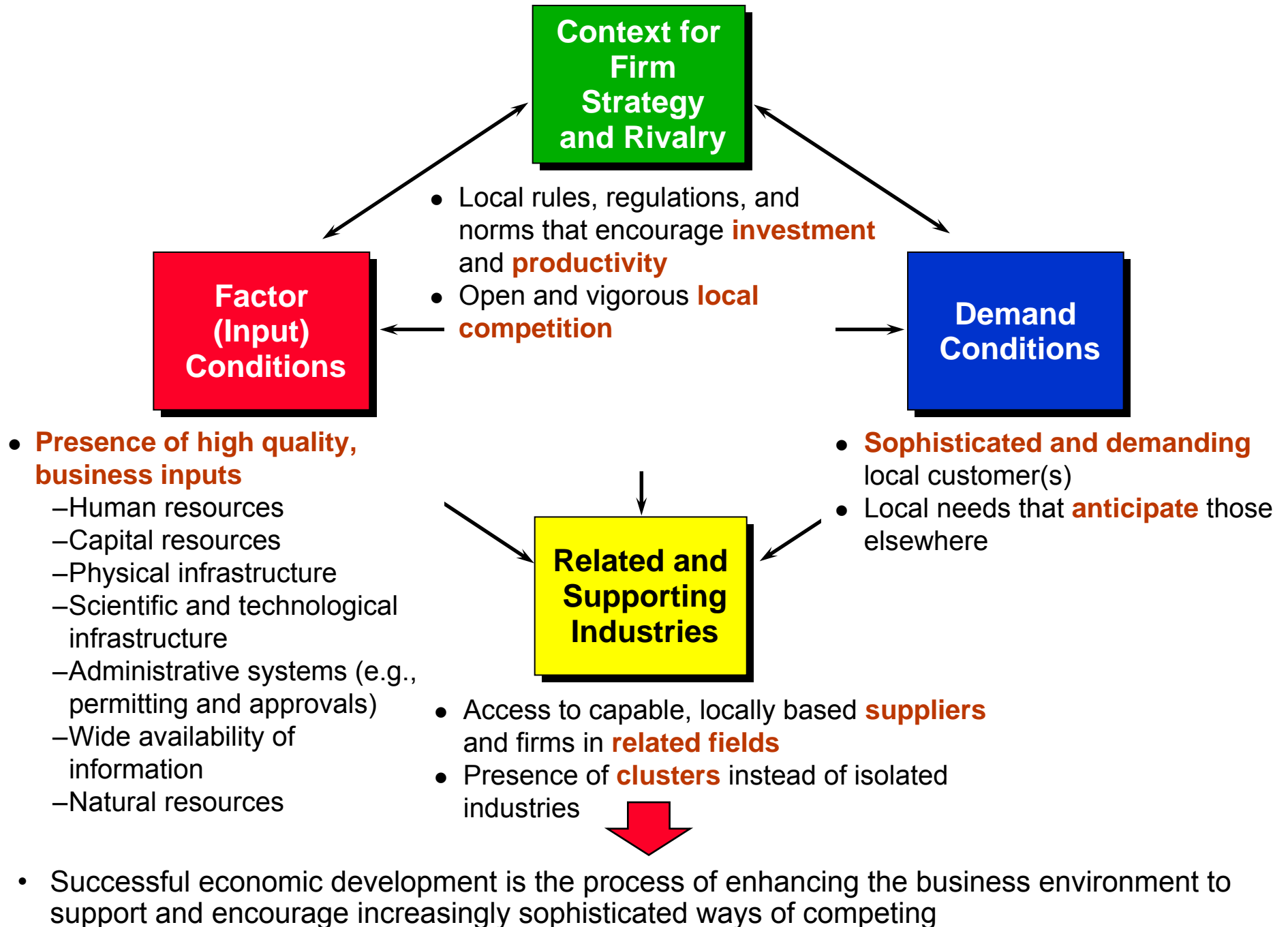
- Macroeconomic policy continues to be **solid**
- The political system is improving but the ability to **implement and enforce** policies and ensure a **stable policy environment** for business remains a challenge
- The legal system still suffers from **low credibility** in terms of swift, predictable, and fair application of the law
- Social conditions remain **challenging** in many parts of the country, especially in the rural areas

Governance

Selected Countries, 2004

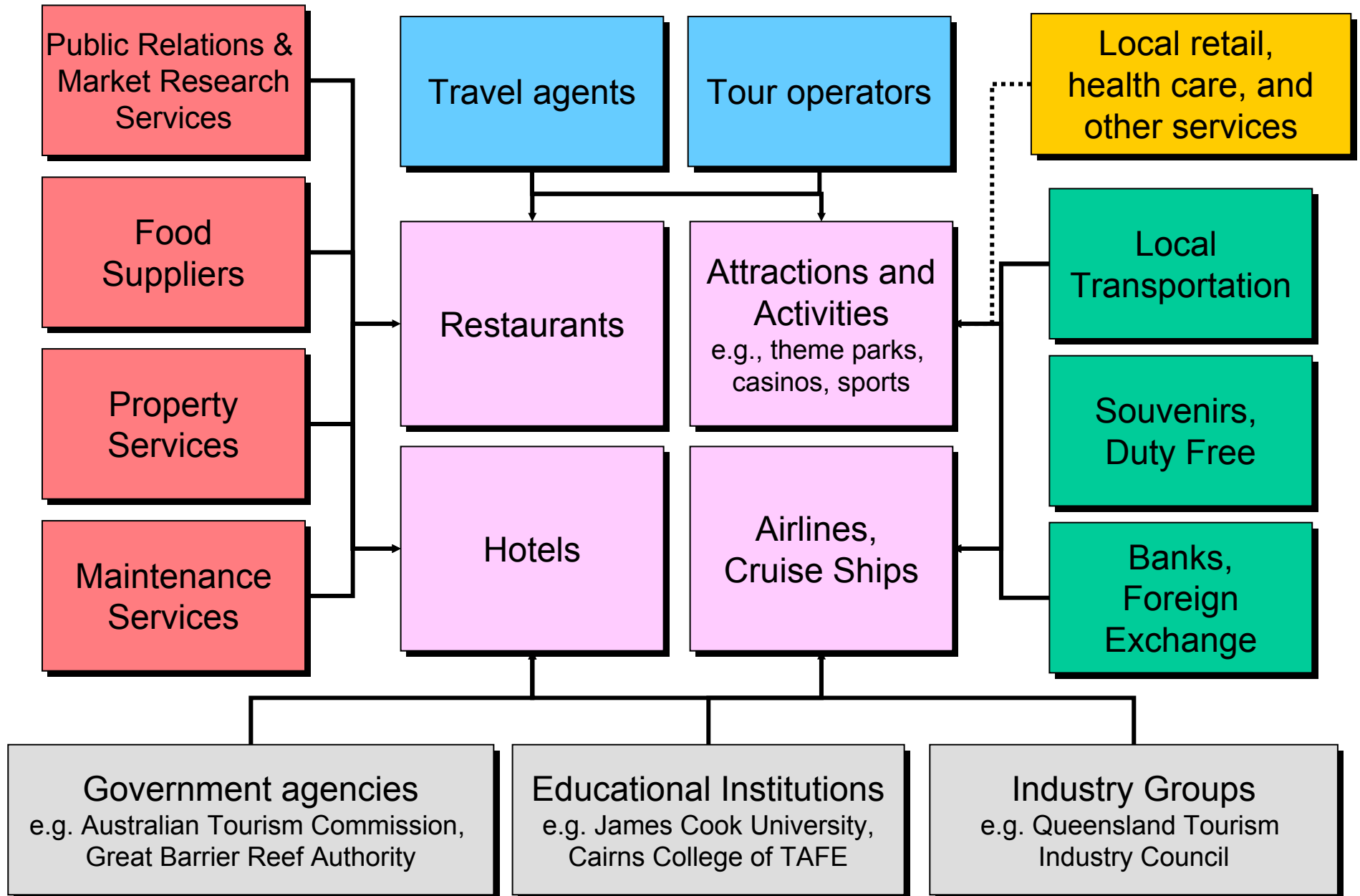


Upgrading the Business Environment



Determinants of Competitiveness

Cluster Development, Cairns (Australia) Tourism

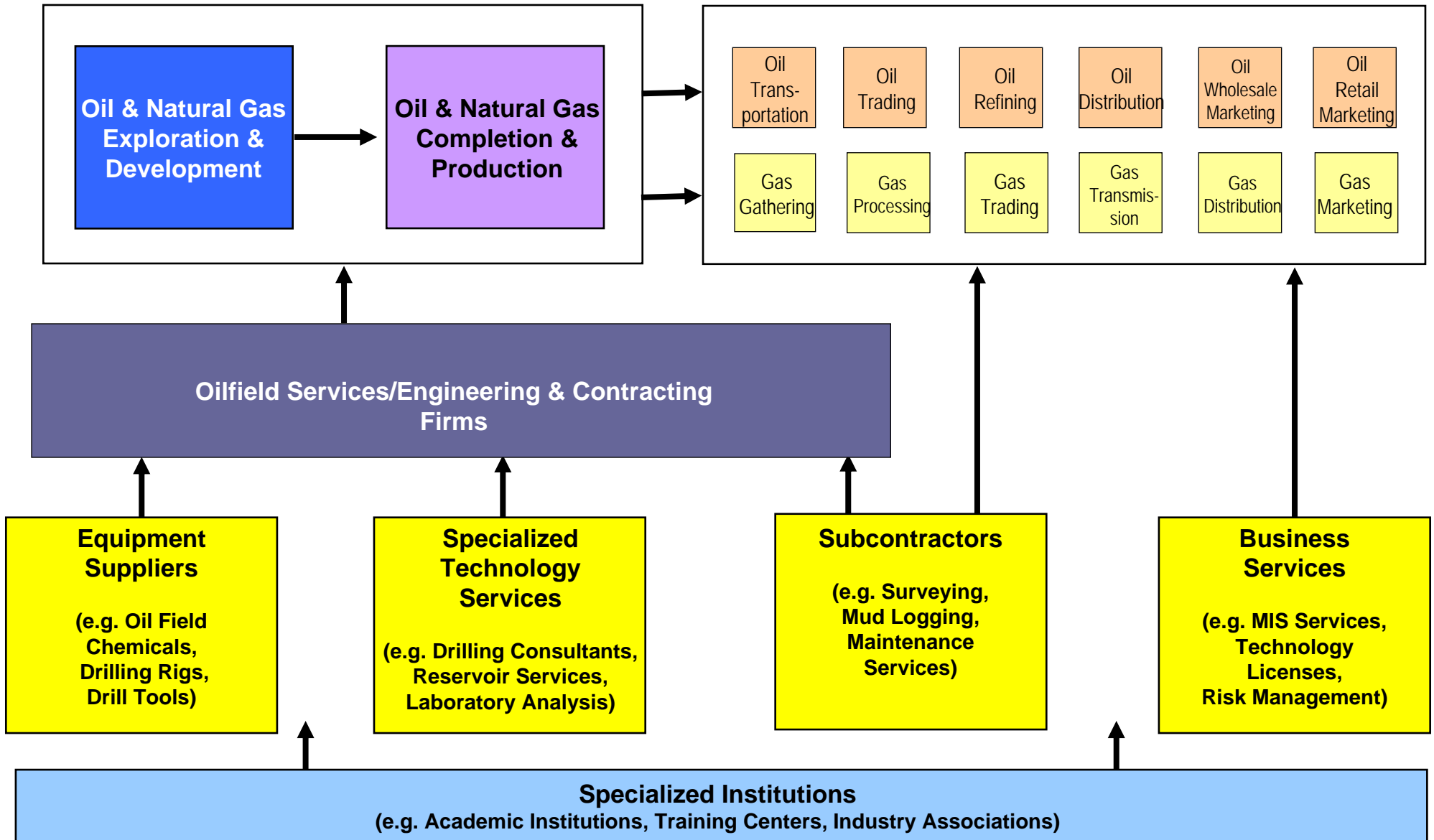


Determinants of Competitiveness

Cluster Development, Houston Oil and Gas

Upstream

Downstream



Clusters and Competitiveness

Clusters Increase Productivity / Efficiency

- Efficient **access** to specialized inputs, services, employees, information, institutions, and “public goods” (e.g. training programs)
- Ease of **coordination** and transactions across firms
- Rapid **diffusion** of best practices
- Ongoing, visible **performance comparisons** and strong incentives to improve vs. local rivals

Clusters Stimulate and Enable Innovations

- Enhanced ability to **perceive innovation opportunities**
- Presence of multiple suppliers and institutions to assist in **knowledge creation**
- Ease of **experimentation** given locally available resources

Clusters Facilitate Commercialization

- Opportunities for **new companies** and **new lines of established business** are more apparent
- **Commercializing** new products and starting new companies is easier because of available skills, suppliers, etc.



Clusters reflect the fundamental influence of **linkages and spill-overs** across firms and associated institutions in competition

Cluster Specialization

Leading Footwear Clusters

Portugal

- Production
- Focus on short-production runs in the medium price range

Romania

- Production subsidiaries of Italian companies
- Focus on lower to medium price range

China

- OEM Production
- Focus on low cost segment mainly for the US market

Italy

- Design, marketing, and production of premium shoes
- Export widely to the world market

United States

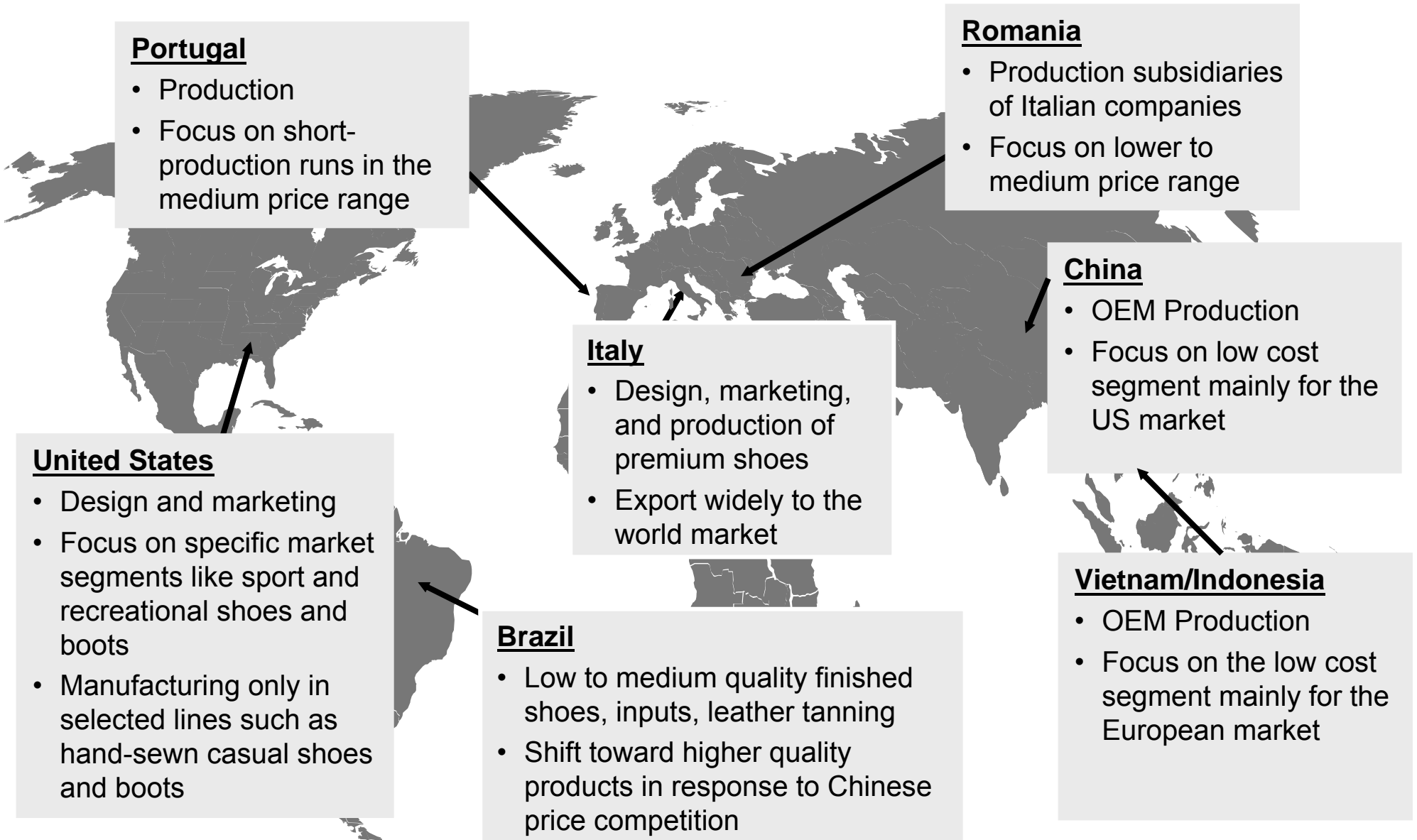
- Design and marketing
- Focus on specific market segments like sport and recreational shoes and boots
- Manufacturing only in selected lines such as hand-sewn casual shoes and boots

Brazil

- Low to medium quality finished shoes, inputs, leather tanning
- Shift toward higher quality products in response to Chinese price competition

Vietnam/Indonesia

- OEM Production
- Focus on the low cost segment mainly for the European market



Institutions for Collaboration

Selected Massachusetts Organizations, Life Sciences

Life Sciences Industry Associations

- Massachusetts Biotechnology Council
- Massachusetts Medical Device Industry Council
- Massachusetts Hospital Association

General Industry Associations

- Associated Industries of Massachusetts
- Greater Boston Chamber of Commerce
- High Tech Council of Massachusetts

Economic Development Initiatives

- Massachusetts Technology Collaborative
- Mass Biomedical Initiatives
- Mass Development
- Massachusetts Alliance for Economic Development

University Initiatives

- Harvard Biomedical Community
- MIT Enterprise Forum
- Biotech Club at Harvard Medical School
- Technology Transfer offices

Informal networks

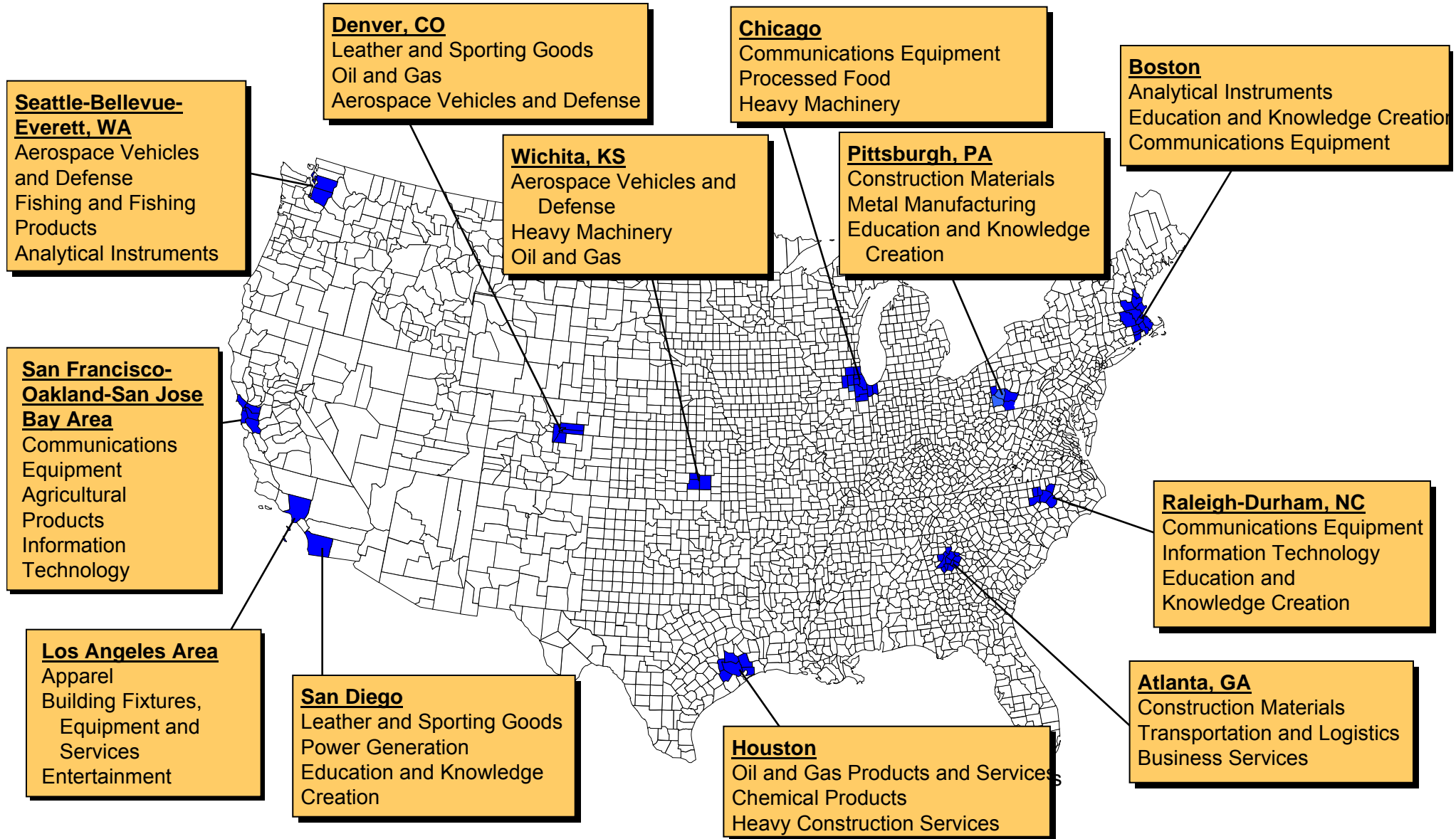
- Company alumni groups
- Venture capital community
- University alumni groups

Joint Research Initiatives

- New England Healthcare Institute
- Whitehead Institute For Biomedical Research
- Center for Integration of Medicine and Innovative Technology (CIMIT)

Specialization of Regional Economies

Select U.S. Geographic Areas

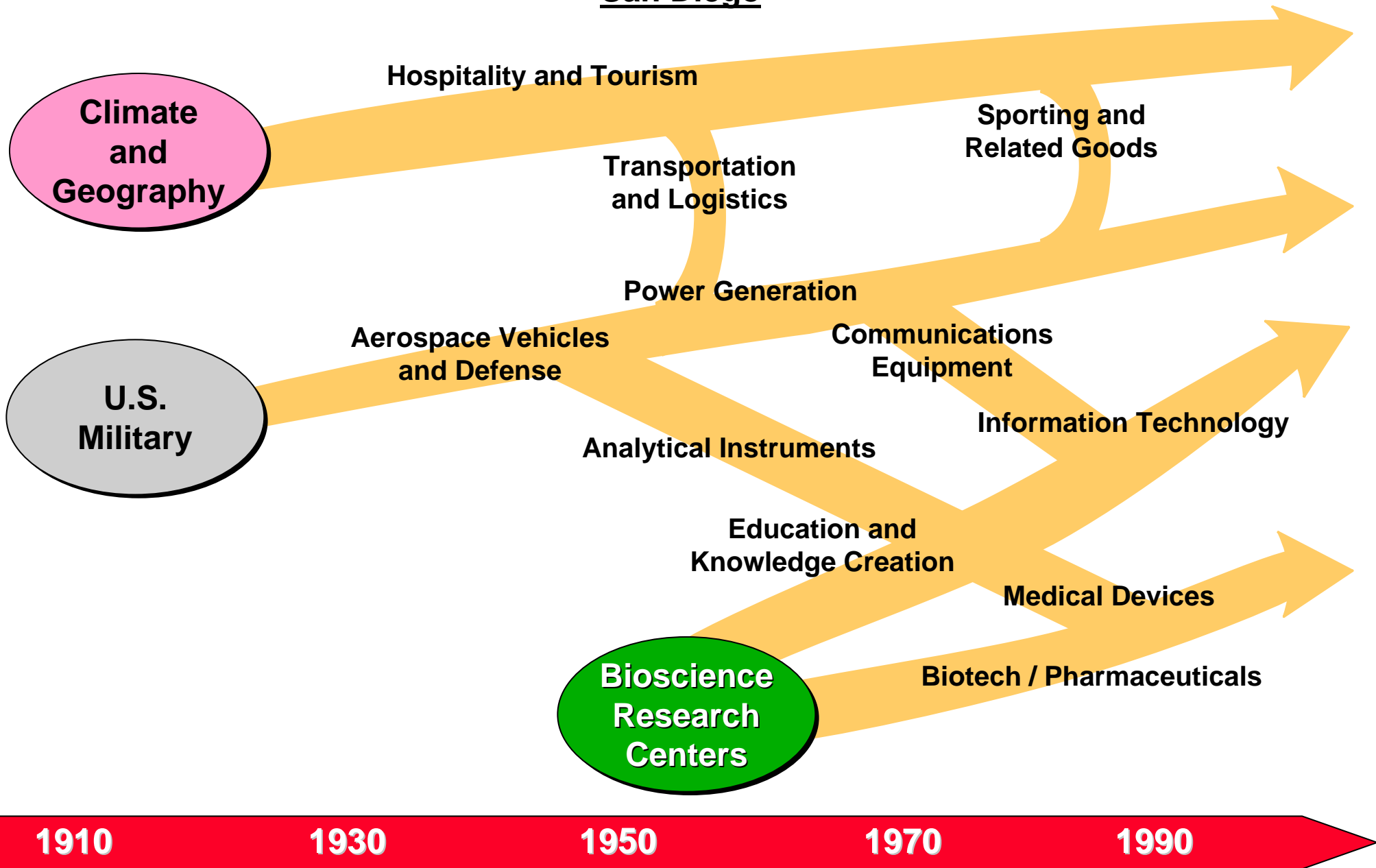


Note: Clusters listed are the three highest ranking clusters in terms of share of national employment

Source: Cluster Mapping Project, Institute for Strategy and Competitiveness, Harvard Business School

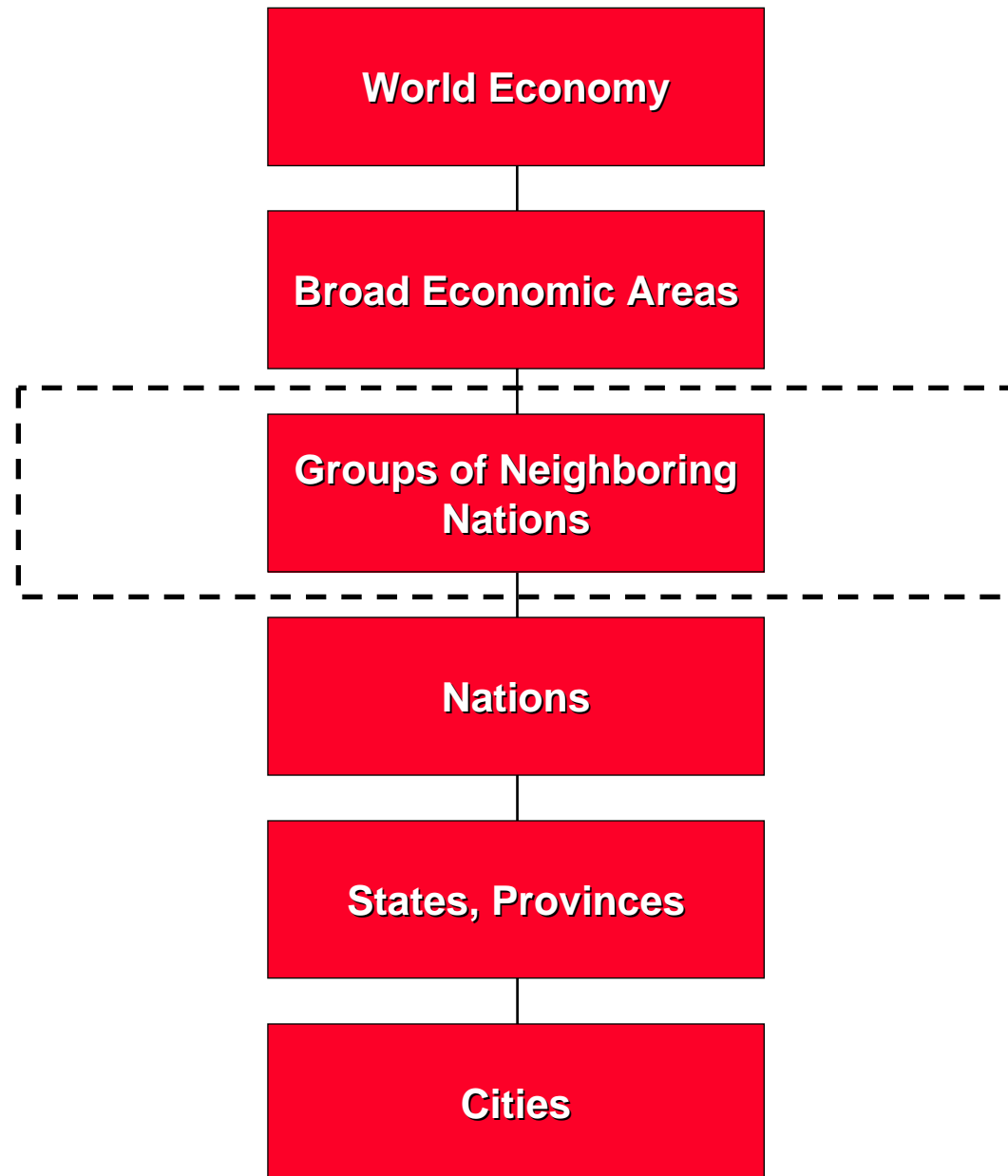
The Evolution of Regional Economies

San Diego



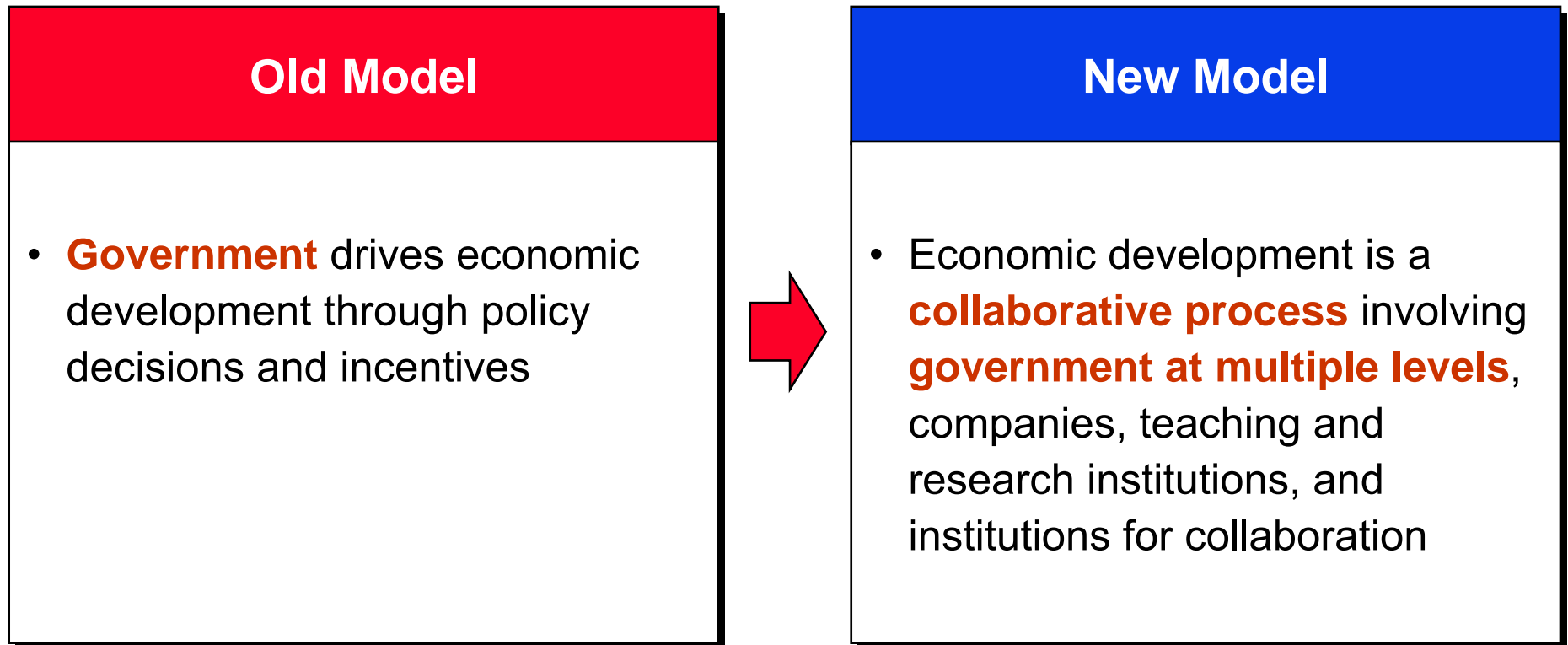
Influences on Competitiveness

Multiple Geographic Levels



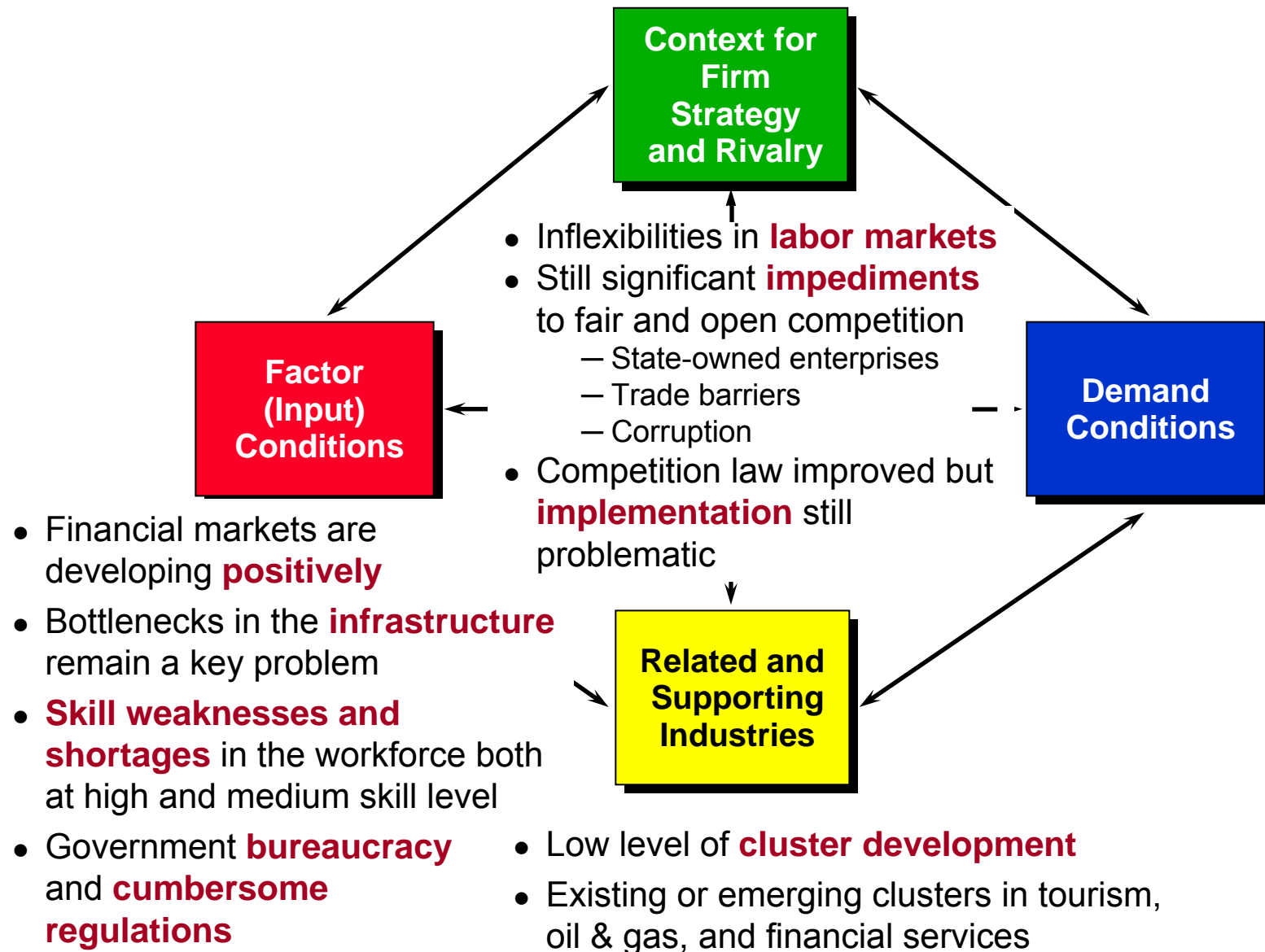
The Process of Economic Development

Shifting Roles and Responsibilities



- Competitiveness must become a **bottoms-up process** in which many individuals, companies, and institutions take responsibility
- **Every** community and cluster can take steps to enhance competitiveness

The Indonesian Business Environment Overview



Factor Conditions

Indonesia Weaknesses 2006

Competitive Disadvantages Relative to GDP per Capita

Country Ranking, Arrows
indicate a change of 5 or more
ranks since 2001

Port infrastructure quality	98	↓
Reliability of police services	98	
Overall infrastructure quality	95	↓
Judicial independence	90	
Quality of electricity supply	87	↓
Financial market sophistication	83	↓
Telephone/fax infrastructure quality	81	
University/industry research collaboration	78	↓
Efficiency of legal framework	75	↑
Air transport infrastructure quality	70	
Railroad infrastructure development	63	↓
Quality of public schools	42	↑

Note: Rank versus 121 countries; overall, Indonesia ranks 35th in Business Competitiveness and 83rd in 2005 PPP adjusted GDP per capita.

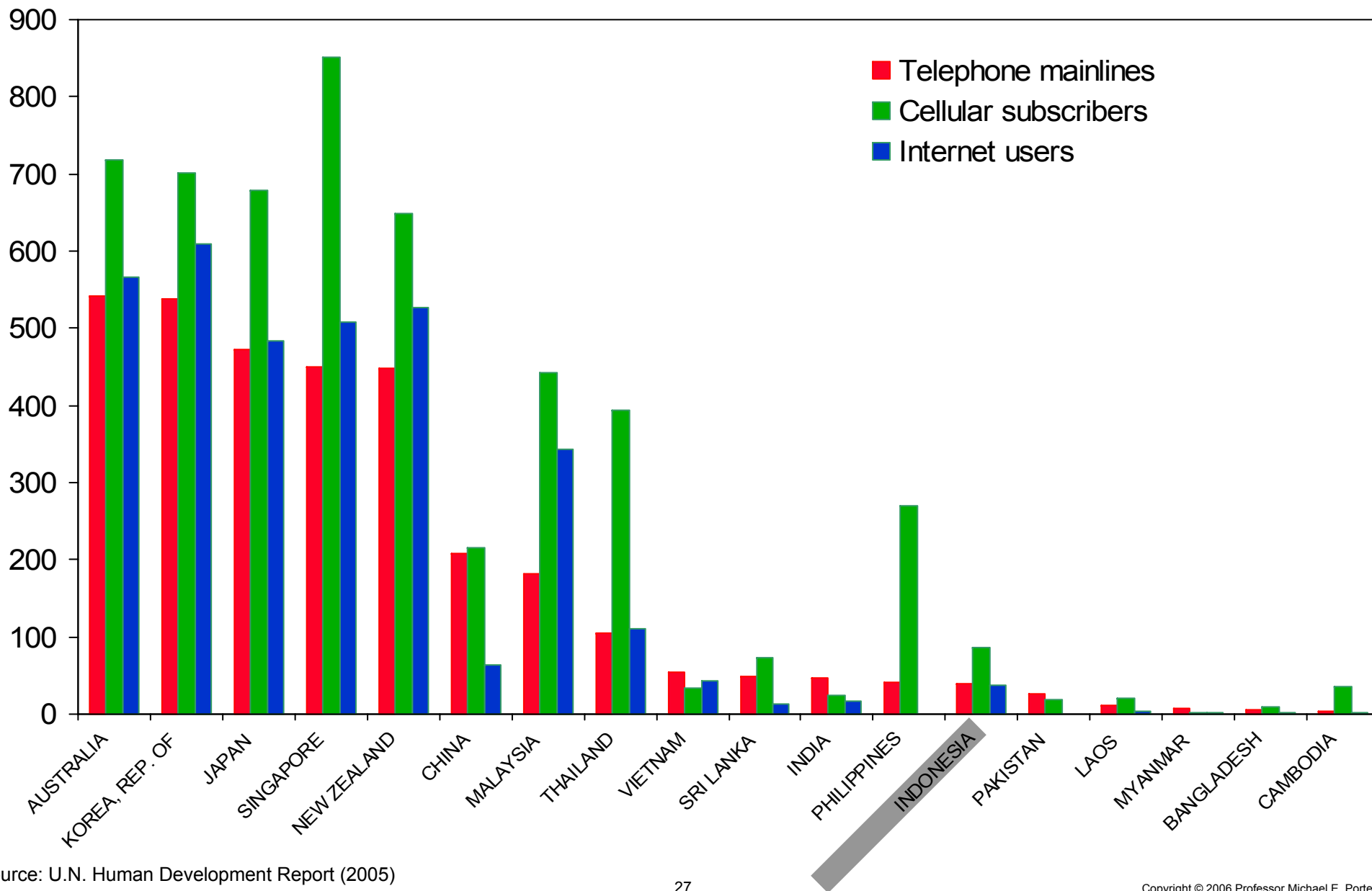
Source: Global Competitiveness Report 2006-2007.

**Factor
(Input)
Conditions**

Communications Infrastructure

Selected Countries

Per 1,000
inhabitants, 2003



Source: U.N. Human Development Report (2005)

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Business Regulations

Indonesia's Relative Position 2006

Competitive Advantages Relative to GDP per Capita

	Country Ranking
Protecting Investors	60
Trading Across Borders	60
Getting Credit	83

Competitive Disadvantages Relative to GDP per Capita

	Country Ranking
Starting a Business	161
Enforcing Contracts	145
Employing Workers	140
Closing a Business	136
OVERALL	135
Paying Taxes	133
Dealing with Licenses	131
Registering Property	120

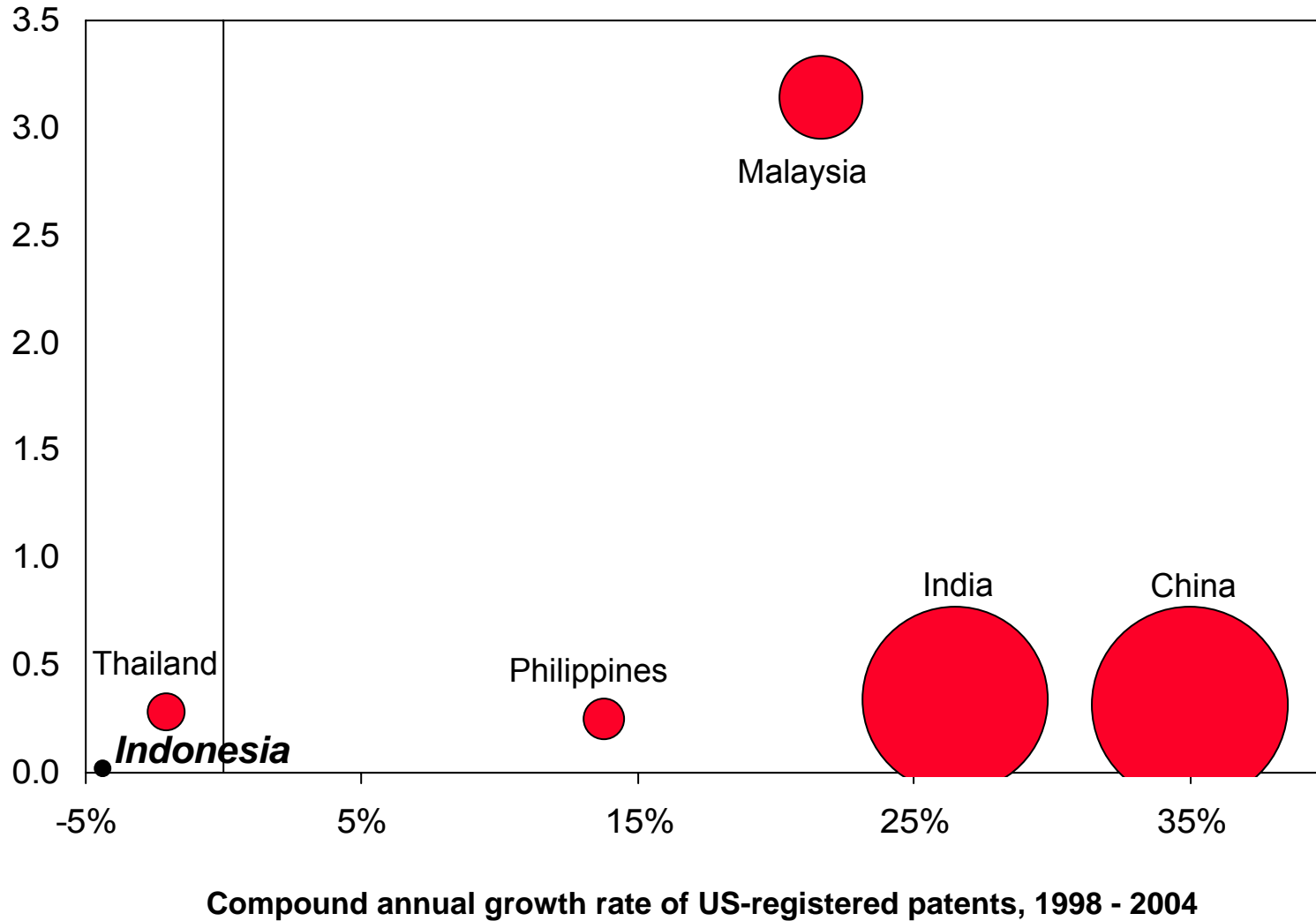
Note: Out of 175 countries, Indonesia ranks 110st in 2005 PPP adjusted GNI per capita.

Source: World Bank, Doing Business (2006)

**Factor
(Input)
Conditions**

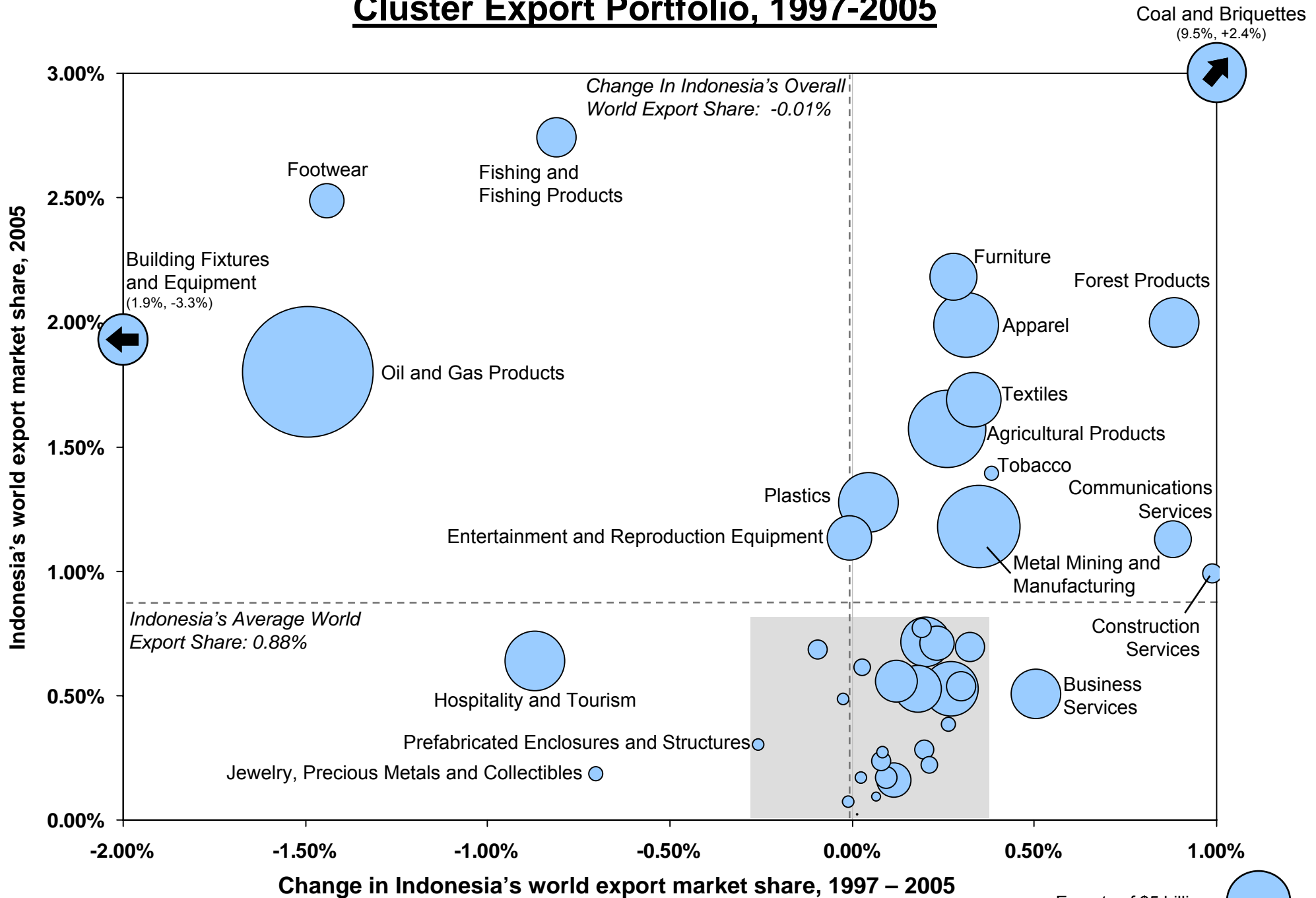
International Patenting Output Selected Countries

Annual U.S. patents per 1 million population, 2004



Indonesia

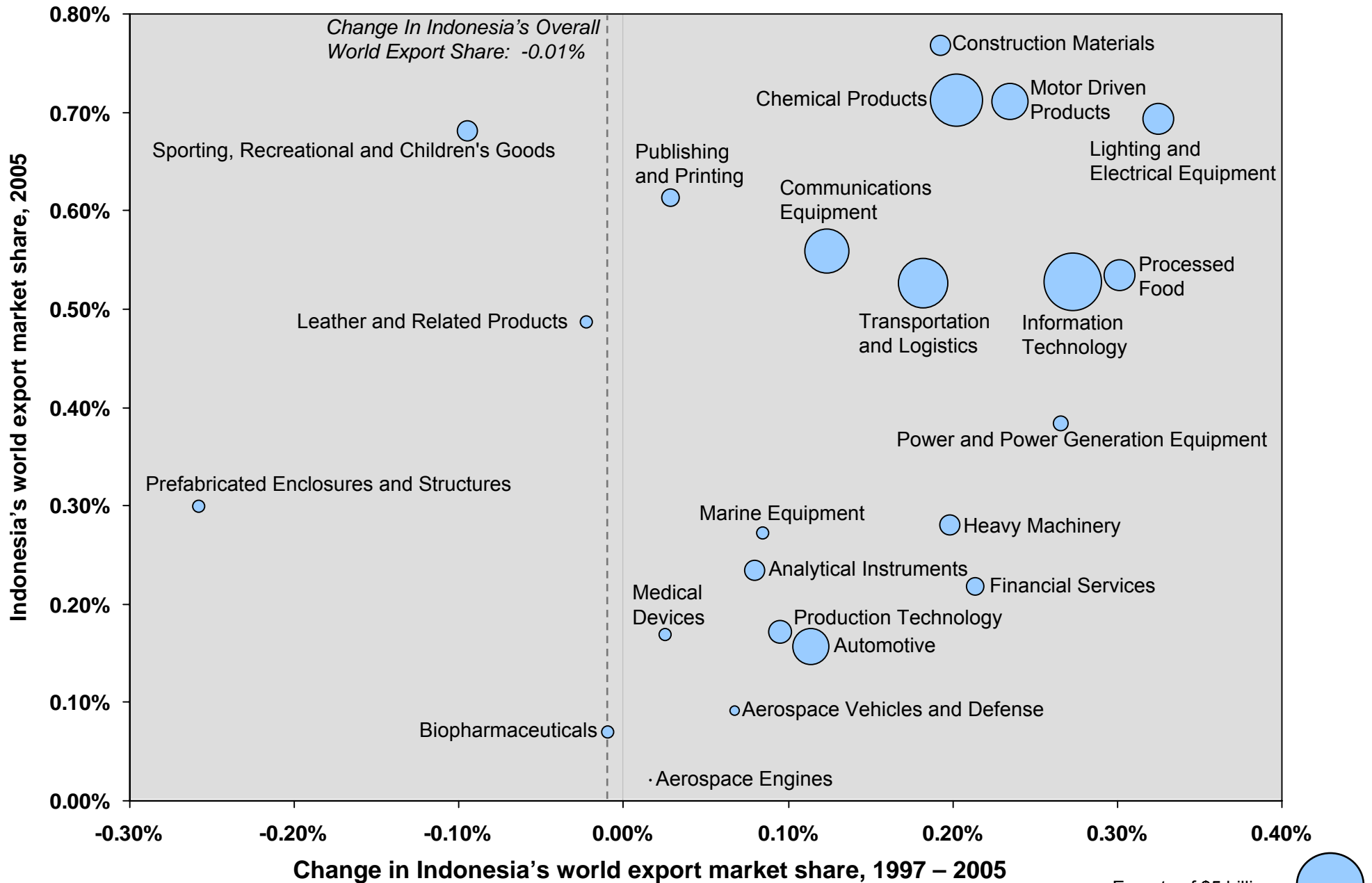
Cluster Export Portfolio, 1997-2005



Source: Prof. Michael E. Porter, International Cluster Competitiveness Project, Institute for Strategy and Competitiveness, Harvard Business School; Richard Bryden, Project Director. Underlying data drawn from the UN Commodity Trade Statistics Database and the IMF BOP statistics.
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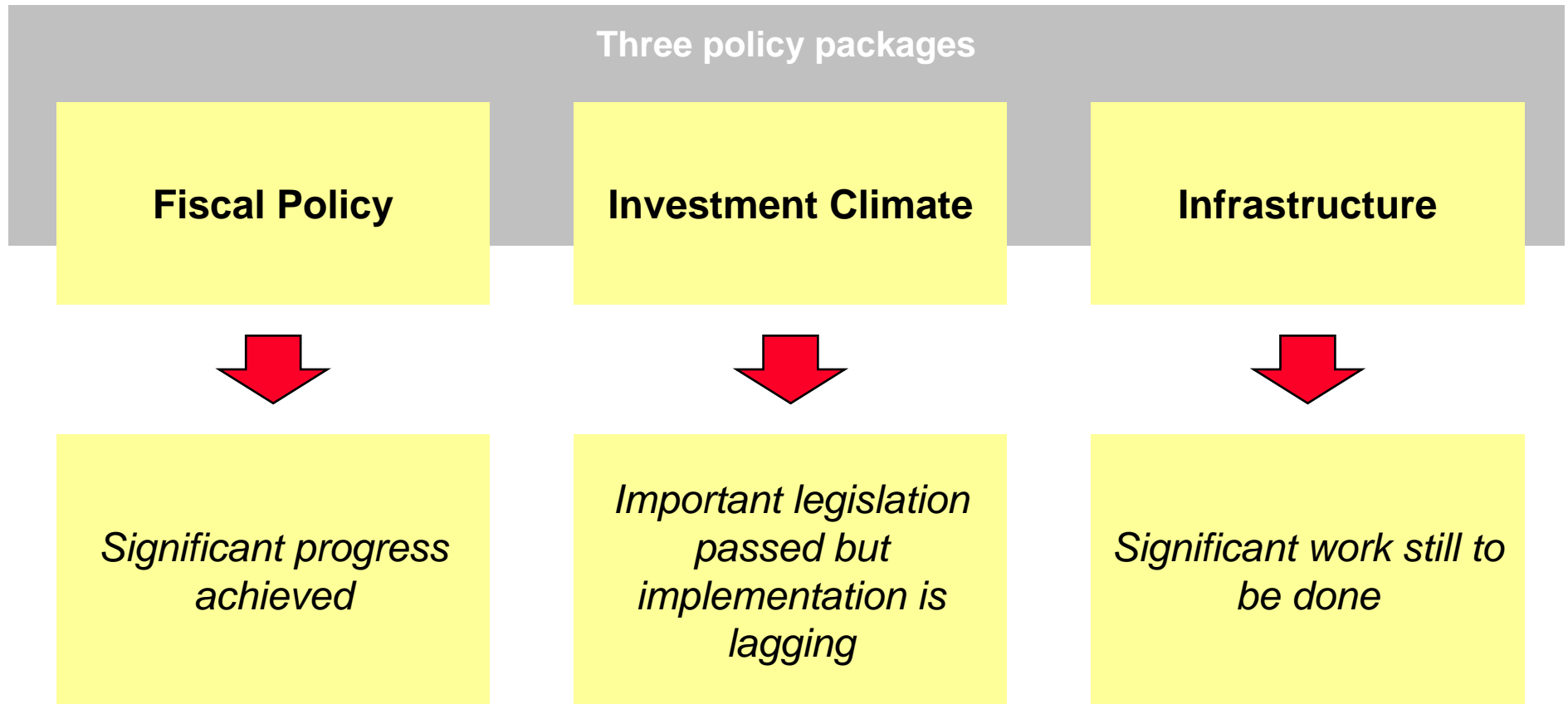
Indonesia

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Indonesian Economic Policy Priorities



- A central policy challenge is one of **implementation** and **consistency**
- **Microeconomic reforms** are especially challenging, with inadequate coordination of different government agencies and regions

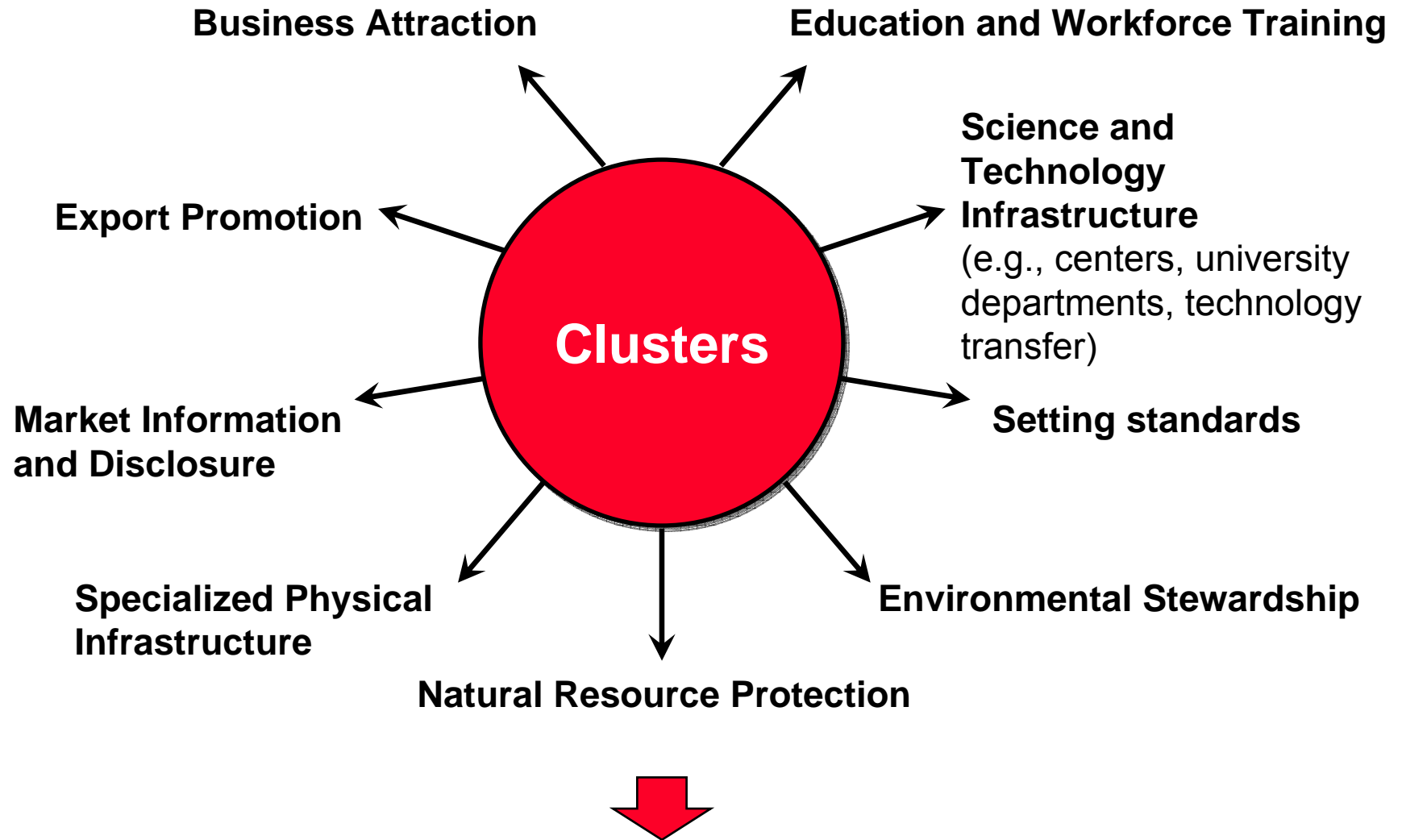
Priorities for Indonesia

- Improve the macroeconomic, political, legal, and social context
 - Legal system reform
 - Institutional and policy stability
 - Government simplification / professionalism
 - Social safety net versus subsidies
 - Structure for public / private policy coordination
- Upgrade the business environment
 - Infrastructure
 - Skills
 - Special Economic Zones
 - Fast track organizations
 - SOE governance / privatization
- Move to cluster-based economic development
- New approaches for FDI attraction
 - Cluster approach
- Effective regionalization of economic development
 - “Regional economic development agreements”
- Enhance ASEAN economic integration



- National Economic Strategy

Clusters and Public Policy



- Clusters provide a framework for **organizing the implementation** of public policy and public investments towards economic development

National Economic Strategy

Value Proposition

- What is the **unique competitive position of the** nation (or region)?
 - What roles in world and regional economy?
 - What unique value as a business location?
 - For what range and types of businesses and functions can the nation or region be competitive?

Developing Unique Strengths

- What **elements of the business environment** are essential to the national or regional value proposition?
- What **existing and emerging clusters** must be mobilized?

Achieving and Maintaining Parity with Peers

- What **macro/political/legal/social improvements** are necessary to maintain parity with peer countries or regions?
- What areas of the **general business environment** must improve to maintain parity with peer countries or regions?