

# Improving Indonesia's Competitiveness

Presentation to President Susilo Bambang Yudhoyono

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Harvard Business School  
*Boston, Massachusetts*  
*September 28, 2009*

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This presentation draws on ideas from Professor Porter's articles and books, including, *The Competitive Advantage of Nations* (The Free Press, 1990), "The Microeconomic Foundations of Economic Development," in *The Global Competitiveness Report*, (World Economic Forum), "Clusters and the New Competitive Agenda for Companies and Governments" in *On Competition* (Harvard Business School Press, 2008) and ongoing research at the Institute for Strategy and Competitiveness. 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 Michael E. Porter. Further information on Professor Porter's work and the Institute for Strategy and Competitiveness is available at [www.isc.hbs.edu](http://www.isc.hbs.edu),  
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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**

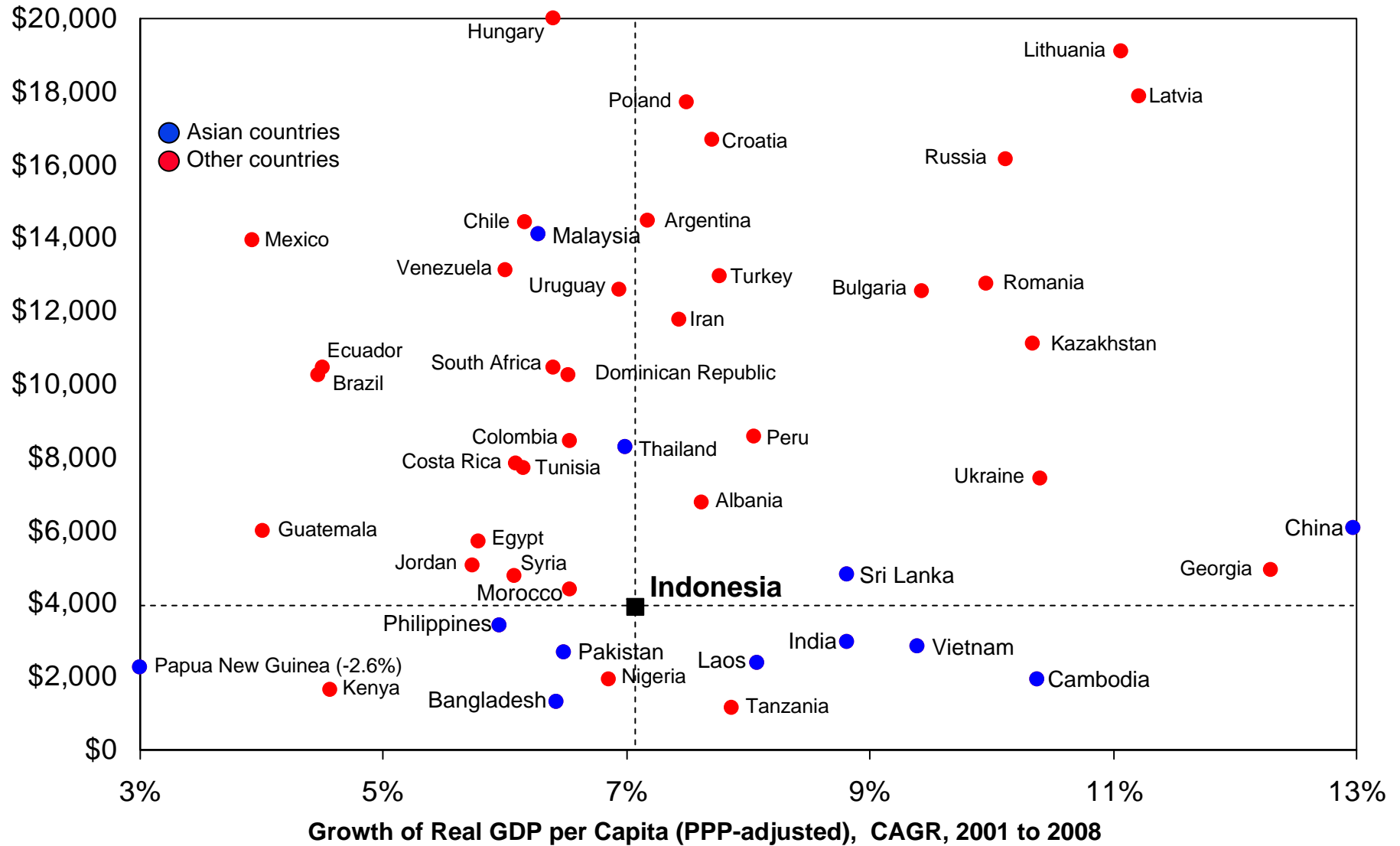


- National **economic strategy**
- **Organizing for competitiveness**

# Prosperity Performance

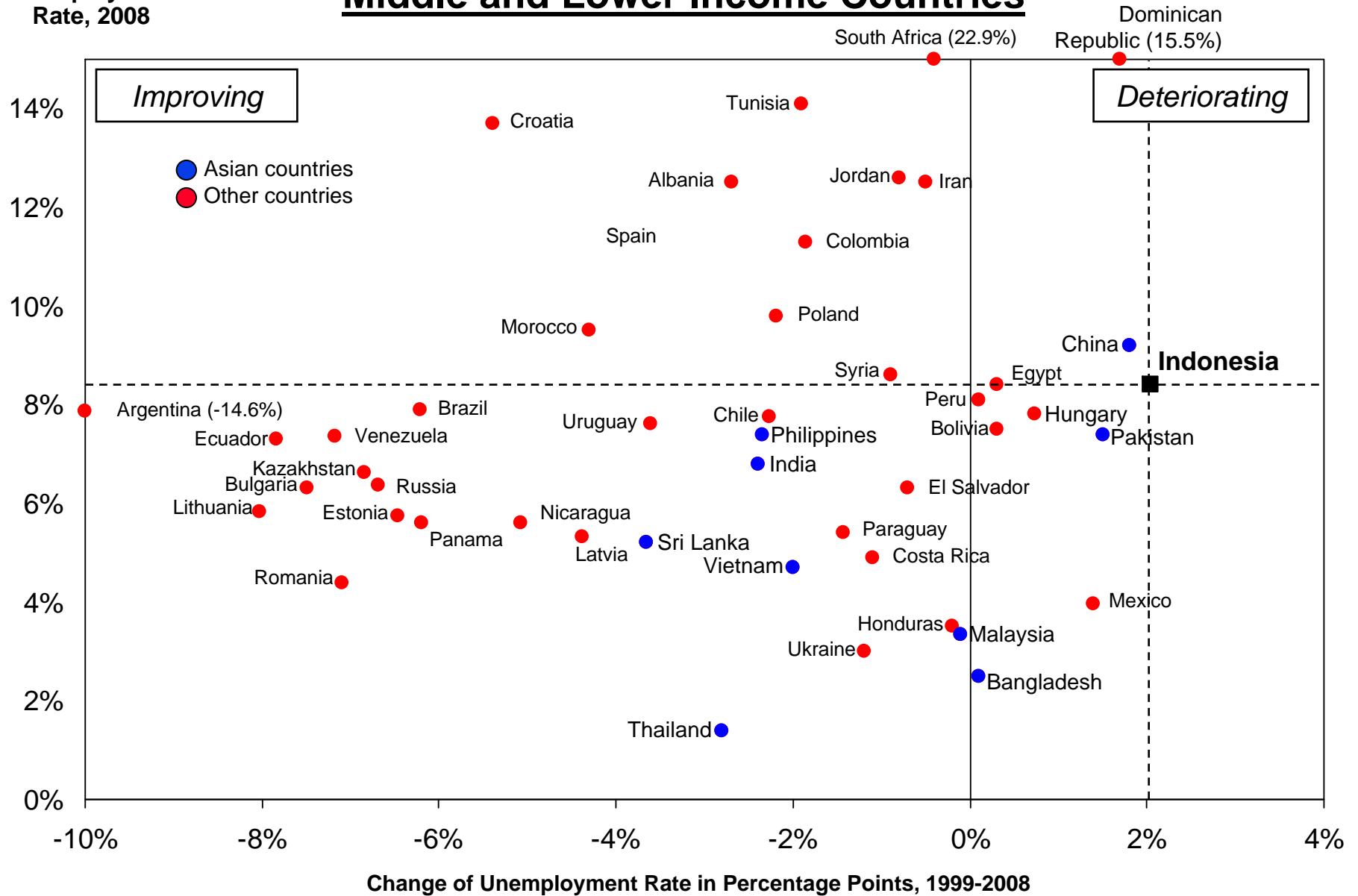
## Lower and Middle Income Countries

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



# Unemployment Performance Middle and Lower Income Countries

Unemployment  
Rate, 2008



Note: In some cases, 1999 data was unavailable, so latest data used.

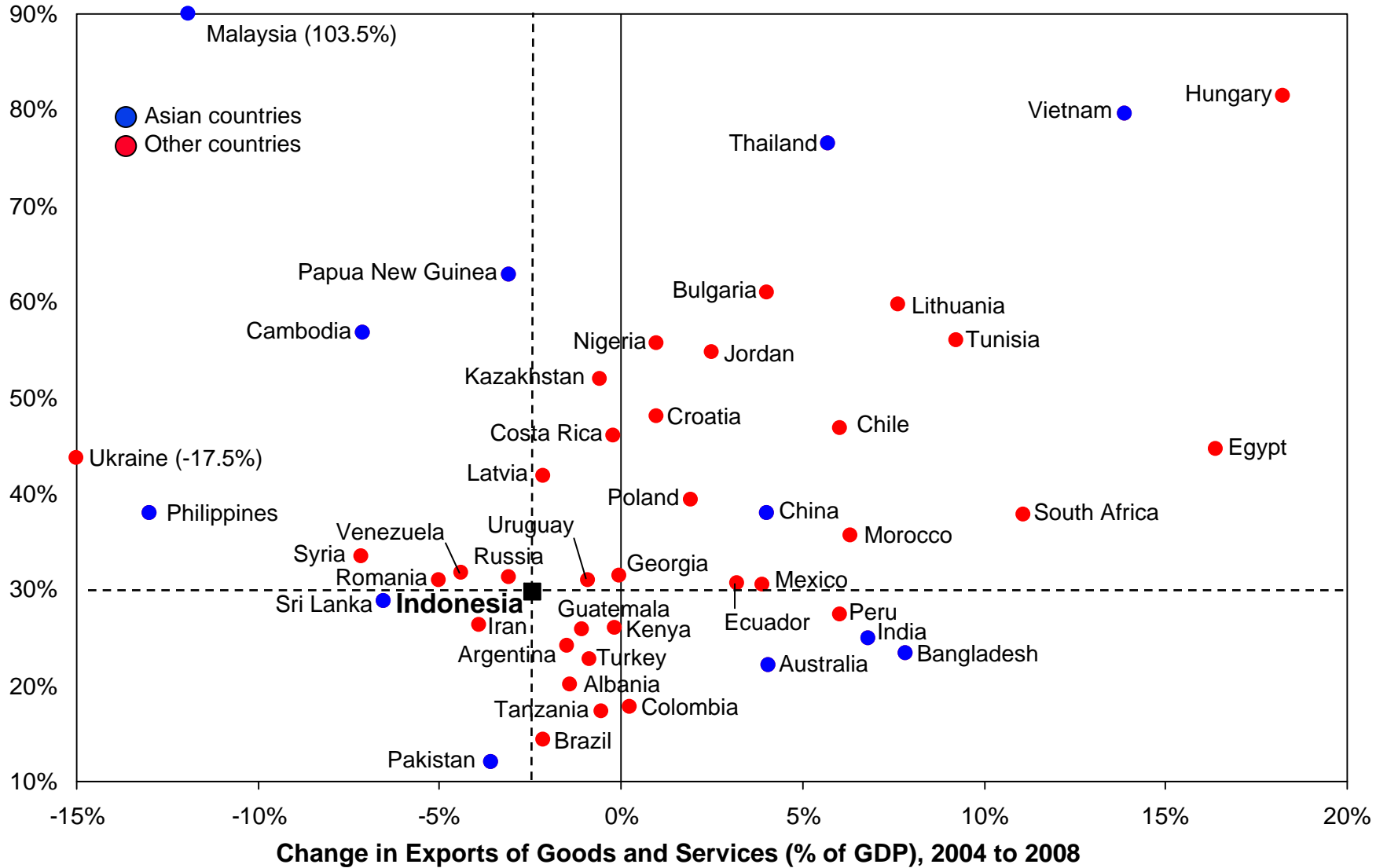
Source: EIU (2009)

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# Export Performance

## Middle and Lower Income Countries

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



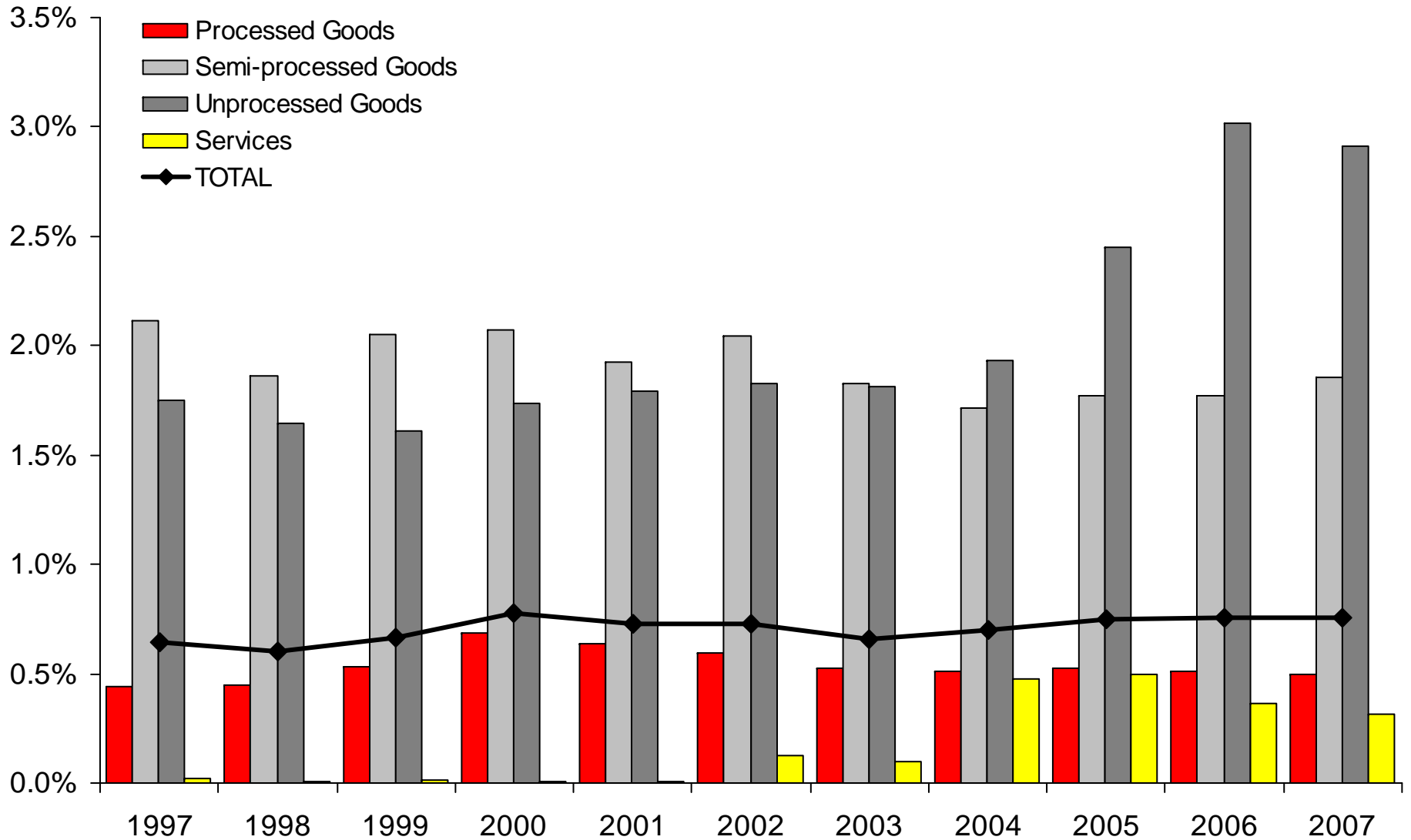
Source: EIU (2008), authors' analysis

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# Indonesia Exports By Type of Industry

## Excluding Oil and Gas Industry

World Export Market Share (current USD)



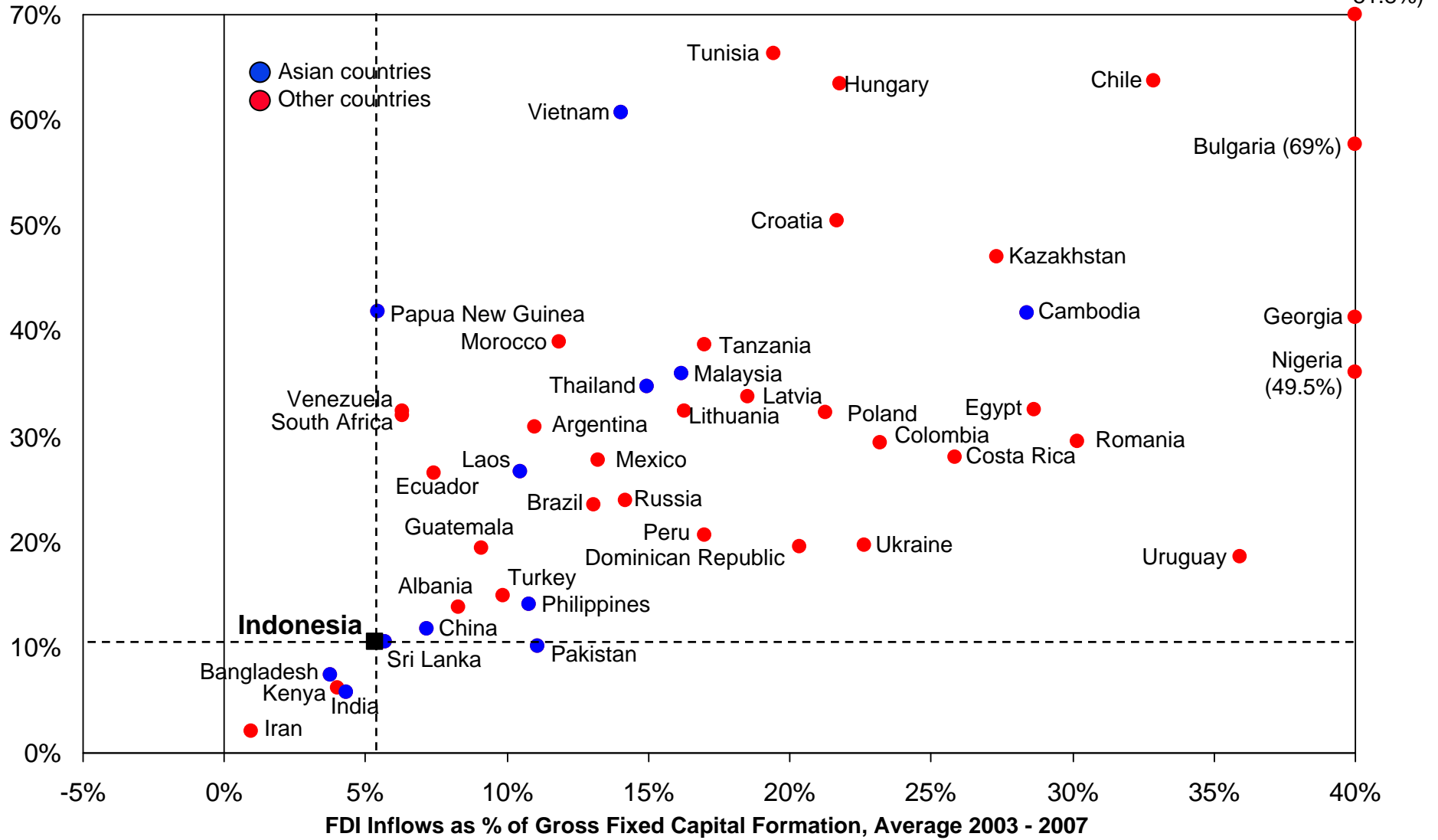
Note: Excluding Oil and Gas cluster

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

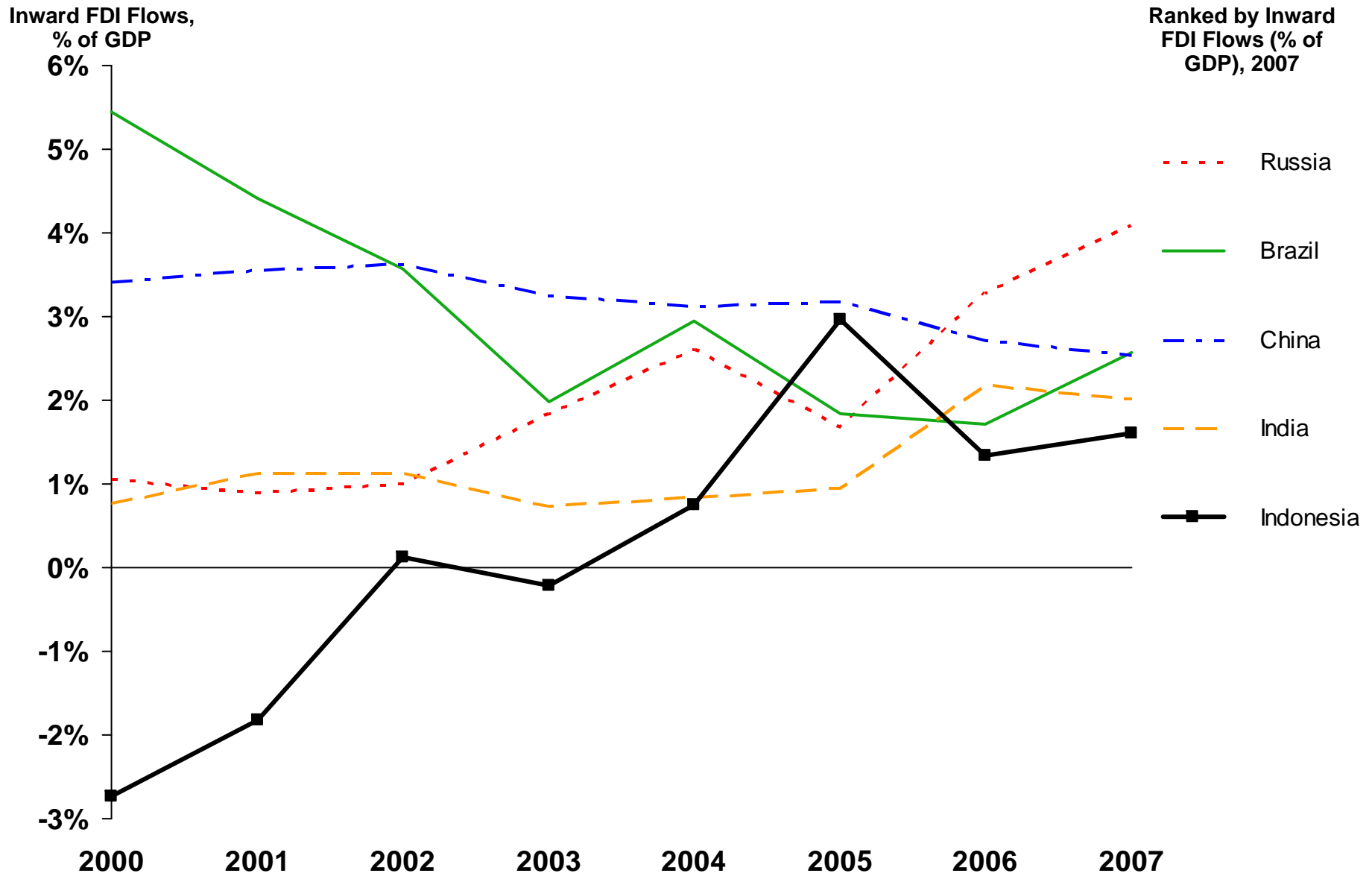


Source: UNCTAD, World Investment Report (2009)

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# Inbound Foreign Investment Performance

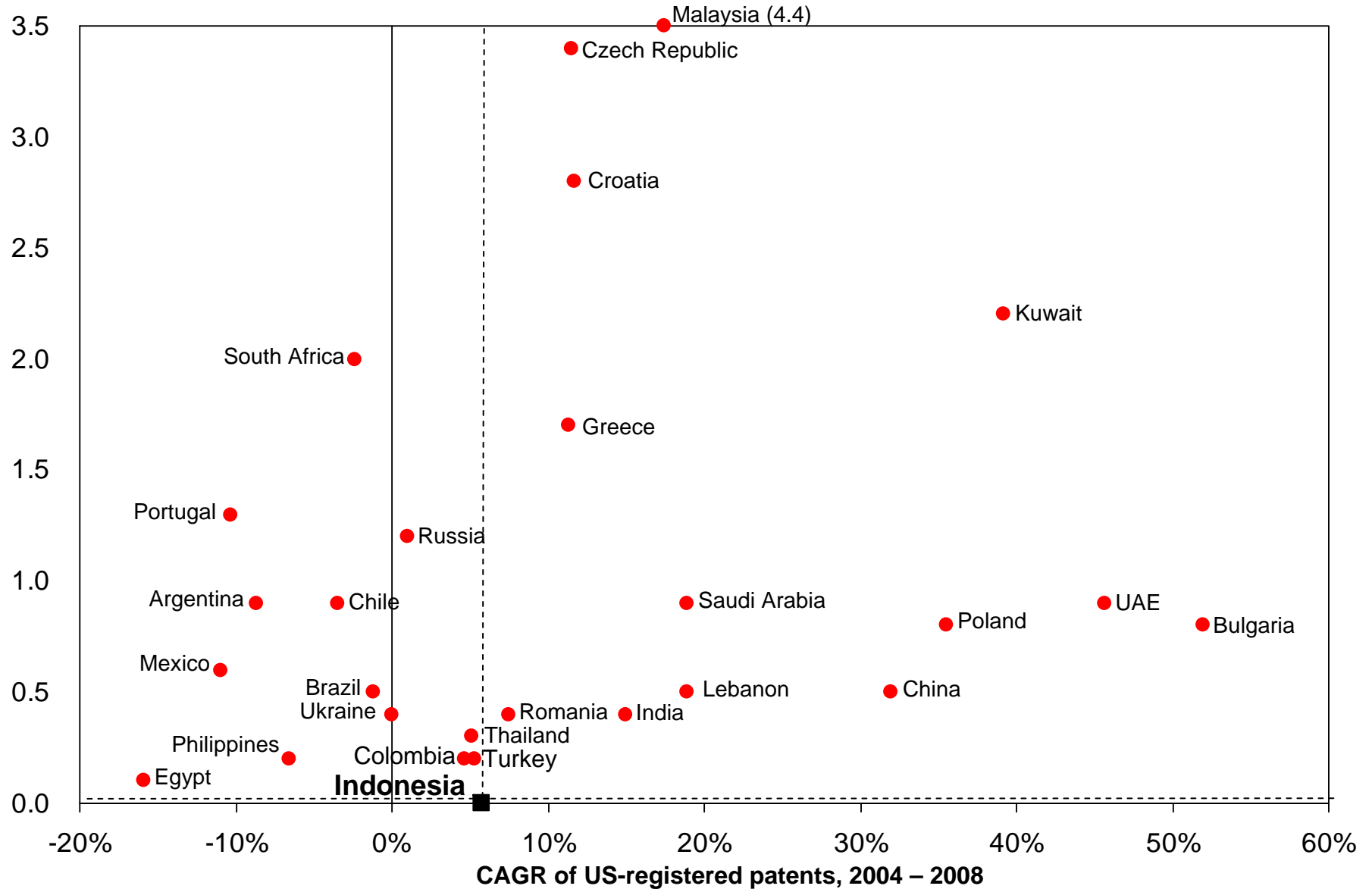
## Flows, Selected Countries





# Innovative Output, Selected Countries

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



Source: USPTO (2008), EIU (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

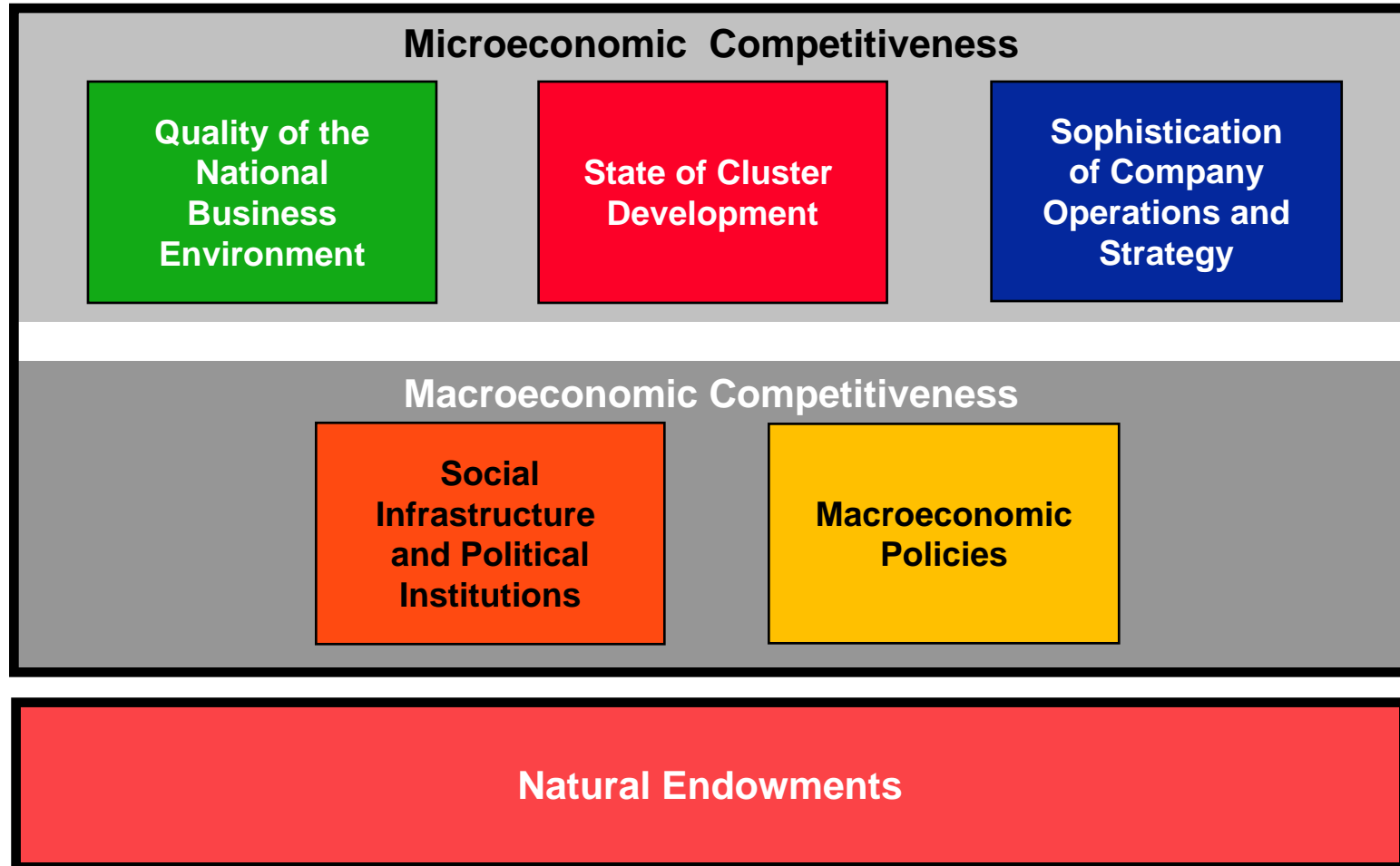
# What is Competitiveness?

- 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

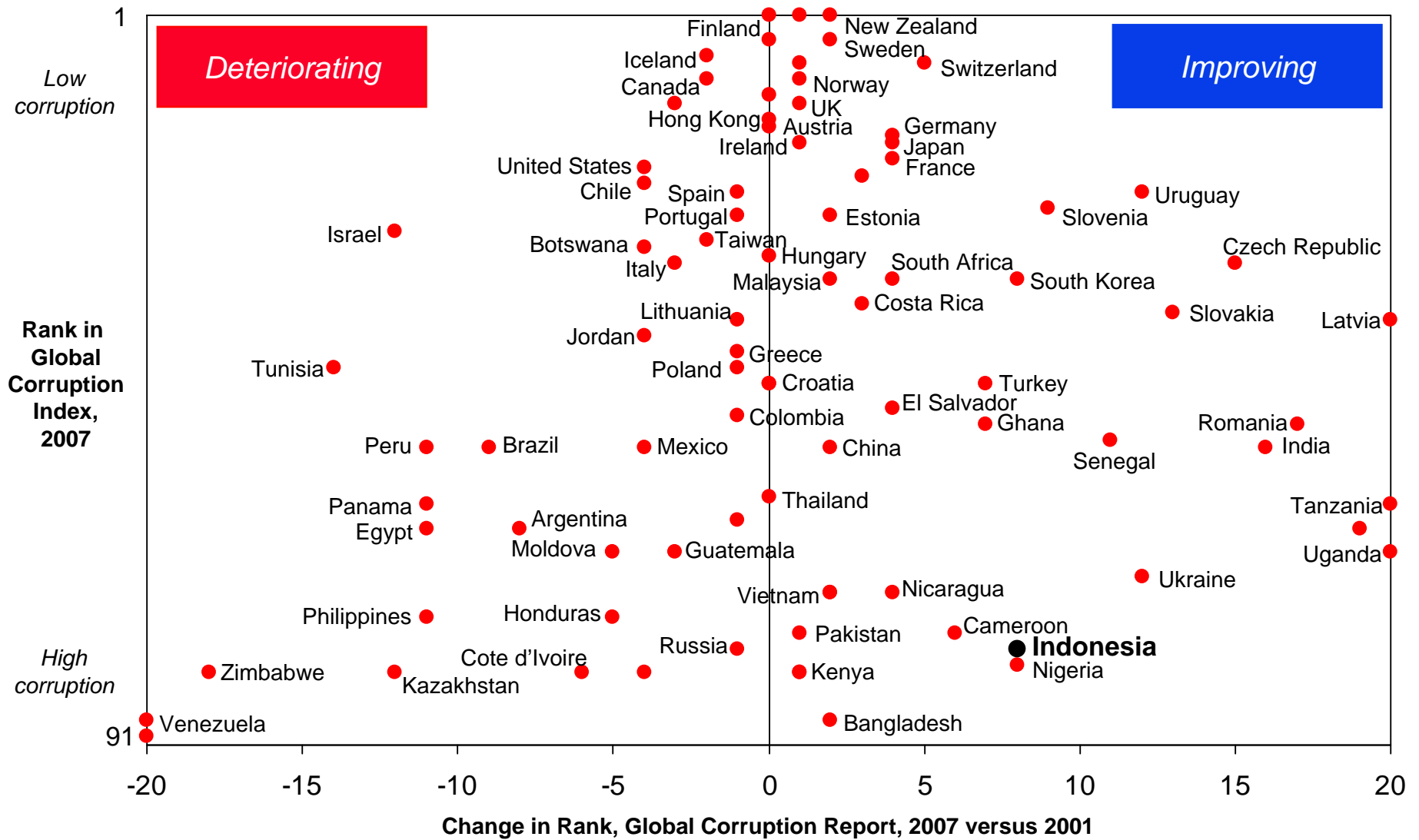


- Natural endowments alone are **not enough** to support a high standard of living
- **Macroeconomic competitiveness** creates the potential for productivity
- Productivity ultimately depends on improving the **microeconomic capability** of the economy and the **sophistication of local competition**

# 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



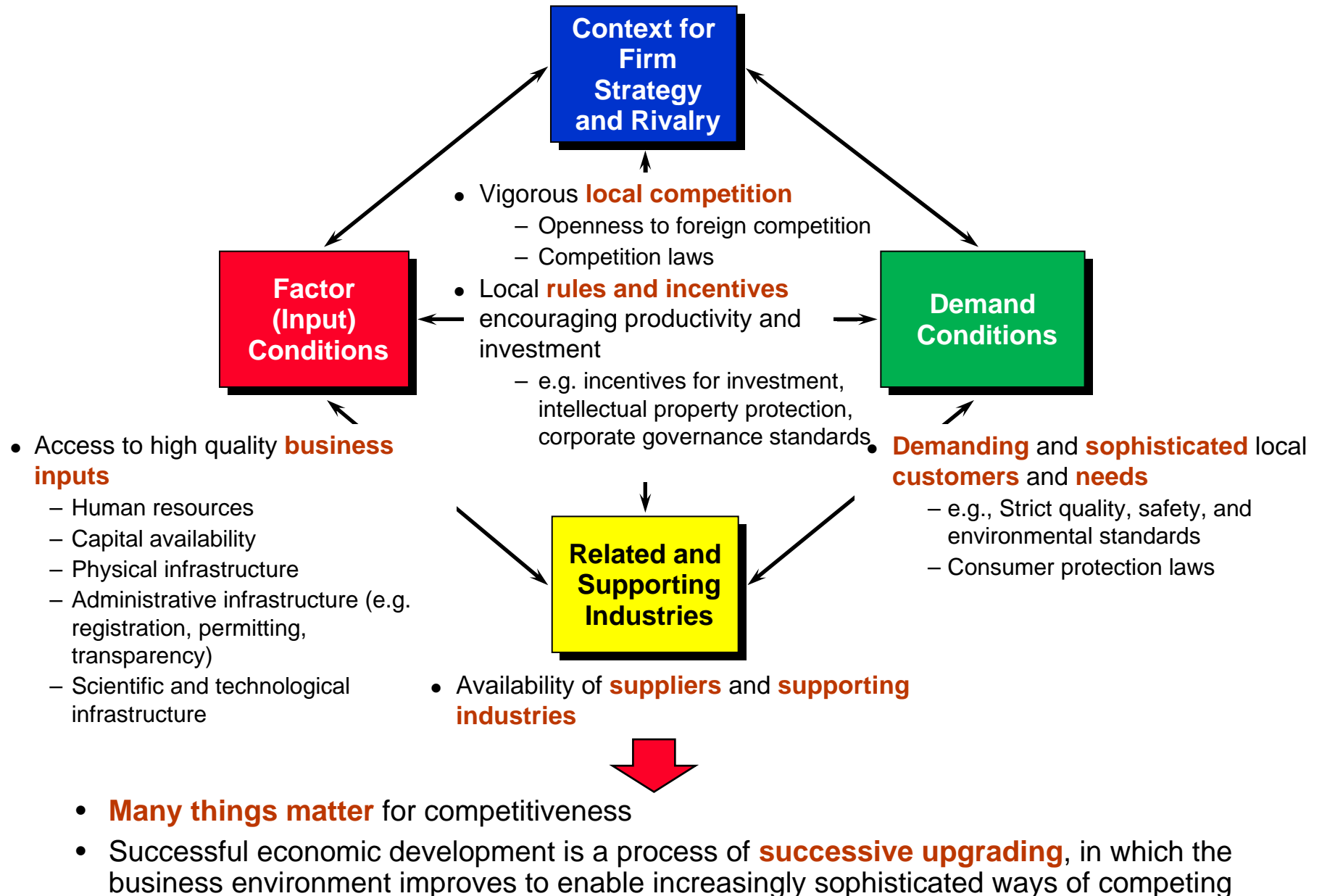
Note: Ranks only countries available in both years (91 countries total)  
 Source: Global Corruption Report, 2008

# Indonesia's Macroeconomic Competitiveness

## Action Priorities

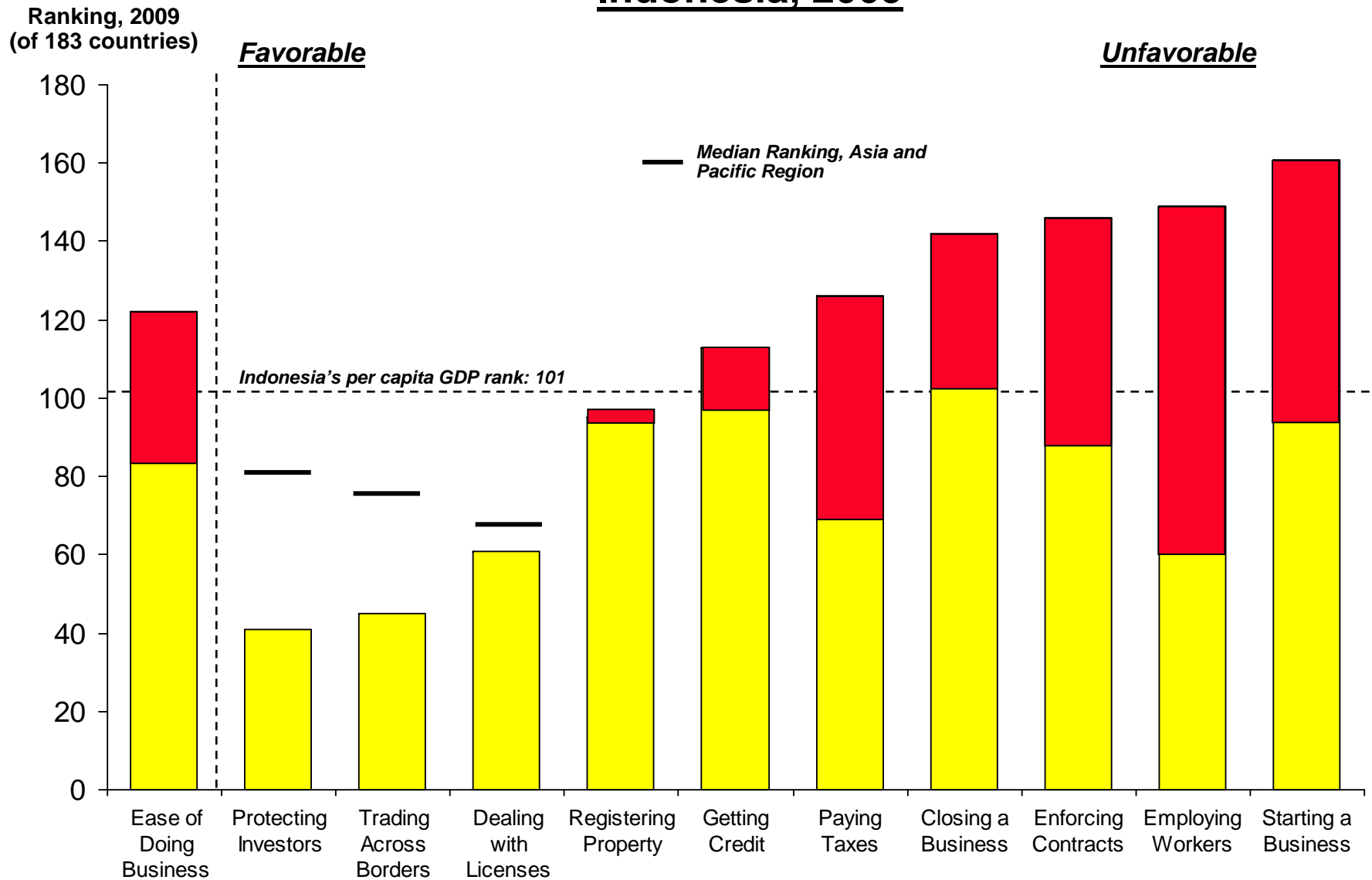
- Sustain progress in improving the **stability of the political system** and the battle against **terrorism**
- Intensify the **fight against corruption**
- Sustain the focus on **stable government finances**, while enabling more effective execution of **public sector investments**
- Create and implement 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





# Ease of Doing Business Indonesia, 2009



Source: World Bank Report, Doing Business (2009)

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# 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

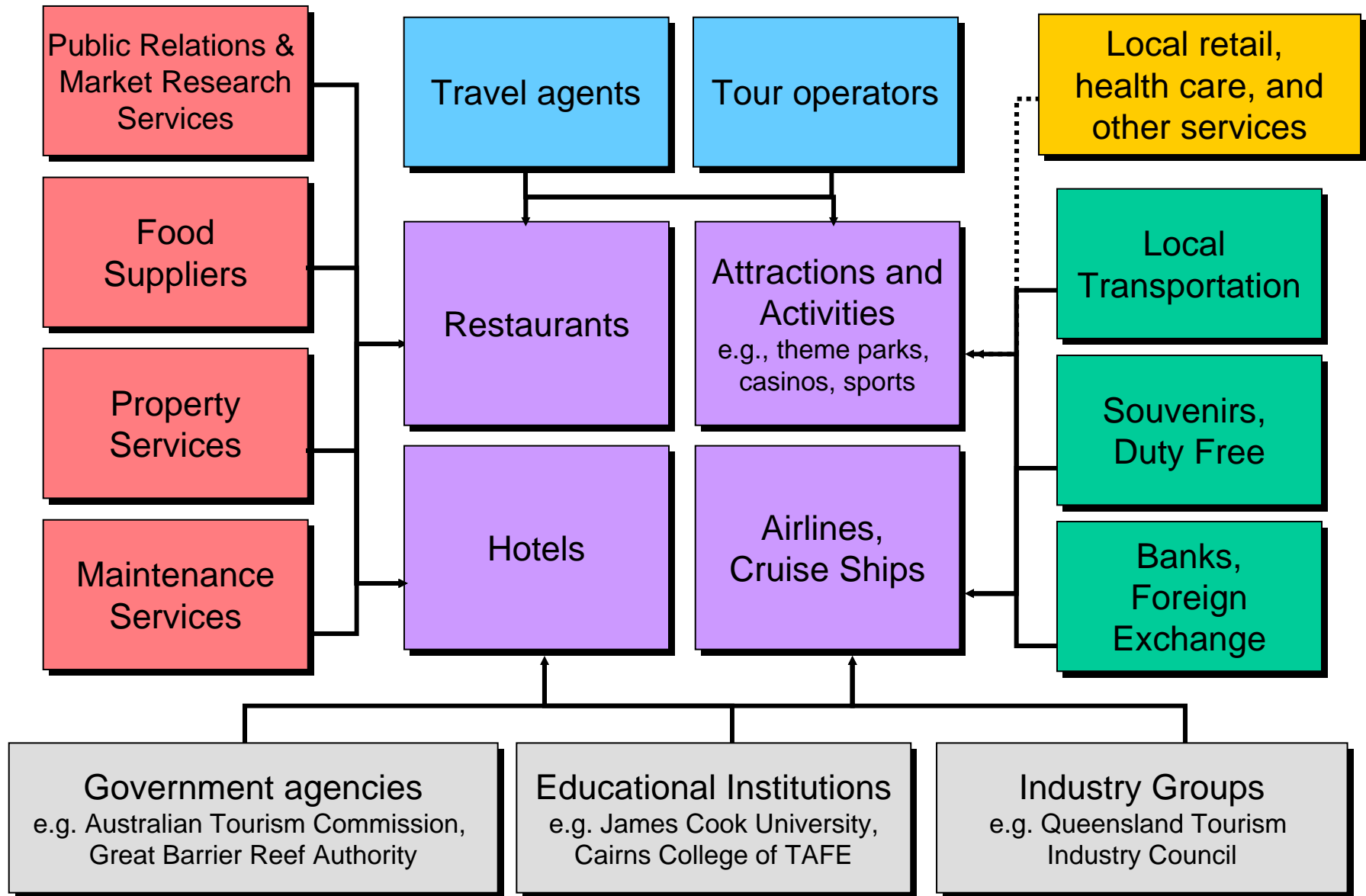
# Indonesian Business Environment

## Action Priorities

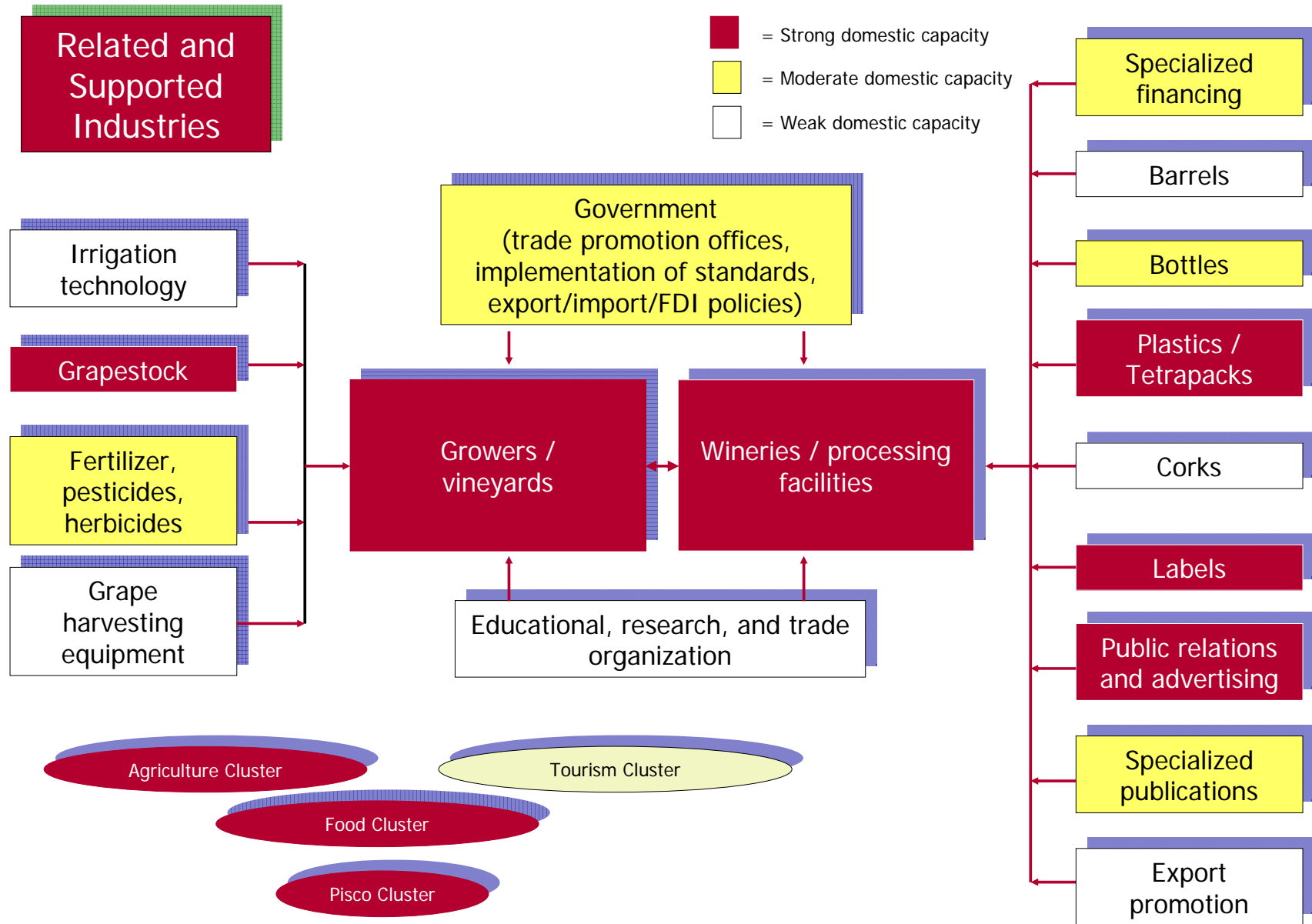
- Continue progress on **regulatory reforms**
- Improve **logistical** infrastructure
- Improve **communications** infrastructure
- Improve the quality of **electricity supply**
- Reduce rigidities in the **labor market**
- Reform **customs procedures** and continue the process of **opening** to international 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



# Chilean Wine Cluster

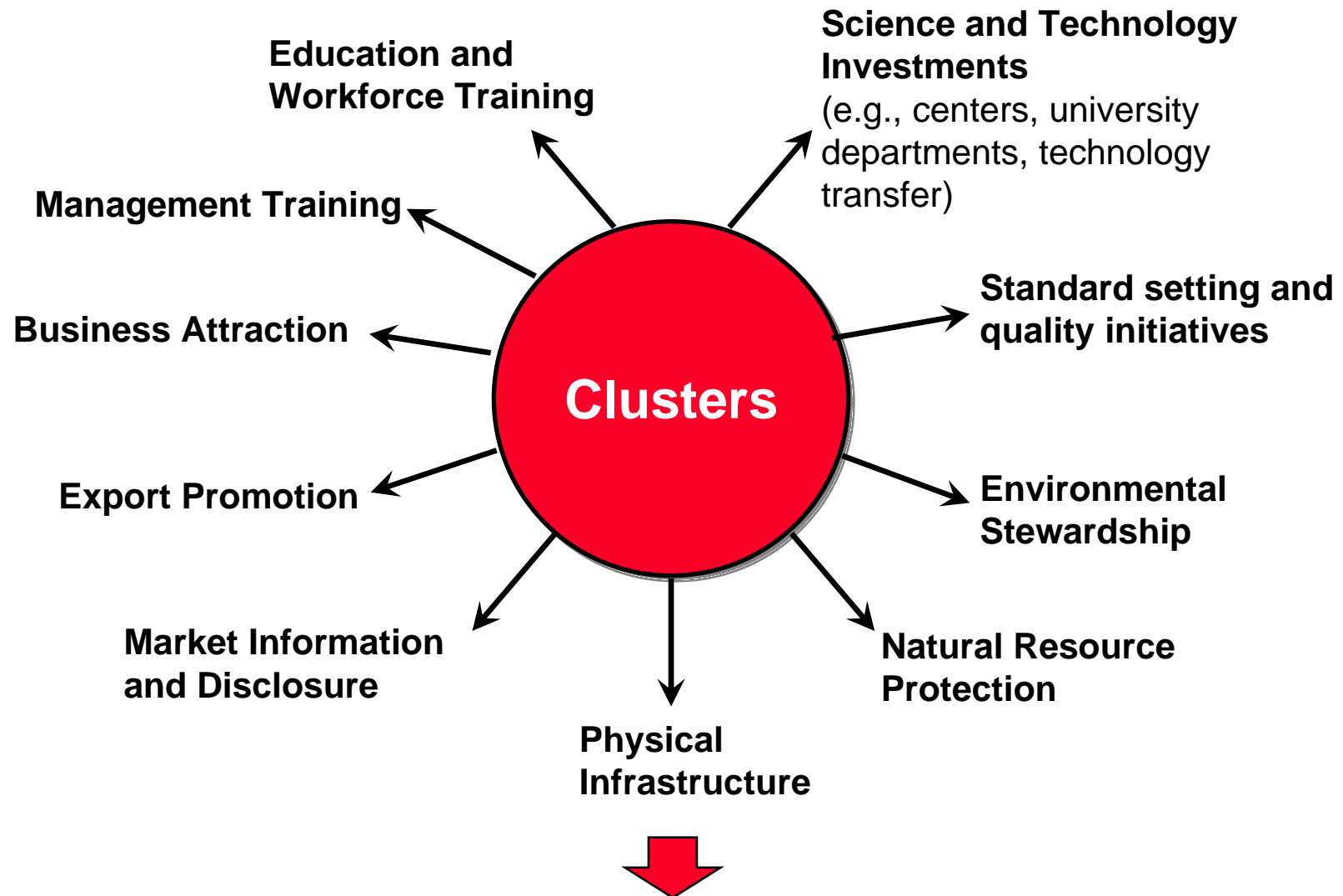


Source: Research by HBS student team (Asier Alea, Judd Belstock, Don Lambert, Jacqueline O'Neill, Noah Sawyer), 2005

# 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



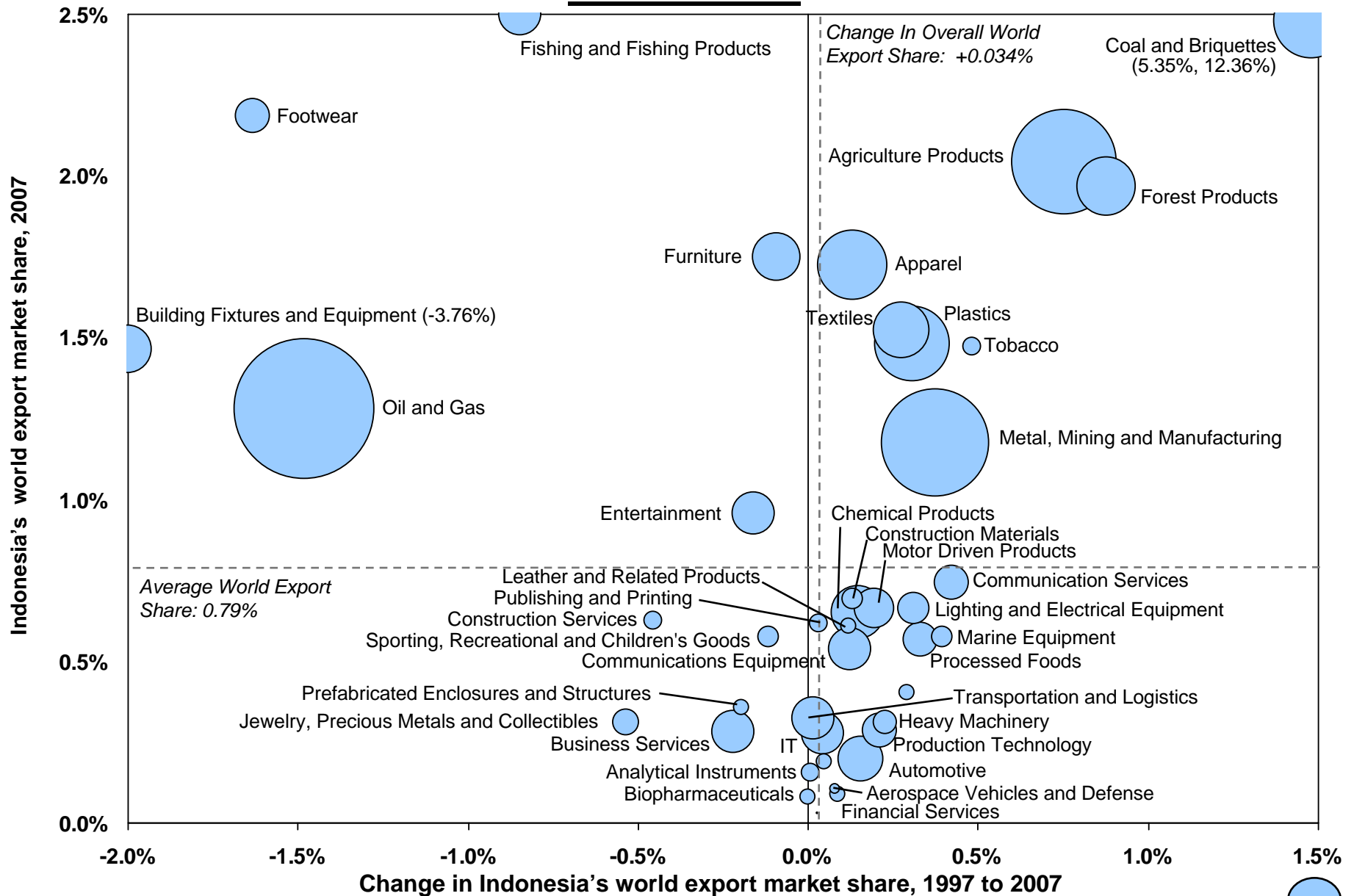
- Clusters provide a framework for **implementing public policy** and **organizing public-private collaboration** to enhance competitiveness

# 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

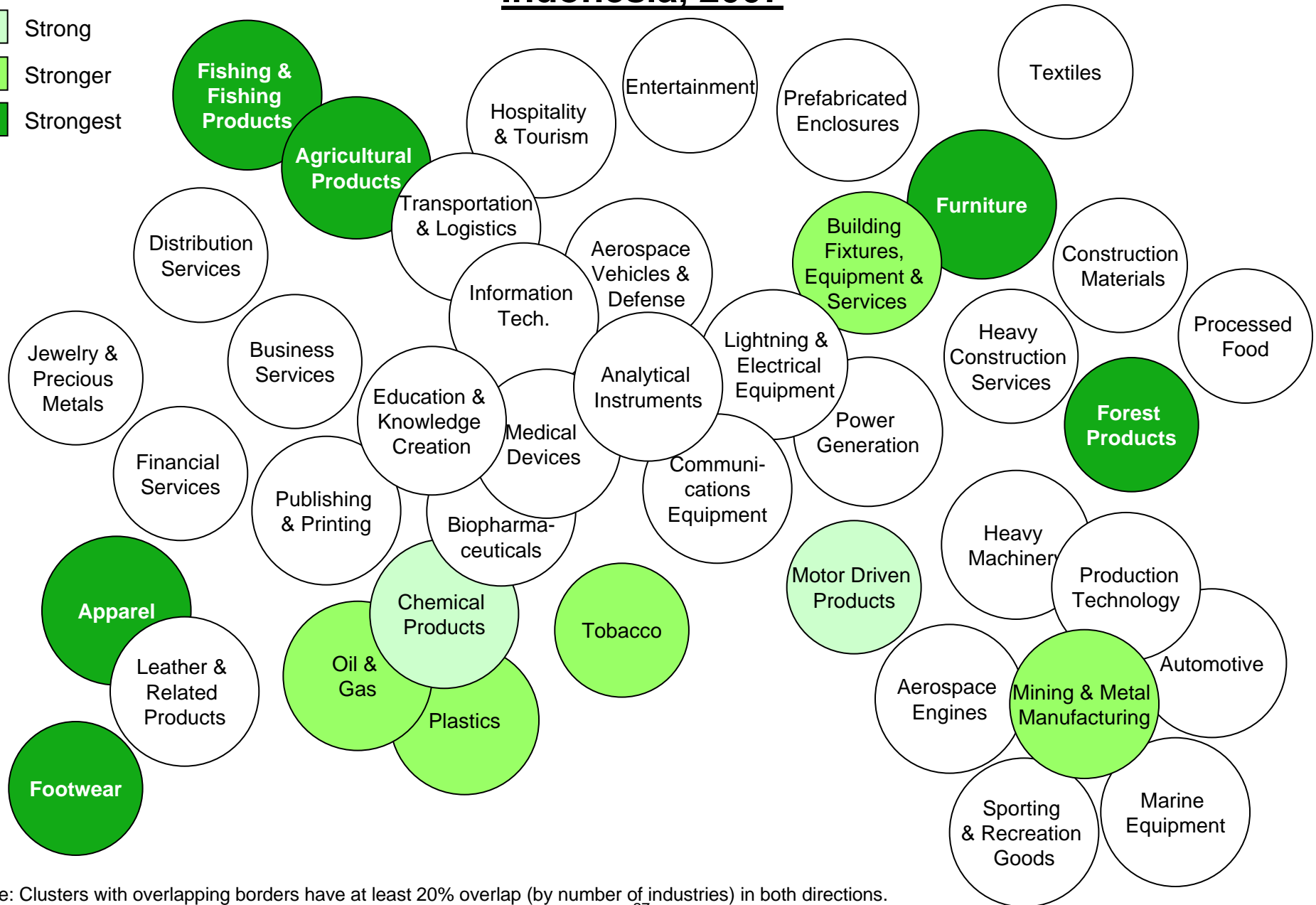


Source: Prof. Michael E. Porter, International Cluster Competitiveness Project, Institute for Strategy and Competitiveness, Harvard Business School; Richard Bryden, Project Director. Underlying data drawn from the UN Commodity Trade Statistics Database and the IMF BOP statistics.

# 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



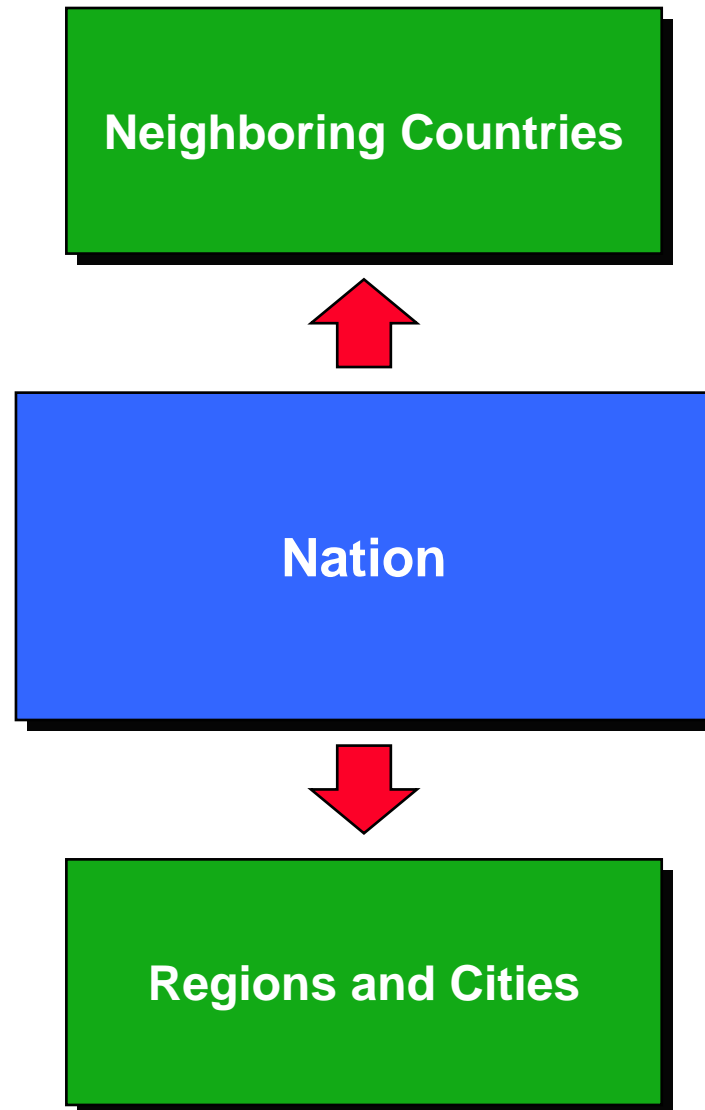
Note: Clusters with overlapping borders have at least 20% overlap (by number of industries) in both directions.

# Indonesian Clusters

## Action Priorities

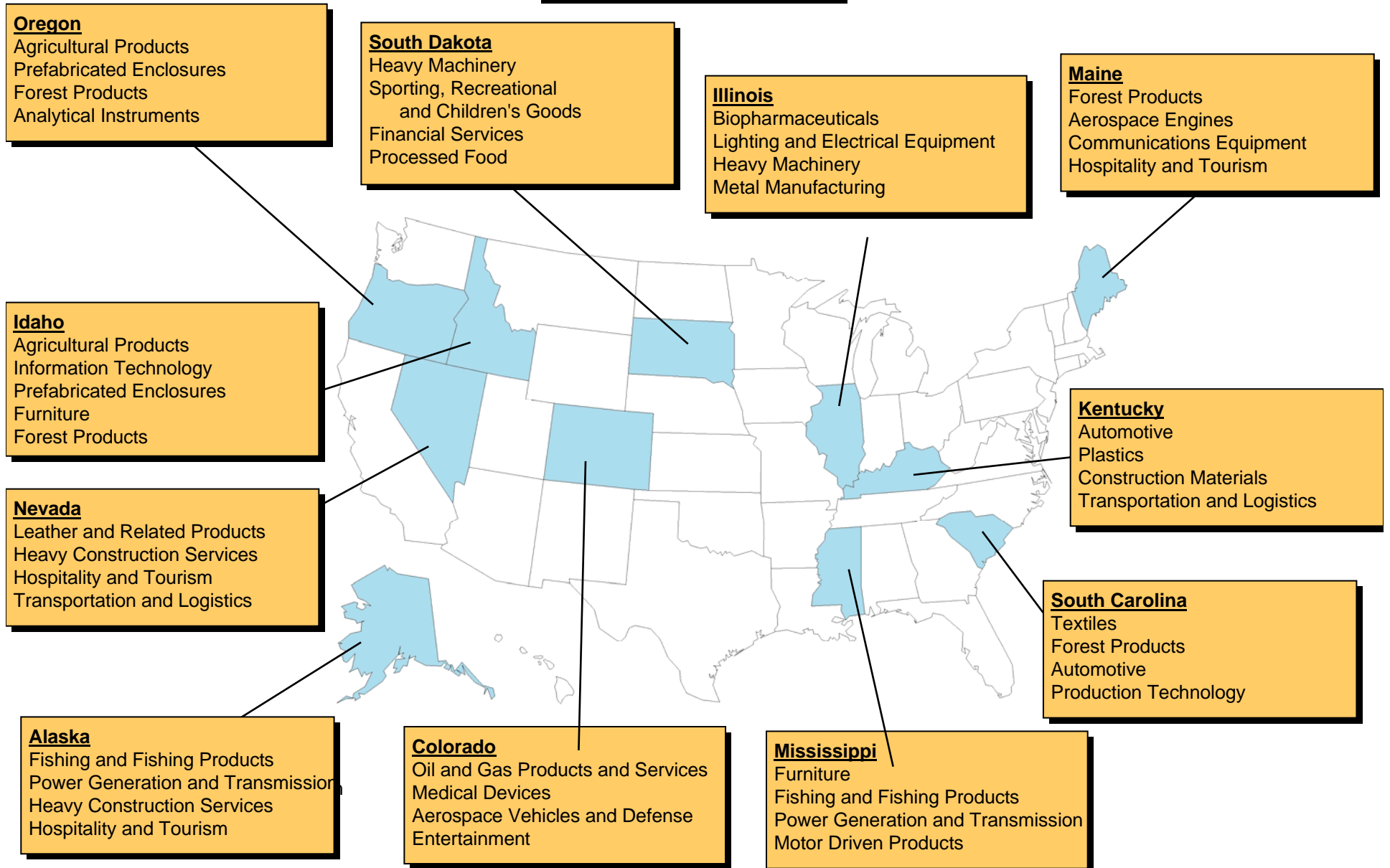
- Adopt **cluster development** as a **central approach** for organizing the government's business development efforts
- Utilize cluster initiatives as a tool to **engage the private sector** in more effective collaboration with government at the national and regional level
- Use clusters to organize **export promotion** and **FDI attraction**

# Geographic Influences on Competitiveness



# Specialization by Traded Clusters

## U.S. States, 2006



Source: Prof. Michael E. Porter, Cluster Mapping Project, Institute for Strategy and Competitiveness, Harvard Business School; Richard Bryden, Project Director.

# Indonesia's Provinces



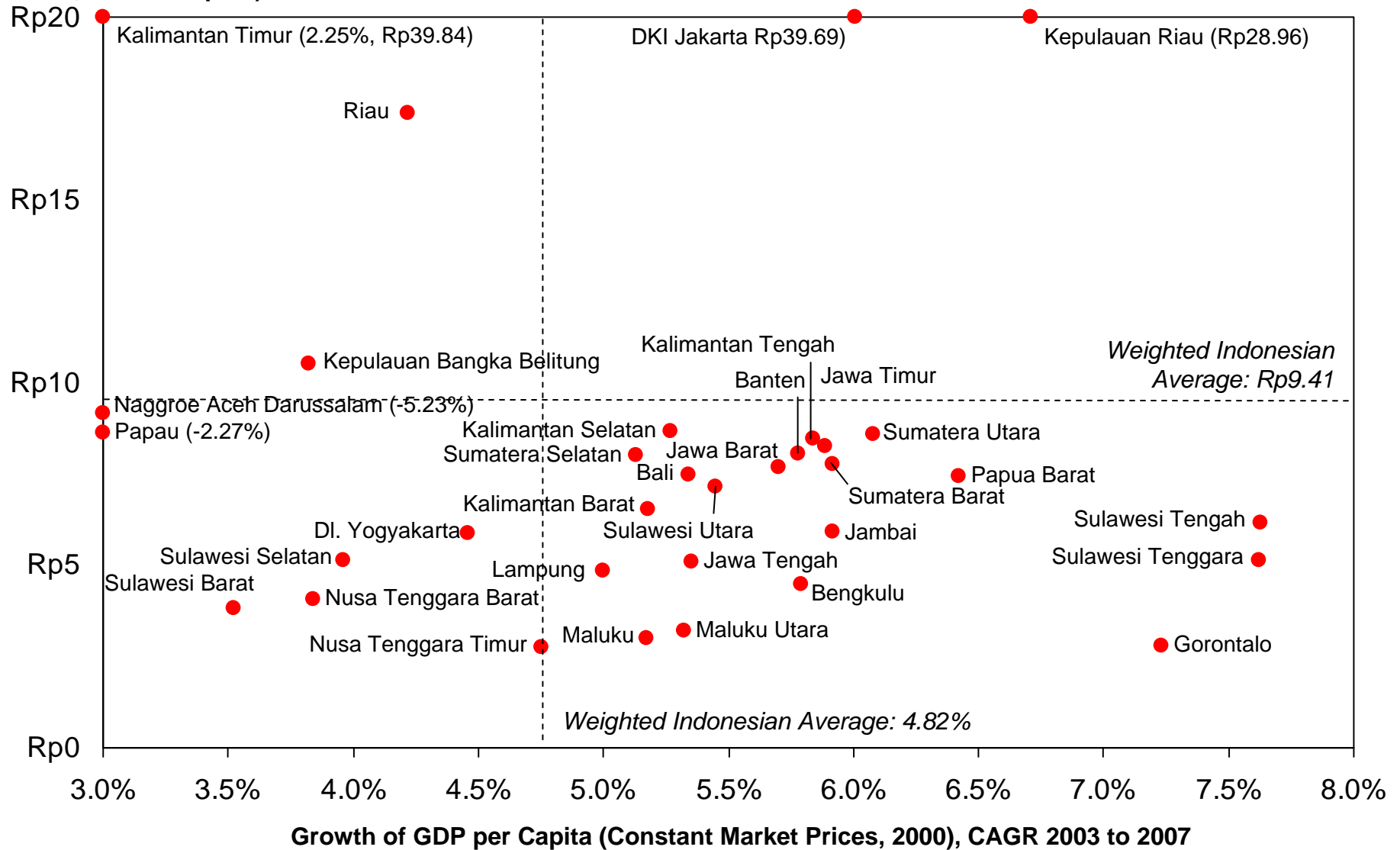
Source: Wikipedia, Provinces of Indonesia

- 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)



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

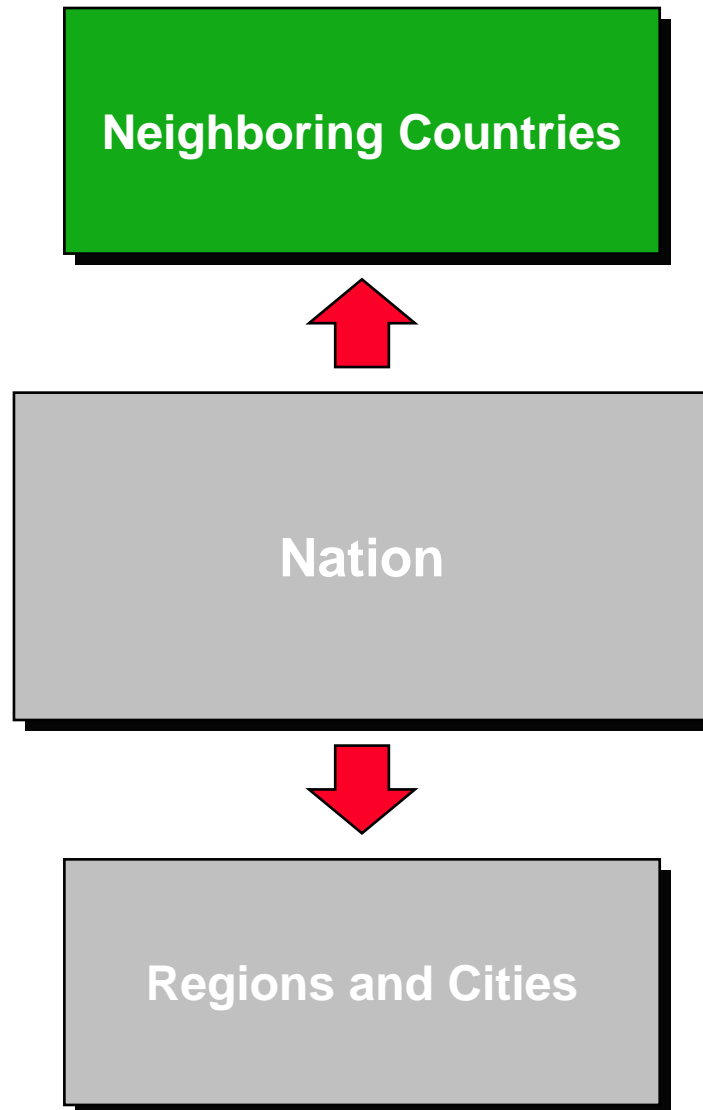


# Indonesian Provinces

## 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



# 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**