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Policy Brief

Key Messages:

- Despite facing global uncertainties, Indonesia has achieved macroeconomic stability, supported by strong responses in fiscal and monetary policy, as well as robust domestic supply chains.
- Indonesian has recorded a positive trade balance since May 2020, but issues related to global value chains remain. Increases in Indonesia's export value have been largely contributed by soaring prices, not value added.
- Indonesia aims to achieve higher economic growth through down-streaming. Capitalising on its natural resources to produce higher value-added goods is important to leapfrog the national economy to another stage of economic development, but the policy should prepare the supporting infrastructure as well industrialisation strategies.
- Indonesia has yet to secure its three main types of infrastructure: physical, human, and institutional. Strengthening these three pillars would help the country attract investments and boost trade.

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Facilitating Global Trade and Investment and Leveraging Value Added in Downstream Industries

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Despite facing global uncertainties, Indonesia has achieved macroeconomic stability, supported by strong responses in fiscal and monetary policy, as well as robust domestic supply chains. By using its natural resources and following the global trend of green industries, Indonesia aims to become a key player in the global renewable energy market. Sound infrastructure is one of the key requirements to attract high-profile investments, but Indonesia struggles with poor and unequal infrastructure. Cumbersome bureaucracy and restrictiveness towards services trade also hinder the nation from reaching its potential. Strengthening physical, human, and institutional infrastructure will help the country secure investments and boost trade.

Indonesia's Macroeconomic Stability Amid Global Uncertainty

Indonesia has achieved strong macroeconomic stability, supported by soft adjustments to its monetary policy as well as joint efforts by the central and local governments to help mitigate disturbances to the domestic supply chain. While the country has increased fiscal spending to respond to and recover from the coronavirus disease (COVID-19) pandemic, the debt has remained manageable. Despite facing global uncertainties, Indonesia achieved remarkable growth of more than 5% in the third quarter of 2022. In addition, Indonesia has been one of the top performing countries in managing its inflation at only 5.9% – moderately lower than Brazil, Russia, India, China, and South Africa (BRICS); the Association of Southeast Asian Nations (ASEAN) Member States (AMS); and East Asian countries. The stability is supported by a huge share of private consumption in gross domestic product (GDP), which totalled 55.7% in 2021 but is expected to lower slightly in 2023 as the looming global recession sets in (IMF, 2022).

Indonesia's trade surplus reached a 4-month high of $5.76 billion in August 2022 – above market expectations of $4.09 billion. However, with the high global uncertainty risk, Indonesia must be aware of the potential of a global economic slowdown affecting domestic growth, the continuity of global tensions and their effects on supply, and aggressive monetary policies being taken by developed nations to combat inflation. The positive macroeconomic indicators set the stage for an optimistic future and show that Indonesia is a haven for investment funds seeking significant returns amid uncertain prospects.

In terms of disparity, the current investment climate in Indonesia is more equitable than ever; since 2019, the share of investment outside Java has increased significantly – overtaking Java in 2022. Central Sulawesi, Riau, North Maluku, and West Java are the top destinations for foreign investors. In addition, Indonesia is focusing on adding value to previously low value-added raw material exports. Through down-streaming, Indonesia aims to become a key player in the global battery, electric vehicle (EV), and renewable industries.

Challenges in Global Trade and Investment

Indonesia is committed to attracting foreign direct investment, with a target of Rp1.400 trillion in 2023. However, certain challenges need to be addressed. Sound infrastructure is one of the key requirements to attract high-profile investment, but Indonesia struggles with poor and inequal infrastructure. The country has been trying to improve its infrastructure development throughout its archipelago. Viet Nam ranked higher than Indonesia on the Logistics Performance Index (Table 1), with higher scores mainly in customs efficiency and the quality of trade and transportation related infrastructure (World Bank, 2018). The logistics process in Indonesia is long and costly, which could exacerbate price volatility.

Indonesia's international trade performance is also facing a classic issue – the low level of involvement in the global value chain (GVC). The country's forward participation in GVCs is sufficiently large, but its backward participation is small (Table 2). This illustrates heavy reliance on natural resources, which are still dominant in the structure of Indonesia's exports becoming raw materials for other countries. The role of the manufacturing sector in GVCs is still very small. One of the factors hindering trade is the cumbersome bureaucracy (EIU, 2022), under which Indonesia takes a restrictive stance towards trade in services, indicated by its low performance on the Services Trade Restrictiveness Index (STRI) of the Organisation for Economic Co-operation and Development (OECD) compared with other emerging countries (Table 3).

Table 1: LPI Rank and Score

Item	Viet Nam	Indonesia
LPI rank	39	46
LPI score	3.27	3.15
Customs	2.95	2.67
Infrastructure	3.01	2.89
International shipments	3.16	3.23
Logistics competence	3.40	3.10
Tracking and tracing	3.45	3.30
Timeliness	3.67	3.67

LPI = Logistics Performance Index.
Source: World Bank (2018).

Another equally challenging issue is human capital. With more investment entering Indonesia and advancements in technology, talent is needed as a key driver for growth and development. In 2021, only 19% of people aged 25–34 had a tertiary qualification – much lower than the OECD average of 47% (OECD, 2021a). The country should optimise the potential benefit from the demographic dividend in the short to medium term as the working-age population continues to grow, creating huge productive labour availability.

Ambitious Initiatives in Downstream Industries

The production and processing of domestically sourced raw commodities are fundamental to the Indonesian economy and constitute a major share of its export basket. Indonesia's strategy to transform its economy includes down-streaming raw materials into high value-added goods, in line with Indonesia's comparative advantage in terms of abundant natural resources – including 30% of the world's nickel reserves. By using its natural resources and following the global trend of green industries, Indonesia aims to become a key player in the global renewable

Table 2: Participation in GVCs

Item	Brazil	Indonesia	Thailand	Viet Nam
GVC backward participation (%)	13.0	14.4	34.6	51.1
GVC forward participation (%)	22.0	24.8	12.5	11.0

GVC = global value chain
Source: OECD (2021c).

Table 3: Services Trade Restrictiveness Index

Item	Brazil	Indonesia	Malaysia	Viet Nam
Logistics cargo handling	0.374	0.436	0.295	0.397
Logistics storage and warehouse	0.341	0.385	0.230	0.286
Logistics freight forwarding	0.277	0.346	0.258	0.242
Logistics customs brokerage	0.276	0.292	0.255	0.255
Telecommunications	0.271	0.639	0.407	0.716
Air transport	0.306	0.539	0.503	0.493
Maritime transport	0.347	0.538	0.311	0.365
Road freight transport	0.334	0.460	0.350	0.325
Rail freight transport	0.283	0.327	0.319	0.331
Courier	0.566	0.456	0.271	0.292
Distribution	0.223	0.658	0.337	0.297

Source: OECD (2021b).

energy market. To achieve this, the government has been negotiating with global companies and offering fiscal/non-fiscal incentives for investment in the country's integrated industrial areas (KITs).

The objective of developing downstream industries is to increase productivity, create employment, and improve equality. Indonesia is focusing on three objectives: down-streaming; micro, small, and medium-sized enterprises partnering with investors; and the Bali Compendium.[1] The impact of the down-streaming of nickel ore production has significantly raised its export value. The government is currently pushing for more downstream efforts in nickel and EV-related products, by aiming to build an electric battery and EV industry. It has partnered with LG, Hyundai, and other companies on this. State-owned enterprises are also supporting the downstream efforts by making significant investments. The downstream policies, however, have been challenged by foreign (mostly advanced) countries.

Nickel and copper production has reached the stage of producing intermediate goods. Thus, further industrialisation to use intermediate products is needed to maximise the possible value added. Future copper demand will increase significantly, supported by EV innovations.

Policy Recommendations

- **To attract more investment, Indonesia needs to ensure political stability, market and regulatory certainty, and institutional capacity.** While Indonesia is on the right path to take-off, the preconditions towards it – stability and certainty – should be fulfilled Global liquidity moves towards countries with a good investment climate and

[1] The Bali Compendium is a non-binding agreement that gives G20 countries room to formulate strategic investment policies according to their respective advantages (BKPM, 2022). Under this agreement, other countries should not interfere with each other or challenge the policies of a given country. The agreement will prevent other countries from interfering in Indonesia's downstream industrial policies, including the issue of export bans at the World Trade Organization.

Indonesia must race to provide it.

- To accelerate global trade, the Indonesian Chamber of Commerce and Industry (KADIN) and the Government of Indonesia should **provide legal certainty and ease of investment, increase human capital quality, enhance public–private partnerships, and safeguard domestic stability**. In addition, Indonesia should enhance its trade and investment opportunities by optimising trade agreements such as the Regional Comprehensive Economic Partnership and attracting industries relocating from China.
- **To lower Indonesia's restrictiveness on services trade**, specifically on logistics-related services, it should improve and develop infrastructure for domestic logistics and support the country's integrated industrial areas (KITs). Developing infrastructure solely through the national budget is not sustainable, as the country will suffer from the high debt that follows and could be a waste as it might not live up to its potential. Lowering barriers to trade in services, especially logistics-related services, would increase foreign participation and competition – creating benefits for Indonesia's emerging market as it would push domestic market actors to innovate and operate efficiently.
- **Down-streaming and industrialisation, especially in the EV sector, must be distinguished and approached differently.** The two policy orientations need different supporting ecosystems. Security and convenience are the key factors underpinning the investment climate. In addition, the EV industry needs government support to accelerate consumer behaviour shifting towards using EVs.

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