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The Big Picture: Indonesia's Partnership with U.S. Investors

The Big Picture: Indonesia's Partnership with U.S. Investors

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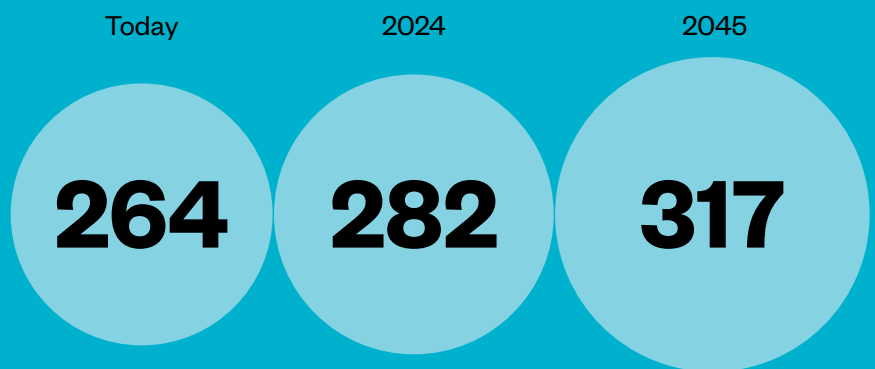
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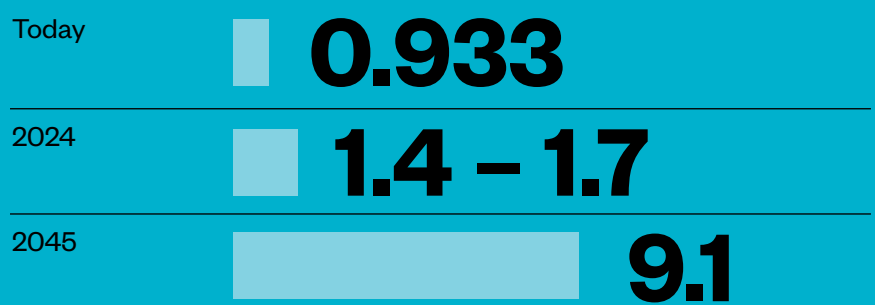
Indonesia Today - 2045



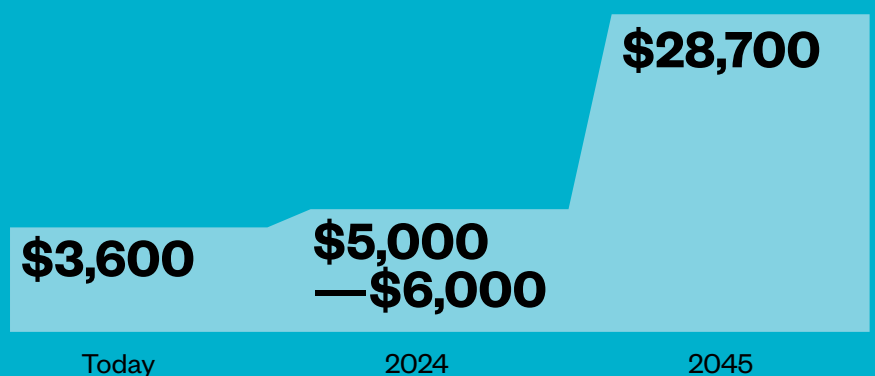
Population (in million)



GDP (\$ Trillion)



Per capita income



Sources: Interviews, Badan Pusat Statistik, The World Bank

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Executive Summary



Credit: iStock

For the fifth year of the U.S.-Indonesia Investment Initiative, we sat down with key policymakers, business leaders and top analysts to try to determine what the big picture for Indonesia is, how the government plans to achieve it, and the challenges standing in its way.

**Moving
From
Vision
to
Reality**



By the time President Joko Widodo's anticipated second term concludes in seven years, the current administration hopes to see Indonesia well on its way to escaping the middle-income trap. From an income per capita expected to range between \$5,000 and \$6,000 in 2024, policymakers are forecasting the country will be able to join the ranks of high-income economies by the mid-2030s.

By 2045, the official vision is for Indonesia to celebrate its 100th year of independence as one of the top 10 largest economies in the world, with absolute poverty eliminated and inequality significantly reduced.

This is the big picture the government sees for Indonesia: A prosperous and equitable nation in less than three decades.

For the fifth year of the U.S.-Indonesia Investment Initiative, a collaborative effort between AmCham Indonesia and the U.S. Chamber of Commerce in Washington, DC, we sat down with key policymakers, business leaders and top analysts to try to determine what the big picture for Indonesia is, how the government plans to achieve it, and the challenges standing in its way. We also outline our recommendations on how to go from vision to reality.

Looming large among the government's efforts to reduce the economy's heavy de-

pendence on unpredictable commodities and consumption is a drive toward re-industrialization, with a specific focus on value-added manufacturing to maximize use of the country's abundant resources, and modern services. In this industrialized economy, Indonesia's traditional heavy lifters – commodities, mining, oil and gas – are expected to play smaller roles as part of a larger overall show. The government has also charted a path toward becoming a \$130 billion digital economy by 2020 – the largest in the region by then.

Backing these goals is the largest infrastructure program in the country's history, spanning everything from roads and ports to power plants and a national broadband network. Recognizing the crucial role the private sector, including foreign investors, will play in fueling this economic growth, President Widodo has also been pushing for greater openness and deregulation. Over the past two years, 16 economic policy reform packages aimed at improving the business environment, including by removing 35 sectors from the Negative Investment List, have been released.

Despite all this, President Widodo's stated goal of 7 percent economic growth does not appear achievable before his first term ends, with the latest forecasts projecting GDP growth rates of 5.1 percent for 2017 and 5.3 percent for 2018.

Getting there

This is part of where the challenge lies: Development economists say moving from middle-income to high-income status requires difficult structural reforms, but the president's efforts have so far clashed against deeply ingrained instincts in the bureaucracy to protect perceived national interests, and to control and overregulate the economy.

In attempting to rapidly develop local industries, the government has chosen policy tools – such as banning raw mineral exports to boost processing at home, and using import restrictions and domestic content requirements to force manufacturers to source locally – that come with unintended consequences. As Indonesia Investment Coordinating

The government has also charted a path toward becoming a \$130 billion digital economy by 2020 – the largest in the region by then.

\$130B

Board (BKPM) Chairman Thomas Lem-bong told AmCham and the U.S. Cham-ber of Commerce, regulations designed to force specific outcomes often drive potential investors away.

While the government says it wants a more liberalized economy, regulations restricting the involvement of foreign investors in Indonesia continue to be issued. Many companies consistently say that new investment plans for Indonesia are held back or delayed by uncertainty in the regulatory environment and worries over compliance issues. These delays are costing the country in terms of growth.

Despite the recognized need to in-crease private-sector participation, policymaking continues to be done be-

hind closed doors, with little consulta-tion – much less actual input – from the industries being regulated.

The challenge ahead for Indonesia is compounded by the onset of the fourth industrial revolution, which will see technological advancements elimi-nate several forms of low-skilled labor, and the projected closing of Indonesia's population bonus window in the 2030s.

For Indonesia to realize the poten-tial everyone knows it has, and for it to attract the foreign investment it needs to help bridge the gap between an average growth rate of 5 percent and 6-7 percent, systemic reforms are needed, including:

1

Redeveloping a comprehensive approach supported by a clear roadmap that everyone can work toward. Assuming such a roadmap is followed, this would allow investors to see if the country's direction is aligned with their plans. Each government regulation issued should be in line with the roadmap, which would help create the regulatory consistency and certainty that both foreign and local investors want.

2

Ensuring this comprehensive approach and roadmap are based on the country's competitive advantages. While Indonesia's large population and rich natural resources give it a major edge, it has to be strategic in order to compete with countries that have more skilled labor, better infrastructure and well-developed industries in certain sectors.

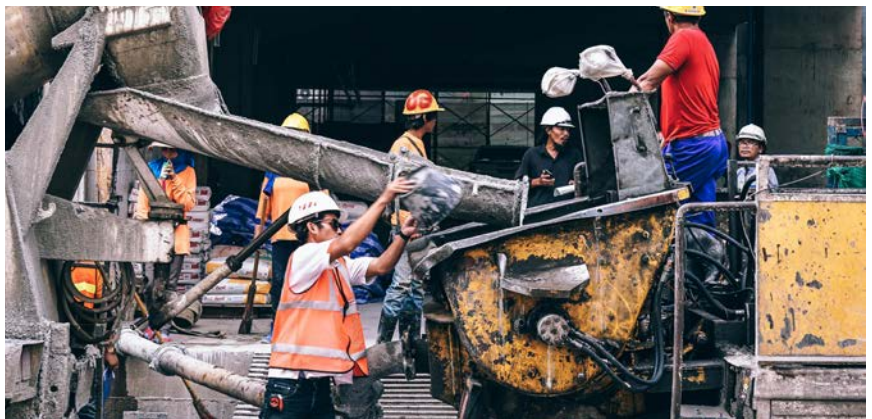
3

Developing regulations transparently based on quality data and sound science, with mandatory public consultation and stakeholder engagement. President Widodo himself has stated that rules, regulations and policies should be made through a transparent process – a standard practice among governments in advanced economies throughout the world. This needs to be put in practice.

4

Boosting competitiveness by investing and regulating for the long term. One consequence of political cycles is the lack of clear planning for the long term and investment in things that don't generate visible returns in the short term. But investing in things like education reform to develop the graduates needed for the kind of economy Indonesia will have in 20 years' time is necessary for Indonesia to become – and remain – competitive over the long term.

Companies consistently say that new investment plans for Indonesia are held back or delayed by uncertainty in the regulatory environment and worries over compliance issues. These delays are costing the country in terms of growth.



Credit: Igor Ovsyannykov



T cha

Chapter 1

By 2024, the current administration hopes to see Indonesia well on its way to escaping the middle-income trap. By its 100th year as an independent nation in 2045, Indonesia aims to become a high-income country and among the top 10 largest economies in the world.

The Big Challenge

Where will Indonesia be in 2024? Well on its way to becoming an industrialized and more equitable economy growing at 6 to 7 percent per year? Or stuck in the middle-income trap, still struggling to break free from its dependence on commodities?

During the commodities boom of the 2000s, Indonesia's rich natural resources were a magnet for investment dollars from all over the world. But when the commodity price supercycle ended, Southeast Asia's largest economy was left unprepared to support the growing needs of the fourth-largest population in the world with an unsustainable economic model.

This part of the story is not new. The next chapter of Indonesia's growth is what policymakers and investors alike have been struggling to figure out over the past five years or so.

As we outline below, with major input from the government's own senior economic policymakers, optimistic projections for Indonesia to join the ranks of

the world's leading economies bump up against the realities of regulatory and bureaucratic challenges and fundamental questions about the degree to which the country really wants to open up to foreign investment. It is important to note that an undercurrent throughout the discussion is the degree to which appeals to nationalism by regulators continue to undermine the government's own stated desire to attract and keep foreign investment. Even as the country grows more open under President Joko Widodo, policies emerge that may restrict imports in certain sectors, impose rules that disrupt investments and make business certainty elusive. These are concerns that are expressed by government policymakers and companies alike and that are held by both local and foreign investors.

In this report, we encourage our readers to admire Indonesia's vision of growth and prosperity while also facing the very real decisions that must be made to realize the best possible future.

High-income target

“By the 100th year of our independence, Indonesia should be at the level of a high-income country, among the top 10 largest economies in the world.”

Bambang Brodjonegoro, National Development Planning (Bappenas) Minister



Credit: AmCham

In the government's ideal storyline, Indonesia would grow at an average pace of 6.4 percent per year over the next two decades. In this optimistic scenario, Southeast Asia's largest economy would have a gross domestic product (GDP) of \$9.1 trillion and a population of more than 300 million by 2045 – the year the country marks its 100th year as an independent nation.

“Based on our calculations, Indonesia will be the fourth-largest economy in the world [by 2045]. I believe these calculations because they were made by economic experts. Who doubts [Finance Minister] Sri Mulyani Indrawati and [Coordinating Minister for the Economy] Darmin Nasution?”

President Joko Widodo said in March 2017, as quoted by *The Jakarta Post*.¹

Given the current global and domestic trends, according to National Development Planning (Bappenas) Minister Bambang Brodjonegoro, a more realistic aspiration is to maintain an average growth rate of 5 percent. At this level, he said, Indonesia would be the world's seventh- or eighth-largest economy by 2045.

“More importantly, in both scenarios, Indonesia will graduate from middle-income [status],” Bambang said in an interview for this report. This will happen by around 2034 at an average growth rate of 6.4 percent, he said, or by 2038 or 2039 at 5 percent.

¹ www.thejakartapost.com/news/2017/03/27/indonesia-to-be-worlds-4th-largest-economy-by-2045-jokowi.html

“By the 100th year of our independence, Indonesia should be at the level of a high-income country, among the top 10 largest economies in the world. We will also achieve almost zero poverty, and relatively low inequality.”

Over the medium term, by the time President Widodo’s anticipated second term ends in 2024, the goal is to move closer to the upper range of the middle-income tier, with an average income per capita of \$5,000-\$6,000.

Indonesia’s economic growth figures

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Nominal GDP (in billion USD)	432.2	510.2	539.6	755.0	893.0	918.0	915.0	891.0	861.0	933.0
GDP (annual % change)	6.3	6.0	4.6	6.2	6.2	6.0	5.6	5.0	4.9	5.0
GDP per Capita (in USD)	1,861	2,168	2,263	3,167	3,688	3,741	3,528	3,442	3,329	3,603

Source: World Bank

Get moving or face the consequences

“[Indonesia] needs to get rich before it gets old”

Rolande Simone Pryce, World Bank operations manager for Indonesia and Timor Leste

However, the Indonesian economy’s ability to maintain an average of 5 percent growth per year is not a given, much less assured to be broad-based and equitable. Escaping the middle-income trap is a feat only 13 of the 101 economies classed as middle-income in 1960 have so far achieved, according to the World Bank.²

The challenge is further complicated by the beginnings of Industry 4.0, or the fourth industrial revolution, that will see technological advancements reduce the need for cheap low-skilled labor in manufacturing, and benefit countries that lead in innovation.

If Indonesia is to join the high-income economy club – which involves more than tripling its current per capita income of \$3,600 to at least \$12,400 – it would not only have to deliver on long-promised systemic reforms to boost competitiveness and shift to a sustainable high-growth economic model, but it would have to do so quickly.

“There is going to be a need for a significant acceleration in the growth rate over the next 13-15 years,” the World Bank’s operations manager for Indonesia and Timor Leste, Rolande Simone Pryce, said at the first Indonesia Development Forum (IDF), organized by Bappenas in

Jakarta in July 2017.

This is because Indonesia’s demographic bonus – that period of high growth opportunity created by having a working population greater than its dependents – is expected to end around 2030.

“The bank has a philosophy that as a country, one needs to get rich before it gets old. You need to do your work on productivity, you need to have your working population, the engine of economic activity, at the time when they are youthful and vibrant,” Pryce said

Unfortunately, Indonesia’s upcoming presidential election in 2019 means the government will soon enter so-called caretaker mode, during which major reforms are unlikely to take place due to political pressure from special interests and populist appeals to voters that often put nationalist campaigning front and center.

If no significant structural reforms take place over the short term, where will Indonesia be by 2024? Will the next chapter of Indonesia’s growth tell the story of a successful exit from middle-income status? Or will it be about an economy that squandered its vast potential and opportunity to maximize its demographic dividend, having failed to keep up with the changing world?

Poverty reduction & inequality in Indonesia

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Relative Poverty (% of population)	16.58	15.42	14.15	13.33	12.36	11.66	11.47	10.96	11.13	10.70
Absolute Poverty (in million)	37.17	34.96	32.53	31.02	28.89	28.59	28.55	27.73	28.51	27.76
Gini Coefficient	0.35	0.35	0.37	0.38	0.41	0.41	0.41	0.41	0.41	0.41

Source: Badan Pusat Statistik

2 <http://siteresources.worldbank.org/EXTPREMNET/Resources/EP98.pdf>

Chapter 2

Indonesia



Credit: iStock

Indonesia's Road Map



To achieve its goals, Indonesia wants to move away from being an economy heavily dependent on raw commodity exports and consumption, toward one driven by value-added manufacturing and modern services, fueled by heavy infrastructure development and increased domestic and foreign investment.

“**T**he Indonesian government’s roadmap for reaching high-income status by 2024 involves shifting away from being heavily dependent on raw commodity exports and consumption toward one driven by value-added manufacturing and modern services, fueled by heavy infrastructure development and increased domestic and foreign investment. We have to reinvent our economies; we have to reinvent our

societies,” President Widodo said at the opening session of the 24th World Economic Forum on East Asia in April 2015.

Today, we must change from consumption back to production, from consumption to investment in our infrastructure, investment in our industry, but most importantly, investment in our human capital, the most precious resource of the 21st century.”

“Today, we must change from consumption back to production, from consumption to investment in our infrastructure, investment in our industry, but most importantly, investment in our human capital, the most precious resource of the 21st century.”

Joko Widodo, President of Indonesia



Re-industrialization

In a series of interviews with AmCham Indonesia and the U.S. Chamber of Commerce, the country's economic ministers outlined priorities that are still broadly in line with those laid out in the Long-Term National Development Plan (*Rencana Pembangunan Jangka Panjang Nasional or RPJPN*) for 2005–2025, issued in 2008 by then-President Susilo Bambang Yudhoyono. At the heart of the 20-year plan was the growth of the industrial sector, which is still a major focus of the Widodo administration.

“We need to re-industrialize our country. We need to increase the portion

of our manufacturing sector to GDP,” Bappenas Minister Bambang said in an interview.

The sector's contribution to GDP has declined from a high of 28 percent to less than 21 percent over the past decade due to a number of factors, including reduced domestic purchasing power and weak global demand for Indonesian exports.

“Currently, we only have 21 percent manufacturing contribution to GDP. We need to make it close to 30 percent. So we hope by 2024, we are already in the 26-28 percent range,” Bambang added.

Capitalizing on natural resources

Much of this manufacturing growth is still expected to be based on the processing of natural resources, evidenced by the government's continued emphasis on developing downstream sectors in both agriculture and the extractive industries.

“We still have abundant resources and we can still tap the value added rather than export the raw materials,” Industry Minister Airlangga Hartarto said in an interview for this report. “So we capture all the value added domestically not only to get better value, but also to get jobs in Indonesia.”

The minister envisions an industrial sector that encompasses the entire value chain, from the design and engineering of products, to their production and distribution, and even including the reuse or recycling of product packaging.

In this industrialized economy, Indonesia's traditional heavy lifters – commodities, mining, oil and gas – will play a much smaller role going forward.

“While these sectors will still expand, the new economy sectors will expand so much faster, which means they will pull less weight in the overall economy,” Thomas Lembong, the chairman of the Indonesia Investment Coordinating Board (BKPM), said in an interview.

To achieve this re-industrialization target, Bambang said the government aims to attract more foreign direct investment, particularly in natural resources-based manufacturing, where Indonesia believes it has a competitive advantage.

“On one side, we really need labor-intensive manufacturing. On the other side, for competitiveness, especially for FDI, we really need to promote natural resources-based manufacturing,” he said.

“We know that [foreign investors], especially from the U.S., have been investing heavily in natural resources – mining and plantations. But for our future, we'd really like more FDI in natural resources-based manufacturing.”



Credit: Badan Koordinasi Penanaman Modal (BKPM)

Regulating outcomes

There is more to the future, of course, than merely trying to lure investment in natural resources-based manufacturing, and the regulatory tool has tended to be the blunt object of forcing local content requirements on a range of industries.

One such controversial policy has been a multi-year effort to boost domestic industries by imposing a 40 percent domestic content requirement, or TKDN, on certain products sold locally, including many electronics and virtually anything used in government projects. Much of the debate over local content has focused on 4G mobile devices, but the policy extends to a wide range of industries. In April 2017, Airlangga even announced plans to form a team to supervise the enforcement of the TKDN requirement, adding that the policy would turn Indonesia from a country that assembles imported components to a strong component manufacturer as well.³

However, there is some recognition among officials that this approach is not effective. In response to some of the criticisms of the policy, the Ministry of Communications and Information Technology issued Circular Letter No. 518 in July 2017,

outlining which 4G devices had to comply with the local content requirements, effectively exempting non-smartphone gadgets. The Ministry has also compromised by accepting a definition of local content that includes local R&D and other factors in calculating TKDN.

“Forcing targets through requirements almost always backfires, whereas if you leave industry to its own devices, local content will naturally go up over time,” Lembong said.

“Forcing high local content to be instantaneous on day one or year one simply means that investment never comes.”

But another regulatory tool to force the development of local industries – import restrictions – continues to be used by various ministries, creating difficulties for companies ranging from food and beverage manufacturers that can’t get the type of sucrose they need, to heavy industries and extractives that can’t source the quality of steel or specific kind of equipment they require. Recent import restrictions have significantly impacted both heavy manufacturing and the extractive industries, causing delays, increasing costs and disrupting production.

Investing in Innovation

If Indonesia is to truly become competitive on the global stage, former Trade Minister Gita Wirjawan says the country has to invest in innovation.

Speaking at the Indonesia Economic Forum 2016, he said China filed almost 700,000 patent applications from 2007 to 2013, almost double the figures for the U.S. and Japan. Indonesia, he said, filed 500 in the same period.

He also pointed out that only 16 percent of Indonesian university graduates have engineering degrees, compared to 33 percent in Malaysia and 24 percent in Vietnam.

Indonesia is now also only spending \$8 per person on research and development,

while neighboring Singapore, which is consistently ranked as the most innovative country in the region, is at \$60 per person.

A 2014 research paper analyzing whether middle-income countries can learn from South Korea’s experience pointed out that the East Asian country’s research expenditure went from 2.42 percent to 3.74 percent of GDP from 1996 to 2010, while Indonesia’s moved from 0.07 percent in 2000 to just 0.08 percent in 2009.

To be innovative, Gita said, Indonesia will have to put more money on the table.

³ <https://en.tempo.co/read/news/2017/04/12/056865340/Government-to-Form-Mandatory-Minimum-Local-Content-Watchdog>

Industry 4.0

The intensified push for manufacturing growth is also taking place in a far different era than when Indonesia last seriously pushed manufacturing investment more than 20 years ago. This is now the beginning of the fourth industrial revolution, where the digitalization of manufacturing – facilitated by technological advancements such as artificial intelligence and the Internet of Things – is redefining the benchmarks for competitiveness and the labor needs of modern economies.

Because of this, Alibaba Group chairman Jack Ma has advised world leaders to stop looking to manufacturing to drive economic growth. “Because of artificial intelligence, because of the robots, manufacturing is no longer the main engine for jobs,” he said at the Bloomberg Global Business Forum in New York in September 2017.

Indonesia’s industry minister has assured the public that the government is cognizant of this; he outlined for this report a four-point strategy that he said would both prepare the country for the changes ahead, and maximize the benefits to the people.

1

Workforce

Human resource capabilities will be developed by transforming middle schools into vocational schools, and emphasizing polytechnic schools. Airlangga said the ministry is working with Tsinghua University in Beijing to gain insights and advice on the needs of Industry 4.0.

2

Support for SMEs

Small and medium enterprises have to be included in the industrialization process, such as by encouraging the development of e-marketplaces. The Industry Ministry will support SMEs by providing access to markets, financial institutions and raw materials.

3

Pilot sectors

Mid- to large-scale companies will be encouraged to grow beyond Indonesia, including by strengthening the domestic and regional value chain and taking advantage of the Internet of Things to improve the efficiency of local production. The ministry will provide a platform for certain sectors to conduct trials for Industry 4.0 in cement, petrochemicals, automotive and textiles.

4

Innovation

The ministry aims to establish innovation centers in Jakarta, Bali and Batam that will incubate young engineers, similar to Singapore’s Block 71 and the Tsinghua x-lab in Beijing.

“We still have abundant resources & we can still tap the value added rather than export the raw materials.”

**Airlangga Hartarto,
Industry Minister**



Credit: AmCham

Digitalization

100%

Under funding objectives, the roadmap seeks to liberalize the e-commerce sector by allowing providers of e-based platforms, including apps and over-the-top (OTT) services, with investments of up to IDR 100 billion a maximum of 49 percent foreign ownership, and to allow those that exceed IDR 100 billion up to 100 percent foreign ownership.

In August 2017, President Widodo signed the long-awaited e-commerce roadmap designed to guide the industry – which touches everything from retail and tourism to logistics, e-payments and financial services – in growing more than tenfold from \$12 billion in 2014 to \$130 billion by 2020.

While the target may seem “ambitious,” as Communications and Information Technology Minister Rudiantara acknowledged, the sector is estimated to have already more than doubled to \$30 billion worth of transactions from 2014 to 2016. The Indonesian E-Commerce Association (idEA) projects 30-50 percent growth to \$45 billion in 2017.

The two-year roadmap lists objectives with specific deadlines for various ministries under eight major components: funding, taxation, consumer protection, education and human resources, communication infrastructure, logistics, cyber security, and the implementing organization.

“This country spends 25 percent of our economy [on] logistics. [That is] considered too high even compared to other countries, not to mention if we compare with America,” Rudiantara told AmCham and the U.S. Chamber, elaborating on one of the issues the roadmap aims to address.

“If we are able to do this [e-commerce roadmap], we believe that we’ll be able to reach \$130 billion and even beyond... And this will make us the largest digital economy in the area,” he continued.

Under funding objectives, the roadmap seeks to liberalize the e-commerce sector by allowing providers of e-based platforms, including apps and over-the-

top (OTT) services, with investments of up to IDR 100 billion a maximum of 49 percent foreign ownership, and to allow those that exceed IDR 100 billion up to 100 percent foreign ownership.

Rudiantara is hoping foreign companies and investors pour money into this side of the ICT business. Most FDI in the sector goes into the hardware or equipment manufacturing business, he said, but more significant growth is expected from the services side. The difficulty will come if the participation of international players is limited, for example, by caps on foreign ownership by electronic payment service providers – a deep concern under the new National Payment Gateway regulation.

There appear, however, to be inconsistencies in the cabinet on this front, with the industry minister expressing a desire to protect local startups.

“I understand that foreign investors are looking more into services rather than manufacturing,” Airlangga said. “The services like distribution, warehousing, electronic payments, e-marketplace... I don’t want that from the very beginning the big players play in the market, [leaving] no possibility for young entrepreneurs to start or to develop the business.”

However, local startups have reported running into problems attracting seed funding, as foreign investments are limited by the minimum capital requirement of IDR 10 billion, which is significantly more than what venture capitalists normally provide during the early stages.

In terms of financial technology, or fintech, Indonesia expects more than \$18 billion worth of transactions this year,

“If we are able to do this [e-commerce roadmap], we believe that we’ll be able to reach \$130 billion [by 2020] and even beyond... And this will make us the largest digital economy in the area.”

**Rudiantara,
Communications &
Information Technology
Minister**



Credit: AmCham

more than the \$14 billion projected for Hong Kong and \$13.5 billion for Singapore.

To nurture the growth of the sector, financial regulators were quick to come out with rules to guide online payment and peer-to-peer lending companies in late 2016, which facilitated the early growth of a number of startups. In this regard, the Financial Services Authority (OJK) allowed up to 85 percent foreign ownership of P2P lending companies.

The regulator has also promised to create a regulatory sandbox for fintech, which would allow startups to safely test innovations before launching them in the market.

Bank Indonesia also issued in July a long-awaited, though controversial, regulation on the National Payment Gateway, which requires that all domestic electronic payments be processed onshore by a licensed switching agency that is 80 percent domestically owned. Foreign players in the electronic payments industry worry that this domestic restriction could disrupt existing investments, slow innovation and harm the investment climate – all concerns that AmCham and the U.S. Chamber have raised in meetings with regulators.

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85%

Massive infrastructure development

“When President Jokowi took office in late 2014, he slashed fuel subsidies and used the resulting fiscal space to launch the largest infrastructure program in the history of our country.”

**Thomas Lembong,
BKPM Chairman**



Credit: AmCham

The government’s push for Indonesia’s re-industrialization and digitalization is being underpinned by strong growth in infrastructure development, not just in roads, airports, bridges and power plants, but also in terms of information technology.

“When President Jokowi took office in late 2014,” BKPM’s Lembong said, “he slashed fuel subsidies and used the resulting fiscal space to launch the largest infrastructure program in the history of our country.”

In the medium-term plan for 2015-2019 that lays out some \$450 billion in infrastructure projects, about 30 percent is expected to be financed by the private sector. Aside from toll roads and airports, these include water supply, low-cost housing, tourism, smelter and electricity projects.

“[We’re giving] opportunities for [foreign] investors to invest in our infrastructure. It could be toll roads, power plants, airports, seaports, oil refineries, natural gas transmission,” Bambang, the planning minister, said.

\$2B

Even though the project only needs about \$2 billion, Rudiantara said going the way of public-private partnerships would allow Indonesia to tap foreign expertise.

“There are a lot of opportunities, and Indonesia really needs infrastructure because as you know we are still way behind in terms of competitiveness based on infrastructure.”

Addressing the land acquisition issues that have long stalled infrastructure development in the country, Bambang promised the situation will improve.

“It will become better,” he told AmCham and the U.S. Chamber. “The government has a mechanism for [acquiring land], and the private sector later can compensate the government for what it has spent in land acquisition.”

In terms of IT infrastructure, Rudiantara said Indonesia aims to improve its position from number four to number two in the region by 2020, next only to Singapore.

“That’s why our objective is to develop the ‘Palapa Ring’ to connect the capitals of provinces throughout the country by 2019,” he said.

The Palapa Ring, a long-planned national fiber-optic network that would provide high-speed internet throughout the archipelago, will be completed

in three stages. The western section is expected to be finished by the first quarter of 2018, the central package by early 2019, and the eastern part of Indonesia will be covered by the second half of that year.

“All the structures [will be financed] by Public-Private Partnerships (PPP),” the minister said.

Even though the project only needs about \$2 billion, Rudiantara said going the way of public-private partnerships would allow Indonesia to tap foreign expertise.

“Because we need brains, we need expertise. We are the government, we are not an operator. So that’s why we structured [the project] as a PPP,” he said.

In the second half of 2017, the government also aims to start its satellite program, also under the PPP model, with a goal of completing it by 2021.

“This is going to be a leapfrog from the technology point of view. We will go directly to the HTS [High-Throughput Satellite]... to complement our terrestrial solution,” Rudiantara said.

“We need brains, we need expertise. We are the government, we are not an operator. So that’s why we structured [the Palapa Ring project] as a PPP.”

Rudiantara,
Communications and
Information Technology
Minister



Source: PT Jakarta MRT

Increased openness



\$8.2B

In the second quarter of 2015 FDI grew 10.6 percent YoY to IDR 109.9 trillion or 15.5 percent in U.S. dollar terms to \$8.2 billion.

From the start of his presidency, President Widodo has consistently touted liberalization and deregulation as necessary for Indonesia to attain rapid economic growth.

Over the past two years, his administration has issued 16 economic policy reform packages aimed at improving the business environment and spurring higher rates of investment growth, including by removing 35 sectors from the Negative Investment List.

“I would argue, unequivocally, that in Indonesia the trend is toward more rational regulations, a more modern mindset, better infrastructure, a more outward orientation, openness, and internationalization,” Lembong said in an interview for this report.

He pointed out, for example, that removing investment restrictions has made a significant difference.

“To give one very illustrative example, the movie production, movie distribution and movie exhibition industries went from zero percent foreign ownership allowed to 100 percent foreign ownership allowed,” he said.

Since then, he said, GIC – the Singapore sovereign wealth fund – announced in December 2016 that it was investing IDR 3.5 trillion in PT Nusantara Sejahtera Raya, the company that runs Cinema 21, Indonesia’s biggest cinema chain. In August 2016, South Korea’s CJ CGV Co spent \$25.4 million to raise its stake in Indonesia’s second-biggest cinema chain, CGV Blitz.

However, investment growth is still falling behind expectations.

In the first quarter of 2017, FDI grew by only 0.9 percent year-on-year (YoY) to IDR 97 trillion, down from 2.1 percent YoY the previous quarter. Things picked up in the second quarter, with FDI growing 10.6 percent YoY to IDR 109.9 trillion or 15.5 percent in U.S. dollar terms to \$8.2 billion.

“While we do have growth in investment, we’re not seeing what we call greenfield investments,” Mari Elka Pangestu, a former minister for both trade and for tourism and creative economy, told AmCham and the U.S. Chamber in an interview for this report.

“It’s more expanding existing investments. We’re not seeing new investments come in.”

According to Bambang, the shortfall between Indonesia’s FDI expectations and realization boils down to issues of licensing, land acquisition and local government attitudes toward foreign investors.

“This is our priority, to make sure there will not be much constraints to FDI coming into Indonesia,” he said.

“We understand that the early registration for businesses has been relatively easy through the BKPM. But when it comes to more technical permits or licenses, some constraints [are still] coming from line ministries, local governments.”

“So when we are talking about a single reform [needed to boost FDI], it’s still on licensing, but on technical licensing rather than general licensing that has been enjoyed mostly by potential investors in Indonesia.”



Chapter 3

Hurdles to High Growth

As Indonesia struggles to reach its current high growth targets, policymakers and analysts cite as hurdles regulatory inconsistency and deeply ingrained instincts to protect national interests and to control and overregulate the economy.



After more than three years in office, the Widodo administration has gained much ground. Indonesia's score in the World Bank's Ease of Doing Business Index improved from 106 in 2015 to 91 in 2016.

The World Bank noted that it now takes 58 days for a company in Indonesia to connect to the nation's power grid, down from 78 days previously, and that the use of online systems, the removal of the paid-in minimum capital requirement for SMEs and the introduction of simpler customs documents have contributed to Indonesia's 15-spot rise.

Indonesia's increased efforts against corruption have also yielded some results, with the country reaching an all-time high of 37 points in Transparency International's 2016 Corruption Perceptions Index, up from a record low of 17 points in 1999.

Despite this, the country still finds it difficult to reach the high growth targets it sets for itself. The Asian Development Bank's latest outlook forecasts GDP growth of 5.1 percent for 2017 and 5.3 percent for 2018.

When it emerged that Indonesia's FDI growth of 0.9 percent YoY in the first quarter of the year was the slowest pace in five years, the BKPM's Lembong laid part of the blame on the government's lack of consistency.

"The number one risk remains the slacking spirit of deregulation and slowing momentum of economic reform," he said at the time, according to Reuters.

In an interview for this report, he cited local content requirements and

various import restrictions as examples of misguided regulations that discourage foreign investors.

"Poor or misguided regulations are the number one investment obstacle by far. This is what academics term [as] trying to regulate outcomes – having a certain designed outcome and simply trying to force people to immediately deliver the outcome by legal requirements," he explained.

"It's usually not realistic, it's usually not natural and it simply means that investment goes elsewhere. Sad to say, we really haven't fully learned the lessons of real-life case studies."

Former trade minister Mari echoed Lembong's comments, pointing out that similar policies failed in the past partly because of insufficient local capacity.

"We need to be smart about our domestic content policy," she said. "At the end of the day, for manufacturers – whether in industry or the creative economy – it makes more sense to hire locally, or to use local products if they're available and of the right quality, because it's more cost effective and easier to manage. So it's in your interest to develop local capacity."

There is also continued resistance to opening up the economy, despite top-level rhetoric about liberalization.

When Indonesia announced its supposed "Big Bang" liberalization in 2016 through the removal of 35 industrial sectors from the Negative Investment List (DNI), 20 new sectors were added. Of the 49 sectors that saw changes in the list, 19 saw increased restrictions.

Indonesia's increased efforts against corruption have also yielded some results, with the country reaching an all-time high of 37 points in Transparency International's 2016 Corruption Perceptions Index, up from a record low of 17 points in 1999.

37 Pts.

"I think we have to be clear: Are we open for business or not? And if we're open for business, what does that mean? Whether it's about foreign ownership, whether it's about foreign workers."

Mari Elka Pangestu, former Minister for Trade, and for Tourism and Creative Economy



Credit: AmCham

Fear & vested interests

These inconsistencies, according to analysts, point to a fundamental issue that has been holding Indonesia back from the high rates of investment growth it might otherwise achieve: A strong underlying reluctance to open up to the rest of the world and to let market forces operate. The Widodo administration's efforts to make the country more competitive and business-friendly clash against deeply ingrained instincts to protect national interests and to control and overregulate the economy.

As a result, despite President Widodo's stated desire for liberalization and deregulation, ministries and local governments continue to issue and implement regulations that run against these principles, sending out mixed signals to potential investors eager to come in and bring not only capital, but technology and best practices as well.

"I think we have to be clear: Are we open for business or not? And if we're open for business, what does that mean? Whether it's about foreign ownership, whether it's about foreign workers," Mari said.

"Whereas I believe we do have to take care of the national interest, it's not necessarily by building walls. Because in today's world, with technological disruption and with the way every other country is going, it doesn't work. What you need to do is develop your capacity while you learn from whatever foreign influences come in."

In the financial sector for instance, Mari pointed out that Bank Indonesia has restricted the number of senior expatriate managers that can work in a local bank. That means, according to analysts, that Indonesian banks will be limited to the best talent among Indonesia's population of 260 million, while they compete with international banks able to draw from the global population of 6.5 billion in the search for talent.

"Take something like the creative economy," Mari added, "You're not going

to grow as a hub for creative industries, whether it's the digital space or the film industry, if you don't allow foreign talent to come in and help you develop."

Amid an increasingly competitive global market for foreign investments, these instincts to protect local players and overregulate, which run counter to the government's own stated goals, create an environment of uncertainty.

"The bottom line, as I'm sure surveys are showing, is that policy uncertainty and unpredictability is becoming an issue for both domestic and foreign investors. A lot of investors are adopting a wait-and-see approach," Mari said.

This is frustrating the government's plans to attract much-needed foreign investments, and ultimately holding Indonesia back from reaching its high-income-economy goals.

The reform drive may be further challenged by the rise of identity politics, which in the recent 2017 Jakarta gubernatorial election helped oust the Christian, ethnic-Chinese incumbent. This has raised concerns that ahead of the 2019 presidential polls, moves toward greater openness and internationalization may prove difficult.

In addition, despite improvements in the fight against corruption, the reality is that bribery and other challenges remain a high risk for companies operating in Indonesia. There has been virtually no progress in the kind of bureaucratic reforms that might mute the incentives for government officials to resort to corrupt practices.

"Let's be honest, salary and compensation in the bureaucracy is still pathetic," Lembong said. "I, for one, believe that it's impossible to ask people to not be corrupt and to really give it their utmost if we only pay our bureaucrats peanuts. But that points to another root issue, which is that, frankly, even if you wanted to raise civil servant salaries right now, we don't have the money."

Chapter 4

Analysis of Sectors



Credit: iStock



Credit: Badan Koordinasi Penanaman Modal (BKPM)



We look at the plans and potential for nine areas in the Indonesian economy where U.S. companies have an active presence, and analyze the challenges each sector faces.

Agriculture

Indonesia's Agriculture goals

- 1 Self-sufficiency in garlic and consumer sugar by 2019
- 2 Self-sufficiency in soybeans by 2020
- 3 Self-sufficiency in industrial sugar by 2024
- 4 Self-sufficiency in beef by 2026
- 5 Become a world food center by 2045

In February 2015, President Widodo confidently announced he was optimistic Indonesia would achieve self-sufficiency, food security and food sovereignty by the time his first term as president ends.

With support from the government and the private sector, he said the kind of productive farming practices he witnessed in a number of regions could be implemented on a national scale. That same year, the government allocated IDR 55.6 trillion to agricultural subsidies, which Bambang Brojonegoro of Bappenas, then the finance minister said would be used to help small farmers access fertilizers and seeds.

In 2016, helped by the La Niña weather pattern, Indonesia harvested enough for the Ministry of Agriculture to declare self-sufficiency in rice, fresh chili, onions and animal feed. The country's rice production of 79.17 million tons for the year in fact exceeded the government target of 72 million tons.

In the coming years, the ministry aims to achieve the same for other produce: self-sufficiency in garlic and consumer sugar by 2019, soybeans by 2020, industrial sugar by 2024, and beef by 2026.

The government also wants Indonesia to regain its glory years in the production of coffee and spices.

By the time Indonesia celebrates its 100th year of independence, the vision is to become a "world food center."

While the goal seems laudable, experts warn that focusing on food self-sufficiency is not an effective way of achieving the ultimate goal of food security.

"Food self-sufficiency does not address the core elements of food security," according to a 2012 review of Indonesia's agriculture sector by the Organisation for Economic Co-operation and Development⁵.

"The focus on self-sufficiency as a means to achieve food security is misplaced, in particular because the use of import protection to increase the returns to farmers also increases food costs for consumers and hinders the competitiveness of the agricultural sector, thereby limiting agricultural productivity growth."

The problem is compounded by continuing concerns over the accuracy of Indonesia's agricultural data, which has normally been grossly overestimated compared to industry data because of incentives for local governments to do so. Import restrictions based on inflated production data could lead to shortages that cause price spikes and hurt consumers further.

Instead of focusing on self-sufficiency as a goal, the OECD recommended facilitating private-sector investment in agriculture as a more sustainable path to the ultimate aim of food security, opening up agri-food markets further to international trade, and reforming input subsidies.

The Ministry of Agriculture has touted the benefits of adopting mechanized technology to boost productivity, providing farmers with up to 100,000 units of agricultural machine tools annually, but the country can benefit further from corporate best practices and private-sector-led agricultural research

"The use of import protection to increase the returns to farmers also increases food costs for consumers and hinders the competitiveness of the agricultural sector."

OECD Review of Agricultural Policies: Indonesia 2012



Credit: iStock

4 <http://jakartaglobe.id/news/jokowi-indonesia-can-attain-food-self-sufficiency-next-four-years/>
5 OECD Review of Agricultural Policies: Indonesia 2012

and development, which is becoming more important as the agricultural workforce shrinks and threats such as global warming increase.

There are reports, for example, showing how state-distributed seeds and fertilizers aimed at boosting cocoa production failed to do so, largely because of a lack of mentoring of farmers. But companies like Cargill have successfully implemented training programs for smallholders on better cocoa-farming methods to increase their yield, the quality of their crop and their incomes. Cargill's field schools not only help thousands of cocoa growers feed their families in Indonesia, they also help ensure a supply of sustainable cocoa for the world⁶.

Other U.S. investors in agriculture have followed suit, increasing crop yields for farmers through certified seed programs, technical training and outreach

services to their farmer-partners.

If Indonesia were to boost private sector involvement in the agriculture sector, though, it would have to address longstanding issues that have kept investment levels low, starting with restrictive policies that cap foreign ownership at various levels depending on the subsector, as well as infrastructure gaps and difficulties in accessing land, among others.

Beyond this, foreign investors have long been calling for transparent and consultative policymaking, in order to help the government develop informed policies that nurture the growth of agribusiness. The sector has suffered from a number of policies aimed at protecting one subsector to the detriment of others. For example, restrictions on the import of cocoa to protect local farmers have instead negatively affected the cocoa-processing industry in the country.

Infrastructure

Indonesia's Infrastructure goals

245 National Strategic Projects, including:

- | | |
|---|---|
| 1 | 37 priority projects worth IDR 2,490 trillion |
| 2 | 35,000 MW power generation program |
| 3 | 1 million houses |
| 4 | Palapa Ring broadband project |

There's a new paradigm to respond to Indonesia's growing appetite for infrastructure, according to Wismana Adi Suryabrata, the deputy minister for infrastructure affairs at Bappenas.

Speaking at the 3rd Indonesia Economic Forum (IEF) in Jakarta in November 2016, Wismana said that if the private sector can undertake an infrastructure project, the government would leave it to them. If not, the government will try to get it done under a public-private partnership (PPP) scheme. Only if those two options are not available would the government use its own budget⁷.

His statement emphasizes how much Indonesia is banking on the private sector to help finance its massive infrastructure needs, estimated at over \$450 billion for 2015-2019. Indonesia only allocated IDR 209 trillion in its state budget to infrastructure in 2015, IDR 317 trillion in 2016, and IDR 387 trillion in 2017.

The significant gaps are expected to be met by state-owned enterprises (SOEs) and the private sector.

To make PPP infrastructure projects more attractive, President Widodo

signed a presidential regulation in 2015 that, among others, provides a long-term payment mechanism and shortens the bidding process. It also expands the types of infrastructure eligible for PPP to include health and education facilities, and processing and storage facilities for the oil and gas industry.

Law No. 2/2012 on Land Acquisition for the Public Interest also took effect in 2015, addressing some of the land acquisition issues that have long plagued both public and private projects.

However, several challenges still remain.

At the Indonesia Infrastructure Finance Forum in Jakarta in July 2017, World Bank Group President Jim Yong Kim enumerated what he said investors were telling him about why they were hesitant to bring funds into the country.

"Investors would love to invest in Indonesia, except they feel that the policies are not yet there for them to feel comfortable investing," he said. "They feel that there's still a problem of corruption in Indonesia, and the dominance of state-owned enterprises makes them worried."

The comments stem from the fact that a number of Indonesian SOEs,

⁶ <https://www.youtube.com/watch?v=Nz9yDD3SPdU&feature=youtu.be>

⁷ <http://indonesiaeconomicforum.com/article/read/finding-new-ways-to-meet-indonesias-growing-appetite-for-infrastructure>

which have easier access to low-cost funds from state-owned banks and have an implicit government guarantee, have been tasked to develop key infrastructure projects.

Former Trade Minister Mari Pangestu echoed the observations, telling AmCham and the U.S. Chamber that the private sector feel they're being crowded out by SOEs, which have limited capacity in terms of funding and ability.

In response, Coordinating Minister for the Economy Darmin Nasution acknowledged that SOEs were prioritized

in urgent projects, but pointed out that more than 50 percent of all infrastructure projects were already being funded by private investors. He clarified that Kim's comments related to perceptions foreign investors had, and did not necessarily reflect the reality.

That, however, does not change the fact that rapid reforms, such as cutting red tape, deepening capital markets and addressing rampant corruption, are still needed to attract the foreign funds needed to accelerate infrastructure development in Indonesia.

Oil & Gas

Indonesia's Energy Mix

	Oil	Coal	Gas	Renewable Energy	Energy Demand
Energy Mix 2011	50%	24%	20%	6%	165 MTOE
Energy Mix 2025	25%	30%	22%	23%	380 MTOE

Source: ADB.Energy Sector White Paper. 2014

When AmCham and the U.S. Chamber asked Industry Minister Airlangga about the major challenges Indonesia needs to overcome to achieve its industrialization goals, he pointed to the high cost of energy, which he said could be addressed by securing domestic supply. But the oil and gas industry, which the government expects to supply almost half the country's growing energy needs, is struggling to keep up.

Though Indonesia wants to reduce the share of oil from 50 percent to 25 percent of its energy mix by 2025, the pace of demand growth means its oil needs will continue to increase over the next decade. Domestic oil production has continued to trend downward, however, approaching levels that haven't been seen in Indonesia since the 1960s.

At this rate, oil production will struggle to stay above 400,000 barrels a day by 2024 – about half of what it is today – which means Indonesia would be importing over 2 million barrels a day by then, up from the current 500,000 barrels a day. This means energy costs will become more vulnerable to global price spikes.

In an effort to attract badly needed investments, the Energy and Mineral Resources Ministry in January announced a gross-split scheme to replace the old cost-recovery system. This would supposedly give contractors a bigger share of output in exchange for bearing all the

exploration and development costs of projects. By August, the ministry had already announced it would revise the gross-split scheme regulation, after failing to successfully farm out 14 oil and gas blocks offered for exploration. Investors complained that the first attempt at a gross-split regime made reasonably profitable investing a huge challenge.

According to the Indonesia Petroleum Association, Indonesia's exploration targets are shifting to more expensive deepwater offshore locations, while global competition for foreign oil and gas funds is intensifying. This year alone, Indonesia was up against about 30 other countries launching new licensing rounds, but the investment rate of return under its gross-split scheme is just 22.3 percent, against 30.4 percent in Australia and 38.2 percent in Papua New Guinea.

In the natural gas sector, the country's current production is only about half of what it needs to achieve its 2025 target of generating 22 percent of its power with gas. With domestic consumption projected to outpace production, more than doubling from 3,950 billion British thermal units per day (BBtud) today to 9,600 BBtud by 2025, the country is also at risk of becoming a net gas importer in the medium term.

The main problem in the gas sector is infrastructure, which currently only covers about 30 percent of what is required, according to Hendi Prio Santoso,

the former president director of state gas company Perusahaan Gas Negara (PGN). To meet the 2025 energy mix target, he said, Indonesia needs 15,000 to 25,000 kilometers of additional pipeline, 14 new liquefaction plants, 74 re-gasification terminals connected to the pipeline grid, 750 gas filling stations for land transportation, and 2.8 million new connections for household city gas.

Echoing what foreign investors have

been saying for years, Hendi told the first Indonesia Energy Conference in April 2017, while still at PGN, that Indonesia needs to overcome these challenges by “promoting more conducive regulations and policies by the government to enable all the players from the upstream to the downstream to produce efficiently, to have certainty of investment return, and to have sustainability in keeping a long-term investment posture in Indonesia.”

Mining

The August 2017 announcement that U.S. mining giant Freeport-McMoRan had agreed to divest 51 percent of its crown jewel, the Grasberg gold and copper mine in Papua, to future Indonesian owners was painted as a huge nationalistic win for the Widodo administration.

Though the harder task of agreeing on the divestment terms still lies ahead, the Framework Agreement was already seen as a major development after months of highly publicized, tense negotiations. Throughout the process and behind the scenes has been the specter of international arbitration should the sides fail to reach an agreement.

But the initial agreement with one of Indonesia’s largest taxpayers and a pioneer foreign investor came at the cost of a number of concessions on the part of Freeport, including the payment of higher royalties and the construction of a second smelter worth up to \$20 billion, with little guaranteed return on investment. Analysts have warned this “win” may instead cost Indonesia more in the long run in the form of lost potential investments due to concerns that Freeport’s existing contractual rights have been battered.

Indonesia’s investment regime already suffers from years of policy flip-flops, fueled by a tug of war between resource nationalism and growth needs. The country hovers near the bottom of the Fraser Institute’s mining policy perception index, sliding down from 91st out of 109 jurisdictions in 2015 to 99th out of 104 in 2016.

Along with persistent low commodity prices and the regulatory confusion caused by the ban on unprocessed mineral ore exports that resulted from the implementation of the 2009 Mining Law, this has meant the mining industry’s contribution to GDP has been on a steady decline since 2011.

Despite endless explanations from industry players and experts that forcing value-added processing – such as building smelters that may not have an economic justification due to global overcapacity – does not automatically result in added value for Indonesia, it’s clear that the government remains focused on smelters. To illustrate, more than half the projects in the Ministry of Energy and Mineral Resources’ 2017 Investment Catalogue related to refineries. The rest were geothermal projects⁸. Mining is almost invisible.

Indonesia’s ranking in the Fraser Institute’s mining policy perception index as of 2016

99th/104

8 https://www.esdm.go.id/assets/media/content/Investment_Catalogue_2017_-_Hires.pdf

Indeed, virtually no new investment is going into exploration, which is the lifeblood of the mining sector. According to PwC, Indonesia has had “extraordinarily low” exploration spending compared to its rich mineral potential over the past decade: Less than 2.5 percent of the global exploration budget from 2006-2015, and only around 1 percent in 2015 and 2016⁹.

Even if the government and Freeport reach a conclusive agreement acceptable to both sides, however, investment dollars will not immediately come rushing back in. Regulatory uncertainty has

contributed to the decision of companies like Newmont Mining, Rio Tinto and BHP Billiton to leave Indonesia in recent years, and industry players say one positive outcome will not make much difference for a sector that requires consistency over decades.

But while there is no short-term fix to the issues that ail Indonesia’s mining industry, a clear move toward rational policymaking will be a significant step, starting with a transparent and consultative process for the planned revision to the 2009 Mining Law.

Pharmaceuticals & Life Sciences

Indonesia’s Pharmaceuticals & Life Sciences goals

- 1 Universal coverage under the national healthcare program by 2019
- 2 Boost domestic production of biotechnology, vaccines, herbal extracts, active pharmaceutical ingredients and medical devices

Over the past four years, Indonesia has made incredible progress in expanding healthcare access to all, with some 70 percent of the fourth-largest population in the world now covered by a universal health insurance scheme launched in early 2014. By 2019, the goal is to achieve 100 percent coverage.

With the expected increase in domestic demand for pharmaceutical products as a result of these efforts, the government has been focusing its policymaking for the sector on boosting manufacturing self-sufficiency. Regulators should be aware, however, that many large investors are not able to supply the innovative, high-quality medicines needed by the healthcare system due to regulatory delays and sometimes non-transparent procurement processes. Addressing these issues would benefit Indonesian consumers and spur growth.

In 2016, the Widodo administration

launched an action plan to accelerate the development of the domestic pharmaceutical and medical device industry. Pharmaceuticals were removed from Indonesia’s Negative Investment List, allowing foreigners to own up to 100 percent of businesses involved in raw materials for medicines. Tax holidays were drawn up and special economic zones were also planned to entice more multinational pharmaceutical companies to set up manufacturing shops in Indonesia.

According to Coordinating Minister for the Economy Darmin Nasution, Indonesia wants more foreign investment in active pharmaceutical ingredient (API) manufacturing, particularly in joint ventures with local companies to facilitate the transfer of knowledge and technology.

These efforts have so far managed to attract some foreign investment in the sector and expand domestic API manufacturing, with Indonesian companies like Kimia Farma and Kalbe Farma

“Indonesia wants more foreign investment in active pharmaceutical ingredient (API) manufacturing, particularly in joint ventures with local companies to facilitate the transfer of knowledge and technology.”

Darmin Nasution,
Coordinating Minister
for the Economy



Credit: iStock

266

Number of clinical trials conducted in Indonesia in 2016, lower than 840 in Malaysia

\$80B

Average amount invested annually in pharmaceutical research and development globally

announcing plans for new production facilities. Indonesia's pharmaceutical sector is already 70 percent controlled by domestic companies; however, more than 95 percent of the APIs they use to produce medicine are imported from China, India and other countries. This is not a bad thing. The overriding point is that aspiring for local self-sufficiency in pharmaceuticals can be self-defeating, leaving the country without access to many state-of-the-art drugs. In addition, there is no hard evidence to suggest that greater self-sufficiency – instead of guaranteeing secure supplies of all needed drugs – would reduce the cost of healthcare or improve access to quality medicines.

Both domestic and foreign companies are reportedly held back by uncertainty over the domestic and export markets for these raw materials, as the space Indonesia is trying to compete in has been dominated for the past 30 to 40 years by India and China. As things stand, the value of Indonesia's pharmaceutical exports already declined by 2.8 percent YoY to \$176.3 million in the first four months of 2017 in the face of intense competition from China. In 2016, pharmaceutical exports also declined 3 percent YoY to \$566 million.

At the same time, multinational pharmaceutical companies have been consolidating their manufacturing processes to increase efficiency. Even if Indonesia manages to attract \$1 billion worth of investments into API manufacturing, industry experts say this would only reduce the proportion of imported raw materials by a few percentage points. The danger in this regard is that a rising tide of local content requirements could slow down or deter foreign investment

in this vital sector.

This does not mean that Indonesia can't attract more foreign investment in pharmaceuticals. But instead of concentrating on manufacturing self-sufficiency, industry players say Indonesia should be paying attention to the research and development subsector, where multinationals invest \$80 billion to \$100 billion annually worldwide. Indeed, this is an area where vast opportunities await Indonesia in terms of investment and health benefits for the Indonesian people.

Currently, the numbers are dismal. Despite having a population of 260 million, just 288 clinical trials were conducted in Indonesia in 2016, lower than in neighboring Singapore (1,578), the Philippines (781) and Malaysia (840). The sad fact is that Indonesia is losing out because it is not as competitive as its neighbors – and clinical trials are a good barometer.

On top of limitations in trained professionals and infrastructure and weaknesses in the country's Patent Law, multinational firms are further constrained by prohibitions on the transfer of clinical trial samples out of Indonesia, a nationalist-inspired restriction dating back about a decade. This is a huge barrier for multinationals, which conduct trials involving thousands of patients across multiple sites around the world.

Indonesian health officials have expressed interest in understanding how to create a more conducive environment for research and development in Indonesia — a multi-year effort that will require long-term planning — but there have been no concrete steps toward this yet. Industry players say, however, that a clear policy direction would already be a significant development.

Consumer Goods

An important component of Indonesia's high economic growth target is maintaining robust consumer spending – which accounts for more than half of GDP – but month after month, consumer goods companies across various sectors have continued to report weaker-than-expected sales.

As a whole, consumer goods companies in Indonesia reported a 31 percent YoY decline in net income in the second quarter of the year, the same period the beverage industry experienced its

first negative growth in years at -3.7 percent, after enjoying double-digit growth rates from 2006 to 2011. Even the tobacco industry hasn't managed to arrest the slowdown that began in 2015, with a 3 percent contraction expected for the full year.

This continued weak consumer spending has baffled both policymakers and analysts, especially as consumer confidence remains strong in the fourth most populous country in the world. There generally remains optimism that

the weakness is temporary, and that private consumption growth will soon return to healthy levels as the middle class continues to grow.

A bigger concern among consumer goods companies continues to be regulatory issues that affect virtually all aspects of operations: Import restrictions and local content regulations that impact on raw material procurement; inconsistent regulations from one local government to another that affect sales and distribution; and reactive policymaking that disrupts operations.

Foremost among these is the 2014 Halal Product Assurance Law, which aims to make halal labeling mandatory for a wide range of goods and services sold in the country by October 2019, including food, cosmetics and pharmaceuticals. The law's long-awaited implementing regulations – which must be signed by the president to go into effect – have yet to be formally issued by the Ministry of Religious Affairs and the newly formed Halal Product Assurance Organizing Agency (BPJPH), formed under the law.

Quiet opposition to the sweeping nature of the law – the strictest in the world despite Indonesia being a secular republic – has come largely from domestic industry and within the government. Critics worry that massive costs and red tape could harm small manufacturers and retailers and scare away investors. Pharmaceutical companies are concerned that innovative and life-saving drugs may effectively disappear from the

market if halal versions are unavailable and that consumers may not be willing to purchase non-halal medicines, fearing that to do so would be illegal. There are already reports of stores in some areas being told by local police to pull products without halal labels – despite the law not yet coming into effect. A rumored judicial review is being discussed and may still change things.

With slowing tobacco sales, there is also a worry the government may again respond as it usually has by raising excise taxes beyond what is planned to meet revenue targets for the next year. While this may prop up government revenue over the short term, analysts warn this could accelerate the decline in consumption further, threatening the livelihoods of millions of tobacco farmers and retailers.

The Constitutional Court's April 2017 decision revoking the ability of the Home Affairs Ministry to cancel local regulations inconsistent with national laws also raises worries further – a concern the central government shares. "We have a lot of local laws that contradict national laws and create a bottleneck in the bureaucracy. They're also slowing us down in processing investment permits for both local and international companies," Home Affairs Minister Tjahjo Kumolo said in response to the decision¹⁰.

The concern for companies is that an already complex regulatory environment could become dramatically worse if the regions can go their own way with no checks for consistency with national laws.

Continued weak consumer spending has baffled both policymakers and analysts, especially as consumer confidence remains strong in the fourth most populous country in the world.



Credit: Diego Delso

10 <http://www.jakartaglobe.beritasatu.com/news/constitutional-court-takes-away-home-affairs-ministrys-power-revoke-local-regulations/>

Information & Communications Technology

\$10B

Planners hope to harness Indonesia's vast market and young population to create at least 10 so-called unicorns and a thousand technopreneurs valued collectively at \$10 billion by 2020.

As Indonesia tries to reshape its economy away from its dependency on raw material exports and commodities toward high-value industry, the ICT industry is a bright spot. Planners hope to harness Indonesia's vast market and young population to create at least 10 so-called unicorns and a thousand technopreneurs valued collectively at \$10 billion by 2020.

Indeed, the country's dynamic and wired population is a fertile breeding ground for startups and innovators, but this ambitious goal is facing several challenges.

To start with, the "1,000 startups movement" is an initiative of startup ecosystem builder Kibar, with backing – but no financial support – from the Ministry of Communications and Information Technology.

Indonesia-based startups also usually raise \$200,000 to \$1 million in seed rounds, meaning they can't legally attract foreign venture capital, which has a \$1 million floor based on regulations governing foreign investment in limited liability companies.

Second, the fastest-growing ICT sector is e-commerce, an area now attracting major foreign players, but issues like low electronic payment penetration and confusing regulatory oversight by two separate ministries continue to constrain its growth, in addition to challenging and expensive logistics across the vast archipelago.

E-commerce websites are also the target of more than 50 percent of

cyber attacks in Indonesia, which have been growing at an alarming rate over the past few years, according to the Coordinating Ministry for Political, Legal and Security Affairs¹¹.

Despite all these, there is much optimism in the industry. ICT Minister Rudiantara is praised for being accessible and progressive, responding to many of the concerns raised by industry players.

In July, he exempted non-smartphone devices from the 40 percent local content requirement after receiving feedback from companies about the impossible situation created by the regulation. The ICT ministry spearheaded the creation of a multi-ministry National Cyber Security Agency after the WannaCry ransomware attack targeted two major Jakarta hospitals in May. And he has promised a revision to relax the data onshoring regulation that has raised concerns across several industries by the end of the year. Data onshoring, however, is likely to remain an issue even after the change because it appears that several government bodies will still ultimately be responsible for deciding data onshoring requirements by sector, something which is unlikely to change or reverse the requirement in banking and payments.

When it comes to app-based over-the-top (OTT) services, Rudiantara has maintained that Indonesia wants foreign companies to establish some form of a local presence to level the playing field in terms of legal and tax obligations. He is vocal in saying foreign firms should

Indonesia-based startups also usually raise \$200,000 to \$1 million in seed rounds, meaning they can't legally attract foreign venture capital, which has a \$1 million floor based on regulations governing foreign investment in limited liability companies.

\$1 Million

¹¹ <http://www.thejakartapost.com/news/2016/06/03/cyberattacks-in-indonesia-rising-at-alarming-rate-officials.html>

According to BI Regulation 19/8/2017, only domestic transactions need to be routed through the NPG, and there is no requirement currently to route credit transactions through the NPG.

not be allowed to reach across borders to Indonesian consumers without being subject to local laws, a challenge faced by countries worldwide. But in response to concerns that a new draft OTT regulation might deter further investment, the minister assured companies that further consultations would be held.

There are numerous specific concerns with regard to the draft OTT regulation, including a provision that requires all OTT transactions to pass through the National Payment Gateway (NPG). Given the fact that most OTT providers currently associate payments with entities that are not in Indonesia, these transactions should be considered cross-border. According to BI Regulation 19/8/2017, only domestic transactions need to be routed through the NPG, and there is no requirement currently to route credit transactions through the NPG.

Most payments for subscription OTT services are based on credit cards, and given that BI's NPG regulation only requires that domestic transactions be routed through the NPG, starting in June 2018, the OTT regulation should clarify that there is no requirement for credit,

online or cross-border transactions of any type to be routed through the NPG.

As the growth of Indonesia's digital economy accelerates, more issues will need to be addressed and anticipated, such as data privacy. While Internet penetration in the country is relatively high, most Internet users are accessing services on smartphones with prepaid cards that have weak digital security. This highlights the idea that digital economy policy requires a coordinated whole-of-government response. For example, digital payments policy should not be the sole province of the central bank, but should involve broad stakeholder input involving key economic decision makers.

Technology will also continue to disrupt traditional industries beyond retail, finance, transportation and tourism, with healthcare seen as the next sector to benefit from tech-based innovation. To encourage such innovations, new disruptors should not have to face the same difficulties that pioneers in the market have had in getting the government to recognize and properly regulate the new services they provide.

Financial Services & Fintech

\$18B

Indonesia expects more than \$18 billion in digital payment transactions this year, more than the \$14 billion projected for Hong Kong and \$13.5 billion for Singapore.

Technology is rapidly changing the face of Indonesia's financial services sector. In a PwC survey of Indonesian banks in 2017, more than half of the respondents said technology will be the main driver of transformation in their organizations over the next three to five years.

At the same time, Financial Technology, or Fintech, is already quickly filling the huge void left untapped by traditional banks through peer-to-peer lending platforms, e-money cards and other non-traditional services. Indonesia expects more than \$18 billion in digital payment transactions this year, more than the \$14 billion projected for Hong Kong and \$13.5 billion for Singapore. This figure is projected to grow 18.8 percent per year to over \$37 billion by 2021.

Even Bank Indonesia is looking at Fintech as a way to rapidly reach the vast areas of the country still unserved: 64 percent of the population of over 260 million is still unbanked, and a credit gap of about IDR 7.5 trillion (\$530 billion) exists.

While the rise of Fintech comes with a whole new set of risks, Junanto Herdiawan,

the head of Bank Indonesia's Fintech Office, told a Fintech discussion in Jakarta in June 2017 that BI is committed to designing a regulatory framework that balances financial inclusion and financial stability.

As the central bank, traditional financial institutions and startups navigate the changing world of financial services, issues such as cybersecurity, privacy and money laundering are front and center of regulatory concerns.

In PwC's banking survey, a regulation requiring foreign trading companies to set up a data center and disaster management site onshore was one of the top concerns named by foreign banks, next to worries over a lack of consultation with regard to planned amendments to banking laws.

Beyond the fact that multinational banks and international electronic payment service (EPS) providers (e.g. Visa and Mastercard) would already have centralized and shared data centers established in different parts of the world, worries about data onshoring (under Government Regulation No. 82/2012) stem from Indonesia's weak cybersecurity and data protection regime. For instance,

the government is still in the process of establishing a national cybersecurity agency.

In response to all these concerns, ICT Minister Rudiantara has promised a revision of the data-onshoring regulation by the end of the year to make it only mandatory for certain strategic sectors. The chairman of the Financial Services Authority (OJK), which also has a role in data onshoring, told an AmCham-U.S. Chamber delegation in September that it was working with the ICT ministry on the revision. Concerns remain, however, that data onshoring will still be required in the financial services and e-payment sector.

The Indonesian Fintech Association has also been waiting for a long-promised regulatory sandbox for startups, and clear regulations to help their members scale up safely. These include digital know-your-customer procedures to allow customers in remote areas to set up accounts without the need for a physical meeting, and the recognition of digital signatures.

While the industry waits for regulations that will support innovative new products and services, Bank Indonesia has instead come out with a National Payment Gateway (NPG) regulation that foreign players warn could deter investments and new products. The regulation requires that all domestic electronic payments be processed by “switching agency” companies that are at least 80 percent domestically owned, in effect applying nationalist criteria to payment processing, and also opening the possibility of security risks by creating a single point of failure for the system.

International EPS companies have operated in Indonesia for decades, and are committed to the development of the country’s electronic payment industry. International EPS suppliers have successfully used their centralized global networks to service the Indonesian market. However, Indonesia has

adopted a series of policy measures that could limit the ability of the international payments companies to provide electronic payment services on a cross-border basis and require payments processing to take place locally. In addition, new foreign equity caps have been introduced in the EPS sector. These measures present significant challenges to the continuation of international payment companies’ business in Indonesia. The 20 percent cap on foreign ownership, assuming it is not changed, represents a significant step back from the current 100 percent foreign ownership provisions in EPS and is unprecedented both in Indonesia and elsewhere in the Asia-Pacific region.

Meanwhile, the insurance sector – which still has an incredibly low penetration rate of about 2.5 percent of the population – has enormous potential to contribute significantly to the economy over the coming years as awareness of these kinds of financial services grow. However, it needs a conducive regulatory environment that recognizes its importance and the benefits of relying on the strengths and best practices of well-established global industry leaders.

Instead, the sector, along with other non-bank financial institutions, still suffers from limited regulatory oversight, and a 2016 regulation mandating increased locally procured reinsurance ignores the benefits of spreading and diversifying risk offshore. In addition, market entry remains an issue for some insurance companies as regulators insist that in order to enter Indonesia, newcomers must purchase an existing local company, regardless of whether the transaction makes economic sense.

Other issues, such as a 20 percent equity cap set by OJK on lending by financing companies regardless of their size or global posture, restrict profits and delay deals that could fuel growth.

While the industry waits for regulations that will support innovative new products and services, Bank Indonesia has instead come out with a National Payment Gateway (NPG) regulation that foreign players warn could deter investments and new products.



Credit: iStock

Creative Industries

62%

Growth of creative industries from 2010 to 2015

Given the richness of Indonesia's culture and the wealth of available local talent, it's not surprising that the creative industries grew by more than 62 percent from 2010 to 2015. But as in other industries, the growth of the creative industries requires good policies that encourage and facilitate investment and help nourish a dynamic environment.

In addition, policies that encourage creative industries cannot be divorced from issues related to e-commerce and the digital economy. As the lines blur between traditional content companies and technology companies, getting policies right is vital to digital growth.

In developing the creative economy, policymakers also should be aware of the need to nurture local talent through education and access to training and international-quality standards. Investors will naturally help promote the growth of world-class talent as more Indonesians are employed in the sector. A supportive regulatory approach can go a long way to boosting the sector.

As of 2015, the 16 subsectors that make up the industry – including film – accounted for almost 7.66 percent of the economy, and employed 11.8 million people. Exports totaled \$19.36 billion that year, with a third going to the United States, followed by Japan and Taiwan at 6.74 percent and 4.99 percent, respectively.

But the government does not believe this is enough. The special Creative Economy Agency (Badan Ekonomi Kreatif or Bekraf) that President Widodo established in 2015 to nurture the sector aims to increase its overall contribution to the economy to 12 percent by 2019.

A big step toward this was the opening up of the film industry – production, distribution and exhibition – to 100 percent foreign ownership under the Negative Investment List (DNI), paving the way for investments in local cinemas from Singapore and South Korea. U.S. companies are also eager to jump into the market for production and distribution.

To further promote growth in the local film industry, Bekraf has sought advice from AmCham and the U.S. Chamber on creating a practical roadmap for movie production, given that the U.S. has the largest movie industry in the world. In response, a senior Disney executive has shared with Indonesian officials how the development of China's creative economy began with the establishment of sufficient protections for intellectual property rights – a concern shared by both local and foreign investors.

While important gains have been made in IP protection by the government through site-blocking efforts and greater enforcement, Indonesia still suffers from staggering rates of piracy, with some 18 million copies of pirated films, music and software circulating in the Indonesian market in any given month, both online and in shopping malls and markets. We encourage the government to continue greater efforts in IP protection, especially as a way to help develop the local industry.

Another constraint in the sector is the 2009 Film Law, which includes a 60 percent local content quota for films screened in cinemas and a ban on the dubbing of most imported films into Bahasa Indonesia. While the implementing regulations for the law have yet to be released, investment in film distribution

Creative industry exports totaled \$19.36 billion in 2015, with a third going to the United States, followed by Japan and Taiwan at 6.74 percent and 4.99 percent, respectively.

\$19.36B

will almost certainly be constrained by quota restrictions. Local companies also agree that it will be difficult to fill cinemas and justify major investments if foreign content is restricted to just 40 percent of screens.

The restriction on dubbing films into Bahasa Indonesia – already being enforced by the national censorship board – is also onerous and harmful to the growth of the local industry. If youngsters who cannot yet read subtitles are not able to watch and appreciate animated movies in their own language, they may be deprived of exposure to the best animation in the world, which can restrict creativity.

We are greatly encouraged that the local industry has encouraged openness and worked closely with foreign players. Our local partners remain concerned

with censorship rules and see the need to reach a compromise on some issues if Indonesian films are to compete globally. The relaxation on investment rules, however, is already bearing fruit in the growth of co-productions between local and foreign film companies.

There is no doubt that Indonesia has the talent and market needed to support robust creative industries, which will benefit substantially not only from foreign capital, but from partnerships with global industry leaders. In fact, U.S. film companies say Indonesian companies make \$2 to \$3 for every dollar they make from local partnerships. But until sufficient protections and conducive regulations are in place, growth will be slower than expected.

\$2 to 3

U.S. film companies say Indonesian companies make \$2 to \$3 for every dollar they make from local partnerships.



Credit: Bali Film Center

Chapter 5

Recommendations

Attracting much-needed foreign investment can help bridge the gap between an average growth rate of 5 percent and the 6-7 percent Indonesia needs to reach its goals. We discuss the structural reforms needed to attract more investment dollars.



Credit: iStock

datations



Four Ideas

There is no question that Indonesia has the potential to become a high-income economy due to its huge population and rich natural resources. However, attracting much-needed foreign investment to help bridge the gap between an average growth rate of 5 per-

cent and the 6-7 percent needed to reach its goals requires structural reforms much deeper than those undertaken so far. Without making a lengthy laundry list of individual laws or regulations that need to be addressed, we instead discuss some general themes below.

A

Develop a comprehensive approach supported by a clear roadmap that everyone can work toward.

The Widodo administration's 16 economic reform policy packages introduced since 2014 have made progress in terms of liberalization and reducing the cost of doing business, but a comprehensive approach toward the goal of increased competitiveness appears lacking.

"What's missing is a holistic picture about how we want to be more competitive, and that requires you not to take a sectoral approach," former trade minister Mari Pangestu said in an interview.

Without a holistic picture, different government agencies come up with different approaches to address shared problems, often resorting to ill-defined nationalism to justify actions and restrictive policies that actually hurt the economy. Inconsistent policies from one ministry to another add to the cost of doing business and erode legal certainty.

A comprehensive approach should

be supported by a clear roadmap, with short-, medium- and long-term goalposts. Assuming such a roadmap is followed, this would allow investors to see if the country's direction is aligned with their plans.

"Your short-term outcomes and policies need to be done very strategically to get political support, and that will hopefully support your medium- and long-term [goals]," Mari continued.

Without political support, even the best policies won't get implemented or funded.

Each government regulation issued should be in line with the roadmap, which would create the regulatory consistency and certainty that both foreign and local investors want. This would represent a fundamental change in policymaking and would compel ministries to act in harmony with one another toward a common set of national goals.

B

A comprehensive approach and roadmap must be based on the country's competitive advantages.

In the increasingly competitive global economy, Indonesia has to be strategic in its goals. While the country's large population and rich natural resources give it a major edge, it has to compete with countries that have more skilled labor, better infrastructure and well-developed industries in certain sectors.

It would be inefficient and counterproductive, therefore, for Indonesia to simply aim for end-to-end manufacturing, force a certain level of local content on a wide range of products and services, or impose import restrictions to force manufacturers to support local producers. These kinds of policies, all too

common now, often show a lack of understanding of the needs of the very industries the country says it wants to develop.

"When you talk about manufacturing, we shouldn't be thinking about it in the old model, which is integration from end to end, because that's not the way the global value chain works anymore," Mari said. "We have to find our specialization."

Manufacturing companies faced with import restrictions that force them to source raw materials locally often end up delaying or canceling plans because local suppliers prove unable to provide the specific quality or quantity of the supplies they need.

C

Develop regulations transparently based on quality data and sound science, with mandatory public consultation and stakeholder engagement.

The practice of policymaking behind closed doors, and issuing disruptive regulations that surprise the industries they directly impact, should end. Public consultations are a standard policymaking practice among governments in advanced economies throughout the world, with clear and open dialogue between regulators and those being regulated the norm in successful economies.

In Indonesia, public consultation is mandated by law but often ignored or minimized. The result is that the government has been forced to retract or amend several disruptive policies that were drafted with insufficient data or consultation.

President Widodo himself has stated that rules, regulations and policies should

be made through a transparent process taking place over “many, many months and many, many times of open public consultation,” according to BKPM Chairman Thomas Lembong.

Some ministries have been more engaged with stakeholders than others, and more agencies are starting to take consultation seriously. But businesses still report that often their inputs are not considered even if they are solicited. Lembong, however, is confident that the government can show progress on achieving this reform over the short term.

“This is something that is fully within the control of the executive branch and something that could realistically be implemented in the next one or two years,” he said.

D

Boost competitiveness by investing and regulating for the long term.

One consequence of political cycles is the lack of clear planning for the long term and investment in things that don't generate visible returns in the short term, such as education reform that would produce the graduates needed for the kind of economy Indonesia will have in 20 years' time, or policies that would foster the kind of research and development environment that can produce innovations after a decade or so.

This lack of forward planning has contributed to the current situation, where Indonesia's oil and gas outputs are at risk of significantly dropping in 10 to 15 years, creating energy insecurity. In mining, the government is laser-focused on adding value to its natural resources now, but the lack of investment in explo-

ration risks leaving the smelters currently being built with insufficient supply in the long run. And even if Indonesia wants to develop a modern services industry immediately, the lack of investment in education and thoughtful reform means the country doesn't have the workforce to make it happen.

Similarly, legal reform is another area where change is badly needed, but there is little short-term incentive to battle the entrenched interests who benefit from the system as it is. Investors frequently complain of being baffled by the legal code and wary of having to enter the country's legal system. As a result, legal costs and concerns mount for companies, leading to delays in making investment decisions.

The rewards for Indonesia's people in terms of quality of life await. What is needed is the will to make it happen.

“Moving from middle-income status to high-income status requires some difficult structural reforms to the economy,” Chris Tinning, the chief economist of development at the Australian Department of Foreign Affairs and Trade, said at the Indonesia Development Forum in July 2017. “That often makes for some difficult decisions in terms of opening up sectors that have traditionally been closed.”

These recommendations summarize what development experts, economists and investors have been saying for years, which many progressive minds in government agree with, recognizing what is needed to shift Indonesia's growth into higher gear. The rewards for Indonesia's people in terms of quality of life await. What is needed is the will to make it happen.



U.S. CHAMBER
OF COMMERCE

