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Contents

Foreword

Part I
Overview of Recent Regional Economic Developments and Outlook

Part II
Strategic Issue: Market Access Diversification and Industrial Zone Expansion for Export-Oriented, Labour-Intensive, Technology-Intensive, and Natural Resource-Based Supporting Industries Development

Box 1
Regional Inflation Convergence to the National Inflation Target

Box 2
Price Fluctuations of Volatile Foods (VF) at Traditional Markets, Modern Markets and Wholesalers

Box 3
Development of the Semiconductor Industry as an Export-Oriented and Technology Intensive Industry to Sustain the Goods Trade Surplus

Box 4
Controlling Inflationary Pressures on Airfares in Bengkulu

Box 5
Strategies to Stimulate the Textile and Footwear Industries: Creating Access to Potential Markets by Strengthening Domestic Industry

Box 6
Strategies to Strengthen the Automotive Industry of Java: Expanding the Export Market by Enhancing Domestic Competitiveness

Box 7
The Role of Bali’s Tourism in Development of Potential Export-Oriented Industries

Box 8
The Downstream Nickel Industry Outside Java
Policymaking at Bank Indonesia take into account the recent economic development issues from a national and regional perspective. To that end, the Board of Governors periodically discuss the regional economic dynamics and issues. The outcome of this meeting becomes input for policymaking at Bank Indonesia and is communicated to all stakeholders through the quarterly Nusantara Report. The publication is compiled in conjunction with the Economic and Monetary Policy Department (DKEM) as well as Regional Departments I, II and III, representing Sumatra, Java and Eastern Indonesia respectively.

Recent economic development concluded that national economic growth accelerated in the fourth quarter of 2017 to 5.19%. The domestic economy achieved 5.07% growth in 2017, up from 5.03% in 2016, supported by solid economic growth in all regions of the archipelago.

Based on the latest assessment, economic growth is predicted to remain in positive trend in the first quarter of 2018, despite moderating from the previous period. Growth in various regions of Eastern Indonesia is expected to accelerate, while Java and Sumatra are predicted to maintain robust growth notwithstanding a slight downturn from conditions in the fourth quarter of 2017. Moving forward to the second quarter of 2018, growth in various regions will pick up, driven primarily by Sumatra and Java, particularly supported by household consumption and exports. For the whole year of 2018, the economy is estimated to accelerate in nearly all regions, with the aggregate at about 5.0-5.4%. Robust domestic demand, increasing investment and the ongoing global economic recovery will sustain economic performance in 2018.

Inflation was maintained within the target corridor of 4.0%±1% in 2017 at 3.61%, supported by low volatile food (VF) inflation (0.71%) and controlled core inflation (2.95%). While inflationary pressures on administered prices (AP) were relatively high, as the government continued to reform subsidy policy by reducing electricity subsidies. The achievement of low and stable inflation in 2017 was also inextricably linked to policy coordination between Bank Indonesia and the Central Government and Regional Government to control inflation.

In the first quarter of 2018, inflation risk on volatile foods (VF) is projected to be minimal in line with the ongoing harvests of several food crops. Nevertheless, pressures on core inflation and administered prices (AP) are expected to accumulate as global oil and international commodity prices rise. As of yearend 2018, inflation is projected at about 3.5±1%. Potential inflationary pressures are expected from the rising global oil price and increasing domestic demand, as an effect of recent economic recovery. Furthermore, a slight build-up of inflationary pressures on volatile foods is also projected in line with potential hikes to several food’s prices such as rice and horticultural commodities.
Furthermore, this edition of Nusantara Report also elaborates issue on the “Development of Export-Oriented, Labour Intensive, Technology Intensive Industries, also Natural Resource-Based Downstream Industries through Market Access Expansion and Industrial Zones.” This issue was raised considering one of the efforts to reduce the current account deficit and achieve solid, sustained, balanced and inclusive growth by strengthening export-based manufacturing industries, including labour-intensive industries, through increased value added products and technology adoption. Efforts to strengthen technology uptake in manufacturing products must be supported by the manufacturing sector through: (i) comprehensive integration with the global value chain; (ii) greater access to export markets through Free Trade Agreements (FTA); (iii) tangible reforms, including the development of economic zones; (iv) strengthening the local value chain; and (v) the provision of human capital to the manufacturing industry.

In this edition, the various potentials and challenges are explored.

As a closure, I sincerely expect the Nusantara Report to be used as a reference to the benefit of all stakeholders and regional economic observers, as well as a valuable Bank Indonesia contribution to regional economic development. May God the Almighty bless each and every step we take in working for our beloved nation.

Jakarta, 26th February 2018
Economy and Monetary Policy Department

Dody Budi Waluyo
Assistant Governor
MARKET ACCESS DIVERSIFICATION AND INDUSTRIAL ZONE EXPANSION FOR EXPORT-ORIENTED, LABOUR-INTENSIVE, TECHNOLOGY-INTENSIVE, AND NATURAL RESOURCE-BASED SUPPORTING INDUSTRIES DEVELOPMENT

In order to transform to higher-income country, Indonesia needs a surplus on current account, supported by surplus on trade of goods and higher employment absorption. This goal can be achieved through strengthening the role of export-oriented, labour-oriented and med-high tech industries.

Policymakers' focus on strengthening manufacturing to support surplus on current account includes:

- Global Value Chain (GVC) Integration
- Linkage between GVC to Local Value Chain (LVC) and SMEs
- Development of Industrial Estate and Connectivity Infrastructure
- Strengthening of Human Resources quality
- Preferential/Free Trade Agreement Optimization

Focus of Export Oriented future industries in several Indonesian regions:

**SUMATERA**
- Labour Intensive
  - Palm Oil
  - Rubber
  - Aluminium
  - Coffee
  - Fishery
- Med-High Tech
  - Semiconductors

**JAVA**
- Labour Intensive
  - Food & Beverages
  - Textiles
  - Food processing
- Med-High Tech
  - Electronics
  - Automotive

**Eastern Indonesia**
- Labour Intensive
  - Nickel
  - Copper
  - Seaweed
  - Cocoa
  - Coconut

**Strategies On Strengthening Export Oriented Industries**

**Input Factor**
- Improvement on Human Resources Quality: Strengthening of vocational education and internationally certified skills
- Development of Industrial Estates: Support of policy regulation, incentives, infrastructure, qualified human resources for labour intensive and med-high tech industries

**GVC and Market Access**
- Strengthening of economic diplomacy to reduce non-tariff barriers
- Strengthening of GVC integration through export-oriented MNCs' linkages with strong global networks
- Providing FTAs to regularize support market access expansion and improve production efficiency

**Local Value Chain**
- Development of Local Value Chain connection to GVC through global players partnership

**Incentives Scheme**
- Tax incentives for upstream industry investment
- Incentives scheme for development of corporate R&D center in Indonesia
PART I

Overview of Recent Regional Economic Developments and Outlook
Overview of Recent Regional Economic Developments and Outlook

Recent Regional Economic Developments

Economic Developments in the Fourth Quarter of 2017

Economic growth in Indonesia accelerated in the fourth quarter of 2017 compared to conditions in the previous period. The national economy posted 5.19% (yoy) growth in the reporting period, up from 5.06% (yoy) in the third quarter on the support of solid export and investment performance, growing respectively by 7.27% (yoy) and 8.5% (yoy). Furthermore, investment and exports sustained household consumption at 4.97% (yoy), increasing from 4.93% (yoy) in the previous period. By sector, the construction sector, transportation and warehousing sector as well as the information and communications sector were the main drivers of national economic gains. Regionally, however, robust economic performance reported on the islands of Java and Sumatra contributed to faster national economic growth.

Sumatra’s economy posted relatively solid growth at 4.43% (yoy) in the fourth quarter of 2017. Growth in Sumatra was underpinned by stronger household consumption together with surging exports, particularly exports of natural resources due to the ongoing harvesting season, which also elevated farm incomes and, therefore, induced more consumption. By sector, the agricultural and trade sectors were the key drivers of Sumatra’s economic growth. In the fourth quarter of 2017, agricultural performance improved as farmers ramped up production of food crops and horticultural produce, coupled with rising plantation commodity prices. The agricultural sector gains fed through to the trade sector, boosting interregional and international trade. Spatially, South Sumatra, North Sumatra, Lampung, Jambi and the Riau Islands were the main contributors to economic growth on the island of Sumatra.

The economy of Java achieved growth of 5.62% (yoy) in the fourth quarter of 2017. Growth in Java was supported by increasing household consumption and a surge of investment activities. The cyclical spike in activities during the year-end holidays and corresponding religious celebrations edged up household consumption, while investment on Java was sustained by the accelerated completion of various infrastructure projects. At year-end 2017, several infrastructure projects entered the completion phase. By sector, Java’s economy was supported by a strong manufacturing industries and construction sector in the fourth quarter of 2017. Increasing demand for commercial transportation equipments, textiles and articles as well as paper for the domestic and export markets helped to drive manufacturing industry performance. Meanwhile, the construction sector benefitted from the development of various government strategic infrastructure projects along with private investments. Geographically, the provinces of Banten, East Java, West Java and Central Java contributed to faster growth in Java. On the other hand, growth in Jakarta and Yogyakarta moderated slightly on the previous period but remained solid.

Similarly, the economy of Eastern Indonesia moderated in the fourth quarter of 2017, from 5.38% (yoy) to 4.85% (yoy), but growth remained robust. The seasonal spike in activities during the year-end holidays and religious celebrations push
up household consumption, while investment in Eastern Indonesia was supported by the accelerated realization of various infrastructure projects along with greater investment in the mining sector and manufacturing industries. Nevertheless, declining coal exports and the Mount Agung eruption were the main drag on economic activities. By sector, construction and trade were the key economic drivers of Eastern Indonesia in the fourth quarter of 2017. Construction sector growth was prompted by the completion of various government infrastructure projects and the development of several commercial processing facilities. Meanwhile, the trade sector growth was driven by imported building materials and consumer goods to meet the annual spike in demand towards yearend. Spatially, Sulawesi and Mapua (Maluku and Papua) were the key drivers of economic growth.

Economic Developments in 2017

For the whole year, national economic growth in 2017 confirmed the ongoing gradual domestic economic recovery. Indonesia’s economy expanded 5.07% in 2017, up from 5.03% the year earlier. Economic growth in 2017 was the strongest on record for the past five years. Meanwhile, investment growth accelerated from 4.47% (yoy) in 2016 to 6.15% (yoy) in 2017 as the government pledged to accelerate infrastructure projects realization, particularly in the second semester of the year. By sector, the economic sectors linked to exports and government investment activities enjoyed the strongest gains. The manufacturing industry was the largest economic contributor, accounting for a 21% share of the economy. Moreover, improving export performance was reflected in the agricultural sector, particularly the plantation subsector, as well as the processing industry. Finally, the government’s plan to accelerate various infrastructure projects sustained construction sector performance. By region, the national economic gains achieved in 2017 were supported by faster economic growth in all regions of the archipelago.

For the whole year, the economy of Sumatra grew 4.30% (yoy) in 2017, up from 4.29% (yoy) in 2016. The increase of economic growth in Sumatra were supported by improving export performance and government spending. Exports of goods and services in 2017 grew 7.99% (yoy), higher than previous 0.89% (yoy) contraction in 2016, affected by external factors such as the increase of CPO, rubber and coal prices. Furthermore, government consumption increased from a 0.88% (yoy) contraction in 2016 to grow 4.62% (yoy) in 2017, in line with greater budget absorption which is increasing from 66.9% to 80.6%. By sector, Sumatra’s economy expanded as a result of sectors linked to investment and export activities as well as government spending were the main drivers of Java’s economy. The impact of stronger exports was reflected in the trade sector and manufacturing industry, particularly paper products and garments. Meanwhile, the increase of investment activities reflected by the growth of metal processing industry subsector and construction sector. By region, Jakarta and Banten were the key drivers of economic growth on the island of Java.

The economy of Eastern Indonesia accelerated from 4.84% (yoy) in 2016 to 5.10% (yoy) in 2017. Similar to other regions, the economic gains in Eastern Indonesia were down to increasing investment and export activities. In 2017, exports from Eastern Indonesia posted 7.70% (yoy) growth after contracting 2.63% (yoy) in 2016. Export performance in Eastern Indonesia improved on rising international commodity prices, namely CPO, coal and rubber. Furthermore, investment growth

1 The salient construction projects in Eastern Indonesia included the Trans-Papua highway, the border road development in West Kalimantan, power stations in West Sulawesi and Gorontalo, CPO processing plants and upgraded oil refineries in East Kalimantan, rubber and biodiesel processing plants in Central Kalimantan as well as downstream projects (smelters).
picked up from 3.61% (yoy) in 2016 to 4.94% (yoy) in 2017, induced by the accelerated realisation of Strategic Government Projects (SGP), downstream projects development and growing investment in capital goods for mining and industry. Sectors associated with export and investment activities fostered economic growth in Eastern Indonesia. Improving export performance was reflected in the agricultural sector, mining and trade, with the agricultural sector accelerating from 4.20% (yoy) in 2016 to 5.20% (yoy) in 2017 on rising plantation commodity prices, particularly rubber and crude palm oil, along with increasing production of food crops and larger volume of freshly caught fish. The mining sector also achieved stronger growth in 2017, from 1.42% (yoy) in 2016 to 2.01% (yoy) in 2017, again on rising international commodity prices, particularly coal, as well as the operation of several new smelters and policy to relax the quota on low-grade nickel mineral exports. By region, Kalimantan was the main driver of economic growth in Eastern Indonesia.

Notes:
- Green: contributes positively to regional GDP
- Red: contributes negatively to regional GDP

Table 1.1. Regional Economic Growth Trends in Q1/Q2018*

<table>
<thead>
<tr>
<th>Regional GDP</th>
<th>Aggrep</th>
<th>SUMATRA</th>
<th>JAVA</th>
<th>EASTERN INDONESIA</th>
</tr>
</thead>
<tbody>
<tr>
<td>Economic Growth</td>
<td>Trend</td>
<td>Assessment</td>
<td>Trend</td>
<td>Assessment</td>
</tr>
<tr>
<td>Household Consumption</td>
<td>Public consumption decreased in Christmas and New Year, coupled with the end of housing season for several commodities</td>
<td>First Phase Program Kalibunga (PNK) disbursement as well as increasing consumption in preparation for local elections and Home Games in 2018.</td>
<td>Increasing number of businesses in ∆ernatia, particularly hotel, retail shops, restaurants, household consumption and investment and imports.</td>
<td></td>
</tr>
<tr>
<td>Government Consumption</td>
<td>Public sector cutbacks due to the end of the quarter and several projects still in the initial stages</td>
<td>First Phase Program Management (PNK disbursements Prior) is in 10 regions, according to the End of the quarter of 2018, as well as preparation for local elections and Home Games in 2018.</td>
<td>Distribution of operational expenditure in support for preparations for the political situation during the year.</td>
<td></td>
</tr>
<tr>
<td>Investment (IGCPF)</td>
<td>The national level of active small business owners falling, the political situation during the previous quarter, together with non-competitive capacity selection</td>
<td>Local government investment at the beginning of the year continued with the same trend, and the infrastructure projects are expected to drive the political situation during the second quarter of the year.</td>
<td>Maintained capital spending from the State Budget at the beginning of the year and government spending.</td>
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<tr>
<td>International Exports</td>
<td>Start of the tracking season on lower export volumes, decreasing export duties on tobacco, increasing imports in US and the like, as well as occurring in international commodity prices in 2018.</td>
<td>Higher global economic growth, increasing export volumes of tobacco, increasing exports of tobacco and related products.</td>
<td>Higher export proceeds on the export of rice, in line with the adequate supply of foodstuffs and price corrections in several commodities, including red chillies, shallots and garlic, as the main contributors to inflation.</td>
<td></td>
</tr>
<tr>
<td>International Imports</td>
<td>Capacity utilisation below historical, political uncertainty, during the approach to the local elections and constraints to the realisation of several government projects that could potentially offset import performance.</td>
<td>Lower import performance due to the delayed and slow realisation of mining projects.</td>
<td>Lower import duties, increase in government expenditure in preparation for the political situation during the year.</td>
<td></td>
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</table>

*Annual trends (yoy)

Notes: green (contributes positively to regional GDP), red (contributes negatively to regional GDP)

Tracking the Economy in the First Quarter of 2018

The national economy of Indonesia is predicted to maintain solid growth in the first quarter of 2018, supported by household consumption, government spending and exports. Persistently robust export growth is expected in the first quarter of 2018 despite remaining underpinned by natural resources. Exports will increase on rising demand as the global economic recovery persists and international commodity prices continue to soar. Meanwhile, the Government is expected to accelerate consumption in the reporting period compared to conditions at the end of last year, primarily in the form of social assistance (Bansos) disbursements to all regions in Indonesia, coupled with the potential disbursement of the Profit Sharing Fund (DBH) for oil and gas as well as mining commodities, which was restrained in December 2017. Nevertheless, household consumption is predicted to remain the backbone of economic growth, supported by an average 8.71% hike to the provincial minimum wage (UMP), up from 8.25% in 2017, combined with preparations for the local elections and hosting the Asian Games in 2018. Furthermore, public purchasing power shall be maintained due to a lack of energy price adjustments at the beginning of the year. The completion of government infrastructure projects and the improvement of investment climate are expected to catalyse investment in the first quarter of 2018, with moderate gains forecasted.

By sector, the agricultural, mining and trade sectors are predicted to be the key drivers of economic growth in the first quarter of 2018. The peak harvesting season of rice in the food crop producing regions, supported by favourable weather factors for the production of fresh fruit bunches (palm oil) in Kalimantan, will boost agricultural performance. On the other hand, the mining sector will ride on buoyant coal and copper commodities, sustained by increasing demand from Kalimantan to supply power stations together with demand from major trading partners. Meanwhile, copper mining performance will improve because the Government has reinstated licenses to export concentrates from Papua.

Inflation

Regional inflation remained under control in 2017, thus supporting attainment of the national inflation target of 4.01%. National inflation stood at 3.61% (yoy) in 2017. Despite increasing on the 3.02% (yoy) recorded in 2016, inflation in 2017 was still below the average for the past five years at 4.91% (yoy). Disinflation in Sumatra and Mapua supported achievement of the national inflation target in 2017 despite rising inflation in all other regions. Meanwhile, regional inflation showed better convergence with the national target in 2017 (Refer to Box 1). Mapua maintained the lowest inflation in 2017 at a rate of 1.53%, followed by Bali (3.20%), Sumatra (3.30%), Kalimantan (3.45%), Java (3.78%) and Sulawesi (3.94%). Regional inflation was controlled in 2017 with the help of low inflationary pressures on volatile foods (VF). VF inflation in most regions declined in 2017, with 13 regions reporting VF deflation at the end of 2017, in line with the adequate supply of foodstuffs and price corrections in several commodities, including red chillies, shallots and garlic, as the main contributors to inflation. Lower VF inflation in most regions translated into a low national rate of VF inflation in 2017 at 0.71% (yoy), down significantly from 5.93% (yoy) in 2016 and the lowest rate on record since 2003. Based on observations, price fluctuations of several food commodities were relatively stable in the modern markets compared to prices in traditional markets, although the modern markets charged higher prices (Refer to Box 2).
Core inflation also tracked a downward trend in 2017 with an even distribution in all regions. National core inflation stood at 2.95% (yoy) in 2017, lower than the previous period at 3.07% (yoy). Consequently, the national rate of core inflation has remained below 4% for three consecutive years and also reached its lowest level since the implementation of the Inflation Targeting Framework (ITF) in 2005. Furthermore, Java, Sumatra and Eastern Indonesia all confirmed low core inflation in 2017. The achievement of low core inflation in 2017 was possible due to anchored inflation expectations, well managed demand-side pressures and controlled exchange rates.

In contrast, administered prices (AP) inflation increased as the Government continued to reform energy subsidies. AP inflation reached 8.70% (yoy) in 2017, up significantly from 0.21% (yoy) the year earlier. The main driver of AP inflation was policy to reform energy subsidies. The Government adjusted electricity rates for 900VA subscribers three times, with the hikes averaging 32%. The hardest hit regions were Sumatra and Java, where more of the resident population was affected by the hikes compared to residents in Eastern Indonesia. In addition, more expensive vehicle registration renewals, airfares, special fuels and duties on clove-flavoured cigarettes also exacerbated inflationary pressures on AP in all regions.

The achievement of low and stable inflation in 2017 was also intricately linked to monetary policy support by Bank Indonesia as well as strong policy coordination with the Government to control inflation. Bank Indonesia consistently oriented policies in 2017 towards maintaining macroeconomic stability and anchoring inflation expectations to the target corridor of 4.0±1%.

Furthermore, policies to control inflation were supported by coordination between the Central Government, Regional Government and Bank Indonesia through the National Inflation Task Force (TPIN) and Regional Inflation Task Forces (TPID) (Box 4 in Part 2 describes an example of effectively controlling inflationary pressures on airfares in Bengkulu with TPID involvement). Central and regional government policies to control inflation were directed towards maintaining adequate supply, uninterrupted distribution and stable food prices.

Efforts to control inflation in 2017 were also pursued in order to realise the inflation control program roadmap. TPID in all regions were directed to consistently support inflation control measures by increasing food production capacity, enhancing infrastructure and the regional logistics system, improving the food trade system, and communicating with the public to anchor price expectations. Furthermore, food price monitoring was complemented by information technology to overcome asymmetrical information between producers, traders and consumers through the Strategic Food Price Information Centre (PHPS).

At the beginning of 2018, inflation in all regions remained consistent with the national inflation target for 2018 at 3.5±1%. In January 2018, national inflation stood at 3.25% (yoy), down from 3.61% (yoy) at yearend 2017. Disinflation was reported in most areas of Java and Eastern Indonesia, after the effects of hikes to electricity rates faded, airfares returned to normal after the yearend spike and demand remained limited at the beginning of the year. In January 2018, annual inflation in all regions was still within the national inflation target for 2018, namely 3.5±1%, with the lowest rates reported in Maluku (3.31%), followed by Kalimantan (3.27%), Bali (3.16%), Sumatra (3.12%), Java (3.36%) and Sulawesi (3.55%).

Inflationary pressures on VF escalated slightly in January 2018, edged up rising prices of several major food commodities. VF inflation in January 2018 was recorded at 2.62% (yoy), increasing on the position at the end of 2017. Rising prices of rice, purebred chicken meat, bird’s eye chilies and red chilies were the main contributors to higher VF inflation. Rice prices have tracked an upward trend since September 2017, in line with higher prices of unhulled rice due to limited supply during the planting season. On the other hand, declining production pushed up the price of purebred chicken meat, while torrential rainfall disrupted the supply of bird’s eye chilies and red chilies at a number of regional production hubs.

Nevertheless, milder inflationary pressures were projected in the first quarter of 2018 as commencement of the main harvesting season alleviated pressures on VF. The supply of foodstuffs, primarily rice, was projected to increase during the main harvesting season from February-March 2018. Furthermore, an adequate supply of shallots is expected at the main corresponding production centres. Meanwhile, the effectiveness of government policies to stabilise food prices will improve. Controlled VF inflation is projected to contain the risk of rising inflation from AP and core inflation attributed to the upward international price trends of oil and other commodities.

Regional Financial Stability

Corporate Sector Resilience

In accordance with the gradual domestic economic recovery, non-financial corporate performance improved incrementally as of the third quarter of 2017. Accordingly, corporate profitability and productivity, liquidity conditions and corporate ability to meet its obligations all improved in the third quarter. Increasing profitability was induced by corporate efforts to enhance efficiency, which raised net profit. By sector, the main drivers of corporate performance were mining firms in Eastern Indonesia and Sumatra, which posted the largest profitability and productivity gains, in line with rising commodity prices, particularly coal. Furthermore, stronger corporate performance was also reflected in growth of outstanding loans disbursed by the banking industry to the corporate sector, accelerating from
Currency Management

Payment System and Rupiah

Household consumption also improved, as demonstrated by a lower ratio of non-performing loans (NPL), improving from 3.36% in the third quarter to 2.96% (yoy) in the fourth quarter of 2017.

Household Sector Resilience

Household consumption picked up in the fourth quarter of 2017, as reflected by the improving financial performance of the household sector. The banking industry reported growth of household loans at 10.92% in the fourth quarter, increasing from 10.0% in the previous period, bumped up by housing loans in all regions. Furthermore, the quality of household loans also improved, as demonstrated by declines in the NPL ratio in all regions below the 5% threshold.

Payment System and Rupiah Currency Management

Cash transactions by the public increased in line with domestic economic momentum in the reporting period. A surge of currency outflow from Bank Indonesia in the fourth quarter pointed to escalating cash payment system activity, even surpassing the outflow growth reported in the same period one year earlier. Outflow increased in all regions, particularly in Java, where growth reached 23.4% (yoy). Bucking the upward trend, noncash transactions actually slowed in the fourth quarter of 2017, including RTGS and clearing. The value of transactions settled through the Bank Indonesia – Real Time Gross Settlement (Bi-RTGS) system grew 3.14% (yoy) in the fourth quarter, down significantly from 12.47% (yoy) in the previous period, while transactions settled through the National Clearing System (SKNBI) contracted by 6.11% (yoy) in the reporting period.

Economic Outlook

Economic Outlook for the Second Quarter of 2018

Increasing economic momentum in Indonesia is estimated to persist in the second quarter of 2017, balanced across all regions. Household consumption, government consumption and exports will remain the key drivers of regional economic growth. Consumption is predicted to spike during the holy fasting month of Ramadan, Eid-Al-Fitr celebrations and school holidays that coincide with the second quarter of 2018 in all regions. Household consumption will be sustained by increasing export proceeds from natural resources and consumption spending during preparation for the local elections as well as social assistance disbursements. Stronger export growth will primarily be driven by Java and Eastern Indonesia. Meanwhile, government consumption will stem from policy to accelerate regional transfers and village fund disbursements, spending on the local elections and disbursements of 13th-month salaries and annual bonuses for civil servants. Nonetheless, investment growth is expected to moderate slightly, in line with the completion of several government infrastructure projects and limited private investment. The agricultural sector, manufacturing industry and trade sector will contribute to regional economic gains in the second quarter of 2018. The main harvesting season for various food crops in Java and Sumatra, combined with the harvesting season for Fresh Fruit Bunches (FFB) in Sumatra and Kalimantan, will underpin agricultural sector performance. Meanwhile, manufacturing industry gains will stem from the food and beverages industry in Java and the processing industry for mining commodities in Kalimantan. Trade sector activity will be triggered by interregional and international exports.

Economic Outlook for 2018

National economic growth in Indonesia is predicted to accelerate in the 5.1-5.5% range in 2018. Positive global and domestic economic momentum achieved in 2017 shall form the foundation of the economic recovery in 2018. From domestic side, investment and exports will drive growth, with the construction sector, manufacturing industries as well as trade, hotels and restaurants sector as the main contributors. Furthermore, economic growth will pick up in all regions and support the national gains. Java’s economy is projected to expand in the 5.5-5.9% range in 2018. Household consumption, government consumption and exports will drive growth together with accelerated investment towards the completion of several multyear government infrastructure projects, including supporting infrastructure for venues hosting the Asian Games in 2018. Exports will increase in line with the favourable economic outlooks projected in major trading partner countries, coupled with efforts to expand the automotive export market. Consequently, exports and investment shall become the foundation upon which household consumption is expected to grow, together with the local elections contested simultaneously across the archipelago as well as the Asian Games hosted in 2018. By sector, Java’s economic growth will be supported by the dominant sectors, namely the manufacturing industry, agriculture and trade. The manufacturing industry is expected to grow to meet increasing domestic and global demand, supported by government efforts to strengthen national industrial competitiveness. Agricultural sector performance should improve now that the climate has returned to normal after the effects of the El Nino and El Nino weather oscillations have faded. Finally, the trade sector will be influenced by exports, household consumption and government consumption. Economic growth in Sumatra is predicted to improve compared to conditions in 2017, reaching 4.2-4.6% in 2018. Consumption will be the foremost driver of growth, both household and government consumption. Again, household and government consumption will be affected by preparations to host the Asian Games in 2018 along with the local elections. Exports from Sumatra are expected to moderate on the gains posted in 2017 due to the predicted declines in COP and rubber prices. By sector, Sumatra’s economic growth will be supported by the agricultural sector, manufacturing industry and trade. In the agricultural sector, food crop performance should improve as the planting season returns to normal in line with conducive weather conditions. Regarding the manufacturing industry, the operation of new smelters will accelerate the production of processed products, while the trade sector will be a key beneficiary of the upcoming Asian Games and local elections in 2018. The economy of Eastern Indonesia is predicted to gain momentum in 2018, with growth projected in the 5.1-5.5% range. The main drivers of growth in Eastern Indonesia will originate from household consumption, investment and exports. Investment will stem from government connectivity projects, downstream mining projects and increasing the production capacity of smelters. Meanwhile, a surge of mineral exports from Papua and West Nusa Tenggara in line with policy support through the extension of export licenses for copper concentrates will boost export performance. Consequently, the investment and export gains will stimulate household consumption. By sector, the economy of Eastern Indonesia will be propped up by mining, construction and trade. Policy to extend export licenses for copper concentrates will bolster the mining sector. Meanwhile, the construction sector will expand in line with government infrastructure development activities and downstream mining projects. Finally, a surge of MICE activities (Meetings,
Incentives, Conferences and Exhibitions) will drive the trade, hotels and restaurants sector, including the Annual IMF–World Bank Meetings in Bali as one of the largest events.

There will remain, however, a number of external and internal risk factors that could impede economic growth in 2018. Externally, the potential risks include monetary policy normalisation in several advanced economies that could trigger a capital reversal. In the medium term, policy in China to switch energy sources may erode mineral exports, particularly coal. Furthermore, the risk of falling commodity prices, especially CPO and rubber, could potentially disrupt regional export performance. The upcoming local elections could delay the realisation of government and private infrastructure projects, while the government’s infrastructure development agenda requires the adequate planning of state revenues.

**Inflation Outlook in the Second Quarter of 2018**

Inflationary pressures are expected to accumulate in several regions during the second quarter of 2018. Consistent with historical trends, the rise in inflation will be down to growing demand for food commodities and air travel services during Ramadan and Eid-A-Fitr. In addition, the demand-side pressures will also escalate on increasing government consumption leading up to the local elections contested simultaneously in 2018. Nonetheless, inflationary pressures in the second quarter of 2018 are not expected to be as intense as those recorded in the same period one year earlier because the Government will not adjust AP before the elections. Eid-Al-Fitr, which falls this year in the middle of June, will leave sufficient time for prices to correct by the end of the period.

**Inflation Outlook for 2018**

Inflation in 2018 is predicted at a rate below that recorded in 2017, with the national inflation target lowered accordingly to 3.5%-1% in 2018. Low inflation will primarily stem from AP as the effects of recent tariff adjustments for 900VA subscribers fade. Furthermore, the Government will not adjust prices in 2018. Nevertheless, core inflation and VF inflation are projected to accelerate slightly compared to conditions in 2017 but remain under control. The main risks to core inflation include the rising global oil price and stronger household consumption. More expensive oil would raise the prices of special fuels and air travel. Meanwhile, VF inflation is projected to rise after experiencing a comparatively deep correction in 2017. Furthermore, rising prices of several food commodities demand vigilance.

The National Inflation Task Force (Tim Pengendalian Inflasi Nasional-TPIN) will institute strategic measures to mitigate inflation risk in 2018. Nationally, five strategic measures to control inflation have been agreed for 2018 as follows: (i) maintain inflationary pressures of VF at a maximum of 4-5% by ensuring adequate food supply; (ii) control the magnitude and timing of AP policies and mitigate the knock-on effects that may arise; (iii) strengthen coordination between the Central Government, Regional Administrations and Bank Indonesia through the National Inflation Control Coordination Meeting in 2018, amongst others; (iv) enhance the quality of data underlying policymaking; and (v) optimise the Bank Indonesia policy mix to maintain macroeconomic stability.

The strategic inflation control measures will be followed up and acted upon by each respective Regional Inflation Task Forces (Tim Pengendalian Inflasi Daerah-TPID). The TPID program in 2018 will support regional inflation control by maintaining VF inflation within the 4-5% range. The TPID inflation control program in 2018 is oriented towards:

a. Managing intertemporal production preparations;
b. Strengthening government food stocks and market operations governance by the Indonesian Bureau of Logistics (Bulog);
c. Refining production management through corporate/cooperative farming, production and post-harvest management, in particular drying and warehousing, as well as marketing;
d. Improving rice yields and quality through milling revitalisation;
e. Disbursing timely and quality Rastra Social Assistance and Noncash Food Assistance;
f. Developing an accurate production data system through e-commerce for food; and

g. Facilitating synergy between farmers and downstream industries.

**Future Challenges**

Increasingly dynamic external and domestic conditions demand strategic and directed efforts to strengthen the structure of the national economy and maintain sustainable economic growth. Strengthening the current account structure will provide more space to achieve sustainable national economic growth. Over the past three years, the current account deficit has narrowed and remained consistently below 3% of GDP. The goods trade balance has been the main contributor to the reducing current account deficit, driven by manufacturing exports, which are nevertheless still dominated by low-tech products and natural resources. Experience in several peer countries has shown, however, that strengthening the export structure, primarily in terms of manufacturing products as well as services, can play a significant role in achieving a current account surplus.

Current account improvements require the backing of policy to strengthen export-oriented industries. The current wave of global and domestic economic recovery momentum must be optimised to strengthen the current account structure in Indonesia, in particular by exploiting the economic endowments of abundant natural resources and tourism potential. Over the past few years, diversification towards a sounder goods trade structure has been observed. To that end, manufacturing industry development towards greater value added has begun in labour-intensive industries and med-high tech industries. Furthermore, the Government has already begun to expand special industrial zones for downstream industries as a concrete measure to strengthen export-based industries. Nevertheless, efforts to grow an export-oriented manufacturing industry require closer interconnectedness with the global production network and global value chain, broader market access through effective international trade agreements and structural reforms targeting regulations, infrastructure and human capital quality. Moving forward, several national industries have vast potential for development, including the semiconductor industry on Sumatra (Refer to Box 3), the textiles and footwear industry as well as automotive industry on Java (Refer to Box 5 and 6), and the creative industry supporting tourism in Eastern Indonesia (Refer to Box 7). In the long term, current account improvements, underpinned by the ability to produce and export value added products, will maintain sustainable economic growth and support Indonesia’s transition to an advanced economy (Refer to Part 2 Strategic Issues: Market Access Diversification and Industrial Zone Expansion for Export-Oriented, Labour-Intensive, Technology-Intensive, and Natural Resource-Based Supporting Industries Development).
Strategic Issue: Market Access Diversification and Industrial Zone Expansion for Export-Oriented, Labour-Intensive, Technology-Intensive, and Natural Resource-Based Supporting Industries Development

PART II

Batik Pattern: Cendrawasih Papua
Strategic Issue: Market Access
Diversification and Industrial Zone Expansion for Export-Oriented, Labour-Intensive, Technology-Intensive, and Natural Resource-Based Supporting Industries Development

Sustainable manufacturing industry growth is a solid foundation upon which to achieve robust and sustained national economic growth. As the engine of the national economy, the manufacturing industry provides a substantial contribution to domestic economic growth. Furthermore, the significant contribution to the national economy and exports emphasises the pivotal role of manufacturing industry in efforts to expand the trade surplus.

Strengthening the domestic manufacturing industry, particularly the export-oriented, labour-intensive and technology-intensive industries that support natural resources would also bolster efforts to strengthen the structure of Indonesia’s Current Account Balance by underpinning the national export structure. The current structure of exports in Indonesia is undergoing a transformation from commodity-based to manufacturing-based exports. Moving forward, efforts to strengthen the manufacturing industry require deeper integration with the global value chain (GVC), broader market access through effective international trade agreements to diversify the export markets, as well as structural reforms relating to regulations, infrastructure and the quality of human resources.

For Indonesia, the current pace of global and domestic economic momentum represents a great opportunity to strengthen the current account structure through export-based industries, while simultaneously facilitating the transition to an advanced economy and avoiding the middle-income trap.

Background

The current account improved in 2017, with a narrower deficit recorded compared to conditions in 2016. The current account gains were primarily attributed to improvements in the goods trade balance, particularly non-oil and gas (Figure II.1). The non-oil and gas trade surplus reached USD26.2 billion in 2017, improved compared to that at the end of 2016, as demand from major trading partners increased. Nevertheless, the significant non-oil and gas trade surplus was fundamentally sustained by primary commodities in 2017, contrasting the low, albeit growing, contribution of manufacturing exports.

In a number of ASEAN peer countries, goods exports, primarily manufacturing goods, represent the backbone of the respective current account surplus.
In Thailand, for example, other than goods exports, tourism services play a key role in the current account surplus (Graph II.1). Indonesia also has vast untapped potential to improve or reverse the current account deficit and achieve a current account surplus similar to Thailand and Vietnam. Both countries have successfully recorded a current account surplus with the ratio to GDP increasing over time after overcoming their respective current account deficits as experienced in Indonesia. Indonesia’s endowments include abundant natural resources and huge tourism potential, which would certainly provide sufficient leeway to improve the current account structure by optimising manufacturing exports and tourism potential.

As a lower-middle income country, Indonesia needs a robust and sustained economic growth as prerequisite to accelerate the transition to a higher income country. To avoid the middle-income trap and transition to an advanced economy, the support of a solid current account structure is imperative, backed by an adequate goods trade surplus. A trade surplus indicates a solid economic structure, underpinned by a competitive, export-oriented manufacturing industry (Graph II.2). Countries that maintain a significant trade surplus tend to enjoy a large manufacturing industry contribution to GDP and exports, such as Indonesia’s peer countries Thailand and Malaysia (Graph II.3). Indonesia needs to fully exploit the current global and domestic economic momentum in order to strengthen the current account balance, particularly through efforts to expand the trade surplus of manufacturing/industrial goods.

* Including insurance and transportation costs to convert CIF to FOB  
** ASEAN peers based on 2016 data  
Source: Bank Indonesia, World Bank, BI Staff, processed

**Table II.1. Goods Account balance and Role of the Manufacturing Sector**

<table>
<thead>
<tr>
<th>Country</th>
<th>Manufacturing/GDP (%)</th>
<th>Manufacturing/Exports (%)</th>
<th>Net Trade of Goods/GDP (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>China</td>
<td>8.5%</td>
<td>16%</td>
<td>76%</td>
</tr>
<tr>
<td>South Korea</td>
<td>8.5%</td>
<td>84%</td>
<td>94%</td>
</tr>
<tr>
<td>Thailand</td>
<td>8.9%</td>
<td>78%</td>
<td>95%</td>
</tr>
<tr>
<td>Vietnam</td>
<td>8.2%</td>
<td>21%</td>
<td>76%</td>
</tr>
<tr>
<td>Indonesia</td>
<td>1.7%</td>
<td>18%</td>
<td>74%</td>
</tr>
</tbody>
</table>

*Graph II.2. Current Account Balance to GDP Ratios*

*Source: World Bank data 2016, BI Staff, processed*
Strategy to Strengthen the Current Account Structure

Considering the experiences of peer countries, one way to strengthen the current account structure is to strengthen the export structure in the balance of trade. There are several strategies to achieve this as follows: (i) increase manufacturing product diversification and technology; (ii) increase linkages with the global value chain (GVC); (iii) strengthen integration between the global value chain (GVC) and local value chain (LVC); (iv) diversely export markets through free trade agreements (FTA); (v) designate special economic zones; and (vi) strengthen the supply of skilled human resources matched to industry requirements.

Strengthen product diversification through higher technology. Over the past few years, early indications of greater diversification towards an improved goods trade structure have been observed. Despite the ongoing dominance of natural resources, more advanced manufacturing industry and value-added development has begun (Graph II.4), including labour-intensive and medium-high tech industries such as the automotive industry. Considering that Indonesia has a large population, however, the ongoing development of low-medium tech, labour-intensive industries is also imperative to absorb the large labour force. Currently, the labour-intensive textile and footwear industries have a strong competitive advantage in terms of international trade.

Expand domestic manufacturing industry integration with the Global Value Chain (GVC). Close linkages between the manufacturing industry of a country with the GVC is indicated by the portion of exports destined to support the global production network. In Indonesia, most products of the domestic automotive industry have competitive advantage and are considered rising stars. Products such as car tyres, motor vehicles and spare parts as well as gear boxes that are integrated into the Global Value Chain (GVC) have a comparative advantage in the global market. Meanwhile, linkages between the domestic electronics industry and Global Value Chain (GVC) need to be improved. Furthermore, industries in Eastern Indonesia could also improve linkages with the production value chain for mining products with competitive advantage such as nickel and copper.

The participation and support of multinationals with global networks is a salient factor in the effective integration of domestic industries in the Global Value Chain (GVC). According to the World Investment Report (2013), 80% of international trade involves multinationals, including inter and intra-company trade. Therefore, attracting more export-oriented Foreign Direct Investment (FDI) to Indonesia is required through policies to enhance the investment climate for export-oriented partnerships and multinationals. Indonesia currently ranks as the fourth most popular investment destination for multinationals behind Thailand, India and China. Such conditions are reflected in the upward trend of Foreign Direct Investment (FDI), primarily absorbed by the manufacturing industry (Graph II.5).

Prioritising intra-regional trade of industrial raw materials in Indonesia (Local Value Chain ~ LVC) is a prerequisite to expanding GVC integration. An efficient local value chain is essential to reduce multinational dependence on imported raw materials by switching to domestic supply. This would ensure more competitive production costs and stimulate growth of local suppliers. Optimising the LVC would also expand the role of micro, small, and medium enterprises (MSME) in the supply chain, while simultaneously encouraging MSMEs to meet higher industrial requirements and increase standardisation. The role of MSMEs in an LVC network that is integrated with the GVC
(MNCs) could potentially strengthen the structure of the manufacturing industry and, therefore, the surrounding ecosystem. In the case of motorcycle exports, the production efficiency gains achieved through LVC optimisation would encourage principal multinationals to expand exports from Indonesia. Currently, the contribution of MSMEs in Indonesia in the production of export products still has vast potential to be improved.

In countries with an independent industrial zone management authority.

The development of Priority Industrial Zones and Special Economic Zones (SEZ) is a government initiative to strengthen the structure and productivity of industry in Indonesia. SEZ development and the presence of industrial zones provide business assurance and continuity to investors. The impact of special economic zones in several Asian countries has drawn more foreign direct investment, reaching 82%, and increased exports by up to 27%. There are currently 14 priority industrial zones and nine special economic zones under development through to 2019 on top of the 73 industrial zones already in operation. The majority of new industrial zones under development are in green field projects. Thus far, three such industrial zones have been operating, namely the Sei Mangkei SEZ in North Sumatra, Morowali Industrial Park in Central Sulawesi (refer to Box 8) and Bantaeng Industrial Park in South Sulawesi. Compared to other peer countries, however, the number of industrial zones in Indonesia is considered minimal (Graph II.7). Industrial zone development, supported by connectivity infrastructure, regulations and quality human resources, has a high chance of success if well managed and prioritised by the Central and local Government.

The Role of Special Economic Zones in Improving the Effectiveness of GMS Economic Corridors (ADB, 2016).

Bilateral and multilateral Free Trade Agreements (FTA) would expand Indonesia’s export markets. FTAs open up access to previously exclusive large markets, shared with the other countries in the agreement (Figure II.3). On the production side, FTAs provide an opportunity for all countries involved to compete for foreign direct investment (FDI) and access to larger markets. In terms of export competitiveness, FTAs can increase exports by reducing import tariffs and creating export product compliance. On the import side, FTAs facilitate the importation of raw materials, thus enhancing domestic production efficiency.

FTA negotiations are oriented towards opening up large markets in advanced economies and accessing broader sources of investment funds. Access to a large markets in advanced economies would be able to increase the efficiency of multinational and domestic producers in Indonesia, through economies of scale and cheaper labour cost. Indonesia currently has around 10 active FTAs, with seven more under negotiation. Although the scope of countries signed up to FTAs with Indonesia is quite broad, there remains potential to increase FTA utilisation for Indonesian exports in the international market.

The government is offering incentives to increase the competitiveness of industrial zones in Indonesia. The most important factor in investors’ decision whether to develop industrial zones is policy consistency, including reliable public services. The government has performed a number of breakthroughs associated with industrial zones, including ease of direct investment construction (KLIK) incentive and policy improvement on tax holidays, tax allowances, import duties, support for certified training and energy incentives. In some cases, however, stronger government commitment is still required.

The support of quality and competitive human resources is also required. The availability of high-
productivity and skilled human resources matched to the needs of the industry (Graph II.8) can sustain investment and development. Therefore, efforts to enhance the skills of workers require the support of educational institutions to match the needs of industry.

The revitalization of vocational education pioneers new efforts to strengthen human resources in order to reduce the skill gap (Figure II.4). The Vocational Education revitalization Roadmap is currently being implemented at a sample of vocational colleges. Furthermore, the vocational curriculum is simultaneously being refined, while the quality of the teachers with special skills is being improved along with the teaching facilities. In addition, cooperation between educational institutions and industry is being strengthened to improve the quality of vocational education and training. Meanwhile, collaboration with industry to prepare the vocational education curriculum and develop teaching factories is expected to enhance the skill-set of workers and reduce the existing skill gap. Moreover, incentives are also being offered to companies providing vocational training to meet their staffing requirements.

Indonesia must also determine which labour-intensive export industries with high value added to prioritise. The choice of priority industries must be based on competitiveness in each respective region, while also consider the strategy to increase value added (Figure V.6). Based on an assessment conducted by Bank Indonesia, there are several industries with the potential for further development to improve the structure of the goods trade account, including low-medium tech industries based on natural resources, that support employment, as well as several medium-high tech industries that could raise the value added and export competitiveness of the national manufacturing industry.

Source: Ministry of Industry

Graph II.8. Determinants of Higher Demand for Skilled Labour

Source: Indonesia Skill Report, World Bank

Figure II.4. Vocational Education Development in Industrial Zones and Cooperation with Industry

Source: Ministry of Industry

Figure II.5. Regional Priority Industry Development
Regional Inflation Convergence to the National Inflation Target

National inflation has effectively been maintained within the target corridor for the past three consecutive years. National inflation for 2015-2017 was recorded at 3.35%, 3.02%, and 3.61% respectively; fell within the corresponding target corridor of 4.0±1%. Over the past decade, however, national inflation has been very dynamic. It fell below the target in 2009 and 2011, whereas it exceeded the target in 2010, 2013 and 2014, due to inflation pressures from volatile foods (VF) and administered prices (AP).

Successfully maintaining inflation within the target range has been influenced by several factors. Core inflation has tracked a downward trend since 2016 in line with anchored inflation expectations, coupled with weak domestic and external pressures. Furthermore, volatile food inflation has also declined, hitting the lowest rate on record for past 14 years in 2017 due to steady supply and distribution, moderate pressures from international commodity prices, as well as closer policy coordination to control inflation. Inflationary pressures on administered prices (AP) were also mild in 2015-2016 (Graph III.1), although increasing in 2017 due to government’s energy subsidy reforms targeting for 900VA subscribers and increase of vehicle registration renewals fee at the beginning of 2017.

Effective inflation control was also evident spatially, with regional inflation continuing to converge towards the national inflation target. Regional inflation convergence\(^6\) is measured using the standard deviation, which has narrowed down over the past decade (Graph III.2). Furthermore, regional inflation convergence has been broad-based across the various provinces of Sumatra, Java, and Eastern Indonesia.

Regional inflation convergence is primarily associated with the trend of inflationary pressures on volatile foods (VF) as the dominant portion of most household expenses is daily staples consumption. The availability of foodstuffs in local areas is determined by adequate supply relative to demand in each respective region. Meanwhile the adequate regional supply depends on local infrastructure for supporting distribution and the proximity to a food production hub. Such dynamics create salient price disparities in different regions.

Core inflation trends also correlate with regional inflation convergence, primarily because of regional variations in economic growth and the local demand response to monetary policy, which relates to the various commodities used to calculate core inflation. Considering that core inflation is determined by fundamental factors that are not specific to a particular region, including exchange rates, international commodity prices, national economic growth and inflation expectations, the effect on regional inflation convergence is relatively muted.

On the other hand, however, regional inflation convergence does not correlate closely with Administered Prices (AP) inflation. Administered prices (AP) are determined by central government policy and the impact is typically nationwide, including fuel prices, electricity rates, cigarette duties, as well as the maximum and minimum thresholds on various modes of transportation. Nevertheless, differences in the value of various AP commodities ascribed by consumers in each respective region create inflation disparities due to administered prices, although the impact is negligible.

Over the past three years, convergence has primarily affected core inflation and volatile foods. Core inflation convergence has been due to policy mix consistency instituted by Bank Indonesia in terms of maintaining exchange rate stability as well as managing demand and anchoring inflation expectations in all regions. Meanwhile, VF inflation convergence has been linked to more consistent inflation control programs rolled out by the Inflation Task Force (Tim Pengendalian Inflasi Daerah-TPID) in each region to manage food supply and distribution.

In contrast, AP inflation convergence has declined due to government hikes of electricity rates on non-subsidised 900VA subscribers, a policy that was implemented nationwide but has had varying impacts on regional inflation because of disparities in the consumption value of electricity. AP inflation convergence fell sharply on Sumatra in 2016 (Graph III.3) due to increasing inflation of airfares in two provinces, namely Bengkulu and Bangka Belitung.

\(^6\) Here, convergence refers to conditions where regional inflation converges on a point, namely the national inflation target, as reflected by a smaller standard deviation.
In 2018, the relatively high risk of inflationary pressures on volatile foods (VF) demands vigilance in order to maintain inflation convergence towards the inflation target of 3.5±1%. The most common risks will affect rice and horticultural produce (Figure III.1). Therefore, the Regional Inflation Task Forces (Tim Pengendalian Inflasi Daerah-TPID) must remain consistent in maintaining adequate food supply through interregional cooperation by promoting modern farming techniques, enhancing farm management quality, and improving post-harvest management.

**Figure III.1.** VF Inflation Risks in 2018 in Various Regions
Price Fluctuations of Volatile Foods (VF) at Traditional Markets, Modern Markets and Wholesalers

The Strategic Food Price Information Centre (Pusat Informasi Harga Pangan Strategis-PIHPS) has shown that in the October – December 2017 Volatile Foods (VF) prices were comparatively more stable, yet much higher, at modern markets than they were at wholesalers and traditional markets. For example, the price of bird’s eye chilli fluctuated within the range of Rp55,150 – Rp61,250 at modern markets, higher than that at wholesalers with the range of Rp23,150 – Rp35,300 and traditional markets with the range of Rp29,250 – Rp43,400. Likewise, the price of rice was relatively more stable at modern markets than at wholesalers and traditional markets (Graph III.4)

On the other hand, price fluctuations at traditional markets tended to mirror wholesaler trends. For example, the price of bird’s eye chillies ticked upwards at traditional markets and wholesalers in the middle of December 2017 almost simultaneously (Graph III.5), indicating the direct transmission of prices from wholesalers to the traders at traditional markets.

The comparatively high price of volatile foods at modern markets facilitated greater price stability. The high prices charged at modern markets minimised the impact of price fluctuations at traditional markets and wholesalers. The large buffer between prices at traditional and modern markets provided ample flexibility for modern markets to maintain VF price stability despite shocks at the traditional markets.

In contrast, disparate price fluctuations are sometimes observed between traditional and modern markets. When the price of bird’s eye chillies spiked at the traditional markets, prices at the modern markets actually decreased. Furthermore, prices fluctuated less at the modern markets compared to that in wholesalers and traditional markets, and were also less susceptible to the price fluctuations observed at wholesalers and traditional markets (Graph III.6).

Moving forward, as public welfare ameliorates, the role of modern markets in the shopping baskets of households will expand. This implies that price fluctuations at modern markets will increasingly represent consumer behaviour (anchor for inflation). More stable prices are predicted to translate into more stable inflation.

Source: hargapangan.id

Graph III.4. Rice Price Fluctuations

Graph III.5. Price Fluctuations of Bird’s Eye Chillies

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Source: hargapangan.id

Graph III.4. Rice Price Fluctuations

Graph III.5. Price Fluctuations of Bird’s Eye Chillies
Development of the Semiconductor Industry as an Export-Oriented and Technology Intensive Industry to Sustain the Goods Trade Surplus

Box 3

Role of the Semiconductor Industry on Sumatra

In 2016, the goods trade balance for semiconductor products (integrated circuits) recorded a USD1,486 million deficit due to an import value of USD1,946 million and corresponding export value of USD460 million (Figure III.2). The comparatively high level of imports was used to meet demand from the high-tech electronics industry on Java as well as raw materials for backend processing/assembly on Sumatra.

Most demand for semiconductor imports originated from Java, accounted for 54% of the total imports, with the remainder from Sumatra, while the main country of origin was Singapore. On the other hand, Sumatra was the largest exporter of semiconductors from Indonesia, commanding an 84% share of total national exports. Furthermore, most semiconductor products from Sumatra were exported to Singapore, accounted for 92% of Sumatra’s semiconductor exports (Figure II.1).

Based on BPS-Statistics Indonesia data, the province of Riau Islands is the major player in the national semiconductor industry, dominating 97.5% of total national production, compared to just 2.5% for Java. The majority (86.4%) of semiconductor products produced on Riau Islands are exported internationally, with the remainder sold to the domestic market as raw materials or finished goods.

In terms of the products, the semiconductor industry on Riau Islands is currently limited to backend processing/assembly with low value added compared to other processes. Backend processing requires little capital or research and development (R&D) but absorbs more labour. In other words, the production line is less capital intensive and more labour intensive. In the global value chain (GVC), backend processing/assembly is more common in developing economies such as Malaysia, Philippines, and Indonesia. In contrast, design and frontend fabrication, which require a large capital outlay, intensive R&D as well as highly-skilled labour, remain the preserve of pioneering semiconductor industries in the United States, China, Taiwan, Japan, South Korea, and Singapore (Figure III.3).

Consequently, Indonesia’s role in the global value chain (GVC) for semiconductor products remains insignificant and well behind the major global players. The market share of semiconductor exports from Indonesia to total global exports represents just 0.08%.

Opportunities and Challenges for Sumatra in the Semiconductor Industry

Upstream semiconductor industry development would provide considerable value added but require extra efforts and a long-term strategy, in particular to enhance the quality of human capital as well as research and development. In terms of current world trade, the largest value in the global semiconductor industry chain is semiconductor production (95%), followed by semiconductor materials (2.6%) and assembly (1.7%). Nevertheless, existing industry development (backend processing/assembly) and downstream industries have vast potential to absorb labour and create new sources of growth in the near term.

In terms of backend processing/assembly, the Riau Islands has a strong geographical dividend due to its close proximity to Singapore, combined with Free Trade Zone (FTZ) status. Furthermore, the electronics industry on Riau Islands is already well established with over 150 companies, coupled with abundant skilled labour and relatively competitive wages. Notwithstanding, the industry also faces a number of challenges, these include a high reliance on global demand, declining export competitiveness, a high import content, sparse supporting industries, low value-added products, and sluggish technology uptake as well as limited research and development.

Regarding the downstream industries, further development has a great potential considering the huge domestic smartphone and electronic card market. Implementation of the government’s policy to increase domestic content requirements (TKDN) is expected to create additional opportunities for local industries and supporting industries already established on Riau Islands. Such developments would create a fertile breeding ground for companies to start downstream product lines, such as smartphone producers and other companies planning to develop similar product lines. A strategy is required, however, to maintain...
the sustainability of TKDN policy, increase fiscal incentives, optimise increasingly limited industrial land on Batam, as well as streamline investment procedures and licensing.

Meanwhile, to break into the design and frontend processing market, Indonesia needs sustained efforts over a prolonged period considering the complex challenges faced, including high-tech competitors with dominant market share, existing ecosystems and adequate skilled human capital as well as the need for high investment costs of around Rp3-8 billion. As a country striving to escape the middle-income trap, however, Indonesia must seek deeper involvement in the semiconductor industry. Several other ASEAN member countries, including Malaysia, Singapore and Vietnam have already made inroads into the industry. Ohno’s stages of catch-up industrialisation\(^\text{10}\) (Figure III.4) revealed the importance of mastering technology and being able to produce high-quality goods for countries wishing to escape the middle-income trap.

Development Strategy for the Semiconductor Industry of Sumatra

Mirroring the transformation achieved in neighbouring countries, advancing the stages of industrialisation is a tangible and achievable target. Taiwan, as a small nation where the semiconductor industry was rooted in backend processing and assembly as recently as 1975, has flourished in terms of the semiconductor industry with exceptional capabilities in all facets, starting with design, fabrication and assembly in 1990. The backing of government policy is critical, including: (i) the provision of local facilities to conduct R&D activities and support technological development; (ii) support for Industrial Technology Research Institutes to conduct R&D activities and transfer the research outcomes to local industries; and (iii) attracting large multinationals to develop domestic high-tech industries.

Consequently, to ensure overarching reforms are achieved to enhance the competitiveness of Indonesia’s semiconductor industry, policies are required to improve the investment climate under the Free Trade Zone around Batam in the near term. A climate conducive to investment is achievable through legal assurance, streamlined licensing, and the availability of skilled labour. Such policies are expected to attract more investors, particularly major players in the semiconductor industry, in order to transfer the technology to the domestic industry. Meanwhile, efforts to provide skilled labour in the near term could be achieved by establishing teaching factories to strengthen coordination between vocational colleges and the related industries.

In the medium-long term, the land constraints faced in the Batam FTZ may be overcome by expanding the FTZ to Karimun and Bintan. In addition, domestic integration between the semiconductor downstream industries on the Riau Islands and electronics industry on Java must be prioritised. Effective domestic integration is expected to reduce the dependence on global demand, which has remained a long-standing challenge for the domestic industry on Sumatra. This would reduce the reliance of the national electronic industry on international imports, while simultaneously boosting exports of electronics with high value added.

\(^{10}\) Avoiding the Middle-Income Trap: Renovating Industrial Policy Formulation in Vietnam (Ohno, K. 2009).
Controlling Inflationary Pressures on Airfares in Bengkulu

Inflation Characteristics of Bengkulu

Growing demand for air travel since 2014 has edged up airfares and their contribution to regional inflation in Bengkulu. At the end of 2016, CPI inflation in Bengkulu hit 5.00% (yoy), with airfares contributing for 1.62% of total inflation. Consequently, intense inflationary pressures from airfares have undermined measures to control inflation in the region.

Average inflation in Bengkulu (5.93%) has remained above the national rate (4.57%) and average for Sumatra (4.93%) over the past three years. The disaggregation of volatile foods (VF), administered prices (AP) and core inflation, respectively, stood at 4.90%, 10.07% and 4.68% (Graph III.7). Relatively high inflation in Bengkulu represented an onerous challenge to regional economic development.

Efforts to Control Inflationary Pressures on Airfares

Acting upon the recommendations of the Bank Indonesia Representative Office in Bengkulu delivered at the High-Level Meeting (HLM), the Regional Inflation Task Force (Tim Pengendalian Inflasi Daerah-TPID) issued an effective policy strategy to control inflationary pressures on airfares. The policy outlined plans to open new direct routes from Bengkulu to six major destinations, namely Padang, Palembang, Jambi, Lampung and Yogyakarta based on a review conducted by the Regional Inflation Task Force (TPID) in Bengkulu, which revealed strong demand for such flights that had previously necessitated a transit via Jakarta.

The strategic measure proposed by the Regional Inflation Task Force (TPID) in Bengkulu aimed to reduce demand for transit flights via Jakarta. Consequently, the new direct flights would alleviate inflationary pressures on ticket prices for air travel from Bengkulu to Jakarta. Furthermore, assuming that a more competitive market would increase supply, the prices offered would also become more competitive.

Following up from the high-level meeting involved the active role of district heads, the Ministry of Transportation, airport operators and the airlines. The support and direct involvement of staff from the Office of the Governor in the negotiations with relevant parties was a key to success of this policy. One of the participating airlines began trials in the third quarter of 2017, with three new routes officially opening in the subsequent period to Padang, Palembang and Jambi.

Effectiveness of Controlling Inflationary Pressures on Airfares in Bengkulu

The direct routes that were officially opened in the fourth quarter of 2017 effectively alleviated inflationary pressures on airfares from 1.72% in May 2017 to 0.78% in the fourth quarter of the year (Table III.1). Furthermore, the successful policy helped to control CPI inflation in Bengkulu and, therefore, headline inflation in the region no longer had the distinction of being the highest in the country. On the other hand, public interest in the new flight routes has also encouraged other airlines to open new routes to and from Bengkulu.

The effective policy to alleviate inflationary pressures on airfares by the Regional Inflation Task Force (TPID) in Bengkulu serves as a solid example for other regions suffering similar issues. TPID plays a crucial role in effective inflation control, primarily by coordinating the various relevant parties to seek joint solutions, temporary and permanent, to dampen regional inflation shocks.
Role of the Textile and Footwear Industries in Java

In Java the textile and footwear industries contribute a trade surplus and are intensive labour absorbers. The trade balance of the textile industry recorded a USD3.7 billion surplus in 2017, primarily originating from downstream industries producing textile garments (articles of clothing), knitted garments and functional garments such as sportswear. Meanwhile, the footwear industry contributed a USD4.3 billion trade surplus, exporting sports shoes, leather shoes, and textile shoes. In addition to contributing a significant trade surplus, the textile industry also employs around 1.5 million people. Regionally, both industries are distributed evenly throughout West Java, Central Java and East Java.

Most textile and footwear exports from Java fall into the categories of competitive advantage and trade surplus, while mapping 11 footwear products (93% share) revealed comparable results. Most textile products with competitive advantage and a trade surplus were garments, while the affected footwear products included sports shoes, leather shoes, and textile shoes.

Nevertheless, the trade surplus of the textile industry has declined over the past decade, eroded by imports of products on the intermediate-upstream chain, such as fibres and fabrics. Average export growth from 2007-2017 was just 3.2%, compared to 9.6% for imports. Bucking the downward trend, however, the trade surplus of the footwear industry has expanded, with exports growing by an average of 11.6% from 2007-2017.

Greater product diversification and stronger export market domination have elevated textile and footwear exports from Vietnam beyond Indonesia’s accomplishments. The export value of textiles from Vietnam totalled USD29.3 billion in 2016, nearly 2.5 times the USD11.8 billion exported from Indonesia. Similarly, the export value of footwear from Vietnam stood at USD13.5 billion in 2016, equivalent to 3 times the USD4.6 billion exported from Indonesia. The application of trade competitiveness diagnostics revealed several salient drivers of industry performance.

First, the ability to optimise trade cooperation with trading partner countries. In terms of market access, Indonesia and Vietnam are comparable. Indonesia currently has 17 free trade agreements, compared to Vietnam’s 16. An important trade agreement for Vietnam is the Generalised Scheme of Preferences with Europe implemented since 2012. In contrast, the trade agreement between Indonesia and Europe (I-EU CEPA) remains at the negotiation phase.

Second, the availability of supporting regulations for industry development. Industry in Vietnam receives tax incentives and enjoys greater ease of doing business, combined with cheaper labour and energy costs compared to Indonesia. In Vietnam, businesses in the textile and footwear industries are subject to corporate income tax ranging from 10-20%, compared to 25% in Indonesia. Regarding ease of doing business, a total of nine procedures must be completed to set up a new business in Vietnam, compared to 11 in Indonesia. Furthermore, labour and energy costs are lower in Vietnam than in Indonesia. In addition, Vietnam waives import duties if used for the production of export goods within 275 days.

Policy Strategy to Strengthen the Textile and Footwear Industries of Java

The textile and footwear industries have a vast potential for development. Exports of 33 different textile products, accounting for 17.8% of the total, have strong potential for improvement, including special textile products not intended for the production of garments. Concerning the footwear industry, non-leather and textile shoes appear to have the most potential for further development.

Efforts to increase textile and footwear exports through product and market diversification must consider the following factors

First, diversification should target potential textile and footwear export markets, such as Europe. The export markets for textiles and footwear are currently concentrated in the United States and Japan, while Europe’s potential as a major export destination for Indonesian textiles and footwear remains underdeveloped despite Europe’s distinction as the second largest importer of textiles after the United States. To that end, trade negotiations with Europe should be accelerated, including the I-EU CEPA. Other than Europe, market diversification should also target other potential markets that do not yet import a large portion of textiles and footwear from Indonesia, particularly Asia, Australia and Latin America.

Second, upgrade the national industries in the global value chain (GVC) by enhancing domestic industrial capacity. Currently, the majority of the domestic garment industry has low value added, namely Cut-Make-Trim (CMT). To increase value added, efforts are required to boost industrial capacity through Original Equipment Manufacturing (OEM), while also utilising local raw materials. Motivation could be stimulated through incentives offered to companies upgrading their business processes. Capacity building would also strengthen backward linkages with producers of raw materials, thus reinforcing the local value chain. Furthermore, the upstream sector requires the support of energy policies that enhance the competitiveness of domestic textile and footwear products. Energy costs incurred by the domestic textile and footwear industries currently account for up to 55% of total production costs. Higher energy costs in Indonesia

11 Mapping used the Revealed Symmetric Comparative Advantage (RSCA) method and Trade Balance Index (TBI).

12 An important trade agreement for Indonesia is the Generalised Scheme of Preferences with Europe (I-EU CEPA).

13 Wages in Vietnam average USD162/month, compared to USD24/month in Indonesia. The cost of energy in Vietnam is 6 cents per kWh, compared to 15 cents per kWh in Indonesia. Energy is the dominant cost component for upstream-industry in the textile and footwear industries, while human capital is the dominant cost for downstream industries.

Graph III.8. Trade Balance of the Textile and Footwear Industries on Java

Graph III.9. Commodities Classifications of Java’s Textile Industry based on RSCA and TBI
compared to that in peer countries erode the competitiveness of domestic production inputs.

Third, raise the quality of human capital. The quality of human resources could be enhanced through link-and-match vocational education to meet the current industry requirements. Deepening the curriculum in relation to high-tech textile and footwear product development is also necessary. Furthermore, production efficiency could be improved through modernisation and restructuring, which was undertaken by the Ministry of Industry in 2015. Most textile companies in Indonesia use outmoded machinery dating back more than 20 years, which undermines industry competitiveness. Restructuring would improve productivity, increase energy efficiency, and lower production costs, while absorbing more labour and strengthening the local value chain.

Fourth, diversification is required towards high-tech products and production techniques. The textile industry on Java has the potential to develop smart sportswear since sportswear exports from the region already enjoy comparative advantage. Sportswear products make up 38% of total functional textile exports. Despite no explicit description, the National Industrial Development Masterplan (RIPIN) has included the development of smart clothing products in the medium-long term. Nevertheless, the production of smart clothing requires a supporting ecosystem, greater uptake of technology through research and development (R&D) activities as well as incentives for industry players. The smart clothing ecosystem needs to encompass sensor technology, data processing, and data security.

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Examples of high-tech products include smart clothing and smart footwear, while high-tech production uses 3D printing, knitting technology as well as robotics.
Strategies to Strengthen the Automotive Industry of Java: Expanding the Export Market by Enhancing Domestic Competitiveness

Strategic Role of the Automotive Industry in the Regional Economy of Java

The automotive industry is a significant contributor to manufacturing industry performance on Java island. In addition to absorbing labour, the automotive industry has also contributed a trade surplus since 2015, primarily due to increasing exports of passenger vehicles and spare parts over the past three years. In 2017, automotive industry exports from Java reached Rp7.5 billion, dominated by shipments of passenger vehicles (MPV), spare parts and tyres. Spatially, most of the automotive industry is concentrated in Western Java, namely in Jakarta and West Java, and specifically in Karawang and Cikarang.

Export products from Java’s automotive industry enjoy comparative advantage. Automotive exports totalled Rp7.5 billion in 2017, of which 43% had comparative advantage and recorded a trade surplus. In addition, 38% of automotive exports were also considered to have potential comparative advantage, backed by an increasing surplus. Passenger vehicles were cited with the potential to increase comparative advantage. Exports of passenger vehicles already enjoy a dominant position and contribute a trade surplus, including MPVs such as Fortuner, Innova, Avanza, APV and Ertiga (Gaikindo, 2017). Nevertheless, there are indications that exports of automotive products from Indonesia have become more concentrated over the past decade. Such dynamics were confirmed by tyre exports to the US, which dominate 53% of the total, as well as exports of passenger vehicles to the Philippines that account for 40% of the respective total. Moving forward, the backing of strategic policy is required to increase the trade surplus of the automotive industry that pays attention to aspects of product competitiveness and the future challenges facing the automotive industry.

Comparison with Automotive Industry Performance in Peer Countries

The automotive industry of Thailand provides a four-fold contribution to exports compared to the automotive industry of Java. Furthermore, 93% of total automotive exports from Thailand have comparative advantage and contribute a trade surplus. Using trade competitiveness diagnostics, the comparative advantage of Thailand’s automotive industry is based on several factors. First, the production lines have been developed to match market demand (SUV and sedan), backed by the incentive of cheaper taxes. Concerning sedan cars, Thailand applies a 40% tax, compared to 30%-125% in Indonesia, depending on engine capacity. Second, strong market penetration through trade agreements with trading partners. Thailand has signed a Free Trade Agreement (FTA) with Australia, stipulating an average 0% import duty on automotive products from Thailand to Australia. Consequently, Thai exports to Australia contribute around 20% of the automotive total. In contrast, an average import duty of 5% is imposed on Indonesian products through the ASEAN-Australia trade scheme. Therefore, the value of automotive exports from Thailand to Australia is much higher, nearly the same as total automotive exports from Java to the international market. Third, regulatory backing that facilitates investment in Thailand. This is reflected in Thailand’s Ease of Doing Business (EoDB) ranking, namely 26. One form of regulatory support is the Corporate Income Tax rate of 20%, which indirectly boosts investment and supports the automotive industry supply chain in Thailand.

Policy Strategy to Strengthen the Automotive Industry of Java

The Government constantly strives to strengthen the competitiveness of national industry, including the automotive industry. Through its 16th Economic Policy Package, the Government reformed unnecessarily complicated bureaucracy and streamlined the process of granting business licenses/permits from the central to the local level. Such government commitment and backing has improved Indonesia’s EoDB ranking from 91 in 2017 to 72 in 2018. Furthermore, to strengthen the national automotive industry in terms of future comparative and competitive advantage, the following aspects demand the attention of all relevant parties.

First, optimising free trade agreements with trading partners to support market expansion and diversification. The Indonesia-Australia Comprehensive Economic Partnership Agreement (IA-CEPA) currently under negotiation and the Preferential Tariff Arrangement with eight Islamic countries (PTA D-8) represent tangible opportunities to broaden market access for the automotive industry. Second, promoting the implementation of internationally recognised quality standards in order to minimise the impact of non-tariff barriers to trade as implemented in other countries. Vietnam, for example, conducts gas emissions tests and technical safety tests on each export batch. The adoption of international standards, such as ISO, is key to overcoming non-tariff barriers to exports.

15 BPS-Statistics Indonesia data from 2016 showed that the automotive industry commanded a 14% share of the total manufacturing industry on Java.
16 Using the Trade Balance Index (TBI) and Relative Symmetric Comparative Advantages (RSCA) approaches.
17 Equivalent to USD31.1 billion.
18 Global demand for cars, namely SUV, sedan and commercial vehicles.
Third, improving the value of Indonesian exports in the global value chain (GVC). This would raise the value added of domestic automotive products and support the market diversification strategy. Market expansion into advanced economies such as Australia, for example, requires clear understanding of the target market’s requirements (commercial vehicles and SUV). In contrast, the current production line of the domestic automotive industry tends to concentrate on MPV vehicles. Meanwhile, the automotive industry in Thailand produces more SUV and commercial vehicles that provide a higher quality margin.

Fourth, strengthening the local value chain (LVC), primarily by supplying automotive factories. In comparison, the number of industries supplying the automotive industry in Indonesia is well below that of Thailand. Solid local supply chain development in Thailand has increased the local content of the automotive industry to 73%, compared to just 63% in Indonesia.

Fifth, accelerating bureaucratic reforms to stimulate investment and exports. Government efforts through various economic policy packages to stimulate investment need regional support. Furthermore, such policies could be strengthened through incentives to develop SUV and sedan vehicles in line with the current trend of global demand. This could be achieved by adjusting Corporate Income Tax and the domestic content requirements (TKDN) for both product categories. In the medium-long term, such policy could help develop the local supply chain.

Future Challenges
The national automotive industry must anticipate the future development of electric vehicles, particularly in the United States, Europe and China. Bloomberg New Energy Finance projects that by 2040, Electric Vehicles (EV) will contribute 54% of total global car sales, gradually replacing the internal combustion engine (ICE). In Indonesia, plans to develop electric vehicles are contained in Presidential Regulation (Perpres) No. 22/2017 concerning the National Energy Plan (RUEN), where 2,200 units of electric/hybrid vehicles are targeted for production by 2025 along with 2.1 million motorcycles. Notwithstanding, national electric vehicle industry development currently faces a number of constraints, including far higher prices that impede economies of scale in domestic production. In addition, the operation of electric vehicles requires sufficient charging stations and, therefore, the support of high-cost infrastructure. As a preliminary step, the automotive industry of Indonesia must collaborate and integrate with the global supply chain for electric vehicles as part of the global value chain (GVC), perhaps by supplying spare parts.

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19 The number of industries supplying the national automotive industry (Tier 1, 2 and 3) in Indonesia is 1,200, compared to around 2,400 in Thailand (Gaikindo, 2017).

The Role of Bali’s Tourism in Development of Potential Export-Oriented Industries

As a region of exquisite natural beauty and extensive services, Bali has distinguished itself as a tourist destination and new source of economic growth. The comparative advantage of Bali tourism is supported by the availability of local products, such as souvenirs, which integrate the Local Value Chain (LVC) and support tourism’s role in the economy. The LVC consists of labour-intensive industries with a high local content.

Over time, labour-intensive tourism-related industries have produced export commodities with comparative advantage in the province of Bali. Such industries include wood carvings and handicrafts, clothing and textiles, which dominate other industries in terms of production value.

Over the past few years, labour-intensive industries on Bali have posted impressive gains. Such developments are evidenced by the number of business units operating in such industries (Graph III.13). Other indicators have also improved, especially in 2017, namely labour absorption, investment value and production value. Labour-intensive industries have also achieved solid performance in line with the consistent increase of international travellers visiting the region over the past few years (Graph III.14). Meanwhile, investment value has increased, indicated by strong investor attention on labour-intensive industries (Graph III.15).

In addition to meeting domestic demand, products from labour-intensive industries on Bali also serve the export market. The strong appeal to visit Bali by international travellers has promoted Balinese wares around the world produced by local labour-intensive industries, which has created the opportunity for such products to be exported worldwide. The most common export products are clothing and textiles. Both industries are also fairly dominant in terms of labour absorption. Furthermore, the production value of both industries contributes around 60% of the total production value of export-oriented labour-intensive industries in Bali province.

Other products with comparative advantage produced by export-oriented labour-intensive industries on Bali include wooden furniture and woven bamboo. These products account for 18% of the total production value of export-oriented industries, while absorbing around 24% of the total labour force. Wooden furniture and woven bamboo products from Bali are unique and, therefore, very appealing to the export market.

Several labour-intensive industries have successfully penetrated the global export market, including Balinese engraved silver and gold jewellery. Interestingly, the marketing of such jewellery relies on the support of air transportation services to distribute the products. Another industry to penetrate the global export market is wooden carvings with market segmentation in the United States and Europe. Nearly 90% of the raw materials used in the wood carving industry is sourced domestically. The quality has been maintained and the uniqueness of the engravings has ensured the industry not only survives but also flourishes, supplying several brands of high-class furniture to the global market. Furthermore, most of the capital behind the wood carving industry is domestically sourced.

Moving forward, other labour-intensive industries have the potential for development, including weaving products as part of the nation’s cultural heritage. The current popularity of weaving products amongst foreign tourists represents solid preliminary capital for international promotion and marketing. Furthermore, several famous designers are using weaving as the raw material for innovative Indonesian fashion, which could introduce weaving products to wider global export markets.

Weaving products have been marketed through exports but the share remains small. The export value of weaving products is approximately US$20 million (Graph III.16) but vast potential remains. The major export destinations are currently the United States, Australia, Spain, Norway and Finland. Weaving products have potential because of their ethnic characteristics, which are currently very popular and highly sought after. Furthermore, potential demand for weaving products from the United States and Europe is backed by the characteristics of thick woven fabrics that are suitable for the cold weather experienced in such destinations.

A number of improvements are required, however, to support further development of labour-intensive industries on Bali. First, the development of export products with comparative advantage on Bali must be upgraded through greater use of technology. Currently, low-medium technology industries are dominant, thereby limiting the value added of products from such labour-intensive industries. The low technology content apparent in labour-intensive industries is also because many of the Balinese products are handmade, which, on the other hand, is very attractive to the market, especially tourists. More efficient and precise production techniques in labour-intensive industries through technology uptake are prerequisites for efforts to increase export volume.
Second, development of labour-intensive industries on Bali require the support of a high-quality creative labour sector. Several businesses operating in labour-intensive industries struggle to fulfil their creative labour requirement. Modernisation has eroded the cultural heritage of Bali. The younger generation is now less interested in preserving traditional and cultural pursuits, which is a threat to the long-term development of labour-intensive industries on Bali.

Regarding the weaving industry, the lack of patents for designs and fabrics could impede industry development on Bali because aspects of weaving designs are simple to replicate and imitate, especially in countries with established and more advanced textile industries. To overcome that threat, industry players are urged to seek design patents for their products. In addition, government efforts to promote Bali weaving designs in the international market should be improved in order to expand weaving market diversification and build awareness of the unique designs and identity of Balinese weaving as part of Indonesia’s heritage.

Several other efforts are available to expand the export markets for the products of labour-intensive industries on Bali. First, increase the promotion of local products amongst foreign tourists through synergy with travel packages and tours to production centres. Second, increase the technology content of industries with potential for mass production, such as clothing. Third, preserve the local creative culture through facilities to teach traditional skills, such as carving, engraving and local design. Fourth, improve standardisation of export products to maintain quality.
Box 8

The Downstream Nickel Industry
Outside Java

Overview

Nickel is an important raw material for industry, particularly strategic and high-tech industries such as electronics and machinery. Nickel deposits are found in most of Eastern Indonesia, especially Central Sulawesi, Southeast Sulawesi and South Sulawesi. Data from the United States Geological Survey (USGS) revealed total global nickel deposits of around 79 million tons, of which 6% are found in Indonesia. As a non-renewable resource, existing nickel potential must be managed with a long-term horizon to ensure optimal benefits for the national and local economies.

Indonesian nickel has a high potential for further downstream processing, which increases the value added. Of the 4.5 million tons of nickel reserves located in Sulawesi, only around 10% has been exploited. In comparison, the Philippines, with around 4.8 million tons of nickel deposits, can produce around 500 thousand metric tons of nickel per year. Production capacity in the Philippines is much higher than the 188 thousand metric tons currently possible in Indonesia. Considering the vast potential and increasing demand for nickel and products thereof, short and long-term downstream nickel processing development is necessary.

Since 2014, the government has introduced efforts to gradually encourage downstream processing of several minerals, including nickel. Initially, efforts to develop the downstream sector were contained in the Mineral and Coal Mining (Minerba) Act (No. 4) of 2009, which restricted exports of mineral ore. The Minerba Act effectively triggered domestic smelter development as part of the downstream sector. Further processing of minerals through smelters provided more value added for nickel production. To ensure downstream development continues, policy support is required that allows the nickel industry to operate efficiently. Policy to strengthen the quality of soft and hard infrastructure is pivotal to downstream processing in the nickel industry.

To develop national industry by accelerating downstream processing of various natural resources, the Government has created industrial zones in several regions in accordance with the Medium-Term National Development Plan (RPJMN) 2014-2019. The development of industrial zones aims to facilitate investment by providing integrated facilities and infrastructure in one interconnected area. Furthermore, industries may receive special treatment in the industrial zones through incentives and excise services. Industrial zone development is currently prioritised in 14 locations outside of Java. On the island of Sulawesi alone, there are three projects to develop industrial zones for downstream processing of natural resources.

In Eastern Indonesia, several industrial zone development projects are progressing well. The Morowali Industrial Park (ferronickel industry) and Bantaeng Industrial Park (ferronickel industry) are at the operational stage with supporting infrastructure being developed. Meanwhile, Bitung Special Economic Zone (fisheries, pharmaceuticals and palm oil) is currently at the infrastructure development stage.

The private sector also has an important role to play in the development of industrial zones. Of the three projects on Sulawesi and 14 priority industrial zones planned nationally, only the Morowali Industrial Park has had private sector participation since the beginning stage, which has ensured rapid development progress.

Morowali Industrial Park Development

Morowali Industrial Park Development has progressed rapidly, thereby accelerating commencement of the production process. The Morowali Industrial Park occupies an area of 2,000 hectares in Morowali regency, sitting on potentially the largest nickel reserve in Central Sulawesi at around 300 million tons. Since designation as an industrial zone in 2014, development progress currently stands at 85%, with completion targeted in 2019. As of 2017, the Morowali Industrial Park had drawn total investment realisation of USD6 billion or Rp80 trillion, backed by an efficient land acquisition and construction process that took less than two years from the beginning of 2014 until the third quarter of 2015. At the end of 2015, the Morowali Industrial Park began operating and initiated first production.

Morowali Industrial Park development has spurred economic growth and exports in Central Sulawesi. Since construction began in 2014 until the site became operational in 2015 and 2017, the economy of Central Sulawesi has expanded on average by 9.4% per year, the highest in the region. In addition, the value of export products processed in Central Sulawesi has increased significantly, reaching USD990 million in 2016 and contributing Rp1.7 trillion to national revenue. Those figures increased appreciably in 2017 to USD1.8 billion and Rp2 trillion respectively.

Morowali Industrial Park Development has also induced demand for more than 100 thousand workers in Central Sulawesi. As of December 2016, around 11,257 workers were required in the integrated industrial zone along with 1,577 supervisors or engineers. Based on the latest estimates, around 26 thousand direct workers and 80 thousand indirect workers will be required in the Morowali Industrial Park by 2019. During the second phase of national industrial development (2019-2020), an additional 10,800 workers and 1,620 engineers or supervisors will be required. Furthermore, labour absorption will persist as other supporting sectors continue to develop, including trade, hotels and restaurants (THR) as well as mining. Such a large employment potential, will double Central Sulawesi economy for more than Rp15 trillion per year.

The realisation of Morowali Industrial Park is the result of an effective public-private partnership (PPP). The Park was built based on the corporate need to optimise local facilities, coupled with incentives from the government. Initially, the government facilitated investment to expand the role of the private sector in Morowali. The government then prepared the land for the industrial zone as part of the incentives and subsequently cleared the land and built the physical infrastructure through a private-public partnership. The industrial zone development process was optimised through a balanced delegation of responsibilities between the Central and local Government. The public sector guaranteed industry sustainability through product marketing assurance. Meanwhile, the central and local governments ensured the backing of quality connectivity infrastructure, including seaports and airports. The role of local government was critical in the land acquisition process and by providing incentives through streamlined licensing to develop the region.

In the long term, the Morowali Industrial Park plans to build an integrated upstream and downstream nickel processing industries. To that end, Morowali Industrial Park development will occur in three stages (Figure 1). The products produced over those three stages include ferronickel, stainless steel and Nickel Pig Iron (NPI). Morowali Industrial Park development involves the participation of a main investor from China throughout all three stages of development. The investor plays a key role in the Global Value Chain (GVC) of nickel.
Currently, the Morowali Industrial Park is managed by PT. Indonesia Morowali Industrial Park (IMIP). The Park has five international corporate tenants engaged in nickel processing. Nevertheless, PT. IMIP expects to draw other private investment to develop processed products with higher value added. One of the latest investors in the Morowali Industrial Park is the iron and steel industry, with high added value. Consequently, a stainless steel factory has been constructed with production trials currently underway (2017). Full capacity production is expected in 2018, producing stainless steel labs that have a higher value added than the existing products. One million tons of stainless steel is predicted to be produced each year with an investment value of USD62 million.

Coordination and Synergy between various Government Ministries / Institutions and Local Government was the Key to Morowali Industrial Park Development

Several lessons were learned from the development of Morowali Industrial Park as follows:

First, synergy is required between several Government Ministries (Ministry of Public Works and Housing (PUPR), Ministry of Energy and Mineral Resources (ESDM), Ministry of State-Owned Enterprises, PLN, Ministry of Health and Ministry of Trade) as well as Local Government to provide the necessary supporting infrastructure.

Second, land availability must be secured through land acquisition from the outset (2014).

Third, a conducive investment climate is a prerequisite through One-stop licensing services (Pelayanan Terpadu Satu Atap-PTSP) in collaboration with the Indonesia Investment Coordinating Board (Badan Koordinasi Penanaman Modal-BKPM) and the Regional Investment Coordinating Board (Badan Koordinasi Penanaman Modal Daerah-BKPMD), Local Government and relevant Government Ministries.

Fourth, connectivity, energy and communications infrastructure are required. In Morowali, connectivity access was achieved by extending a road 40km from the Bungku seaport to the industrial zone and a road 5km from the airport to the industrial zone.

Fifth, provide fiscal and non-fiscal incentives. In Morowali, a fiscal incentive in the form of a tax holiday was provided for construction of the industrial zone throughout 2014 along with non-fiscal incentives in the form of import concessions for export purposes (Kemudahan Impor Tujuan Ekspor-KITE) and a master list of industrial equipment as well as national vital objects (2017). The submission of national vital objects remains under evaluation.

Considering the vast potential of Morowali Industrial Park, the supporting infrastructure and sources of human capital must be strengthened. The development of electrical infrastructure to support industry development will soon be realised through the construction of a thermal power station with a capacity of 2 x 350MW worth USD500 million. Furthermore, the pace of development at the Morowali Industrial Park must be balanced with the supply of trained workers. The utilisation of foreign workers in the zone remains high due to the skill gap between local workers and the needs of the industry. With the backing of structured and appropriate vocational education policy, the use of foreign workers will gradually decline, replaced by greater absorption of domestic workers.
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