Strategy for Economic Transformation

CHAPTER IV

The continuation of structural reforms is essential for improving economic structure and accelerating the economic transformation for Indonesia to become an advanced economy in the long-term. Economic transformation is taking place by strengthening of the leading sectors as new sources of economic growth, including manufacturing, tourism and the sharia economy and finance. Reinforcing the economic transformation is supported by financial market deepening, to provide the basis for sources of economic financing.

"The economic transformation involves strengthening the role of priority sectors that can generate high value added for the economy"

Transformation of the economy is a vital precondition for Indonesia to become a high-income country by 2045. The economic transformation involves strengthening the role of priority sectors that can generate high value added for the economy. The priority sectors are those capable of driving economic growth and also supporting external resilience through an improved current account. Similarly, the economic transformation relates to strengthening productive sectors through increased investment. Increasing value added of the economy will also come from optimum empowerment of various domestic resources used as production inputs and the strengthening of supporting infrastructure, including in the financial sector.

Manufacturing is one sector envisaged to accelerate Indonesia's economic transformation to advanced country. Strengthening of the manufacturing sector requires a two-pronged approach: to improve manufacturing's role in sustaining export performance; and to generate higher value added. Reinforcement of manufacturing sector role is taking place in an end-to-end strategy that is comprehensive, integrated and inclusive. Manufacturing sector is being strengthened in all industries on a comprehensive basis, covering the full range of strategy, including strengthening of the production factors; regulation and institutional arrangements; and access to markets. Creating an intersectoral and interregional integration is also key to generate strong local value chains. Moreover, the strengthening of manufacturing sector is directed to be an inclusive strategy that generates broad impact on the economy.

Transformation of the economy is also being pursued through development of the tourism sector. It is envisaged that the development of tourism sector will support improved jobs, incomes and the current account deficit through greater foreign exchange inflows. To this end, development of tourism sector will need to be underpinned by improving the quality and competitiveness of tourism destinations. The effort to reinforce the role of the tourism sector entails the 3A2P approach (Access, Attractions, Amenities, Promotion and Providers) supported by policy synergy among the relevant authorities. Looking forward, the transformation of tourism sector will continue to focus on strengthening the 3A2P approach at super-priority and other leading destinations.

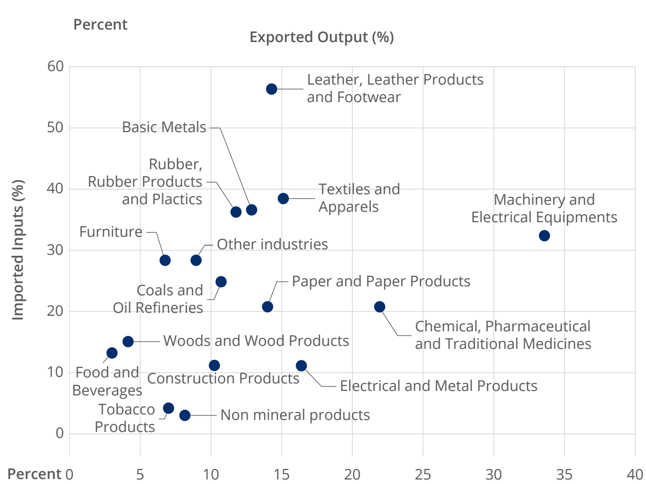
Optimizing the potential of the sharia economy and finance will also play an important role in the economic transformation. Development of the sharia economy is moving forward on the basis of a wider role for halal manufacturing and Muslim-friendly tourism. These, in turn, will strengthen the demand for sharia compliant financing. This strategy is being pursued in an integrated approach that involves development of the halal value chain ecosystem, supported by sharia compliant financing and improved literacy in the sharia economy and finance. Looking ahead, transformation of the sharia economy and finance will remain focused on an ecosystem approach supported by Government commitments. At the same time, accelerated financial market deepening is also playing a vital role in support of economic transformation. These efforts have been pursued by policy synergy between Bank Indonesia and other related authorities with focus on developing sources of financing and risk management; financial market infrastructure; and the regulatory framework. In addition, financial market deepening is is also directed to develop physical infrastructure, which is one of the priorities of the Government's medium-term development plan.

4.1 Transformation of Manufacturing Sector

Transformation of Indonesian economy towards a high-income country entails strong and sustained economic growth. For the time being, Indonesia ranks among the middle-income group of nations with a per capita income of USD3,840. A substantial efforts is needed to transform Indonesian economy to become a high-income country. Indonesia is predicted to move up from the middle-income countries into the ranks of high-income countries in 2045, when per capita income is forecast to climb above USD12,376.

It will be important to pursue the economic growth with due consideration for continued reform of the Indonesian economic structure. Currently, exports are dominated by primary and resource-based commodities, which are vulnerable to global commodity price shocks. Indonesia continues to rely heavily on imports for most of the raw materials used in domestic production, including for exports (Chart 4.1). This condition poses a challenge, because higher economic growth along current lines will drive up imports, resulting in a wider current account deficit (Chart 4.2). This underscores the importance of structural improvements in the current account balance, both in exports and imports of goods and services, for the economy to sustain high growth.

Chart 4.1. Manufacturing Industries' Export-Import Relation



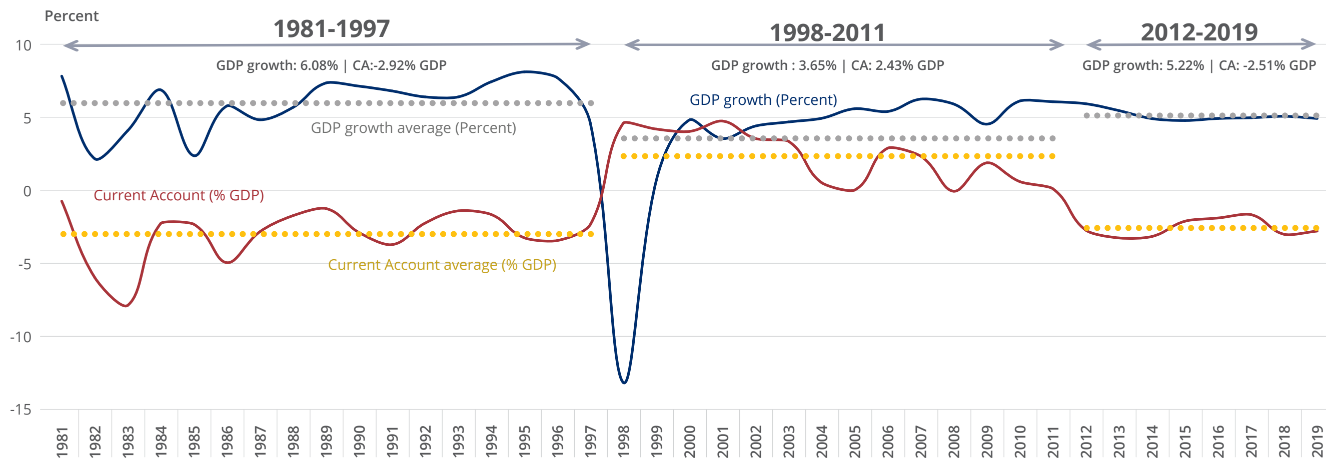
Source: 2010 IO Table, calculated

The manufacturing sector has a strategic role in reinforcing the economic structure, including by strengthening exports. In looking at Indonesia's peers, the countries that report a large surplus of trade in goods (relative to GDP) are generally those that benefit from a strong share of manufactured exports. This is visible in the share of manufactured exports for peer countries that runs higher than 60% (Chart 4.3). These numbers are well ahead of Indonesia, where manufactured exports account for no more than 44% of GDP and therefore need to be developed further. In addition, Indonesia's exports are still dominated by primary commodities and a shift towards higher value added is necessary for greater resilience to external shocks.

The effort for transformation of manufacturing sector also aims to increase its value added. This is inline with Government policies for structural reform that focus on expansion of the manufacturing sector. In the 2020-2024 Medium-Term National Development Plan (RPJMN), one of the main strategies for economic transformation is a reduction in the economy's dependence on natural resources by a shift towards competitive manufacturing and services sectors that generate high value added.[1] This requires the development of domestic industry for generating increased value added by more downstream

1 Detailed information about the structural reform policies is presented in Chapter 2, Section 2.3.

Chart 4.2. Economic Growth and Current Account Balance



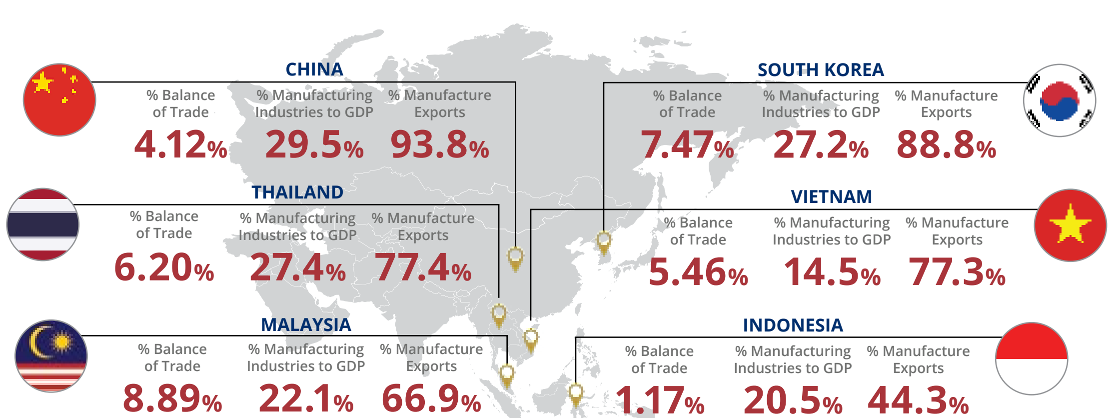
Source: BPS, World Bank, IMF, Bank Indonesia, calculated

processing of resource-based products. Downstream development will not only create a more robust economic structure, but also support intersectoral and interregional integration. Downstream development will enable the regions outside Java to supply raw materials to manufacturing sectors on Java, which for the time being remains dependent on imports, which widens the current account deficit.

To support manufacturing sector transformation, it is necessary to pursue a strategy for stronger manufacturing sector by a two-pronged approach. In general terms, the strategy for structural reinforcement of manufacturing sector seeks to (i) promote highly competitive industry that can bolster the outlook for exports, and (ii) promote the development of industry that will support growth in value added and other industries with potential to be competitive. This two-pronged approach will be implemented end-to-end on a comprehensive, integrated and inclusive basis (Figure 4.1).

In the first approach, strengthening manufacturing sector will focus on encouraging industry to be highly competitive in support of exports. This objective will begin by determining the priority industries that are already highly competitive, followed by those with a surplus trade performance. In the short term, this approach would help boost foreign exchange earnings. A mapping of commodity exports by competitiveness and trade performance shows that the strategy can be focused on a number of

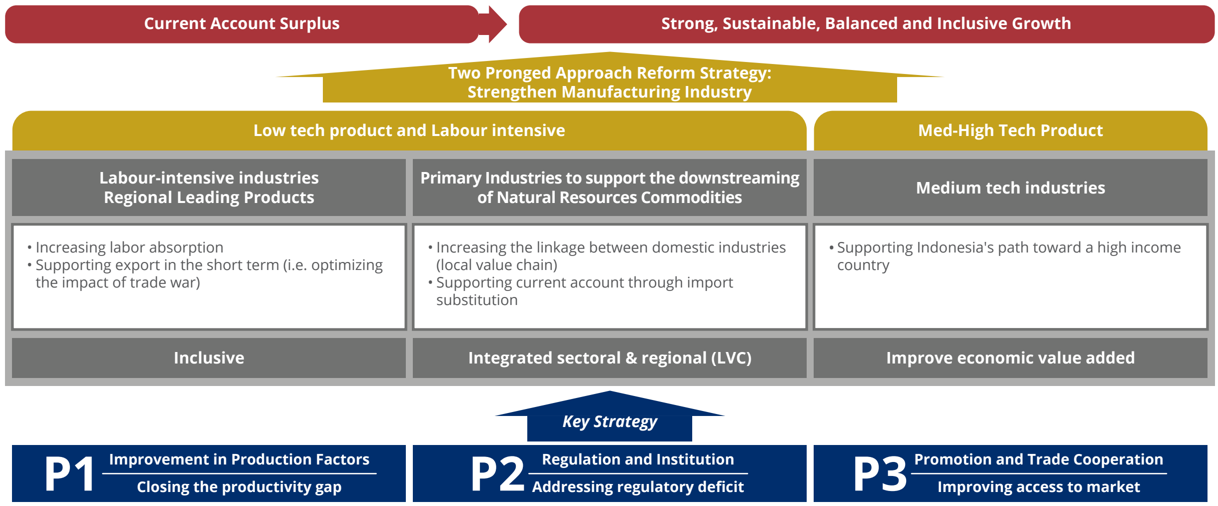
Chart 4.3. Role of Manufactures Exports to the Economy



Note : - % manufacture exports is manufacture exports as percentage of merchandise trade from World Development Indicator, World Bank
- average of the last 5 years (2014-2018) except for Vietnam (2013-2017)

Source: World Bank, calculated

Figure 4.1. "Two Pronged Approach" Strategy to Strengthen Manufacturing Industry



specific industries.[2] Industries that could be designated as priority, include textiles and apparel, footwear, automotive and food and beverages, led by fisheries and coffee.

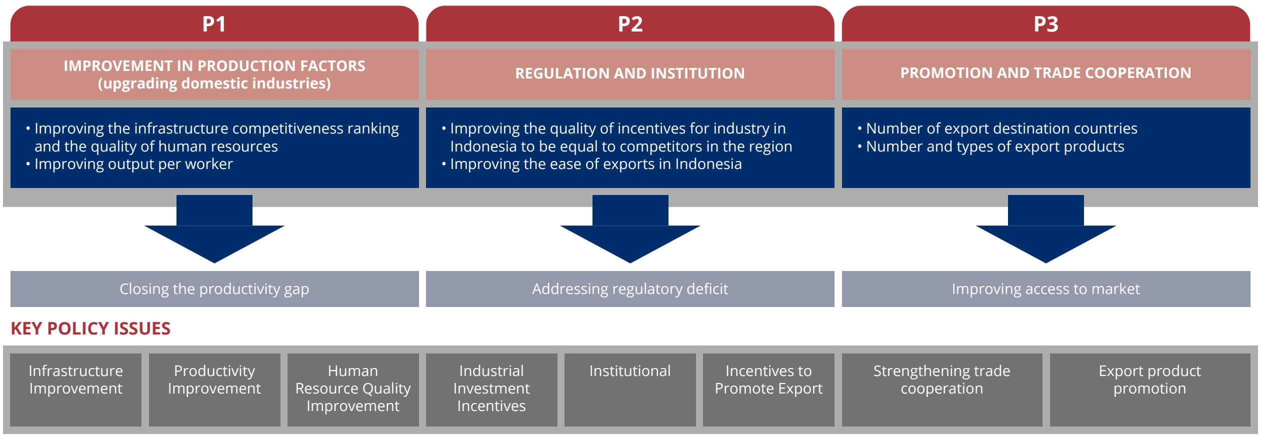
The second approach seeks to promote industries that will support increased value added and other industries with potential for competitiveness. This approach has been taken in view of the sub-optimal capacity and capability of domestic manufacturing sector, which leaves industries dependent on imports for some of the raw materials needed in domestic production. One explanatory factor is the lack of raw material supply chains within Indonesia. The majority of industry is located on-Java with only limited integration with other regions that could supply inputs. This is due to the limited capacity of industrial suppliers and differences between the specifications of products produced by supporting industries and those of the end products. Due to these differences, high volumes of imported raw material are needed to support domestic production. For this reason, efforts are needed to build strong local value chains involving supporting industries in some regions, in a phased process over the medium term. These efforts are expected to reduce the heavy dependence on imported raw materials and support external resilience. Apart from increasing value added, the strategy also needs to focus on development of other industries with potential to become competitive. These are industries that play a vital role and serve as the main sources of revenues for regional, i.e., off-Java, economies.

The policy strategy for transformation of manufacturing sector will be implemented through end-to-end approach which is comprehensive, integrated and inclusive. Manufacturing sector will be strengthened by addressing the full range of key obstacles, whether in terms of production factors, business climate or market access. The development strategy must also be integrated to ensure that on-Java industry becomes more closely integrated with supporting industries outside Java, thereby reducing dependence on imports of raw materials. Efforts to increase value added will also support intersectoral and cross-regional integration that will bring the specifications for products from domestic supporting industries outside Java into alignment with the needs of industries in Java. In addition, the development strategy must also be inclusive, with a broad impact on all levels of society. In this regard, initiatives such as MSME clusters, as well as innovation improvements through the development of technology and innovation centers as public goods, with benefits that are inclusive, are a vital element of this strategy for transformation of manufacturing.

The policy strategy for transformation of manufacturing sector is being implemented in a comprehensive basis in the 3P framework. The 3P framework, adopted from trade competitiveness diagnostics, is intended to facilitate identification of the main obstacles to the strengthening of manufacturing sector (Figure 4.2). The 3P framework consists of: (i) improvements of production factors to narrow productivity gaps; (ii) a regulatory and institutional framework that can reduce the regulatory deficit that often

2 The results of the mapping are presented in Chart 1.10.

Figure 4.2. End-to-end Industrial Development Strategy



poses obstacles to investment; and (iii) strengthening trade cooperation and promotion for improved access to global markets.[3]

Concerning the first "P" (relating to improvements in production factors) the focus of the strategy will be to reduce productivity gaps with support from quality infrastructure, logistic services and vocational training. This strategy includes expanding the carrying capacity of infrastructure targeted at development of upstream and intermediate industries in order to strengthen the linkages among domestic industries, thereby driving improvements in local value chains. Efforts to improve connectivity will also focus on supporting supply chain efficiency in order to boost industry competitiveness in terms of production costs and exports. Alongside this, vocational education policy will focus on expanding the role of industry/private sector cooperation in education and vocational training.

Development of manufacturing sector also requires support from industrial zones. The strategy for development of manufacturing sector within an integrated industrial estate or industrial zone offers another solution for improving the efficiency of production processes. These zones will be developed in an integrated approach that combines support from connectivity and supply of the requisite energy and human resources. In the medium term, the Government will focus on development of nine industrial zones outside Java.

Regarding the application of advanced technology, the Government is pursuing a series of steps for implementing the Making Indonesia 4.0 policy. The first step is implementation of policies beginning with measurement of the level of readiness on the part of actors in industry for Industry 4.0. According to a government assessment, Indonesia's manufacturing industry is ready to move ahead with Industry 4.0. The second step is aimed at forming an ecosystem for innovation through development of innovation centers and human resources in support of Industry 4.0. The third step is the formulation of a regulatory framework and incentives, for which a draft Presidential Regulation has been prepared on the Making Indonesia 4.0 road map, including a super deductible tax incentive to ensure

> "The strategy for development of manufacturing sector within an integrated industrial estate or industrial zone offers one solution for improving the efficiency of production processes"

3 For elaboration of details, see the Indonesia Economic Report 2018, Chapter 2, Box 2.1, Stimulating Export-Oriented Manufacturing.

that the policy is implemented on a broad scale. The fourth step will involve brainstorming for innovation and mentoring of technology-based start-up companies for Industry 4.0. In the fifth step, an international investor road show will be held as a campaign to promote the government policy to the international community. The sixth step will focus on preparation of the human resources for industry and facilitation for small and medium industries in a vocational program for link-and-match of small and medium industries with industry and through e-smart training for small and medium industries.

Policies for the second "P" (relating to improvement in the regulatory and institutional framework) will be introduced through improvements in regulations and government incentives to encourage investment and exports in ways that will support transformation for greater manufacturing sector competitiveness. Institutional support will be provided through streamlining, synchronizing and harmonizing regulations, especially those pertaining to investment licensing, in order to boost investment in manufacturing sector. In addition, Government will provide incentives for industry to boost exports and investment and increase local value added.

The final "P" concerns strengthening collaboration in trade and promotion and policies to improve access to global markets. A number of trade agreements now in the negotiating or ratification stage need to be accelerated to achieve this goal. With trade facilitation and promotion by the Government, this strategy is expected to bring about greater diversification of manufactured products exported to non-traditional markets. Also, better market analysis and more comprehensive market intelligence are needed to better understand global demand trends.

The policy strategy for transformation of manufacturing sector is also being pursued on an integrated basis. The heavy reliance on imported raw materials is largely attributable to the lack of integrated local value chains across Indonesia. According to a 2015 analysis with the inter-regional input-output (IRIO) model, for example, the automotive industry, which is mostly based on-Java, has a low level of integration with other regions that could supply intermediate inputs. This limited integration of supply chains in the automotive industry is caused by specifications for products manufactured by domestic supporting industries (such as steel, plastic, rubber, aluminum) differ from the specifications actually required. As a result, imports of raw materials for products made by suppliers to the automotive industry remain high. Through efforts to increase value added, the regions outside Java will be able to supply raw materials that satisfy the needs of industry on-Java that currently depend on imports. This calls for a measure for greater spatial integration into the automotive industry by some supporting industries in some regions, to be phased in over the medium term. Through these measures, it will be possible to reduce the heavy dependence on imported raw materials and thus support external resilience.

The vital role of integration in support of manufacturing sector is illustrated by a number of success stories. In the metals industry, the Indonesia Morowali Industrial Park (IMIP) has been developed into an integrated industrial zone. Morowali was chosen as the IMIP site because of the presence of nickel mineral resources in the Morowali district, where the nickel would then be processed into downstream products and exported. The entire process, including export and import formalities, operates within the IMIP site. Initially developed in 2014, IMIP has now become an industrial zone with one of the world's most complete production chains for steel. Five metal producing companies are now operating at IMIP and account for a 54% share of Indonesia's total iron and steel exports. Taken overall, IMIP has contributed to the national and regional economies by exports and employment. Among its achievements is the establishment of a polytechnic school to ensure the supply of labor with the requisite

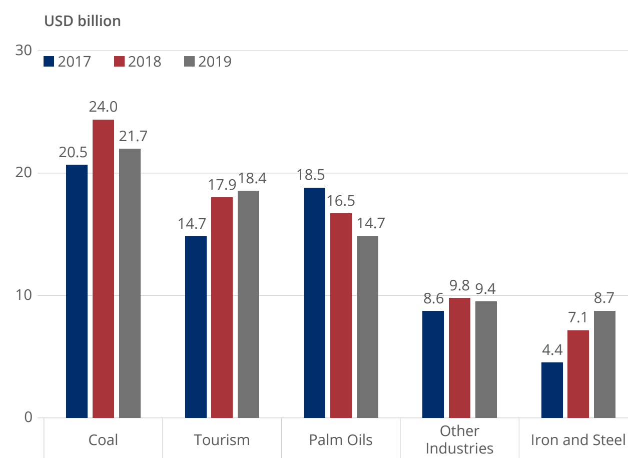
skills and qualifications. In another example, the synthetic rubber needed in tire production is still mostly imported. Through collaboration between rubber producers and a number of industry players involved in tire manufacturing, it is expected that the volume of imported synthetic rubber required for production can be progressively reduced.

Lastly, the transformation of manufacturing sector also needs to be an inclusive strategy in order to have a broad impact on society. Increased exports to the global market can support the transformation of manufacturing sector, but this should also be supported by integration into global value chains. The dominant role of the informal sector in the economy is reflected in the total number of MSMEs in Indonesia at over 60 million. This indicates that MSMEs have a strategic role in the performance and prospects of the economy. Nevertheless, MSMEs currently face enormous challenges relating to innovation, and as a result, only a limited number of MSMEs are connected to global value chains; more needs to be done to increase their contribution to exports. In view of this strategic role of MSMEs, Bank Indonesia is working to promote the development of MSMEs ready to export, focusing on regional mainstay commodities that have potential to be developed into export commodities and support performance, for example, of the tourism sector. In addition, the Government and Bank Indonesia are helping to facilitate the expansion of access for MSME products in the drive to go digital. Furthermore, the innovation-related challenges facing MSMEs call for the development of a technology and innovation center, with benefits that could be felt far and wide.

4.2
Tourism Sector as a New Source of Growth

The growing tourism sector has potential to support an accelerated pace of economic transformation. This potential is reflected in foreign exchange earnings from tourism, consisting of travel and transportation, which reached USD18.4 billion in 2019, up from the previous year and from an average of USD14.5 billion per year over the past 5 years. When compared to other exports of services, tourism accounts for the largest share, at 54% of the total, up from 44% in 2014. In addition, tourism sector looks well-placed for future growth, driven by a steady increase in foreign exchange earnings. While leading export commodities have contracted in recent years, the continued upward trend in tourism has propelled the sector into second place in foreign currency earnings after exports of coal (Chart 4.4).

Chart 4.4. Highest Contributors of Foreign Currency Earnings by Commodities



Source: Ministry of Trade, calculated

Tourism sector's potential can be developed into a new source of economic growth. As evidence, foreign tourist arrivals and foreign exchange earnings continued to increase in 2019, despite the slowdown in global economic growth. Reflecting this, employment in the tourism sector improved by 10.3% compared to 2018. In analysis by sector, tourism is Indonesia's fourth largest source of employment. The sector's potential to further boost economic growth is underscored by its improving competitiveness. According to the Travel and Tourism Competitiveness Index (TTCI), Indonesia's competitiveness rating has improved considerably in the past decade. In 2010, Indonesia ranked 81st in competitiveness, but by 2019, Indonesia's rating had improved significantly to 40th position. The improvement in competitiveness was achieved mainly in the regulatory framework and tourism and travel policy categories, which climbed from the previous 113th ranking to 4th place. Various tourism development policies aggressively implemented in recent years at priority and super-priority destinations contributed to the improved rating.

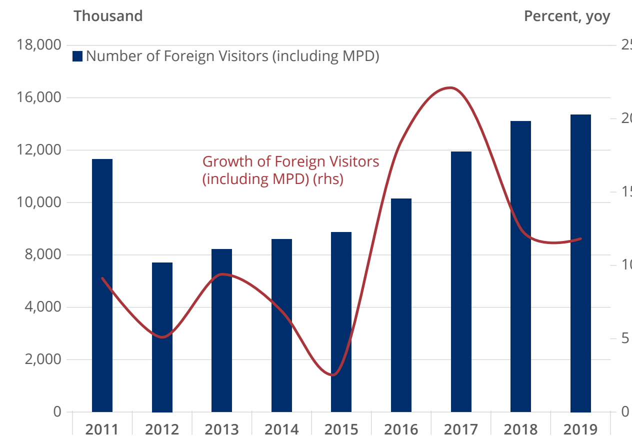
Indonesia's world-renowned natural and cultural potential is one factor supporting development of the tourism sector. Bali, one of the leading tourist destinations in Indonesia, has become the world's fourth most popular destination according to Trip Advisor Traveler's Choice 2020, and it ranked ninth in Agoda's Top 10 City Destinations 2019. In addition to Bali, Indonesia has other potential destinations with natural and cultural attractions that have become well-known worldwide, including Lombok; Labuan Bajo; Borobudur; Raja Ampat;

and Lake Toba. Indonesia has even greater potential for tourism destinations compared to peer countries, as reflected in the improved ranking for the natural and cultural resources indicator in the TTCI.

A key factor in the opportunity to become a new source of economic growth is the steady growth in global tourism demand. According to UNWTO projections, the number of tourists traveling across borders is expected to reach 1.8 billion persons a year by 2030, representing an increase of 300 million over the total number of tourists in 2019. Indonesia still has considerable opportunity to tap this potential. In 2019, foreign tourist arrivals in Indonesia reached 16.1 million, equivalent to 1.07% of global tourist visits (Chart 4.5). At this level, it is still possible to increase numbers considerably further, particularly in view of peer countries such as Thailand and Malaysia, where foreign tourist arrivals reached 35.6 million and 25.9 million in 2018 (Chart 4.6). In addition, tourism development at various potential destinations in Indonesia is still at the exploratory stage, underscoring the still considerable potential for tourist visits. Such destinations include Labuan Bajo, Raja Ampat and Lake Toba.[4]

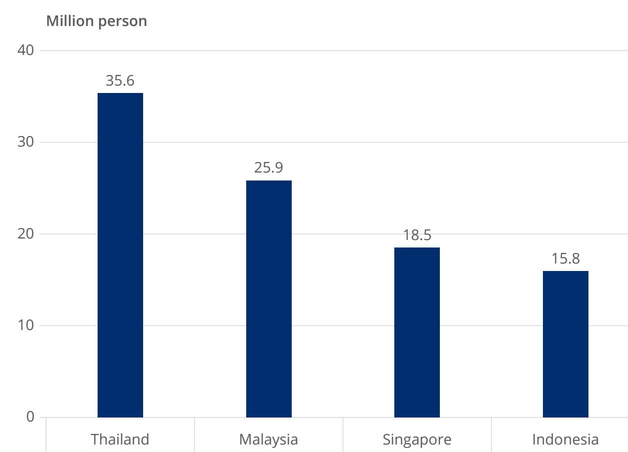
Overall, improvement in competitiveness will be key to supporting performance in tourism. One of the main indicators of tourism performance is a higher tourism competitiveness ranking in the TTCI compared to peer countries. This is confirmed by the positive correlation between the TCCI and the growth in foreign tourist arrivals in various countries (Chart 4.7). Indonesia's 40th place ranking by competitiveness in 2019 already represented an improvement over in the level achieved in 2017. Looking ahead, there is still room for improvement, to put Indonesia's tourism competitiveness on a par with peers like Thailand, Malaysia and Singapore, all of which rank in the top 25. Of four competitiveness indicators used by TTCI (Chart 4.8), some including infrastructure and the enabling environment, lend themselves to prioritization for further development in order to raise Indonesia's competitiveness ranking. Nevertheless, performance in some competitiveness indicators (natural and cultural resources: and tourism policy and enabling conditions) is better than that of countries, although further improvement is needed.

Chart 4.5. Number of Foreign Visitors



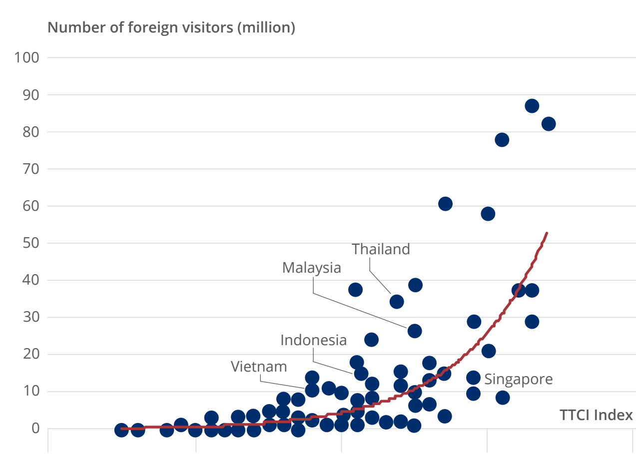
MPD: mobile positioning data (without immigration data)
Source: BPS, calculated

Chart 4.6. Number of Foreign Visitors in Peer Countries



Source: UNWTO, calculated

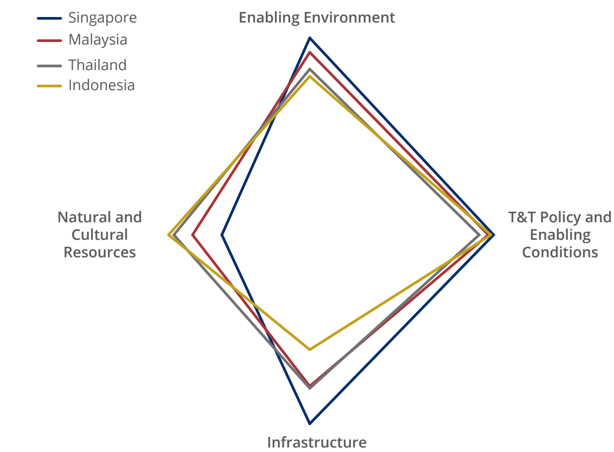
Chart 4.7. TTCI and Growth of Foreign Visitors



Source: TTCI, WEF

4 Tourism cycle by Butler, 1980, is an analysis of the stages of tourism development based on aspects of the interaction of the environment, living things and socio-economic. The exploration phase reflects destination conditions that still have original natural advantages and minimal social effects.

Chart 4.8. Comparison of the Components of the Tourism Competitiveness



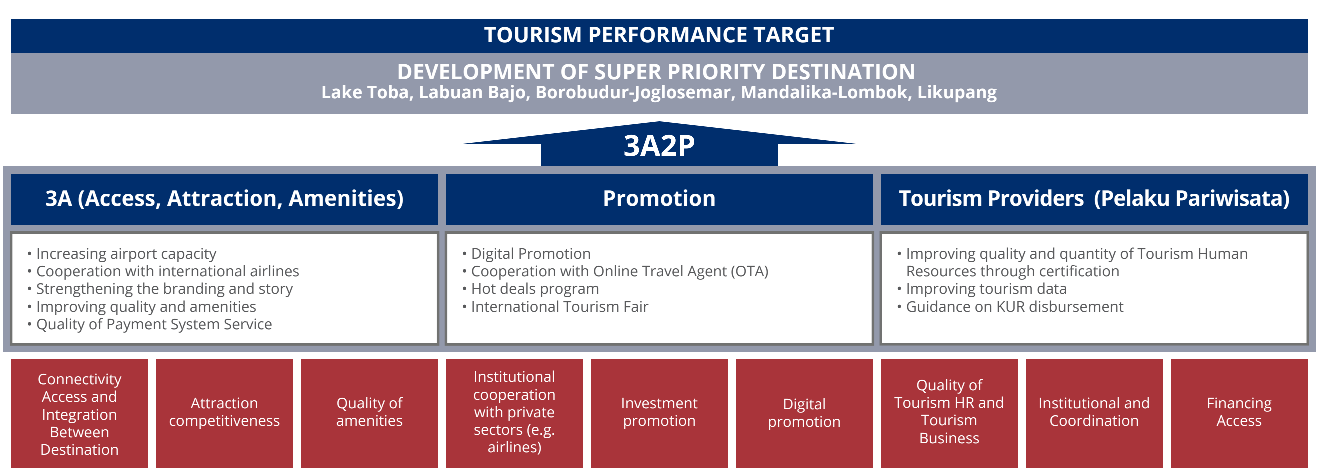
Source: TTCI, WEF

The strategy for strengthening tourism sector involves the 3A2P (Access, Attractions, and Amenities – Tourism Promotion and Providers), supported by policy synergy. In 2019, development of the 3A focused on provision of quality Access, Attractions and Amenities by: (i) expanding airport capacity at the main points of entry; (ii) strengthening the destination branding and story; and (iii) development of international chain hotels. Regarding the industry providers, the steps taken for transformation of tourism sector involve government policy in issuing certification that will support improvement in the quality of human resources. Transformation in the area of promotion involves the spread of information through the digital media, online travel agents and promotional discounting. Synergy among policy makers has helped support this transformation through coordination and resolution of bottlenecks in tourism sector development. Transformation of tourism sector is implemented through, the 3A2P development that focuses on five super-priority destinations, namely: Lake Toba; Borobudur-Joglosemar; Mandalika; Labuan Bajo; and Likupang, as well as broader destinations such as Jakarta, Bali, and the Riau Islands. Implementation of the 3A2P strategy is expected to raise further Indonesia's competitiveness ranking relative to peer countries (Figure 4.3).

Expansion of basic infrastructure is a priority for greater competitiveness of the tourism sector. This priority is the basis for the Government rationale in targeting the completion of basic tourism infrastructure by 2020. The expansion of basic infrastructure is focused primarily on connectivity of inbound travel in Indonesia and between tourism destinations in Indonesia. In support, airport expansion will focus on the five super-priority destinations, which currently operated at only limited capacity. In addition, the Government is cooperating with airlines to overcome obstacles posed by limitations in transportation services, particularly to Lake Toba, Labuan Bajo and Lombok.

Improvements will also be made in the quality of attractions and amenities at individual destinations. Concerning attractions, Indonesia is already quite competitive although more attention is needed to some aspects, like the destination's branding and story. To build positive perceptions among foreign tourists, the Government implemented a policy in 2019 for the development of attractions, part of which involves stronger branding. In addition, the Government made provision

Figure 4.3. Tourism Development Strategy



Source: Joint Secretariat for Accelerated Development of the Tourism Sector for higher quality amenities offered by international hotel chains working in collaboration with investors. International hotels have now been built at some of the super-priority destinations, including at Mandalika, Labuan Bajo and Borobudur-Joglosemar, but efforts need to be stepped up at Lake Toba and Likupang. In the development of these amenities, Bank Indonesia will contribute through the electronification program for the payment system at various tourism destinations including Labuan Bajo and Borobudur.

Intensive promotions through digital media and online travel agents, in addition to expansion of price promotions, will support the travel and tourism policy for greater competitiveness. This effort to increase competitiveness of tourism sector focuses mainly on improved tourism branding. The Government is engaged in intensive, digital media-based promotions targeting Europe, the United States, China and the Middle East, especially countries that are less represented in tourist arrivals in Indonesia than in peer countries. In addition, the Government is helping to build more extensive awareness of Indonesia's tourism branding and promotions through greater collaboration with online travel agents and in 'hotdeal' offers, which are expected to yield direct results in higher numbers of foreign tourist arrivals.

The competitiveness of the enabling environment will also benefit from quality improvements on the part of service providers. These quality improvements will involve the issuance of training certification with the short-term objective of expanding the supply of skilled personnel. In the long run, due to steady growth in demand for tourism human resources, it will be necessary to design appropriate education and training programs that will ensure that human resources are properly prepared in both quantity and quality. Efforts to improve quality among tourism industry providers will be supported by availability of investment and financing. To this end, the Government will step up efforts for promoting investment in tourism and adopt technical directives for disbursement of the People's Business Credit (KUR). Investment promotions have been regularly held at various international events by the relevant ministries and business players. Additionally, the technical directive for KUR disbursing institutions, enacted in March 2019, is expected to provide agents in the tourism sector with greater access to bank financing. Overall, these efforts will boost employment in tourism sector, which is one of the success indicators for development of the sector.

"Strengthening of the tourism sector is supported by synergy among policy makers"

Strengthening the tourism sector is further supported by synergy among policy makers, underpinned in part by establishment the Joint Secretariat (SekBer). To strengthen synergy among government agencies, the Coordinating Ministry for Maritime Affairs issued Decree of the Coordinating Minister for Maritime Affairs No. 109 of 2019 concerning the Joint Secretariat for Accelerated Development of the Tourism Sector, with members from relevant line ministries and Bank Indonesia. The Joint Secretariat is a forum for regular coordination and evaluation of progress in transformation of the tourism sector. The Joint Secretariat also coordinates with industry representatives and the other related agencies to identify and resolve bottlenecks to development of tourism in some regions.

Tourism development at Borobudur-Joglosemar offers an example of good progress in implementing the transformation of tourism sector under the 3A2P scheme. The Government has pursued all aspects of 3A2P development to support the preparations for Borobudur-Joglosemar to become a new Bali with a target of up to 2 million foreign visitors. For accessibility, the Yogyakarta International Airport project with a capacity

of 8 million passengers per year was completed on-schedule in December 2019. Support for improvement in the quality of amenities (involving construction of international chain hotels) is provided through investment facilitation by the One Stop Service (OSS), which has progressed well. Good coordination has been held to overcome obstacles to land acquisition, and these issues are expected to be resolved in 2020. Likewise, there has been good progress in development of attractions, in part through integration across supporting regions, such as Dieng, Solo, Yogyakarta and Semarang. Reflecting this is the development of connectivity linking the supporting regions, such as the Bawen-Yogyakarta and Solo-Yogyakarta toll roads that are on track for completion in 2021. Concerning tourism industry providers, the development of villages for MSME-based tourism—that is, offering quality products made by MSMEs--will also become part of the core attractions. Among these villages are Wanurejo, Tanjung Sari and Majaksingi. The central and regional governments are also working intensively on promotion through overseas tourism exhibitions, digital promotions and collaboration with travel agents.

A key success factor in the transformation of tourism at Borobudur-Joglosemar is the strong synergy forged among the relevant institutions. The objective of the synergy is to provide support for smooth coordination between the central government and the regional governments of the two involved provinces (Yogyakarta Special Region and Central Java). The Borobudur-Joglosemar synergy also benefits from the active role of the Borobudur Authority Agency (BOB), which is responsible for planning and the strategy for development of the zone, coordination and assisting in resolution of strategic issues in the zone development. Strong support from the relevant line ministries and the availability of financing has helped sustain the active role of BOB in developing a more integrated Borobudur zone.

Looking forward, strengthening the tourism sector will be continued in a multifaceted strategic approach. Tourism development under the 3A2P framework will be boosted at super-priority destinations and the other leading destinations of Bali, Wakatobi, and Bromo-Tengger-Semeru. Related to this, priority will continue to be given to development of connectivity infrastructure at all destinations. In the short term, accelerated resolution is needed for administrative obstacles delaying expansion of facilities for international flights at the Ngurah Rai and Soekarno-Hatta airports. Completion of construction work on the Yogyakarta rail link to the Yogyakarta International Airport (YIA) will enable international flight routes to be transferred more quickly from the Adi Sucipto airport. In seaport infrastructure, the near-term priority is to finalize administrative requirements for launching operations at the Gili Mas port in Lombok.

Work will continue on the development of attractions and amenities at super-priority destinations. The short-term focus for development of attractions is the 2021 MotoGP in Mandalika. Hosting of the 2021 MotoGP is still hampered by issues concerning amenities, particularly limited accommodation. Coordinated action can be taken to fast-track completion of some hotels and to collaborate with nearby regions for provision of accommodation in order to overcome these constraints. Concerning amenities, the focus for the short term is development of international chain hotels at Lake Toba and Borobudur.

Promotional tourism programs need to be expanded further and to improve the quality of tourism service providers. This includes offering better ‘hotdeal’ promotions and cooperation with

online travel agents and international airlines. Opportunities also exist for more robust promotional programs involving MICE in view of the state of preparedness of leading MICE destinations in peer countries. Furthermore, with regard to service providers, work will continue on various programs for building the quality of human resources, including certification and training collaboration with international hotels.

One of an important aspect on developing tourism sector is strengthening and upscaling Tourism Crisis Management (MKK) in the midst of COVID-19 outbreak. The expansion of MKK to several major destinations and strengthening the mechanism for dealing with tourism crises is important for maintaining positive perceptions of Indonesia and providing assurances to foreign tourists. The measures currently taken by the MKK, mainly in Bali, are consistent with the safety measures prescribed by the WHO, which include body temperature checks at the airport; readiness of hospitals for dealing with COVID-19; information on prevention and treatment; and a crisis and contact center for handling COVID-19. Extra measures to contain spread of the virus include the suspension of tourist arrivals from countries that already have high rates of COVID-19 cases.

4.3
The Sharia Economy and Finance for Inclusive Growth

The strengthening of the sharia economy and finance in national economic development is a key element for inclusive and sustainable growth. This axiom rests upon the fundamental principle of the sharia economy that ensures financial transactions are based on real assets or projects. For this reason, the sharia economy plays a vital role in support of development of the real sector and sustainable economic expansion. Further, development of the sharia economy will be implemented by building halal value chains, including the application of business models based on varied partnership schemes ranging from MSMEs to large corporations.

The Indonesian sharia economy is a new source of economic growth due to the considerable potential of the halal industry in terms of prospects for consumption by Muslims worldwide. The value of this consumption is predicted to reach USD3.2 trillion in 2024.[5] This has prompted some countries to become leading players in the global halal industry. Development of the halal industry with the aim of promoting economic growth has been adopted as a strategy by various countries, including some without Muslim-majority populations. Among these nations, China has emerged as the largest exporter of Muslim clothing to the Middle East; Japan has designated the halal industry as a leading economic sector in 2020; South Korea has adopted a vision to become a world-class halal tourism destination; and Thailand is now focusing on establishing itself as a world-class supplier of halal cuisine. In addition, Australia and Brazil are both major global suppliers of halal beef and poultry.

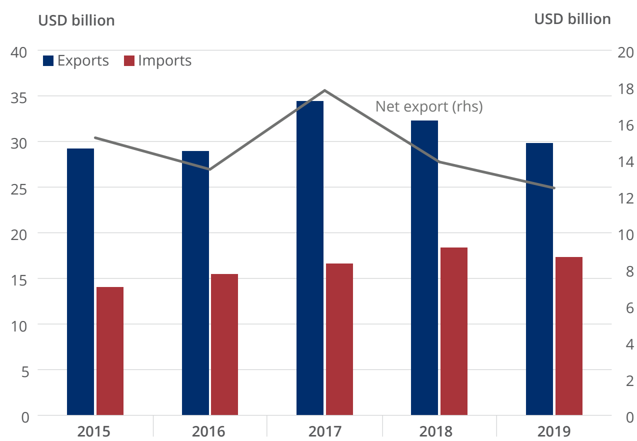
The potential of the global sharia economy presents Indonesia with wide opportunities to become a leading player in the global halal industry and to expand the tourism industry. Indonesia has vast potential for building the halal sector into a market leader, instead of Indonesia being just a target market. At the same time, Indonesia's 'demographic bonus' offers tremendous opportunity for companies operating in the national halal industry to step up production and become leading players in the global halal industry. An upscaling of production could boost Indonesia's exports of halal products, particularly in food and beverages, medicines and cosmetics and fashion. This potential is illustrated by Indonesia's exports of halal foodstuffs, which reached USD29.3 billion in 2019 (Chart 4.9). In the preceding year, Indonesia's exports of halal foodstuffs accounted for only 15.4% of total global halal food exports.[6] Another source of potential economic growth from the halal industry is Muslim-friendly tourism, with Indonesia ranking first place in the Global Muslim Travel Index of 2019.

Potential of the sharia economy offers support for wider national growth. Growth in the sharia economy is on an accelerating trend, bolstered by the halal industry and sharia financing. This will help expand the sharia economy's contribution to the economy as a whole. The trend has been visible over the past five years, with the domestic sharia

5 State of the Global Islamic Economy Report 2019/2020, Dinar Standard.

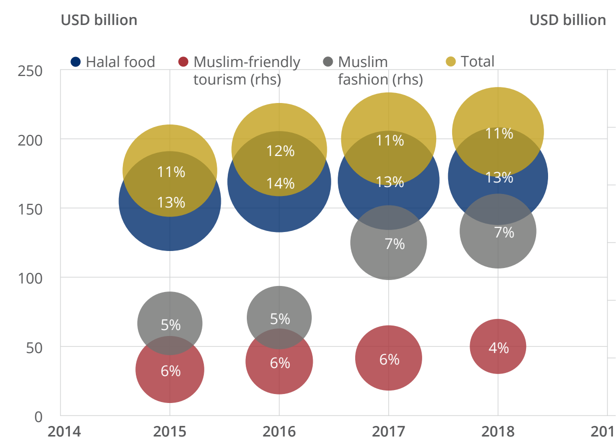
6 According to the State of the Global Islamic Economic Report 2019/2020, global halal food exports totaled USD210 billion in 2018.

Chart 4.9. Value of Halal Food Exports of Indonesia



Note: calculated based on Halal guides from LPPOM MUI
Source: Bank Indonesia

Chart 4.11. Share of Indonesia Sharia Market to Global Sharia Market 2018



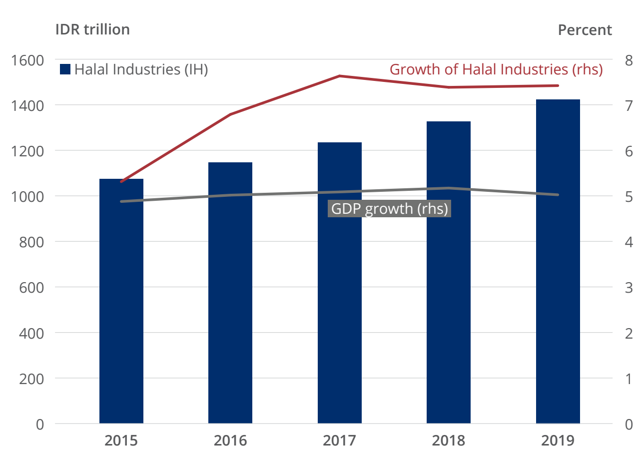
Note: bubble size represent the size of Indonesia's respective sector to global
Source: State of The Global Islamic Economy Report, calculated

economy maintaining steady growth ahead of overall GDP. Among others, this is visible in the halal industry as halal food and beverages, Muslim fashion and Muslim-friendly tourism (Chart 4.10).

Over time, the contribution of the sharia economy in Indonesia has steadily expanded its global reach. Indonesia's sizable market, with contributions from the halal foods industry, fashion and Muslim-friendly tourism, now accounts for approximately 11% of the global halal market (Chart 4.11). A market of this size highlights the urgency for transformation of the national sharia economy and finance, to make Indonesia more than just a target market for other countries.

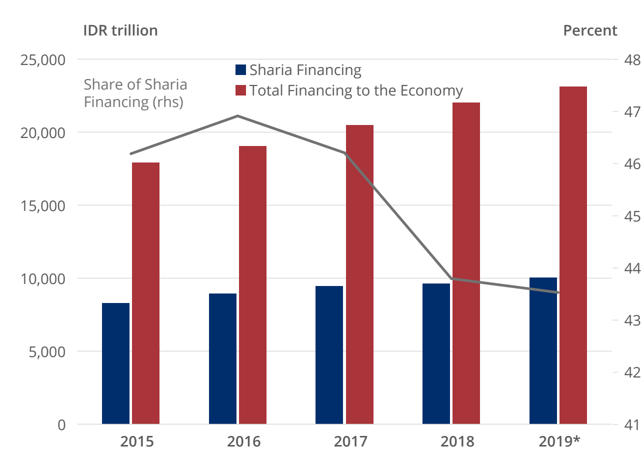
The effort to increase halal industry production and build the sharia economy will increase demand for sharia-compliant financing. Meeting these demands will require innovation in sharia financing products that can respond to the needs of sharia businesses. Indonesia has seen steady expansion in the range of sharia compliant instruments for economic financing (Chart 4.12), although accelerated development is still needed for continued strong growth.[7] These sources of economic financing

Chart 4.10. Domestic Halal Industries and GDP



Source: BPS, Bank Indonesia, calculated

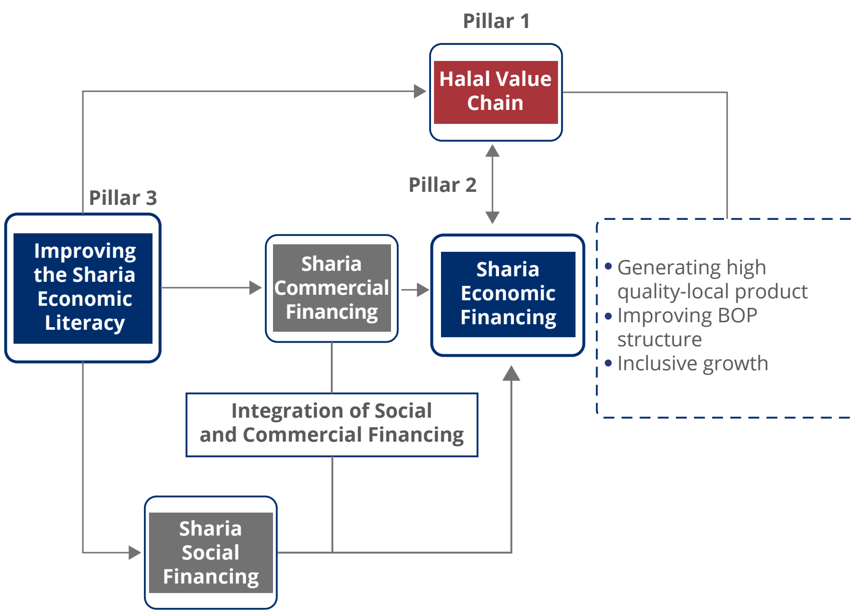
Chart 4.12. Sharia Financing



*as of November 2019
Source: Bank Indonesia, Integrated Financial Balance Sheet

7 Based on an integrated financial balance sheet with the following range of financing instruments: securities, credit or financing in their broad meaning (not only credit extended by financial institutions), and equity, whether or not listed on a stock exchange.

Figure 4.4. Interconnectivity between Pillars of Blueprint of Sharia Economic and Financial Development



are not limited to the commercial finance sector, but it also includes social finance under sharia (*zakat,* mandatory alms-giving, and *wakaf* endowments) that represent financing alternatives operating within defined sharia principles.

Bank Indonesia has initiated a development strategy in the Bank Indonesia Sharia Economy and Finance Development Blueprint, which is aligned to the drive for transformation of the sharia economy and finance.[8] The strategy in the blueprint applies a sharia economy development approach within a halal value chain (HVC) ecosystem, including financing from sharia complaint financial services. This integrated approach requires good understanding and literacy on the part of the public concerning the sharia economy and finance. These considerations are summarized in Figure 4.4, with the sharia economy in Pillar 1; sharia finance in Pillar 2; and education and public dissemination in Pillar 3. These three key pillars will be reinforced by the use of digital technology for improving efficiency, broader coverage and accelerating implementation.

The strategy for developing the sharia economy through the HVC ecosystem encompasses sharia business player at the various levels, halal industry infrastructure and the institutional framework. By sector, the development program focuses on the key sharia sectors that include agriculture; halal food and beverages; Muslim fashion including cosmetics; and Muslim-friendly tourism. Regarding the sharia business player, the ecosystem will be developed through capacity building for MSMEs and strengthening of economic self-sufficiency for Islamic boarding schools, and development of partnership linkages. This development of partnership linkages is the major focus in the development of each unit within an HVC. Partnerships may be formed between sharia compliant MSMEs themselves or with Islamic boarding schools and even with large-scale businesses and industry. Development along these lines promotes inclusiveness in the economy. The HVC development strategy itself includes local unit chains aimed at developing import substitutes and global unit chains for boosting Indonesia's halal industry exports. To this end, the establishment of halal industrial zones is one of the necessary conditions for accelerating the development of the halal industry sector from the viewpoint of halal industry infrastructure and institutions.

As the monetary authority, Bank Indonesia is also strengthening the sharia-based monetary policy framework and financial market deepening in order to promote financing. One of the outcomes of this strategy is the financing raised through Bank Indonesia Sukuk or Islamic bonds (SUKBI), a negotiable sharia-compliant monetary instrument. This monetary instrument can also serve to deepen the sharia financial market, which will improve the efficiency of liquidity management by sharia financial institutions. With financial markets operating more efficiently, monetary policy transmission will become more effective, which will in turn promote sharia financing to meet growing demands of the sharia economy. Equally important, macroprudential policies that apply sharia principles are also directed at promoting sharia financing while maintaining a healthy level of financial system stability in

8 The Bank Indonesia Sharia Economy and Finance Development Blueprint was launched in June 2017.

synergy with the Ministry of Finance and the Financial Services Authority (OJK).

A comprehensive education and dissemination strategy has been adopted to improve public understanding of the sharia economy and finance. This strategy aims to build the capacity of human resources to be dependable, professional and competitive. In practice, the strategy will involve the design of an education program that is highly relevant to industry needs, including development of a curriculum; enrichment of the vocational program; and professional certification for the sharia economy and finance industry. One indicator of success in carrying out this education is the level of public literacy concerning the concepts and basic principles of the sharia economy and finance. The higher the literacy rate, the greater the demand from the public for sharia compliant products and services. On the other hand, the stronger the competence of personnel in the sharia economy and finance, the greater the opportunity for Indonesia to become an active player in meeting needs in this sector.

In addition to efforts involving formal education, non-formal education and dissemination are being targeted on a continuing basis. One of the activities carried out under this strategy is the annual Indonesia Sharia Economic Festival (ISEF). The ISEF is a shared venue that can be attended by all stakeholders, but particularly by sharia business players, as well as members of the general public in Indonesia. For sharia business players, the ISEF is a facility for promoting Indonesian halal products. For line ministries and relevant government agencies, the ISF is a platform for introducing programs for development of the sharia economy and finance. For sharia financial institutions, the ISEF can raise awareness and promote social inclusion with regard to sharia financial instruments. For sharia social financial institutions, the ISEF can support the drive for building a joint commitment in developing and optimizing sharia social financing. Meanwhile, for academics, associations and the general public, the ISEF is a forum for building awareness, understanding expertise and ultimately broad-based inclusion. The strategy of organizing the ISEF on an international scale also aims to establish Indonesia as a global reference for the sharia economy and finance.

“The drive for transformation of the sharia economy and finance will remain focused on an ecosystem approach”

The strategy for development of the sharia economy and finance has evolved and been upscaled at the national level. Bank Indonesia’s initiatives for integrating the development of the sharia economy with sharia compliant finance have been up-scaled to a national strategy. On May 14, 2019, the National Committee for Sharia Finance (KNKS), chaired by the President of Indonesia and acting on behalf of the Government, launched the Indonesia Sharia Economy Master Plan (MESKI). MESKI is a document that includes the Indonesia Sharia

Finance Architecture Master Plan (MAKSI), originally launched in August 2016. In the MESKI, the strategy for strengthening sharia finance is based on the MAKSI, thereby integrating the sharia economy and finance into the broader development strategy. Similarly, the development strategy for the national sharia economy in MAKSI contributed to the emphasis on HVC development, in line with the strategy initiated by Bank Indonesia.

Going forward, transformative development of the sharia economy and finance will remain focused with an ecosystem approach. Furthermore, the integrated development strategy has been given added force by the issuance of Presidential Regulation Number 28 of 2020 concerning the National Sharia Economy and Finance Committee (KNEKS). This Presidential Regulation reinforces the strategic focus on intensified development of the sharia economy and finance in support of national economic development. Consistent with the Government's development plan, the sharia economy and finance development plan will encompass the following areas of growth and development: (i) the halal products industry; (ii) the sharia financial industry; (iii) sharia social funds; and (iv) sharia businesses and expansion of their activities.

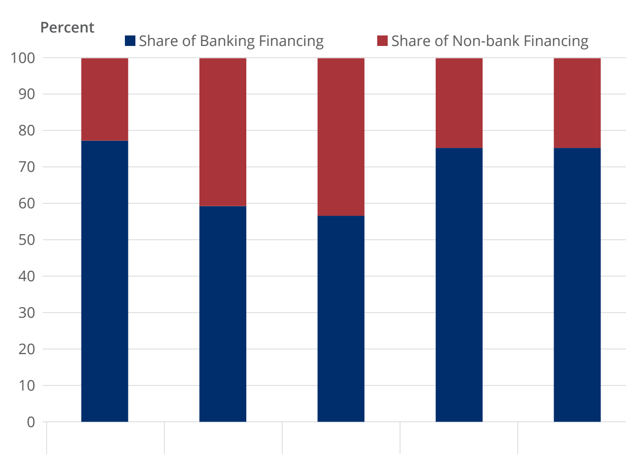
4.4 Financial Market Deepening

Economic transformation to promote the sustainability of sources of economic financing needs support from financial market deepening. Financial markets play a strategic role as a source of economic financing; as a medium for monetary policy transmission; and as support for financial system stability. When the financial market is deep and liquid, these characteristics will enable more efficient allocation of capital and serve as a basis for additional new sources of economic financing. As described in economic growth theory, increased financing will support increased capital accumulation and investment that will improve productivity with an overall impact of sustained growth in the economy. In addition, a deep, liquid, inclusive and secure financial market will absorb pressures when markets encounter turbulence, thereby supporting effective monetary policy transmission and financial system stability. Furthermore, financial markets with a wide range of financial instruments and a diversified investor base will contribute to the sustainability of sources of economic financing.

Financial deepening policy is set against a background of still limited sources and volume of funds for economic financing, especially from non-bank financial institutions. Over the past 5 (five) years, non-bank sources of economic financing, which represent one measure of economic deepening, have remained near 31% of GDP. Bank credit continues to dominate financing, accounting for about 69% of domestic economic financing (Chart 4.13). This domination of financing by the banking system limits the options for borrowers to access funds and it enables a high cost of funds. Furthermore, Indonesia's financial market deepening continues to lag behind peer countries, and for this reason needs to be taken further (Chart 4.14).

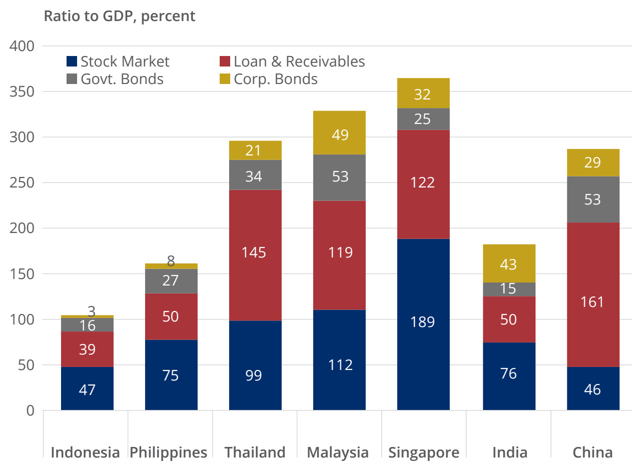
Coordination between Bank Indonesia, the Ministry of Finance and OJK has also been strengthened under the National Strategy for Financial Market Development and Deepening (SN-PPPK), which focuses on three pillars of development. The first pillar, that of developing sources for economic

Chart 4.13. Indonesia's Economic Financing



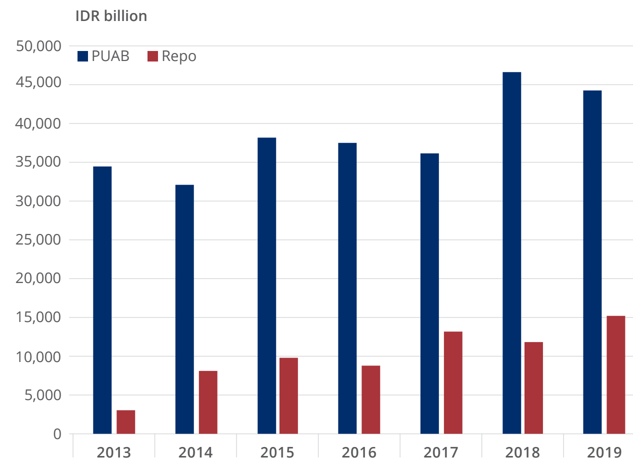
Source: OJK

Chart 4.14. Depth of Financial Market Instruments



Source: World Bank

Chart 4.15. Repo and PUAB position

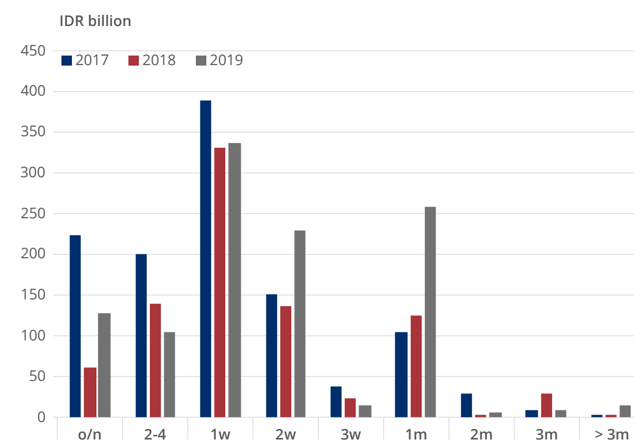


Source: Bank Indonesia

financing and risk management, has been implemented by stimulating the demand and supply of financial instruments. On the demand side, the emphasis is on expansion of the investor base, including both domestic and international investors. On the supply side, the focus is an enrichment of alternatives for financial instruments, both for financing and mitigation of risk. This mix of demand and supply will be marked by healthy, dynamic interaction through strong intermediation institutions. The second pillar, namely the development of financial market infrastructure, focuses on access to information; supports efficient pricing on the market; and rapid, secure and efficient settlement of transactions. The third pillar, that of financial market deepening, involves the establishment of an integrated regulatory framework and improved understanding of financial products on the part of market participants.

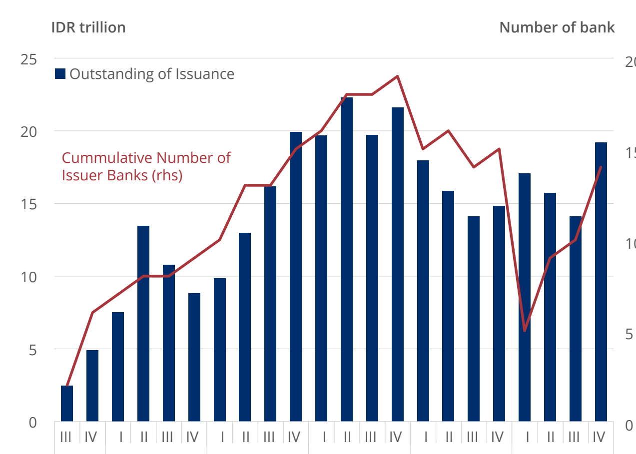
Implementation of these three strategies has given a boost to Indonesia's financial markets. In the money market, development of the repo market continues to support management of rupiah liquidity in longer tenors. In 2019, repo transactions were up in volume, accompanied by an increase in the proportion of transactions in tenors greater than 1-month, from 18.7% in 2018 to 26.1% in 2019 (Chart 4.15 and Chart 4.16). Short-term funding in the form of certificates of deposit also increased in value (Chart 4.17). In addition, non-bank corporations operating in financing and preparation of infrastructure projects, have begun making use of commercial paper, a money market instrument for short-term financing. Other positive developments were visible in the continued efficiency of the forex market, which

Chart 4.16. Daily Average of Repo Transaction



Note: w: weekly m: monthly
Source: Bank Indonesia

Chart 4.17. Certificate of Deposit Outstanding



Source: KSEI

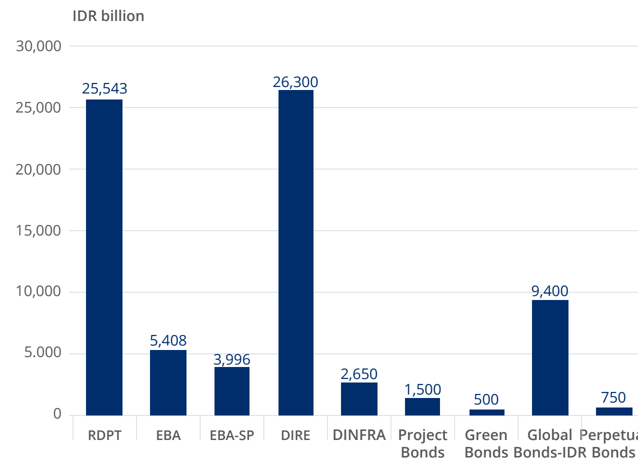
has helped curb pressure on the rupiah exchange rate. Reflecting this efficiency was a consistently thin bid-ask spread in rupiah spot transactions against the US dollar. In addition, transaction volume was up for nearly all forex derivative instruments used for hedging, including DNDFs. In turn, the greater depth and efficiency of the domestic financial market has bolstered the sustainability of sources of economic financing.

Going forward, the three pillars of development in the SN-PPPK will continue to serve as the policy strategy for the medium term (2023-2024). The leading priorities of development are: (i) broader participation by borrowers and creditors, the role of intermediation institutions, and alternative financial instruments; (ii) enhanced market efficiency with the aid of financial market infrastructure; and (iii) improvements to the legal framework and building of market player competencies. In keeping with the government's medium-term development plan, economic financing will focus on support for infrastructure development. Under the 2020-2024 Medium-Term Development Plan, the financing needed for construction of infrastructure is estimated at IDR6,445 trillion (6.2% of GDP). Support from government financing is projected at only IDR2,385 trillion, or 37% of the total requirement. Therefore, innovative measures are needed to promote private sector support in financing infrastructure. In this regard, the Government has created a financing scheme to encourage participation from the private sector, known as the public-private partnership (PPP). The PPP scheme focuses primarily on financing of infrastructure that is economically viable but financially marginal.

Various strategies are being continued to promote the role of financial markets as a source of infrastructure financing. This involves such actions as development

"Greater depth of the domestic financial market will support the sustainability of economic financing" of innovative financing for infrastructure, including the Infrastructure Fund (DINFRA); earnings-based assets (EBA); project bonds: and green bonds (Chart 4.18). Regarding the development of green bonds, Bank Indonesia has entered into a joint commitment with OJK and the Ministry of Finance to work together in the Coordinating Forum for Development Financing on Financial Markets (FK-PPPK) for the development of green financing on the domestic market. To date, this commitment has taken shape through the issuance of regulations by Bank Indonesia and OJK. Bank Indonesia has also issued regulations concerning: interest rates swaps (IRS), overnight index swaps (OIS) and DNDFs for mitigating interest rate and exchange rate risks; loan to value issues; and the Macroprudential Intermediation Ratio (MIR) for the green sector. Meanwhile, OJK has issued regulations on issuance of green bonds and sustainable investment. In supporting these green bonds, Bank Indonesia collaborated with the UK Embassy for facilitation of technical assistance in preparation for the green bonds project and worked with the World Bank for facilitation of grant assistance. Following this, Bank Indonesia also became a member of the Network for Greening Financial Systems (NFGD) on November 6, 2019.[9] Green bonds are expected to broaden the range of available infrastructure financing alternatives for issuers while stimulating investor interest by offering a diversified product selection.

Chart 4.18. Innovative Financing for Infrastructure



Source: KSEI, as of December 2019

9 The NFGD is a coalition of central banks and supervisory agencies working in support of green financing in the financial system.