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Economics, Macroeconomics

MGI_Unleashing_Indonesia_potential_Full_reportitute September 2012 The archipelago economy: Unleashing Indonesia's potential T he McKinsey Global Institute The McKinsey Global Institute (MGI), the business and economics research arm of McKinsey & Company, was established in 1990 to develop a deeper understanding of the evolving global economy. Our goal is to provide leaders in the commercial, public, and social sectors with the facts and insights on which to base management and policy decisions. MGI research combines the disciplines of economics and management, employing the analytical tools of economics with the insights of business leaders. Our micro-to-macro methodology examines microeconomic industry trends to better understand the broad macroeconomic forces affecting business strategy and public policy. MGI's in-depth reports have covered more than 20 countries and 30 industries. 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For further information about MGI and to download reports, please visit www. mckinsey. com/mgi. McKinsey & Company in Indonesia McKinsey & Company is a global management consulting firm that helps many of the world's leading organisations address their strategic challenges, from reorganising for long-term growth to improving business performance and maximising revenue. With consultants deployed in more than 50 countries across the globe, McKinsey advises on strategic, operational, organisational, and technological issues. For more than eight decades, the firm's primary objective has been to serve as an organisation's most trusted external adviser on critical issues facing senior management. McKinsey started serving clients in Indonesia in 1988 and established an office in Jakarta in 1995 with a team of global and local professionals. Today, the office employs more than 60 Indonesian staff and serves private local companies, state-owned enterprises, and the public sector in Indonesia, as well as multinational corporations across industries interested in building their presence in the country. Copyright © McKinsey & Company 2012 McKinsey Global Institute September 2012 The archipelago economy: Unleashing Indonesia's potential Raoul Oberman Richard Dobbs Arief Budiman Fraser Thompson Morten Rossé Preface Indonesia is in the throes of a rapid transformation, swept along by its position at the heart of the world's most dynamic economic region, rapid urbanisation, and rising incomes that will propel an additional 90 million Indonesian people into the world's consuming class by 2030. Over the past decade, the economy has grown more strongly and been more stable; today it is more diversified than many outsiders realise. On current trends, Indonesia is on course to become the seventh-largest economy in the world in 2030 from the 16th largest today. If Indonesia can meet a range of constraints on growth, it can fully leverage today's positive economic trends and offer businesses and investors a lucrative market opportunity. In this report, the McKinsey Global Institute (MGI) discusses the recent record of the Indonesian economy, looks at its future prospects, suggests priorities for government and business that might best maintain the economy's momentum, and, finally, discusses the potential size of the private business opportunity in Indonesia to 2030. Raoul Oberman, a McKinsey director and chairman of McKinsey Indonesia, and Richard Dobbs, a director of MGI, led this research together with Arief Budiman, a partner and president director in McKinsey's Jakarta office, and Fraser Thompson, an MGI senior fellow. 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Alisjahbana, president director and CEO of Femina Group, and Petty Siti Fatimah, editor-in-chief and chief community officer of Femina magazine; and Zulkifli Zaini, president director of Bank Mandiri. McKinsey Global Institute T he archipelago economy: Unleashing Indonesia's potential This report contributes to MGI's mission to help global leaders understand the forces transforming the global economy, identify strategic locations, and prepare for the next wave of growth. As with all MGI research, we would like to emphasise that this work is independent and has not been commissioned or sponsored in any way by any business, government, or other institution. Richard Dobbs D irector, McKinsey Global Institute Seoul James Manyika D irector, McKinsey Global Institute San Francisco Charles Roxburgh D irector, McKinsey Global Institute London Susan Lund D irector of Research, McKinsey Global Institute Washington, DC September 2012 Indonesia today . . . 16th-largest 45 million 53% 74% economy in the world members of the consuming class of the population in cities producing of GDP 55 million $0. 5 trillion skilled workers in the Indonesian economy market opportunity in consumer services, agriculture and fisheries, resources, and education . . . and in 2030 7th-largest 135 million 71% 86% economy in the world members of the consuming class of the population in cities producing of GDP 113 million $1. 8 trillion skilled workers needed market opportunity in consumer services, agriculture and fisheries, resources, and education McKinsey Global Institute T he archipelago economy: Unleashing Indonesia's potential Contents Executive summary 1 1. Five myths about Indonesia's recent growth 11 2. Indonesian growth could benefit from powerful trends 21 3. Meeting the challenges facing Indonesia 29 3. 1 Transform consumer services 32 3. 2 Boost productivity in agriculture and fisheries 43 3. 3 Create a resource-smart economy 58 3. 4 Invest in skill building 70 4. A $1. 8 trillion business opportunity by 2030 81 Appendix: Technical notes 85 Bibliography 94 McKinsey Global Institute T he archipelago economy: Unleashing Indonesia's potential 1 Executive summary Indonesia's economy has enormous promise. Already the 16th-largest economy in the world, this dynamic archipelago has the potential to be the seventh biggest by 2030. It is a much more stable and diversified economy than many outside observers assume. In recent years, Indonesia has made enormous strides in its macroeconomic management. Inflation has fallen from double into single figures, and government debt as a share of GDP is now lower than in the vast majority of advanced economies. The economy, part of a resurgent Asia, is transforming rapidly. Indonesia has a young population and is quickly urbanising, powering growth in incomes. Between now and 2030, Indonesia will be home to an estimated 90 million additional consumers with considerable spending power. This growth in Indonesia's consuming class1 is stronger than in any economy of the world apart from China and India, a signal to international businesses and investors of considerable new opportunities. But Indonesia is at a critical juncture. The archipelago economy is confronted by three major challenges in the period to 2030. First, Indonesia faces a productivity imperative. The economy has performed relatively well on labour productivity, which has accounted for more than 60 percent of economic growth over the past two decades, the rest being delivered by growth in the labour force. But our analysis suggests that Indonesia needs to boost productivity growth by 60 percent from the rate achieved from 2000 to 2010 if the economy is to meet the government's target of 7 percent annual GDP growth, above current trend growth of between 5 and 6 percent (Exhibit E1). Exhibit E1 Achieving Indonesia's 7 percent annual GDP growth target will require labour productivity to grow 60 percent faster than in 2000—10 Annual real GDP growth rates % 7. 0 2. 4 4. 6 2. 9 GDP growth target Expected growth from increased labour inputs1 Required growth from labour productivity, 2010—30 Additional labour 60% productivity growth required Historical labour productivity growth, 2000—102 1 Driven by additional workers joining the workforce due to demographics and increased participation in workforce; productivity assumed to be the average in 2010—30 based on a business-as-usual growth rate of 5 to 6 percent. 2 Based on an average among national and international data sources. SOURCE: CEIC Data; Indonesia's Central Bureau of Statistics; Conference Board Total Economy Database; International Monetary Fund (IMF); United Nations Population Division; McKinsey Global Institute analysis 1 We define the consuming class as those individuals with net income of more than $3, 600 per annum in purchasing power parity (PPP), at 2005 exchange rates. 2 Second, an uneven distribution of growth across the archipelago and rising inequality are concerns. Indonesia might want to consider how to ensure that economic growth is as inclusive as possible. The third challenge is to ensure that Indonesia does not suffer from infrastructure and resource constraints as its expanding consuming class delivers a welcome injection of growth–and that this demand creates potentially lucrative new markets. In the years ahead, this oncein-a-generation economic transformation will need careful management. This report highlights action that Indonesia could take in three key sectors–consumer services, agriculture and fisheries, and resources–to boost productivity and remove constraints on growth. In addition, we highlight ways to tackle an impending shortage of skills across all sectors. If Indonesia embraces these four priority areas, it has the opportunity to build on recent successes and create a platform for a productive, inclusive, and resilient economy in the long term. IndonEsIa’s rECEnT IMprEssIvE EConoMIC pErforManCE Is noT wIdEly undErsTood The Indonesian economy, today the 16th largest in the world, has performed strongly over the past decade or more and is more diverse and stable than many observers from beyond its shores realise (Exhibit E2). Over the past decade or so, Indonesia has had the lowest volatility in economic growth among any advanced economy in the Organisation for Economic Co-operation and Development (OECD) or the BRICs (Brazil, Russia, India, and China) plus South Africa. E xhibit E2 Indonesia has performed impressively over the past decade Overview of OECD and BRIC1 plus South Africa GDP 2011, current prices Rank $ trillion 1 United States 2 China Real GDP growth, 2000—10 % GDP growth standard deviation, Share of debt to annualised, 2000—10 GDP, 2009 % % Inflation rate, 2011 %, GDP deflator 15. 1 China 11. 5 Indonesia 0. 86 Russia 8. 7 Japan -2. 0 7. 3 India 7. 7 Australia 0. 95 Estonia 9. 0 Czech Republic -0. 7 3 Japan 5. 9 Indonesia 5. 2 Portugal 1. 48 Luxembourg 12. 8 Ireland 4 Germany 3. 6 Russia 4. 9 Norway 1. 56 China 16. 5 Germany 0. 7 5 France 2. 8 Slovakia 4. 9 France 1. 59 Australia 24. 1 Switzerland 0. 7 -0. 4 6 Brazil 2. 5 South Korea 4. 2 New Zealand 1. 70 Indonesia 2 25. 0 Slovenia 0. 8 7 United Kingdom 2. 4 Turkey 4. 0 Belgium 1. 74 Czech Republic 32. 0 Denmark 0. 9 8

Italy 2. 2 Poland 3. 9 Switzerland 1. 78 Norway 35. 4 Sweden 0. 9 9 Russia 1. 9 Estonia 3. 8 Canada 1. 82 Slovakia 38. 2 Portugal 1. 0 10 Canada 1. 7 Chile 3. 7 India 1. 85 Denmark 40. 8 Italy 1. 3 11 India 1. 7 Brazil 3. 6 South Korea 1. 98 Sweden 44. 2 Netherlands 1. 4 12 Spain 1. 5 South Africa 3. 5 Poland 2. 00 Spain 46. 4 Spain 1. 4 13 Australia 1. 5 Czech Republic 3. 4 China 2. 02 Germany 47. 6 France 1. 6 14 Mexico 1. 2 Israel 3. 1 Netherlands 2. 09 Poland 48. 1 Greece 1. 6 15 South Korea 1. 1 Australia 3. 1 United States 2. 10 Turkey 51. 4 Slovak Republic 1. 6 16 Indonesia 0. 8 Slovenia 2. 8 South Africa 2. 14 Canada 53. 1 (36) S. Africa 7. 8 17 Netherlands 0. 8 Luxembourg 2. 8 Austria 2. 14 India 53. 7 (38) Indonesia 8. 4 18 Turkey 0. 8 New Zealand 2. 6 Italy 2. 17 Netherlands 58. 2 (39) Turkey 9. 0 1 Organisation for Economic Co-operation and Development; Brazil, Russia, India, and China. 2 Based on 2011 debt level. SOURCE: Conference Board Total Economy Database; IMF; World Bank; McKinsey Global Institute analysis Government debt as a share of GDP has fallen by 70 percent over the past decade and is now lower than in 85 percent of OECD countries. Inflation has decreased from 20 percent to 8 percent and is now comparable with more mature economies such as South Africa and Turkey. According to the World Economic Forum’s competitiveness report on Indonesia, in 2012 the country ranked 25th on macroeconomic stability, a dramatic improvement from its 2007 McKinsey Global Institute The archipelago economy: Unleashing Indonesia’s potential ranking of 89th place. Indonesia now ranks ahead of Brazil and India, as well as several ASEAN neighbours including Malaysia, Thailand, and the Philippines. 2 A nother misperception is that Indonesia’s economic growth centres almost exclusively on Jakarta; in fact, many other

Indonesian cities are growing more rapidly, albeit from a lower base. The fastest-growing urban centres are large and mid-sized middleweight cities with more than two million inhabitants (excluding Jakarta), which have posted annual average growth of 6. 4 percent since 2002, compared with Jakarta's 5. 8 percent. These cities include Medan, Bandung, and Surabaya as well as parts of Greater Jakarta such as Bogor, Tangerang, and Bekasi. Nor is Indonesia, as many assume, a typical Asian manufacturing exporter driven by its growing workforce or a commodity exporter driven by its rich endowments of natural resources. The reality is that, to a large extent, it is domestic consumption rather than exports, and services rather than manufacturing or resources, which are propelling growth. Indonesia's exports as a share of GDP are roughly half those of Malaysia in 1989, when Malaysian average incomes were at similar levels to those of Indonesia today. The resource sector's share of the economy has actually fallen since 2000 despite booming resource prices. Mining and oil and gas account for only 11 percent of Indonesia's nominal GDP, similar to more advanced economies such as Australia (8. 4 percent) and Russia (11 percent). Indeed, Indonesia is a net oil importer. In contrast, services account for roughly half of economic output. Over the past two decades, labour productivity improvements accounted for more than 60 percent of economic growth with the rest coming from more labour inputs due to an expanding working-age population. Perhaps surprisingly, the majority of Indonesia's productivity gain has come not from a shift of workers from lower-productivity agriculture into more productive sectors, but from productivity improvements within sectors. The three sectors making the largest contributions to this productivity improvement are wholesale and retail trade; transport equipment and apparatus manufacturing; and transport and telecommunications. And contrary to the widespread belief that productivity improves at the expense of employment, both have risen in tandem in Indonesia in 35 of the past 51 years. ThE EConoMIC ouTlooK Is proMIsInG, supporTEd by favourablE loCal and InTErnaTIonal TrEnds Indonesia’s economic growth should benefit from a number of powerful positive trends including the resurgence of Asia, continuing urbanisation that is boosting the number of consumers with the power to spend on discretionary items, and a young population offering the economy a potential demographic dividend. On the current expected trajectory of growth, an additional 90 million Indonesians could join the global consuming class by 2030, powered by the continued rise of urban Indonesia (Exhibit E3). Only China and India are likely to surpass this increase in absolute terms, while Brazil, Egypt, Vietnam, and other fast-growing economies will each bring less than half of Indonesia’s number into the consuming class in the same period. By 2030, Indonesia could become the seventh-largest economy in the world after China, the United States, India, Japan, Brazil, and Russia– overtaking Germany and the United Kingdom. 2 Association of South East Asian Nations. 3 4 Exhibit E3 An estimated 90 million Indonesians could join the consuming class by 2030 Million people1 265 280 280 240 145 Below consuming class 180 195 135 Consuming class2 110 45 2010 Additional people in the consuming class 170 85 20203 2030 in 5—6% GDP scenario 2030 in 7% GDP scenario 40 90 125 1 Rounded to the nearest five million. 2 Consuming class defined as individuals with an annual net income of above $3, 600 at 2005 purchasing power parity

(PPP). 3 Based on annual GDP growth of between 5 and 6 percent. SOURCE: McKinsey Consumer and Shopper Insight (CSI Indonesia 2011); 2010 Population Census, Indonesia's Central Bureau of Statistics; Canback Global Income Distribution Database (C-GIDD); McKinsey Global Growth Model; McKinsey Global Institute Cityscope 2. 0; McKinsey Global Institute analysis ƒ The rise of Asia. T he global consuming class will increase its membership by 1. 8 billion members over the next 15 years, of whom more than 75 percent are likely to be in Asia. The economic transformation in India and China is happening at a scale and pace unprecedented in history. Average incomes are growing at ten times the pace and on more than 200 times the scale of their increase during England's Industrial Revolution. This will fuel demand for a range of resources and commodities supplied by Indonesia. Exports to other Asian economies, particularly those of China and India, have already accelerated strongly in recent years at annual growth rates of 15 to 20 percent. In 2010, Indonesia exported $3. 8 billion of palm oil to India and $2. 1 billion to China. In the same year, China was Indonesia's largest export market for coal, receiving $3. 6 billion, and India was the destination for $2. 0 billion of coal exports. ƒ Urbanisation. T he proportion of Indonesians living in urban areas could reach 71 percent in 2030, up from 53 percent today, as an estimated 32 million people move from rural to urban areas. New cities will be created, helping to increase the overall share of Indonesian GDP generated by urban areas from an estimated 74 percent today to 86 percent in 2030. Other urban areas will continue to outpace Jakarta's growth. Small middleweight cities, defined as having between 150, 000 and two million inhabitants, will continue to contribute the majority of growth and increase their share of GDP to 37 percent (from 31 percent today) with annual growth of more than 6 percent. We expect that cities including Pekanbaru, Pontianak, Karawang, Makassar, and Balikpapan will lead growth among small middleweight cities, each having annual growth rates of more than 7 percent. Growing even faster in relative terms at rates of around 7 percent are 20 mid-sized and large middleweight cities with between two million and ten million inhabitants. Together, these cities will contribute roughly one-quarter of GDP in 2030. In contrast, Jakarta's contribution to GDP is expected to remain relatively constant, at around 20 percent. McKinsey Global Institute The archipelago economy: Unleashing Indonesia's potential ƒ Growing working-age population. Indonesia's young and expanding population could total 280 million by 2030, up from 240 million today. Unlike demographic trends in the many economies that are aging–including some in Asia–we expect those in Indonesia to remain positive until 2025 and contribute an annual 2. 4 percent to overall economic growth until 2030. ƒ An emerging digital and technology-driven nation. O ver the next decade, Indonesia will become a mobile and digital nation. Today there are 220 million mobile subscriptions in Indonesia. The Internet is becoming mainstream. Growing at an annual rate of more than 20 percent, Internet access is expected to reach 100 million users by 2016, dramatically improving connectivity. Green technologies could also dramatically change the resource market in coming years. For instance, Indonesia is home to 40 percent of the world's potential geothermal energy sources. If fully exploited, these could generate up to 24 terawatt hours a year–roughly equivalent to 70 percent of Jakarta's annual energy consumption today.

IndonEsIa’s EConoMy faCEs sEvEral ChallEnGEs– and aCTIon In four arEas wIll bE CrITICal To addrEssInG ThEM To meet its triple challenge of boosting productivity, ensuring inclusive growth, and meeting the challenge of soaring demand from its expanding consumer class, Indonesia needs to tackle problems relating to excessive bureaucracy and corruption, access to capital, and infrastructure bottlenecks. However, we believe that beyond these widely discussed issues, Indonesia could usefully prioritise tackling barriers in four key areas of the economy that have significant potential if current constraints on growth are removed. Three of these four areas relate to transformation within three key sectors: consumer services, agriculture and fisheries, and resources. The fourth area is building worker skills to enable further diversification of the economy. 1. Transform consumer services The burgeoning consuming class will give rise to large new markets, notably in financial services and various retail services such as food and beverages (Exhibit E4). The new wave of consuming class in Indonesia is a huge opportunity, but to capture the full economic potential, the sector needs to boost its productivity and ensure that consumer services are widely available across the Indonesian archipelago. Telecommunications and broadband Internet can be one way to ensure a boost to productivity and improved access to consumer products services as it offers a means to overcome physical barriers. Relatively low levels of productivity in local consumer-facing service sectors explain more than 60 percent of Indonesia’s overall productivity gap with Malaysia today. There are a number of barriers to higher productivity. In financial services, regulation is often a constraint. In retail trade, protectionism that is preventing companies from adopting more efficient practices and is limiting competition is arguably holding back growth. In transportation, poor or insufficient infrastructure is a hindrance. Past MGI work has found that removing barriers to competition is crucial to promoting higher productivity in consumer services. Governments can play a vital role in this regard. 5 6 E xhibit E4 Indonesia's savings and investments and retail sectors are expected to become large consumer markets by 2030 Annual consumer spend $ billion, 2010 price 2011 Savings and investment Compound annual growth rate, 2010—30 % 2030 85 Food and beverage 565 73 Leisure 26 Apparel 194 22 Education 13 57 14 Transportation 105 42 10. 5 5. 2 7. 5 5. 0 6. 0 30 4. 6 26 4. 5 Housing and utilities 11 Telecom 8 19 4. 7 Personal items 6 16 5. 3 Health care 4 13 6. 2 ~260 ~1, 070 7. 7 Total SOURCE: CSI Indonesia survey 2011; Indonesia's Central Bureau of Statistics; Canback Global Income Distribution Database (C-GIDD); McKinsey Global Growth Model; McKinsey Global Institute analysis 2. Boost productivity in agriculture and fisheries Increasing numbers of relatively affluent consumers in India and China and Indonesia itself will raise demand for food and agricultural products significantly. This increased demand comes at a time when more than eight million Indonesians may leave behind farming to migrate out of the countryside into cities; additionally, pressure on land resources is growing partly because cities are expanding. As a consequence, productivity improvements in the agriculture and fisheries sector are a must. For example, to meet domestic demand alone, productivity among Indonesia's farms will need to increase by more than 60 percent from just over three tons of crops per farmer to five tons in 2030. Environmental concerns and urbanisation are both reasons that increases in production need to come from more intensive production systems rather than more extensive land use. Agriculture is responsible for a significant share of the deforestation and peat-land degradation that account for around 75 percent of Indonesia's total greenhouse gas emissions. In agriculture, if Indonesia pursued three approaches–boosting yields, shifting production into high-value crops, and reducing post-harvest and value-chain waste–Indonesia could become a large net exporter of agriculture products, supplying more than 130 million tons to the international market. McKinsey Global Institute The archipelago economy: Unleashing Indonesia's potential 3. build a resource-smart economy Indonesia is entering a period of resource-intensive growth during which demand for energy, materials, water, and other key resources is likely to increase rapidly. Annual demand for energy, for instance, could nearly triple from six quadrillion British thermal units (QBTUs) today to 17 QBTUs by 2030, and demand for finished steel could grow by more than 170 percent from nine million tons to 25 million tons, which is equivalent to 40 percent of India's steel demand today. Indonesia also faces a significant challenge in expanding the supply of safe water and basic sanitation to its growing urban population. We project that 55 million of Indonesia's poorest people, accounting for 20 percent of the total population, could have no access to basic sanitation in 2030 and that 25 million could lack access to water of a decent quality. Given the strong demand for natural resources that we anticipate, it would be advantageous for Indonesia to maximise its energy supply from unconventional sources such as next-generation biofuels, geothermal power, and biomass, and to more productively extract, convert, and use natural resources such as energy, steel, and water. “ Game-changing" forms of energy from unconventional sources could meet up to 20 percent of Indonesia’s energy needs by 2030, reducing the country’s dependence on oil and coal by almost 15 percent as well as lowering greenhouse gas emissions by almost 10 percent, compared with business as usual. The potential to improve Indonesia’s energy efficiency is also significant. For instance, using more efficient methods to generate power, improving transportation, and retrofitting and constructing more energy-efficient buildings could together reduce 2030 energy demand by as much as 15 percent. 4. Invest in skill building Indonesia’s evolving economy will need new skills to support growth. Research by the World Bank suggests that human capital is a major obstacle to the development of a vibrant Indonesian manufacturing sector. The World Bank finds that 84 percent of employers in manufacturing report difficulties in filling management positions and 69 percent report problems in sourcing other skilled workers. 3 In addition, strict regulations related to the termination of a job create a difficult environment for corporations. In order to achieve our base-case projection of between 5 and 6 percent annual GDP growth, we estimate that demand for semi-skilled and skilled workers will increase from today’s level of 55 million to 113 million by 2030, a rise of almost 60 million workers. Increasing female participation to the level of Thailand today could add 20 million semiskilled to skilled workers, but this would not be sufficient to meet Indonesia’s need for skills to support economic growth. On current trends and policies, and assuming that female participation rises to the levels of Thailand today, we project that, by 2030, Indonesia could face a shortfall of nine million workers educated to the secondary and tertiary levels–nearly the population of Jakarta today (Exhibit E5). 3 Indonesia skills report: Trends in skills demand, gaps, and supply in Indonesia, World Bank, May 2010. 7 8 E xhibit E5 Indonesia is projected to face challenges in ensuring that workers receive the right level of education Workforce demand vs. supply, 2030 projections Million workers Demand Skilled and semi-skilled Tertiary labour Upper secondary (general) Upper secondary (vocational) Lower secondary 113 25 Supply Difference between supply and demand Undersupply 104 -2 23 35 25 17 26 -10 30 36 Oversupply 13 -10 â–ª â–ª Total demand for skilled and semi-skilled workers = 113 million Undersupply = 9 million 59 39 Primary and below 20 SOURCE: Indonesia's Central Bureau of Statistics; CEIC Data; United Nations Statistics Division; World Bank; The Economist Intelligence Unit; McKinsey Global Growth Model; McKinsey Global Institute analysis Drawing on McKinsey's global education work, we have identified three measures that could help to close the looming skills gap: (1) raise the standard of teaching significantly, with an emphasis on attracting and developing great teachers; (2) develop a more demand-driven curriculum; and (3) create new, flexible education pathways. Closing the skills gap will require significant investment. Assuming that the government continues to spend about 3 percent of GDP a year on public education, there could be a gap of $8 billion a year by 2030 given expected total demand for education. ConCErTEd aCTIon In ThEsE four arEas Could offEr busInEssEs a $1. 8 TrIllIon opporTunITy by 2030 If Indonesia acts decisively in these four areas, we estimate that they collectively offer private-sector business an opportunity that could be worth $1. 8 trillion by 2030, the lion's share of which would come from consumer services (Exhibit E6). ƒ Consumer services.

W ith an additional 90 million consumers expected in Indonesia, consumer spend in urban areas could increase at 7. 7 percent a year to become a $1. 1 trillion business opportunity by 2030. The total opportunity could increase to $1. 5 trillion if Indonesia were to achieve the government's 7 percent annual GDP growth national target, a growth rate that would result in 125 million new consumers. There will be business opportunities across consumer services, but the largest is expected to be in financial services. ƒ Agriculture and fisheries. Revenue from agriculture and fisheries could increase at a rate of 6 percent per year to reach $450 billion by 2030. Revenue from production could increase to $250 billion, with increasing yields accounting for almost half the total potential increase. The downstream food and beverages industry could develop into a $180 billion opportunity, while upstream activities, such as machinery, fertiliser, and seeds could offer additional annual potential of $10 billion and total potential of $20 billion a year. McKinsey Global Institute The archipelago economy: Unleashing Indonesia's potential 9 We see the largest absolute production potential in the provinces of West, East, and Central Java, while East Nusa Tenggara could be the location for one of the fastest-growing opportunities in this sector. ƒ Resources. In 2030, the Indonesian energy market could be worth about $270 billion, including both the opportunity in new sources of energy and the savings from pursuing energy-efficiency measures. New sources of energy such as geothermal and biofuels could grow rapidly at rates of more than 10 percent a year to become over a $60 billion market. However, the largest potential of an estimated $150 billion is likely to continue to come from oil, gas, and coal. Measures to increase energy efficiency could be worth an additional $60 billion in savings and societal value by 2030. ƒ Human capital. T here is a large opportunity in private education, demand for which could potentially increase four-fold from $10 billion a year to an estimated $40 billion in 2030. We project that the number of students in private education will nearly double to 27 million by 2030. If this opportunity were realised, Indonesia could expand its labour force by an additional 13 million semi-skilled and skilled workers. To capture these opportunities, businesses will need to rethink their geographical footprint in Indonesia given the shift toward middleweight cities and the rise of new, economically important regional centres. Businesses will also need to consider how they can collaborate most effectively with local governments to tackle some of the barriers impeding regional growth today and how they can best develop local talent, particularly in the ranks of middle management. Exhibit E6 Four Indonesian sectors offer a potential $1. 8 trillion business opportunity by 2030 Estimated annual revenue, 20301 $ billion, 2010—11 prices Projected growth, 2010/11—30 Consumers 1, 070 Agriculture and fisheries Private education 810 Total 1, 830 7. 0 30 40 6. 0 200 270 7. 7 310 450 Resources2 Compound annual growth rate, 2010/11—30 % 7. 2 1, 350 7. 3 1 Rounded to the nearest $10 billion. 2 Only includes upstream energy market, and savings and societal value from increased energy efficiency. SOURCE: McKinsey Global Institute analysis 10 * * * Indonesia could be on the cusp of a new era of sustained growth and rising prosperity with the advantage of a following wind from major domestic and international trends. But there is still much to do if the archipelago economy is to make the most of this opportunity. In chapter 1, we examine five misconceptions common among external observers of Indonesia's economy. In chapter 2, we look at Indonesia in the context of powerful positive trends that should buoy growth. In chapter 3, we discuss some of the barriers to growth that Indonesia faces, highlighting the importance of action in four priority areas. Finally, in chapter 4, we size the potential private-sector opportunity in Indonesia and offer some brief thoughts on how businesses need to react and adapt to prospects in the archipelago economy today. McKinsey Global Institute T he archipelago economy: Unleashing Indonesia's potential 1. Five myths about Indonesia's recent growth Indonesia has performed remarkably well during the past decade, emerging as a vibrant democracy, a strong economy, and a serious player on the international stage. At the turn of the century, Indonesia was the 28th-largest economy in the world; by 2011, the economy had surged up the global GDP rankings to 16th place. Within Asia, Indonesia is the fifth most important economy behind China, Japan, India, and South Korea, and an established member of the G-20 leading economies. The economy rebounded strongly after the financial crisis that swept through Asia in 1997 and 1998, growing steadily at an average rate of 5. 2 percent a year between 2000 and 2010, a pace exceeded only by China and India. Projections indicate that Indonesia's prominence in the global economy will continue to grow. Indonesia is one of six countries that the World Bank believes will account for more than half of all global growth by 2025, the others being Brazil, China, India, South Korea, and Russia. 4 In short, the Indonesian economy is larger, more stable, and more advanced than many companies and investors around the world realise. In this chapter, we discuss five widely held misperceptions about this fast-changing and dynamic archipelago economy. MyTh 1: ThE IndonEsIan EConoMy Is rElaTIvEly unsTablE Far from being unstable, Indonesia’s economy has had one of the most consistent growth rates among global economies over the past ten years. During these years, Indonesia has experienced the least volatility in economic growth of any Organisation for Economic Co-operation and Development (OECD) or BRIC (Brazil, Russia, India, and China), plus South Africa economy in the world (Exhibit 1). From 2000 to 2010, Indonesia’s annual GDP growth ranged between 4 and 6 percent. In comparison, annual growth in Malaysia and Thailand in this period has been much more variable, ranging from 9 percent to minus 2 percent during the global financial crisis that began in 2008. Indonesia’s recent growth has been supported by high demand for its export commodities combined with a strong domestic market. Indonesia’s macroeconomic management has improved considerably. According to the World Economic Forum’s competitiveness report on Indonesia, the country ranked 25th on macroeconomic stability in 2012, an impressive rise from its 2007 ranking of 89th place. 5 T his put the country ahead of BRIC nations (Brazil in 62nd, and India in 99th place) and its ASEAN neighbours (Thailand in 27th, Malaysia in 35th, and the Philippines in 36th place). 4 G lobal development horizons 2011: Multipolarity–The new global economy, World Bank, May 2011. 5 The Indonesia competitiveness report 2011: Sustaining the growth momentum, and The global competitiveness report 2012—2013, World Economic Forum, June 2011 and June 2012. 11 12 Indonesia’s exchange rate is fully floating, and its public finances have been restored to health. Government debt as a share of GDP has fallen by 70 percent from a peak in 2000 of around 90 percent to stand at 25 percent today, a lower ratio than in 85 percent of advanced OECD economies. 6 Exhibit 1 Indonesia's recent economic growth has been stable Overview of OECD and BRIC plus South Africa % GDP growth, standard deviation, annualised, 2000 —10 Real GDP growth, 2000—10 Indonesia 0. 9 China Australia 0. 9 India 11. 5 7. 7 Portugal 1. 5 Indonesia Norway 1. 6 Russia France 1. 6 Slovakia New Zealand 1. 7 South Korea Belgium 1. 7 Turkey 4. 0 Switzerland 1. 8 Poland 3. 9 Canada 1. 8 Estonia 3. 8 India 1. 8 Chile 3. 7 South Korea 2. 0 2. 0 South Africa China 2. 0 Czech Republic Netherlands 2. 1 Israel United States 2. 1 4. 9 4. 2 Brazil Poland 5. 2 4. 9 Average rest 3. 6 3. 5 3. 4 3. 1 3. 1 Australia 3. 4 Average rest 1. 7 SOURCE: Conference Board Total Economy Database; International Monetary Fund; World Bank; McKinsey Global Institute analysis Having experienced hyperinflation, which peaked at 1, 000 percent per annum in the 1960s, Indonesia's inflation rate now stands at around 8 percent, compared with around 20 percent at the turn of the century. This makes it comparable with rates in more developed economies, such as South Africa and Turkey, although still somewhat higher than in other economies of the region including China, South Korea, Thailand, and Australia. Although Indonesia's economic fundamentals have demonstrably improved, the economy remains vulnerable to negative trends in the international economic environment (see Box 1, " Lessons from the 1997—98 financial crisis"). 6 Japan is at the extreme end of the scale; its government deficit has been persistently rising over the past 15 years to today's high of 208 percent of GDP. Singapore's government deficit was around 70 percent of its GDP in the late 1990s and now stands at 96 percent. McKinsey Global Institute The archipelago economy: Unleashing Indonesia's potential Box 1. Lessons from the 1997—98 financial crisis What caused the 1997—98 financial crisis in Indonesia? There are two schools of thought. The first holds that " a combination of panic on the part of the international investment community, policy mistakes at the onset of the crisis by Asian governments, and poorly designed international rescue programmes have led to a much deeper fall in (otherwise viable) output than was either necessary or inevitable". 1 T he second argues that " the crisis reflected structural and policy distortions in the countries of origin" and was triggered by fundamental imbalances, even though " market overreaction and herding caused the plunging of exchange rates, asset prices and economic activities to be more serious than warranted by the initial weak economic conditions". 2 A lthough the two perspectives disagree on the forces driving the crisis (investor panic and poor rescue programmes versus weak financial fundamentals), there is a consensus that underlying domestic financial weaknesses contributed. These weaknesses included a large amount of foreign short-term debt, which reached $35 billion in June 1997. Part of this debt was used to finance credit for more speculative investment, such as real estate, rather than increasing productive capacity such as manufacturing for export. By June 1997, the ratio of foreign debt to foreign exchange reserves was 1. 7. 3 T he impact of the crisis was severe. In 1998, the Indonesian economy shrunk by 13.

7 percent and fell into deep recession. The worst-hit sectors were construction (minus 39. 8 percent GDP growth), finance (minus 26.

7 percent), and the retail trade, hotel, and restaurant industry (minus 18.

9 percent). Incomes fell and the share of Indonesians living in poverty rose to

about 24 percent. The ensuing riots brought an end to the Suharto era. 4 In contrast, Indonesia has emerged from the 2008 crisis relatively unscathed. In 2009, it was the only country in the G-20 to lower its public debt-to-GDP ratio–reflecting improved economic management over recent years, as well as appropriate policy responses during the crisis. Indonesia was also supported by high terms of trade, largely thanks to strong coal and palm oil prices. However, global economists have cautioned that the economy still needs to be strengthened by a more credible monetary policy, a better financial regulatory framework, and more government spending to support productive investment. 5 1 Steven Radelet and Jeffrey Sachs, The onset of the East Asian financial crisis, Harvard Institute for International Development, March 1998. 2 Giancarlo Corsetti, Paolo Pesenti, and Nouriel Roubini, “ What caused the Asian currency and financial crisis? ", January 1998, published in Japan and the World Economy, Volume 11, Number 3, 1999. 3 Steven Radelet and Jeffrey Sachs, The onset of the East Asian financial crisis, Harvard Institute for International Development, March 1998. 4 Tulus T. H. Tambunan, “ Indonesia during two big economic crises 1997/98 and 2008/09: How was the impact and what was the main difference between the two crises? " E3 Journal of Business Management and Economics, Volume 2, Number 2, August 2011. 5 Thomas Rumbaugh and Laura Lipscomb, “ Indonesia’s economy: Strong with room for improvements, " IMF Survey Magazine, September 17, 2010. 13 14 MyTh 2: EConoMIC GrowTh CEnTrEs alMosT ExClusIvEly on JaKarTa Some assume that Indonesia’s growth comes almost entirely from its capital city, but this is not entirely correct. Jakarta is indeed the major contributor to Indonesia’s economic output, accounting for between one-fifth and one-quarter of the total if the whole of greater Jakarta–known in Indonesia as Jabodetabek– is included. However, a broad swathe of mid-sized cities is outstripping the capital’s GDP growth: ƒ Mid-sized and large middleweight cities. T he economies of mid-sized and large middleweights–with between two million and ten million inhabitants– have been growing at a faster pace than Jakarta (6. 7 percent a year for large middleweights and at least 6. 4 percent for mid-sized middleweights) since 2002 (Exhibit 2). These cities include Bandung, Bekasi, Bogor, Medan, Surabaya, and Tangerang. Bekasi, Bogor, Depok, and Tangerang are often treated as part of the Jakarta urban agglomeration. The output of these cities is expanding mainly thanks to their high population growth. Bandung (Java) is growing at 6. 7 percent a year, while Surabaya (Java) and Medan (Sumatra) are each growing at 7 percent a year, largely driven by productivity improvements. Exhibit 2 Large and mid-sized middleweights are growing faster than Jakarta % Jakarta GDP compound annual growth rate, 2002—10 5. 8 6. 4 Small middleweights Cities 150, 000—2 million Share of population, 2010 5. 9 5. 3 4 6 5 11 6 31 30 7 6. 7 Mid-sized middleweights Cities 2 million—5 million Rural1 19 Large middleweights Cities 5 million—10 million Other cities Cities