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Made in Indonesia?

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Manufacturing industry in Indonesia

Indonesia is a politically stable, reform minded, emerging powerhouse with a burgeoning domestic market supported by a sound macro economy. Manufacturing plays a key role in Indonesia's vibrant economy as it employs almost 15 million people and continues to be a prime target of foreign direct investment (FDI). Indonesian manufacturing maintains two principle advantages: an abundant supply of relatively cheap labor and increasing domestic consumption buoyed by a growing middle-class. Yet the country's manufacturing potential continues to be limited by a volatile business environment and poor infrastructure. Indonesia is performing well below is potential which is highlighted by the fact that its manufacturing export sophistication levels are only half of those of much smaller Malaysia and Thailand, while Vietnam, who in 2007 only possessed half of Indonesia's manufacturing export output, has since caught up.

That being said, in 2013, foreign direct investment (FDI) into the emerging economy increased 17 percent from 2012, reaching a record USD 28.6 billion. Moreover, domestic investment increased 39 percent to USD 13.55 billion, highlighting the increasingly expansionist nature of Indonesian companies. Although much of this investment went to the ever-popular energy and mining industries, various manufacturing sectors such as transportation machinery and automotive, chemicals, food processing and metal and electronic machinery recorded impressive investment inflows in 2013. Currently, electronics giants Foxconn and Samsung are considering large investments into the archipelago. As Indonesia's consumer class continues to expand while Chinese labor costs increase, the country's manufacturing sector has the potential to boom, so long as the government provides the necessary facilities to attract C-Suite companies.

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Currently, Deloitte ranks Indonesia as the 17th most competitive nation for manufacturing while it is expected to improve to the 11th spot over the next 5 years. This starkly contrasts with the perception of Indonesia some 15 years ago when the country was hit hard by the Asian Financial Crisis and political upheaval. In 1998, the country lost about 13.5 percent of

GDP while the value of the rupiah (Rp.) went from some Rp. 2,600 per USD to Rp. 14,000. During the hysterics, many international companies fled the country as uncertainty about the economy, politics, and security scarred off investors. Moreover, the newly democratizing/decentralizing nation erected numerous barriers and labor market restrictions, making the archipelago a less favorable investment destination in comparison to regional competitors such as Vietnam and Thailand. The crisis combined with uncertainty and a less attractive business policy environment fostered a dramatic slowdown in the manufacturing sector for a number of years.

Since 1998, the country has slowly recovered with GDP growth rates ranging between 4 and 6 percent, with 2012 GDP growth reaching 6.3 percent. Moreover, Indonesia weathered the recent Global Financial Crisis quite well, realizing positive growth of 4.63 percent in 2008 while developed nations contracted. Even though the economy grew, manufacturing has been relatively slow to rebound. Although manufacturing grew modestly, as a percentage of exports, it declined from 50 to 40 percent from 1998 to 2008. Indonesia's modern day economy contrasts with pre-Asian Financial Crisis where the Suharto regime heavily promoted and subsidized manufacturing. Since his demise, a shift to commodity sectors, rising labor and logistics costs, international competition, and tighter profit margins have made Indonesia's export manufacturing less competitive than many of the regional players. Although problematic, production for the domestic market has increased as in-country manufacturers continuously expand their reach across the vast archipelago.

Domestic micro-level challenges such as the high costs of transportation and logistics, the lack of transparency and certainty in regulations, stringent labor laws, and the negative investment list that caps foreign ownership confound the aforementioned macro issues. Foreign stakeholders in the manufacturing industry have stated that they could accept marginally higher costs, training requirements, and reasonable labor regulations so long as they could be certain all companies would be treated equally with transparent legislation combined with continuous improvements in infrastructure. Without legislative reform and infrastructure development, it is doubtful that Indonesia will ever be able to achieve the economies of scale enabling it to compete with manufacturing powerhouse China, while smaller competitors such as Vietnam, Bangladesh, and emerging Myanmar attract limited foreign funds away from the archipelago.

The government is aware of how poor infrastructure has hindered economic growth and has attempted to improve the situation. In May 2011, the Indonesian Government released the Master Plan for Acceleration and Expansion of Indonesia's Economic Development (MP3EI), a program that plans to boost economic growth by developing the infrastructure and industry of six economic corridors based on their comparative advantages. The MP3EI prioritizes the construction of 155 infrastructure projects such as the Sunda Straits Bridge (JSS), the Batang Steam Power Plant (PLTU), and the Trans-Sumatra Highway. Some infrastructure projects have already been completed such as the Kuala Numu

International Airport in Medan while construction has started on other projects such as the Gempol-Pesuran toll road in Java and the Meulaboh coal-fired power plant in Aceh. However, numerous projects have been delayed due to land acquisition problems, overlapping regulations, poor coordination between government ministries, and changes in land status to conservation areas. Although challenging, in August 2014, the government increased the budget of the Transportation Ministry Rp 44.6 trillion (US$3.9 billion) from Rp 36 trillion (US$3.1 billion) to stimulate development.

Aside for infrastructure, the development of special economic zones (SEZs) and industrial parks have achieved mixed results. In the 1980's, the government designated the Riau Islands of Batam, Bintan and Karimun, just a short boat ride away from Singapore, as SEZs. These islands have flourished over the last couple decades and now support a variety of industries as well as a growing tourism sector. Over the years, Batam has attracted over US$15 billion in investments while over 1,000 foreign companies operate on the islands. The Susilo Bambang Yudhoyono administration has noticed Batam's success and in 2014, announced plans to develop additional SEZs in Morotai, North Maluku; Tanjung Api-Api, South Sumatra; Mandalika, West Nusa Tengarra; Bitung, North Sulawesi; Palu, Central Sulawesi; and West Papua. It is hoped that these zones will grow similarly to Batam, but critics worry that some of the sites will not have the necessary infrastructure or incentives to attract significant investments.

Aside for SEZ's, Indonesia also has numerous industrial zones across the country. These zones are invaluable to the Indonesian industrial sector as acquiring private land can be quite complicated based on conflicts in land title and community demands. Moreover, it is mandatory that foreign investors locate their production facilities in designated industrial zones. According to Indonesia's Industrial Park Association (HKI), Indonesia has over 60 industrial parks with well over 7,000 companies in residence. Zones host a variety of industries from less invasive sectors such as warehousing to others that are focused on heavy industry. Although industrial land is still available, its slow development combined with heightened demand has increased the cost of property. Moreover, a majority of the industrial parks are located on the island of Java, with very little industrial activity outside the dense island. Companies that want to expand to Indonesia should consider various factors aside from cost such as distance from a sea port, quality of infrastructure, availability of labor, etc. before selecting an industrial zone. Considering the abundance of industrial zones, local knowledge and experience can be invaluable to maximizing the benefits of investing in Indonesia.

Despite these challenges, investors in manufacturing are plugging their money into the emerging economy. As Chinese industry moves into more value added activities with rising wages, Indonesia is seen as an alternative to the traditional factory of the world. Aside from the cost basis, companies are looking to diversify their manufacturing portfolio to both mitigate political and natural disaster risk while simultaneously entering new markets, jumping tariff and non-tariff trade barriers, and accessing trade agreements. Moreover, Indonesia's burgeoning domestic market which is fueled by a population of over 250 million people, 50 percent of whom are under the age of 30 with comparatively low wages in Asia, attract investors geared towards local consumers. Indonesia per capita income is now over $3,500 with urban average salaries ranging well above this figure. As Indonesia progresses from a lower-middle income country to a middle-income nation, domestic shoppers are poised to begin purchasing more luxury items such as brand name clothing and cars.

Based on this growth and potential, Indonesia is fast becoming a major player in the automotive manufacturing sector. Indonesian automotive exports grew at more than three times the world rates from 1998-2003 and 2003-2008. Toyota, Suzuki, GM, Tata and others have increased their investments in the archipelago, delivering a greater variety of vehicles to meet demand. Japanese companies seem focused on holding their combined market share and have plans to invest billions of dollars from 2012, with Toyota announcing $2.7 billion over the following four years, and Suzuki over $797 million. GM has reactivated a production facility and is now rolling out vehicles, while Ford is considering an investment. BMW and Mercedes also assemble, manufacture, and sell in Indonesia, catering to the luxury market. Indian operated Tata Motors is also developing a presence, building a manufacturing plant, retail outlets, and supply industries to serve Indonesia and other ASEAN nations. Today, Indonesia is Southeast Asia's fastest growing vehicle market with domestic automobile sales surpassing 1.2 million in 2013, with a vast majority of these vehicles being produced domestically. The Indonesian Automobile Association (GAIKINDO) forecasts significant growth in the coming years with annual sales surpassing 2 million units by the end of the decade. Although the big name vehicle manufacturers are already operating in Indonesia, there is ample potential to supply them or the aftermarket component market.

While there is growing hype for Indonesia, the government should not be complacent as it is much easier to dissuade foreign investors than it is to attract them. Recently, lawmakers passed a number of contentious business policies while minimum wages continue to rise and labor becomes increasingly vocal for populist measures. Legislation such as the repackaging law that limits the resale of finished products, the snails' pace at which regulations are harmonized to international standards, and the way in which decentralized, local governments perceive new investment, mitigates investors' excitement for the emerging economy. The World Bank's Ease of Doing Business Report highlights many of Indonesia's challenges, where the country is ranked 128 out of 185.

Indonesia is on the verge of a manufacturing tipping point with the potential of creating millions of new jobs and evolving its economy away from its natural resource base. Slight changes in policies, regulations, productivity, and costs can tip the scale in either direction. On the one hand, the country's large, emerging consumer class, solid macroeconomic fundamentals, and abundance of natural resources place it as a top destination for manufacturing investment. On the other hand, the archipelago is regulating and taxing the business community in an opaque, ever-changing manner while lags in infrastructure inflate logistics costs. As capital is increasingly mobile in a progressively globalized world, it is in Indonesia's best interest to improve the overall business environment to continue attracting investment that will employ the population, train new skills, diversify domestically produced products, and lead to a more refined economy. Companies are itching to come in, but they will also take their money elsewhere without a little bit of cooperation.

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