

Agus D W Martowardojo: Growth diagnostic for Indonesia – focusing on human capital and infrastructure

Keynote speech by Mr Agus D W Martowardojo, Governor of Bank Indonesia, at the Bank Indonesia-Asian Development Bank International Seminar “Structural Reform in Emerging Asia”, Jakarta, 23 March 2016.

* * *

Distinguished speakers, seminar participants, ladies and gentlemen,

Good Morning.

1. It is such a pleasure for Bank Indonesia to host this international seminar jointly organized with Asian Development Bank, and I am very delighted to welcome you all to this event.
2. I find the theme of this seminar “***Structural Reform in Emerging Asia***” both relevant and important for all of us today, with the global economy still in a state of growth deficit, and the future path seems to look bleak if not uncertain.
3. I believe that the seminar will provide a great opportunity to discuss how structural reform can provide a breakthrough which accelerates growth, and make it more sustainable and inclusive. The discussion will also be a good platform for sharing of experiences on the implementation of structural reforms in various countries, and from that we can draw valuable lessons.
4. I am also excited to know that the seminar has been preceded by a ***technical workshop*** on issues surrounding the similar topic, particularly the use of Growth Diagnostic method and relevant economic models to identify the growth most binding constraints and the needed policy reforms.

Ladies and gentlemen,

Global and Indonesia’s recent economic development and challenges

5. Entering 2016, the global economy continues its period of uncertainty that has lingered since the global financial crises in 2008. With global growth declining and inflation remaining low, another sign of ambiguity in the global economy emerged, which is divergence of economy and monetary policies among major economies.
6. Pressures in the financial market in the beginning of 2016, in the middle of uncertain bottoming-up of oil prices, have added to concerns about global growth. Conversely, the deteriorating macroeconomic outlook and worries about medium-term vulnerabilities in the global economy have unsettled financial markets. With financial institutions under renewed pressure, adverse feedback effects between finance and the real economy could become significant.
7. The emerging economies have once withstood the recent global economic turmoil by taking advantage of credit-fuelled growth as a spillover effect from large accommodative monetary policy in advanced economy. What may happen next after the recent normalization of US monetary policy and China’s current economic rebalancing process could be a heightened pressure in emerging economies’ growth and financial market. We may simply face a period of emerging market-originating spillbacks, from the previous emerging market-receiving spillovers.
8. Despite tangible results from efforts to increase resilience to external shocks, the vulnerability of emerging economies remain, due to their rather weak economic structure.

Indonesia's economy in particular, has managed to pick up its growth in 2015 with the help of increased government consumption on goods and investment in infrastructure projects.

9. In the meantime, dissipating global economic uncertainty and improved confidence on Indonesia's economy have led to a surplus in capital and financial account during the last quarter of 2015, bolstered by increase in foreign capital inflows, mainly to government securities.

10. The confidence on Indonesia's economy also contributed to a more stable Rupiah with an upward trend and less volatility, while foreign exchange reserves still hover well above the international standards. Moreover, the low global prices amid weakened domestic demand also brought domestic CPI inflation to slow down.

Outlook, risks and policies

11. Against the background of maintained stability with carefully monitored vulnerabilities, we are still optimistic that domestic economic growth is going to be slightly higher in 2016, supported by the acceleration of infrastructure projects on the fiscal side, and increased private investment as a result of government policy packages and measurable monetary easing while maintaining macroeconomic stability.

12. Inflation is expected to be at around of the 4±1% inflation target, with the current account deficit projected to be below 3% of GDP.

13. However, this outlook is presented with some overshadowing risks in the horizon, both external and domestic, including another FFR increase expected in the second half of 2016, the slowdown in the Chinese economy, the continuing decline in commodity prices, and domestically, rising volatile food inflation.

Distinguished guests, ladies and gentlemen,

14. The recent economic dynamics show us the significance impact of external economic conditions on Indonesia's economy, and emerging economies in general. While Indonesia is still optimistic toward rising growth, risks are weighing down, especially those from the external sector, normally uncontrollable to a small open economy or emerging markets in general.

15. In this juncture, we are arriving at the point why domestic economic strength needs to be increased, and the effective way to do it is by rising its own growth potential. ***Monetary and fiscal policies are mainly aimed at supporting demand, but demand cannot be optimized if structural problems are not addressed well.*** Therefore, I believe it is timely for policymakers in emerging economies, Indonesia included, to focus on structural reform to boost economic growth in a sustainable manner.

Growth dynamic analysis

16. On that note, it is important to point out that reform needs will differ from one country to another. History reveals that reform packages commonly prescribed only provide small benefits for countries that tried to adopt it. On the other hand, countries that implemented well-focused reforms in key areas have accelerated their growth. Having that said, we certainly need growth strategy that cater to domestic opportunities and constraints.

17. Economists have concluded that ***growth accelerations materialize when binding constraints on growth are removed.*** Many countries including Indonesia, have keen interest in a growth diagnostic approach, which aims at identifying the most binding constraints on economic activity, and the respective set of policies that should be prioritized and implemented to allow for accelerated and sustainable growth.

18. Growth diagnostic method has been profound and used by a number of countries as well as international organizations such as the IMF, the World Bank and the ADB itself for

their country analysis. A number of donor agencies has also used this approach as part of their toolkit when formulating their operational strategies in developing countries.

Growth diagnostic analysis for Indonesia

19. Bank Indonesia has also conducted research using growth diagnostic analysis, which takes into account the view that development priorities should not only put emphasis on factor-driven aspects, but also efficiency-driven and innovation-driven areas, all combined to avoid middle-income trap.

20. BI's growth diagnostic research is unique since it takes into account different characteristics of Indonesia's regional economies and brings up quantified analysis for policy response. The result reveals that the low level of return from economic activities is the main factor that hinders Indonesia's economic growth.

21. Further analysis shows that the root of the problem, which is the most binding constraints hindering the country's economic growth, are in the area of **human capital enhancement and infrastructure development**, particularly in relation to connectivity and logistics.

22. Human capital issues is indeed a classical problem for middle income countries. Human development is certainly important for inclusive growth. Currently, Indonesia is in the period of demographic bonus for up to 30 years ahead, where the period of 2015–2045 will be marked by 70% working class out of the total population.

23. However, having large population without appropriately large proportion of highly skilled and educated people would make it difficult to exit the middle income trap. Labor force with high education is crucial to shift the existing majority of labor-intensive/low-technology and resource-based industry up to the middle or high technology industry.

24. The development of human capital would **lift up the productivity level of the labor force**, which would in turn enhance Indonesia's competitive advantage, which is an important prerequisite to excel within the current ASEAN Economic Community Era.

25. Infrastructure problem also poses as Indonesia's major constraint for accelerated growth. Connectivity issues among regions, including the need for high quality and high capacity harbors, airports, roads and railways in Indonesia have spurred logistical costs. Manufacturing activities related to exports and imports are especially in need of appropriate harbors, even for Java region which contribute the largest part to the national economy.

26. In addition, energy particularly electricity, also becomes a crucial issue and serves as important prerequisite for domestic industry's development. A reliable and adequate supply of electricity would attract investors' interest to build manufacturing facilities in Indonesia. The increased foreign direct investment will enhance Indonesia's role within the global value chain.

27. Policy simulation in our growth diagnostic research indicates **the importance of resolving these human capital and infrastructure issues for growth acceleration process**. Bank Indonesia found that modest increase in electricity capacity and human development will each enhance growth of around 0.25% per year, while enhancement in the quality human capital will contribute to an increase in employment of around 0.50%.

Ladies and gentlemen,

Policy priorities

28. To address the existing challenges, I believe we have come to a common understanding that **reforms to improve the economic structure should be underlined and properly implemented**. Cyclical policies from monetary and fiscal domains remain indispensable indeed, but not sufficient as it only responds to short term recurrent symptoms.

29. Thus far, Bank Indonesia's monetary and macroprudential policies have been among the key factors in safeguarding macroeconomic stability, which support the structural reforms pursued by both central and regional government.

30. Bank Indonesia has lowered BI Rate and Primary Reserve Requirement as available room to ease monetary policy became apparent on the back of solid macroeconomic stability, including lower inflationary pressures going forward. However, stability remains the priority.

31. In this regards, Bank Indonesia will also continue to **strengthen coordination with the Government**. In addition, by cooperating in harmony with other authorities such as Indonesia Financial Service Authority (OJK), Bank Indonesia also strives to maintain financial stability, which together with macroeconomic stability, will provide strong ground for the country's accelerated and sustainable growth.

32. The needed structural reforms itself should be targeted to address the most binding constraints. For Indonesia in particular, it may include building more education facilities, providing highly competent teaching resources, as well as increasing funds for education both from government and private sector.

33. To address infrastructure problem, providing sufficient land for power plants, improving business climate for investment in infrastructure, and enhancing regional tax collection, as well as public private partnership to raise funds for infrastructure projects can become priority policies to implement.

Ladies and gentlemen,

Going forward

34. Let me reiterate that a good balance of monetary policy, fiscal policy and structural reform will altogether bring out a policy mix that will take the country many steps forward toward faster and more sustainable growth. Lessons from countries that are successful in implementing structural reforms to boost their economic growth such as China and India, will be especially valuable.

35. Let me also express my special appreciation for the successful collaboration between ADB and BI in producing a joint book entitled "**Growth Diagnostic of Indonesia**." I am looking forward to the launching of the book, which I am certain will provide valuable insight to all of us.

36. As a final note, I would like to wish you a pleasant and fruitful experience during this one day seminar. I believe that ideas, insights, and experiences shared among international and domestic experts as well as the audiences during the sessions will contribute to better understanding on the important topic of Growth Diagnostic, and bring refreshed ideas for policy formulation and priorities.

Thank you.