



## Creating more and better jobs through ASEAN

Strategies for Indonesia to leverage regional integration

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JustJobs Network, Perkumpulan Prakarsa and Akatiga Center for Social Analysis

December 2015



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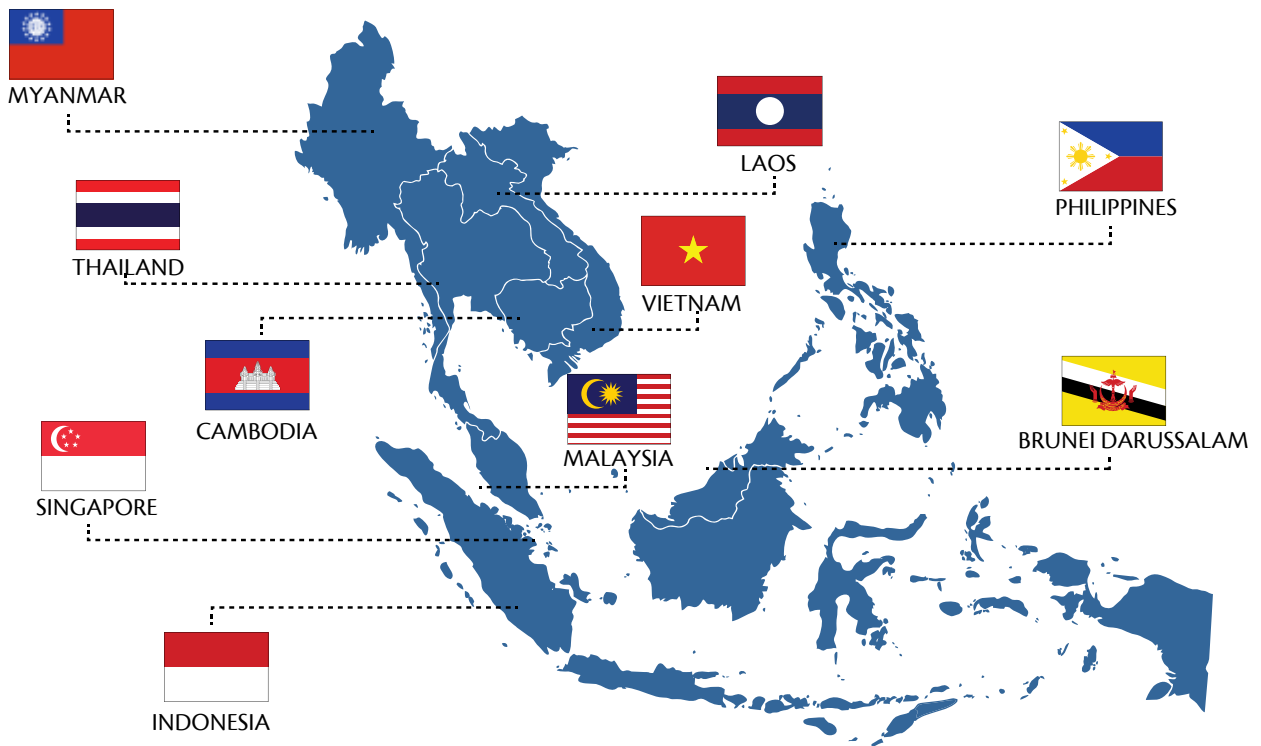
*Cover Photo: 'Women Homeworkers and their families, Asahan, North Sumatra, Indonesia'  
By the International Labour Organization in Asia and the Pacific. © ILO/Ferry Latief 2012.*

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## ASEAN Member Countries



ASEAN was founded in 1967 and constitutes ten Asian member states in various stages of development.

# Introduction

The end of 2015 marks the integration of one of the most dynamic markets in the world – the Association of Southeast Asian Nations (ASEAN). From 2009 to 2013, while much of the world was reeling from the impact of the Great Recession, the regional bloc posted impressive Gross Domestic Product (GDP) growth rates – averaging 5.1 percent per annum.<sup>1</sup>

Foreign Direct Investment in ASEAN grew by 18 percent in the last two years alone, reaching US\$ 136.2 billion in 2014.<sup>2</sup> It comes as no surprise therefore that policymakers and investors from around the world see ASEAN as a critical emerging market that has

the power to lift the global economy and boost the ranks of the global middle class.

But if ASEAN is to realize these ambitions, the leaders of the regional community must aspire to not only achieve higher GDP growth rates but also to create more and better jobs for its burgeoning youth population. This is particularly true for

Indonesia – a country representing 40 percent of ASEAN's economic output as well as 40 percent of its population.<sup>3,4</sup>

While Indonesia's macroeconomic indicators have remained stable and resilient over the past decade, trends in the country's labor market are mixed.

On the one hand, Indonesia has made impressive progress in moving workers from the informal to the formal economy – with only 52 percent of Indonesian workers laboring in the informal economy in 2015, compared to nearly 66 percent in 2011.<sup>5</sup> Wages for formal economy workers

have also risen significantly – with the average minimum wage increasing by 61.8 percent in real terms between 2007 and 2013.

But on the other hand, wages for those working in small, informal enterprises have barely risen – recording an increase of just 9.5 percent in real terms between 2007 and 2013.<sup>6</sup>

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Table 1

**ASEAN growth in international comparison**

GDP 2013, current prices (\$ trillion)		Real GDP Growth, 2000-13	
United States	16.8	China	10.0
China	9.3	India	7.0
Japan	4.9	<b>ASEAN</b>	<b>5.1</b>
Germany	3.6	Russia	4.4
France	2.7	Brazil	3.2
United Kingdom	2.5	Canada	1.9
<b>ASEAN</b>	<b>2.4</b>	United States	1.8
Brazil	2.2	United Kingdom	1.5
Russia	2.1	Germany	1.1
Italy	2.1	France	1.0
India	1.9	Japan	0.8
Canada	1.8	Italy	0.0

**Source:** IHS; International Monetary Fund, World Economic Outlook; McKinsey Global Institute Analysis

In other words, the Indonesian growth story seems to have mostly benefitted those with access to jobs in the formal economy. The majority of workers have not witnessed an appreciable rise in their purchasing power.

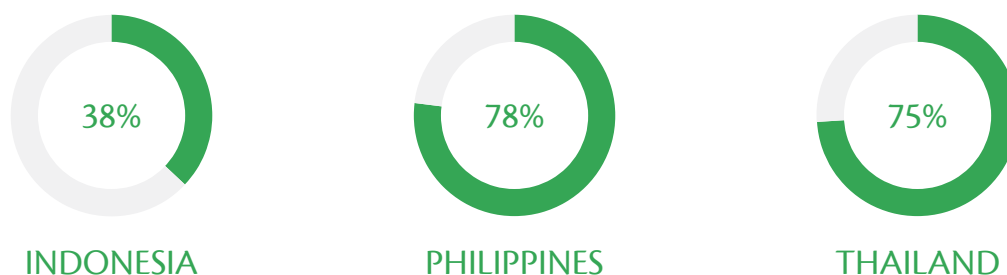
Moreover, the decline of Indonesia's manufacturing sector further threatens the positive trend of workers entering the formal economy. Only 38 percent of Indonesia's exports were manufactured goods in 2013, compared to 45 percent in 2006 and 56 percent in 2001.

In Thailand and the Philippines – Indonesia's ASEAN peers – the figures are much higher: 75 and 78 percent, respectively.<sup>7</sup> The current trend is worrisome, as manufacturing has historically created a stable base of formal economy jobs in the Indonesian labor market.

The most pressing concern for Indonesia is youth unemployment, which stood at nearly 22 percent in 2013.<sup>8</sup> Among ASEAN countries, Indonesia is the worst performer when it comes to providing its young people with productive work. Among

Figure 1

### Share of manufactured goods in total exports (2013)



Source: World Bank. 2015. World Development Indicators.

major emerging economies globally, only South Africa has a higher rate of youth unemployment than Indonesia. And given that over 43 million of ASEAN's 111.6 million residents aged 15 to 24 live in Indonesia, the lack of jobs for young people threatens the economic prospects for the entire region.<sup>9</sup>

So how do regional trade and ASEAN fit into the future of Indonesia's employment landscape?

Economic integration presents both a challenge and an opportunity for Indonesia to sustain the progress it has achieved, while addressing the many obstacles it faces in advancing the goal of shared prosperity.

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On the positive side is the rapidly expanding middle class in the region, which will create new markets for Indonesian products and services. For example, Vietnam's "middle and affluent class" is projected to grow to up to two-thirds of the size of Thailand's by 2020.<sup>10</sup> Such developments will lead to increased consumption and regional trade, benefitting certain job-creating sectors

in Indonesia – the logistics industry, for example.

At the same time, increased integration will lead to greater competition in the region. Indonesia must ensure that its industries and workers – including those who migrate –

reap the benefits of a growing regional economy. In the context of regional competition, Indonesia is unlikely to sustain such impressive gains in



terms of formalizing workers unless it addresses the eroding competitiveness of its manufacturing sector – including important industries like food processing – in which ASEAN peers are stronger players.

This report presents five steps Indonesia's government must urgently take to leverage ASEAN integration toward the creation of more and better jobs for its people.

## Recommendation 1: Lower borrowing rates in manufacturing to enhance regional competitiveness and boost labor-intensive growth

Indonesia can only fully enjoy the benefits of ASEAN integration if reforms are made to enable its manufacturing sector to grow more competitive. The two main challenges faced by the sector are (i) lack of access to credit and (ii) high lending interest rates. With the great and unrealized potential of manufacturing to create jobs, and the fact that the open unemployment rate is high for vocational high school graduates – reaching 18 percent in 2014<sup>11</sup> – Indonesia's strategy for managing and leveraging ASEAN integration must make manufacturing a priority.

Today, Indonesian banks prefer financing the service and trade sectors over the manufacturing sector. According to Indonesia's central bank, though the manufacturing sector is catching

up, the largest share of total bank credit still goes to the trade, hotel and restaurant sector – at 30 percent – followed by manufacturing (25 percent).<sup>12</sup>

Growth of manufacturing lags behind services. Manufacturing's share of Gross Domestic Product (GDP) and its share of exports have both declined. In 2004, manufacturing's share of GDP (value-added) stood at over 28 percent, but by 2013 it had dropped to 24 percent. Meanwhile, manufactured products constituted 57.1 percent of total exports in 2000, declining to 37.5 percent in 2010.<sup>13</sup>

According to the Indonesian Chamber of Commerce and Industry (KADIN), high interest rates are to blame for the poor performance of the

manufacturing sector. The Reference Interest Rate of Bank Indonesia (the country's central bank) is 7.5 percent, while it is 3.5 percent in Malaysia, 4.9 percent in Singapore, and 1.8 percent in Thailand. As the Net Interest Margin in Indonesia is also the highest, the effective lending rate for banks in Indonesia is usually about 12 percent.<sup>14</sup> Indonesia's banks might be thriving, but their rates are reducing the competitiveness of other economic sectors in the country, particularly manufacturing.

This trend is a worrying one for the employment landscape, as labor-intensive manufacturing is critical for the creation of formal employment. While Indonesia's overall unemployment rate is

only 6.3 percent, its youth unemployment rate is nearly 22 percent – an indication of worsening job prospects in the formal economy.<sup>15</sup> The manufacturing sector could create much needed jobs for Indonesia's youth, but its decline will only accelerate if it cannot compete with ASEAN peers.

Two potential solutions can reduce barriers for manufacturing firms and help them access credit, grow, and create jobs.

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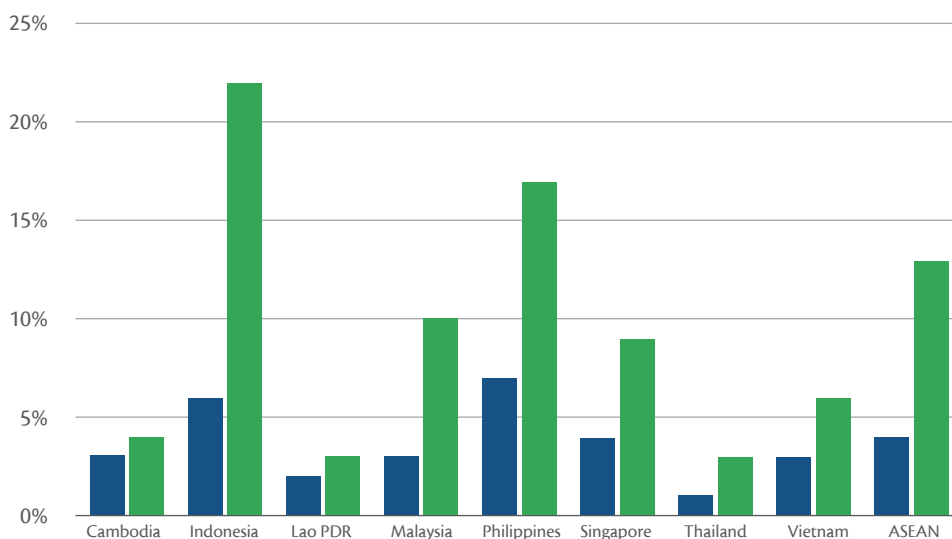
First, the Financial Service Authority (*Otoritas Jasa Keuangan*, or OJK) could frame a policy similar to the one that enhances credit access for micro, small and medium enterprises. This regulation obligates banks operating in Indonesia to

Figure 2  
Reference Interest Rates of Central Banks



Source: Neraca Info Bank. May 7, 2015. Bunga Kredit Perbankan Dinilai Tidak Kompetitif.

Graph 1  
**Unemployment rate, total and youth,  
 most recent year (percent)**



**Source:** International Labour Organization(ILO) and Asian Development Bank(ADB). 2014. ASEAN community 2015: Managing integration for better jobs and shared prosperity Bangkok. Thailand: ILO and ADB.

allocate a portion of their loan portfolio for small enterprises. A similar policy for manufacturing firms could boost their access to credit. Second, the government should set up a financial institution that aims to facilitate credit access for the manufacturing sector by lowering interest

rates. The recommendation to set up this type of financial institution was included in Law No.3 of 2014 Regarding Industry,<sup>16</sup> and would represent a breakthrough for financing industrial development.

## Recommendation 2: Align efforts to up-skill and re-skill Indonesian workers with ASEAN growth opportunities

Deepening regional integration among ASEAN countries will inevitably stimulate a restructuring of the labor market, a process that has already begun across the region. While projections from the International Labour Organization and Asian Development Bank show that – in every member country – more jobs will be created than lost due to ASEAN integration,<sup>17</sup> governments must take into account the increased churn in the labor market that results from greater competition and freer flow of goods and services.

The opportunity and the challenge are both clear. Indonesia should leverage the ASEAN Economic Community (AEC) to shift its workforce into higher-skill occupations – formal economy jobs that pay higher wages and offer greater opportunities for economic mobility.

But if current trends continue, over 60 percent of Indonesian workers in high-skill jobs will be under-qualified by 2025.<sup>18</sup> This would leave Indonesia's competitiveness in a vulnerable position, with critical sectors facing the threat of losing market share to countries with better trained workforces.

Robust, market-aligned skill development programs are required in order to manage the increased labor market churn and the increased opportunity that come with ASEAN integration. As the economy in Indonesia reallocates workers from waning to high-growth sectors, older workers must be re-skilled and up-skilled to make the leap from their current jobs to employment of equal or better quality in other industries.

Youth, meanwhile, must be trained in the transferable skills that an integrated 21<sup>st</sup> century Indonesian economy demands.

***If current trends continue, over 60 percent of Indonesian workers in high-skill jobs will be under-qualified by 2025.***

The requirement for skilled workers – as well as the potential shortage – will be greater in Indonesia than in any other ASEAN country. In Indonesia alone, nearly 7 million high-skill jobs will be created between 2010 and 2025. Even greater will be the increase in demand for medium-skilled workers, with about 21 million new medium-skill jobs created in the same time period.<sup>19</sup> In contrast to the Philippines, Thailand and Vietnam, Indonesia will actually witness a contraction in the demand for low-skilled workers.<sup>20</sup>

ASEAN integration will have a neutral or net positive impact on the vast majority of sectors in

Indonesia's economy. However, a few industries are projected to grow less or contract more under the regional agreement in terms of employment. Locating the potential skill alignment between sectors set to lose and those projected to gain jobs can help the Indonesian government form an effective skilling strategy.

For instance, grains other than rice – a sector of agriculture already set to shed employment in the coming decades – will contract at a slightly faster rate under ASEAN. Meanwhile, with growing middle classes across

the region, demand for meat and horticultural products is rising rapidly (urban Indonesians now spend as much on fruit and vegetables as they do on rice).<sup>21,22</sup> The government should focus on upgrading the skills of agricultural workers – especially those dependent on soy, wheat and other grains – so that they are equipped to raise livestock and cultivate the fruits and vegetables Indonesia currently imports.

The logistics and transportation industries will be among the most robust over the next decade. The global logistics company DHL announced

in early 2013 that it would expand its number of employees in Indonesia by 70 percent. More Foreign Direct Investment flows into Indonesia's transportation and logistics industry than any other except mining, reaching US\$ 2.8 billion in 2012.<sup>23</sup> And estimates suggest that trade and

transport sectors will add almost 18 million jobs between 2010 and 2025.<sup>24</sup> Skill development policies should promote the management skills required by this burgeoning part of the economy, which ASEAN integration will only boost further.

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With other regional players better positioned, Indonesia will add about 400,000 fewer jobs in food processing between 2010 and 2025 than it would have without the regional agreement. In addition to strengthening the food processing industry to better compete – for instance, by connecting agricultural workers with the skills and capital to enter agro-processing (see Recommendation 3) – the government should also step up efforts to train industrial workers for manufacturing sectors that will benefit from ASEAN integration: metals, chemicals, and machinery.

## Recommendation 3: Focus entrepreneurship policies on enabling value-added activities in agro-processing

While ASEAN integration will provide an almost “borderless” market of 600 million consumers, Indonesian agriculture will be negatively impacted. Not only are Indonesian agricultural commodities less competitive than other member states; the growth of Indonesian value-added per worker in agriculture is also slower compared to peer ASEAN countries such as Malaysia, Vietnam, and Thailand.<sup>25</sup> These problems, in addition to other structural barriers, have been recognized by the Indonesian Ministry of Agriculture<sup>26</sup> and must be dealt with effectively.

While agriculture remains important in Indonesian labor market, most of the households employed in agriculture do not engage in processing raw goods or any other value-added activities. Currently, over 26 million households – 35 million workers – depend on Indonesia’s agricultural sector for employment<sup>27</sup>, but less than 10 percent of these households (about 2.4 million) process their own agricultural products.<sup>28</sup>

***Currently, over 26 million households – 35 million workers – depend on Indonesia’s agricultural sector for employment, but less than 10 percent of these households (about 2.4 million) process their own agricultural products.***

The 2013 Agriculture Census shows that between 2003 and 2013, only 155 additional agricultural enterprises were registered – a mere 3.9 percent increase over a decade – indicating a minimal level of entrepreneurship in the sector.<sup>29</sup>

Meanwhile, imports of processed foods and beverages have increased 13 percent in just the last four years – from US\$ 2.44 million in 2010 to US\$ 2.76 million in 2014.<sup>i,30</sup> Current projections suggest that the share of employment in food processing will decrease (-0.3 percent) with ASEAN economic integration.<sup>31</sup> To change this scenario, Indonesia should link entrepreneurship policies to the underdeveloped agro-processing sector.

Such policies should enable smallholder farmers to engage in the activities critical for adding value to their agricultural products: 1) handling of post-harvest commodities; 2) processing (thermal, biological, and chemical); 3) food quality and

<sup>i</sup>Indonesia’s trade balance for agriculture as a whole (processed and unprocessed goods) has been in surplus since 2008. However, the growth rate of imports surpassed that of exports between 2008 and 2012 (3.2 percent vs 13.2 per cent). In 2014, Indonesia had an agricultural surplus of US\$ 15.2 billion, but 95 percent of the surplus consists of the plantation subsector (in which palm oil contributes over 70 percent). Other sub-sectors (horticulture, fisheries, food crops, livestock) suffer from a trade deficit.

safety control; 4) packaging; 5) marketing; and 6) new innovations.<sup>32</sup> In addition, product standardization will play a major role in facilitating access to regional markets.<sup>33</sup>

Addressing these skill gaps among would-be entrepreneurs in agriculture does not require a new battery of schemes. Existing government programs, such as TKS (*Tenaga Kerja Sarjana*), TKM (*Tenaga Kerja Mandiri*), or TKMT (*Tenaga Kerja Mandiri Terdidik*), can be transformed to focus on building the skills necessary for agro-processing among farmer households through intensive training, coaching, and mentoring.

Second, a cluster approach must be used to ensure that cooperatives and micro and small enterprises have better access to markets and face fair competition. A number of government

policies to strengthen farmer cooperatives and MSMEs have been implemented for this and have proved effective.<sup>34</sup> Existing programs such as OVOP (One Village One Product) could be expanded and strengthened through a focus on higher-value-added activities in agro-processing – with the caveat that such programs should avoid making entire villages dependent on one occupation, rendering whole communities vulnerable to economic shocks.<sup>35</sup>

Third, smallholder farmers must be provided with networks and legal support (to found an enterprise for instance, individually or collectively) that would help them secure access to supporting facilities and materials that are vital for food processing activities. This includes chemical and mechanical supplies as well as capital.

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## Recommendation 4: Encourage SMEs to participate in regional value chains

As in many other emerging and developing economies, small businesses play an essential role in job creation in Indonesia. Micro, small and medium enterprises (MSMEs) generate 57 percent of the total value-added in Indonesia's economy, and account for 97 percent of employment.<sup>36</sup>

Yet MSMEs account for only 20 percent of Indonesia's non-oil exports – and this figure is in decline.<sup>37</sup> Less than one percent of small businesses in Indonesia are exporters – mainly because the vast majority of MSMEs operate in the informal economy.<sup>38</sup> Enabling small businesses to harness ASEAN integration in order to grow and generate employment requires addressing several limitations and obstacles they currently face.

The government has allocated funds to encourage the growth of SMEs through the provision of small loans, training, and technical management of production and business development services. The 2014 budget includes an allocation of 1.4 trillion rupiah (US\$ 105 million) to aid the development and growth of SMEs.

However, in the context of ASEAN integration, government programs must boost the capacity of small and medium enterprises to export their products and participate in regional value chains. The following recommendations represent the most critical steps the Indonesian government should take to increase MSMEs' regional competitiveness.

First, the government must further improve access to capital. The size and interest rate of a

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loan received by a business in ASEAN is a strong determinant of its capacity to export.<sup>39</sup> MSMEs in Indonesia need larger capital investments. The *Kredit Usaha Rakyat* (KUR) program is now limited to only three banks and the maximum loan is barely more than US\$ 1,000 – not enough capital to spur MSME exports. KUR should also have a dedicated

channel for export finance, a strategy other countries have pursued through their export-import banks.

Second, MSMEs require assistance in improving product quality. Indonesia's SME Service Center represents a step forward in providing guidance



to small businesses on access to finance, human resources, marketing, and intellectual property rights, but one of the largest obstacles MSMEs face in exporting is meeting the product quality requirements of buyers and importing countries. MSMEs would benefit from targeted training programs aimed at improving production techniques, ensuring quality standardization, and understanding product certification.

Third, the government should aim to develop and expand labor market matching services for SMEs.

Currently, information gaps hinder small businesses in their search for skilled workers, and qualified candidates struggle to find employment that matches their skills.<sup>40</sup> The government could partner with the private sector to develop effective technology-enabled tools for job-matching that reduce recruitment costs for small businesses. Moreover, vocational training centers (*Balai Latihan Kerja*) could play a proactive role by offering job placements to qualified trainees in SMEs that require a skilled workforce to grow.

***The challenge lies in supporting MSMEs and removing barriers to growth in the short term, while simultaneously ensuring that MSMEs remain competitive in the long term.***

Finally, efforts should be taken to harmonize central and local government policies that support MSMEs. While the central government formulates policies to support small businesses, implementation is the mandate of local governments. Wide disparities exist between the vision for programs targeting small businesses

and the reality of their execution. Recent studies suggest that government programs to support small businesses do not match their needs.<sup>41</sup> A feedback loop is required – wherein local governments can improve the relevance and responsiveness of national

policy frameworks by communicating ground-level insights to officials in Jakarta.

The potential for small businesses to grow, generate employment, and enhance Indonesia's regional competitiveness is yet to be realized. The challenge lies in supporting MSMEs and removing barriers to growth in the short term, while simultaneously ensuring that MSMEs remain competitive in the long term.

## Recommendation 5: Ensure the portability of benefits for migrant workers living abroad, including those engaged in the informal economy

Indonesian migrant workers living in other ASEAN countries today face great difficulty in accessing social security schemes. Even those who do have access are often unable to transfer the benefits back home when they retire or return to Indonesia. With advancing globalization of labor, it is imperative to consider social security in the context of ASEAN integration, which will increase the flow of both skilled and unskilled workers.

Indonesia is a net exporter of migrant labor, and a significant portion of those leaving Indonesia are destined for other ASEAN countries. According to Malaysia's Ministry of Home Affairs, there were approximately 1.3 million documented Indonesians and an additional 700,000 undocumented Indonesian migrants living in Malaysia as of 2006.<sup>42</sup>

While Indonesia currently offers a provident fund scheme that gives coverage to non-nationals as well, it does not have social security agreements with the other ASEAN countries. In such a situation,

migrants to Indonesia are able to contribute to and export their provident fund savings, but Indonesian workers in other ASEAN countries may not be able to access local social protection schemes or export their benefits. In Malaysia, for example, the social insurance scheme only covers permanent residents or nationals, but not migrant workers. In Singapore, no social security schemes are available to migrant workers.<sup>43</sup>

***Indonesia is a net exporter of migrant labor, and a significant portion of those leaving Indonesia are destined for other ASEAN countries. According to the most recent estimate, 1.3 million documented Indonesian migrants, and another 700,000 undocumented, are living in Indonesia.***

Right now, the lack of any agreement to ensure that Indonesian migrant workers can access their benefits means there is no "totalization" for social security across both the home and host country. Totalization means that, for workers who split their lives across two countries, the contribution or membership periods completed in both the home and host country are accounted for and the full allocation of benefits is provided.<sup>44</sup>

On all fronts, it is in Indonesia's best interest to have Social Security Portability (SSP) agreements

with the countries to which its citizens are migrating, particularly the neighboring ASEAN nations.

Indonesia must push for an SSP framework in the region that addresses the following issues:

1. Coverage for migrant workers
2. Exportability of benefits
3. Totalization of benefits – including, for example, inflation adjustment

With such a regime in place, the Indonesian economy will benefit, as migrant workers have more incentive to return home and spend their earnings in Indonesia, and more income when they return as well. Such an agreement might also increase formalization of work and legal migration, with the incentive of stronger social security.

## Conclusion

The economic relationship that Indonesia develops with the broader ASEAN region over the next decade will determine how successfully the country tackles its youth employment challenges, enlarges the formal economy, and sustains impressive GDP growth.

The integration of ASEAN represents a major opportunity for the country that has 40 percent of the regional community's population and generates 40 percent of its economic output. But ASEAN integration also introduces new challenges, as Indonesia grapples with competition from regional peers that are better positioned in particular sectors – for example, agro-processing – and in regard to certain macroeconomic conditions – for instance, borrowing rates in manufacturing.

The prospects for young Indonesians entering the labor market hinge on whether the country addresses the challenges and leverages the opportunities ASEAN presents through policies that generate more and better jobs. For example, well managed integration could boost exports and provide relief for Indonesia's declining manufacturing sector – the backbone of the country's formal labor market. But if poorly managed, integration could accelerate the decline of manufacturing's value-added, threatening to reverse recent gains in formal employment.

For Indonesia, regional integration demands smart interventions that up-skill and re-skill workers, enhance the competitiveness of the manufacturing sector – especially small businesses and agro-processing units – and protect the migrant workers who seek opportunities abroad in the rapidly evolving ASEAN region.

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