IBC
Indonesian Business Council

BUSINESS OUTLOOK 2026

Inflection: Breaking the Growth Plateau

JANUARY 2026

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IBC is committed to the continuous refinement of its research standards and analytical frameworks. As we deepen our methodologies to capture the complexities of the economy, this report represents our best assessment based on current capabilities and available evidence.

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FOREWORD

As Indonesia enters 2026, the country stands at a decisive inflection point. Amid a global landscape shaped by fragmentation, geopolitical tension, and shifting trade and investment flows, Indonesia's economy has continued to demonstrate resilience and stability. This outcome reflects years of prudent macroeconomic management and strong institutional discipline. Yet stability, while vital, is not an end in itself. History reminds us that it is only meaningful when converted into sustained progress.

The strategic imperative for Indonesia today is no longer the preservation of stability, but its transformation into higher-quality and more durable growth.

The challenge ahead is less about crisis mitigation and more about policy delivery: the effectiveness of institutions, the credibility of implementation, and the alignment of incentives toward productivity and long-term value creation.

The IBC Business Outlook 2026 is the Indonesian Business Council's contribution to this strategic conversation. Informed by rigorous analysis and extensive engagement with economists, business leaders, and international partners, this Outlook is designed not merely as an economic projection, but as a practical strategic reference—one that supports both policymakers and the private sector in navigating uncertainty, recognizing structural constraints, and identifying pathways to strengthen Indonesia's competitiveness.

A central insight of our assessment is that macroeconomic stability, financial resilience, and structural reform are deeply interconnected. Long-term growth emerges from the interaction of these domains. While investment is ultimately driven by opportunity, capital allocation depends on more than market potential alone. It is critically shaped by institutional quality, particularly the rule of law and the operational space afforded to the private sector. These fundamentals determine whether short-lived sentiment evolves into realized investment.

This understanding forms the basis of this year's theme: **"Inflection: Breaking the Growth Plateau."** Advancing beyond the current growth ceiling requires more than aspiration. It demands disciplined execution across three essential pillars:

Certainty — strengthening institutional trust and ensuring consistent, credible policy direction to anchor long-term investment.

Capabilities — elevating workforce productivity and reinforcing the foundations of structural economic transformation.

Capital — mobilizing and allocating financial resources toward productive, sustainable economic activity.

The synchronization of these pillars is key to creating a virtuous cycle of renewed confidence, quality job creation, and sustained productivity growth.

At IBC, we view the private sector not only as a beneficiary of sound policy, but as a strategic partner in shaping Indonesia's economic future. This Outlook is offered in that spirit, supporting constructive dialogue and shared action, and contributing to a growth trajectory that is stronger, more inclusive, and more sustainable.

Sofyan A. Djalil
CEO Indonesian Business Council

ACKNOWLEDGEMENT

The IBC Business Outlook 2026 reflects the effort of the Indonesian Business Council (IBC) to strengthen national competitiveness through evidence-based research and strategic dialogues with economists, business communities and private sector leaders. As a flagship publication, this report underscores IBC's commitment to providing a credible, forward-looking compass for policymakers and business leaders navigating Indonesia's evolving economic landscape.

The analytical direction and synthesis of this report were led by Denni Puspa Purbasari, Chief Economist of IBC. We extend our sincere appreciation to our research partner, LPEM FEB Universitas Indonesia (LPEM UI), whose rigorous academic discipline and strong empirical grounding significantly enhanced the credibility and depth of this study.

This Outlook integrates academic rigor with practical business strategy. The core project team was comprised of Prayoga Wiradisuria (Director of Policy and Program), Karlina Aucia Agusta, Rebekka Angelyn, Fazlur Rahman Hassan, Bima Nur M.R., and Alifa Salsabila. We also acknowledge the vital support of Diana Permana (Director of Membership & Corporate Affairs), alongside Wildhan Vallerey Denissindra and Janice Elysia, as well as the relevant IBC teams. The initiative was executed under the supervision of William Sabandar, Chief Operating Officer, and the strategic direction of Sofyan A. Djalil, Chief Executive Officer.

We extend our sincere gratitude to the IBC Board of Trustees and Members for their continued guidance, leadership, and engagement, which remain central to the strength and relevance of the Council.

We also acknowledge the valuable insights shared by members of the IBC Panel of Experts across various forums, which provided important context and perspective for this work.

Finally, we recognize the contributions of senior economists, business communities, international partners, and industry leaders who participated in our Focus Group Discussions throughout 2025. Their collaboration and engagement remain essential to our shared mission of advancing a resilient, competitive, and forward-looking Indonesian economy.

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LIST OF ABBREVIATIONS

ACFTA	ASEAN-China Free Trade Area
AHS	Effectively Applied
AIFTA	ASEAN-India Free Trade Area
AKFTA	ASEAN-Korea Free Trade Area
APEC	Asia-Pacific Economic Cooperation
ASEAN	Association of South East Asian Nations
ATIGA	ASEAN Trade in Goods Agreement
BRI	Belt and Road Initiative
BRICS	Brazil, Russia, India, China, South Africa
BKPM	Badan Koordinasi Penanaman Modal
CBAM	Carbon Border Adjustment Mechanism
CEPA	Comprehensive Economic Partnership Agreement (generic)
CRA	Contingent Reserve Arrangement
DDI	Domestic Direct Investment
EMDEs	Emerging Markets and Developing Economies
EU	European Union
EUDR	EU Deforestation Regulation
EV	Electric Vehicle
FDI	Foreign Direct Investment
FX	Foreign Exchange
FY	Five-Year
FTA	Free Trade Agreement
G7	Group of Seven
GDP	Gross Domestic Product
GSCPI	Global Supply Chain Pressure Index
GSCSI	Global Supply Chain Stress Index
GTAP	Global Trade Analysis Project
HS	Harmonized System (product classification)
IA-CEPA	Indonesia-Australia Comprehensive Economic Partnership Agreement
IC-CEPA	Indonesia-Chile Comprehensive Economic Partnership Agreement
ICOR	Incremental Capital-Output Ratio
IDR	Indonesian Rupiah
IEA	International Energy Agency
IEU-CEPA	Indonesia-European Union Comprehensive Economic Partnership A
IJEPA	Indonesia-Japan Economic Partnership Agreement
IMF	International Monetary Fund
IPKSA	Instansi Penerbit Keterangan Surat Asal (SKA issuing body)
IP-PTA	Indonesia-Pakistan Preferential Trade Agreement
LCS	Local Currency Settlement
LNG	Liquefied Natural Gas
LPI	Logistic Performance Index
MBG	Makan Bergizi Gratis/Free Nutritious Meals Program
MFN	Most-Favored Nation
MIGA	Multilateral Investment Guarantee Agency
MRA	Mutual Recognition Agreement

MRV	Measurement, Reporting, and Verification
NDB	New Development Bank
NTM	Non-Tariff Measures
NIIP	Net International Investment Position
OECD	Organization for Economic Co-operation and Development
PMI	Purchasing Managers Index
UNCTAD	United Nations Trade and Development
US	United States
USD	United States Dollar
Q1	Quarter 1
ROO	Rules of Origin
SEA	Southeast Asia
SKA	Surat Keterangan Asal/Certificate of Origin
SMEs	Small and Medium Enterprises
TKDN	Tingkat Komponen Dalam Negeri (Local Content Requirement)
UAE	United Arab Emirates
UK	United Kingdom
UN	United Nations
WITS	World Integrated Trade Solution
WTO	World Trade Organization

EXECUTIVE SUMMARY

The global economy is predicted to grow moderately in 2026 with uneven regional growth. World's GDP is forecasted to grow in the range of 2.4% to 3.1%, based on estimates by the IMF, OECD, and the World Bank. These estimates are lower than their pre-pandemic levels, suggesting a prolonged scarring effect on the global economy. There are three main forces that shape this projection: softening policy rates amid limited inflation risk, growing geopolitical tensions and heightened regulatory uncertainty, and China's slowdown. Fragmentation continues with trade and capital flows increasingly determined by political alignment. Meanwhile, softening demand and industrial overcapacity in China send waves of pressure to global markets.

In this era of increasing tensions and uncertainty, Indonesia is expected to continue to expand at a rate of around five percent. Macro aggregates remain stable with contained inflation and improvement in external buffers compared to past cycles. Nevertheless, the stable macro blanket is built upon some wobbly pillars. The drivers of growth are weakening in quality: household consumption softens and is under pressure, investment is losing momentum, and productivity gains have slowed. Meanwhile, the fiscal side has limited space in exerting stimulus. These dynamics suggest that while Indonesia is not facing an imminent macroeconomic crisis, sustaining higher and more inclusive growth will be significantly more challenging in the year ahead.

Domestic demand is cooling as consumption and investment come under pressure. Although labor market conditions have improved since the pandemic, underemployment and informality remain the biggest challenges, limiting wage growth and dampening consumer confidence. Credit growth has slowed as households adopt more precautionary saving behavior or have started to dissave. Meanwhile, firms delay expansion amid uncertain demand prospects, and some put a wait-and-see strategy as the global and domestic regulatory framework shifts their landscape. Investment activity remains concentrated in capital-intensive sectors and commodity-dependent industries with limited employment and productivity spillovers, reducing its ability to support broad-based productivity growth.

Indonesia's external position remains supported by trade surpluses, but buffers are narrowing and exposure to external shocks is rising. The trade surpluses recorded since 2020 were reinforced in 2025 by the front-loading of exports ahead of anticipated tariff changes. Looking ahead to 2026, the surplus is expected to narrow as global demand moderates, commodity prices become less favorable, and trade frictions intensify. This is compounded by a weak financial account, marked by capital outflows in the wake of global uncertainty and subdued foreign direct investment. In addition, we anticipate upcoming downside risks from the global market, including policy-rate increases in Japan and a flight to safe assets. Yet, there is modest upside if Indonesia's ongoing trade negotiations yield better-than-expected outcomes, which would improve market access and export receipts, thus strengthening the external balance.

Policy space to respond to these challenges remains limited, affirming the need to prioritize structural adjustment. Fiscal capacity is constrained by a persistently narrow tax base, rising public spending needs for the administration's flagship programs, and higher pressures on debt service. Meanwhile, monetary policy faces trade-offs between supporting growth and preserving financial stability amid volatile global conditions. These constraints reinforce the role of productivity-enhancing reforms, institutional strengthening, and improvements in regulatory efficiency to support competitiveness and investment.

The economy is unlikely to converge to the administration's ambition of 8-percent growth, unless some catalysts and policy reforms are properly executed. We see the potential of three catalysts (i.e., Certainty, Capability, and Capital) to address the overarching misallocation of resources that have manifested as suboptimal growth. The first catalyst, represented as Certainty, is strengthening the rule of law and regulatory quality to reduce the cost of doing business, as well as improve predictability, contract enforcement, and credibility of commitments. The second catalyst is investment in human capital, represented as Capability, which aims to support the workforce to deliver more complex production, technology adoption, and movement into higher value-added activities would be a key catalyst as well. The third catalyst is creating more competitive markets, represented by Capital. Such a competitive market is important so that productivity growth can be driven by healthy firm dynamics with productivity-enhancing reallocation and within-firm innovation, rather than incumbents' inertia to grow. These 3Cs' catalysts *include reducing asymmetric barriers, improving competition enforcement, and aligning industrial incentives with measurable efficiency gains.*

Indonesia's 2026 outlook calls for a shift beyond macro stability toward credible structural and productivity reforms, as growth near 5 percent is constrained by weak fiscal capacity, lower investment quality, shallow financial markets, and persistent misallocation. Accordingly, policy should prioritize strengthening revenue mobilization, refocusing spending toward high-multiplier investment, and advancing institutional reforms, particularly rule of law, competition, and regulatory simplification, while the private sector adapts through demand diversification, input-risk management, skills upgrading, and early alignment with sustainability requirements.

1. GENERAL OVERVIEW

Following a period of heightened volatility in 2025, shaped by realignment of global order and domestic policy adjustment under the new administration, Indonesia enters 2026 with macroeconomic stability in place amid increased uncertainty. In this outlook, Indonesia's growth is projected to remain stable in 2026, although it is subject to ongoing external headwinds and domestic challenges.

The IMF's latest Article IV assessment views Indonesia's macro-foundations as sound: growth around 5.0-5.1 percent in 2024-2025, low and contained inflation, resilient financial sectors, and strengthening external buffers driven by FDI and portfolio inflows. At the same time, risks from commodity price volatility and slower growth in key trading partners remain salient. The World Bank's Indonesia Economic Prospects projects Indonesia's medium-term growth averaging about 5.0 percent over 2025-2027, driven by private consumption and gradually rising investment, but warns that downside risks and rising external financing needs require prudent macro-fiscal management. Consistent with this cautious view, the Indonesian Business Council (IBC) forecasts growth at 4.95 percent in both 2025f and 2026f, reflecting concerns over weak growth quality, limited seasonal support, and the absence of near-term structural transformation. Taken together, these projections underline a clear gap between Indonesia's current growth path and its more ambitious political targets.

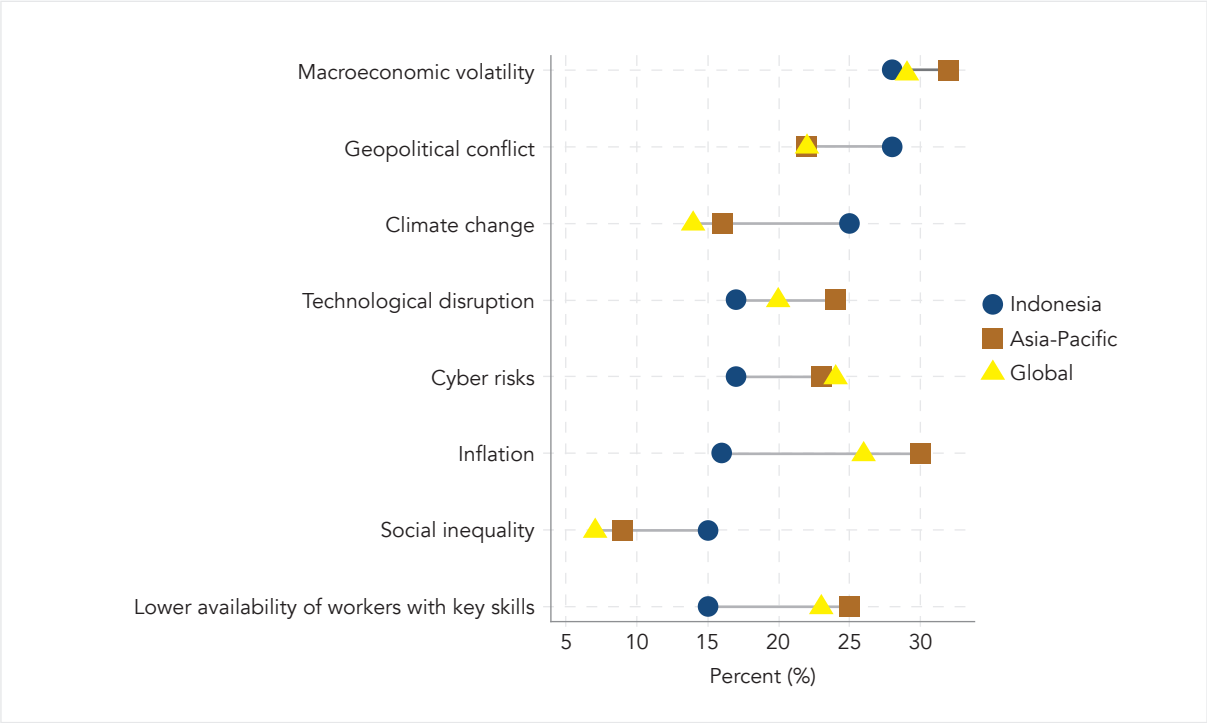
Table 1.1 GDP Growth Forecasts: Indonesia's Growth Around 5.0-5.1% for 2026

Countries	IMF		World Bank		ADB		OECD	
	2025F	2026F	2025F	2026F	2025F	2026F	2025F	2026F
World	**3.2**	**3.1**	**2.3**	**2.4**	**-**	**-**	**3.2**	**2.9**
US	2.0	2.1	1.4	1.6	1.7	1.8	2.0	1.7
Euro Zone	1.2	1.1	0.7	0.8	1.2	1.2	1.3	1.2
Indonesia	**5.0**	**5.1**	**5.0**	**5.0**	**5.0**	**5.1**	**5.0**	**5.0**
Vietnam	**6.5**	**5.6**	**5.8**	**6.1**	**7.4**	**6.4**	-	-
Malaysia	**4.5**	**4.0**	**3.9**	**4.3**	**4.5**	**4.3**	-	-
Thailand	**2.0**	**1.6**	**1.8**	**1.7**	**2.0**	**1.6**	**2.0**	**1.5**
Japan	1.1	0.6	0.7	0.8	1.1	0.6	1.3	0.9
China	4.8	4.2	4.5	4	4.8	4.3	5.0	4.4
India	6.6	6.2	6.3	6.5	7.2	6.5	6.7	6.2
Russia	0.6	1.0	1.4	1.2	-	-	0.7	0.5
Brazil	2.4	1.9	2.4	2.2	-	-	2.4	1.7
ASEAN-5	4.2	4.1	-	-	-	-	-	-

Source: **IMF** World Economic Outlook, Oct 2025 and Article IV: Indonesia, Nov 2025; **World Bank** Global Economic Prospects, Jun 2025 and Indonesia Economic Prospects, 16 Dec 2025; **ADB** Asian Development Outlook, Sep and 10 Dec 2025; **OECD** Interim Economic Outlook, 2 Dec 2025.
Note: All growth forecasts were estimated prior to the Sumatran floods and the US' attack on Venezuela.

Business sentiment mirrors this mix of resilience and constraint. PwC's latest CEO Survey shows that Indonesia-based CEOs are more optimistic about global growth compared to last year, supported by strong investment and ASEAN's rise as a hub for finance, digital services, and manufacturing. Yet they remain wary of macroeconomic volatility and geopolitical conflict as key threats, and their optimism still trails global and Asia-Pacific averages.

Figure 1.1 Key Threats in the Next 12 Months: Indonesia-based CEOs



Source: PwC's 28th Annual Global CEO Survey, 2025

The global outlook is shaped by heightened geopolitical rivalry, rising fragmentation, and precarious conflict, which together are increasing uncertainty and weighing on growth prospects. The intensifying US-China rivalry is accelerating a shift toward a multipolar global economy, disrupting global supply chains, redirecting trade and investment flows, and raising costs for businesses through tariffs, sanctions, and export controls.

Domestically, household consumption's momentum has become increasingly constrained by subdued real wage growth and rising informality. Investments remain concentrated in physical assets, providing limited support for productivity and technology adoption. On the production side, the declining role of manufacturing, dominance of low-value added sectors, and continued reliance on commodities constrain diversification and productivity gains. These structural constraints are compounded by tightening fiscal space as weak revenue mobilization, rising debt service, and expenditure reallocation limit the government's capacity to support growth-enhancing spending.

Looking ahead to 2026, Indonesia's upside potential remains constrained by weakening investment quality, tightening fiscal space, and persistent structural rigidities. While macroeconomic stability, contained inflation, and resilient financial conditions provide a buffer against external shocks, softer global demand and commodity price volatility will continue to weigh on growth prospects.

Domestically, subdued productivity gains, declining manufacturing dynamism, commodity-biased investment, and constrained fiscal capacity, amid weak revenue mobilization and rising debt service, limit the government's ability to scale up growth-enhancing spending. These cautions suggest that without deeper structural reforms, stronger revenue performance, and effective government spending, Indonesia's growth in 2026 is likely to remain stable but modest and below its more ambitious medium-term aspirations.

2. GLOBAL OUTLOOK*

Summary of Key Findings

i. US-China rivalry leads to global supply chain disruption, thus shifting trade activity towards ASEAN. However, ASEAN remains dependent on China's upstream inputs, creating an uneven impact among ASEAN countries.

ii. BRICS is emerging as a diplomatic and economic coalition, pushing for a multipolar order through alternative financing and market access.

iii. Geopolitical tensions in the Middle East and Ukraine remain major macro risks via energy and commodity price volatility and supply-chain disruptions.

iv. Export controls, such as rare earth restrictions, can quickly disrupt high tech supply chains and lift input prices.

v. China's slowdown weakens demand for iron-ore, limits metals upside despite electrification support. While, tighter market-access rules add trade and margin pressures in 2026.

vi. Easing policy rates can improve global financing, but elevated risk aversion and global fragmentation can still trigger volatile exchange rates and portfolio flows.

vii. Global finance remains dominated by advanced economies and dollar markets, where ASEAN relies more on FDI flows and bank-based financing than deep capital markets.

2.1. Geopolitics, Conflict, and Fragmentation

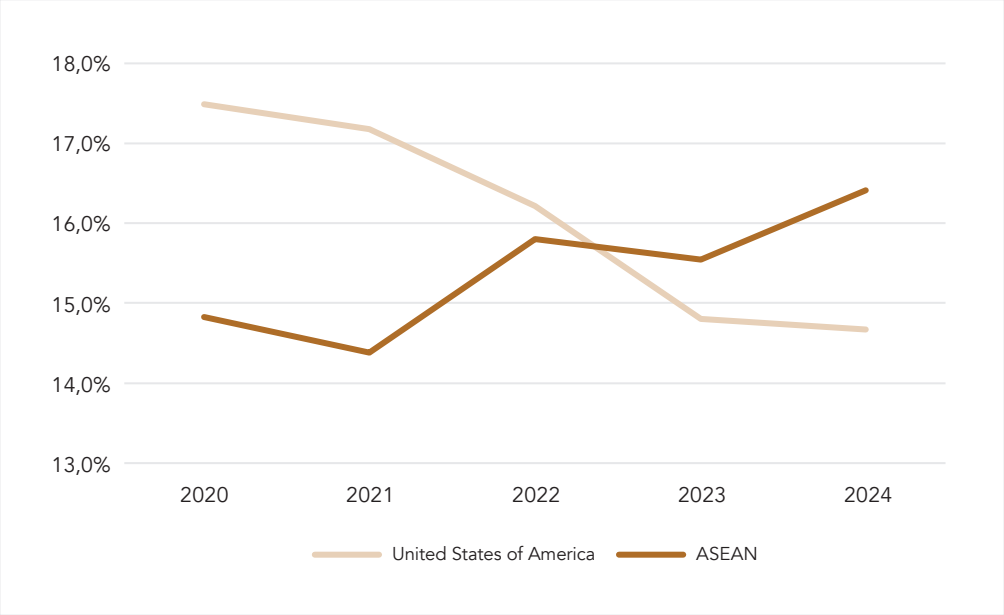
US-China Rivalry

The US-China rivalry is accelerating a shift toward geopolitical multipolarity and generating economic pressures. This rivalry disrupts the global supply chain, heightens economic instability, and redirects investment flows. Against this backdrop, the ASEAN region appears as the primary arena for strategic competition, as it is at the intersection of great power rivalry.[1]

The US-China rivalry creates direct and indirect consequences that are impactful on the global economic conditions. Both sides are designing and deploying economic "weapons," such as targeted sanctions, investment screening, and China's control over critical inputs like rare earths, and the US's extremely high tariff imposition on China. As the U.S. and China vie for economic supremacy, trade wars and tariffs have disrupted global supply chains, creating uncertainty for businesses worldwide. Amid escalating tensions, lower demand from Asian exports is expected, reducing potential growth. Economic growth for emerging economies, including Indonesia, is expected to slow further in 2026 due to the rising uncertainty on market access in the global landscape. Higher tariffs and sanctions have led to higher costs for goods and shifts in the supply chain, which affect the efficiency and costs of doing business globally.

* The analysis does not include the impact of US-Venezuela conflict.

Figure 2.1 Share of Exports from China to the United States and ASEAN from 2020 to 2024 (in %)



Source: ITC Trade Map; LPEM FEB UI calculation

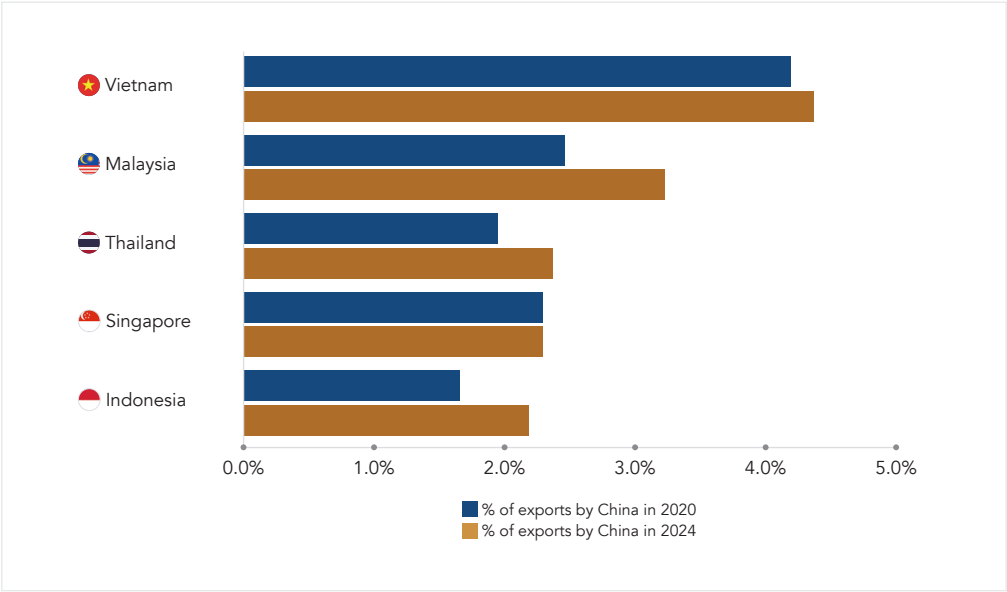
China's export share to the United States has declined sharply, falling from 17.5% in 2020 to 14.6% in 2024 as seen on Figure 2.1, with export values around 524.9 billion USD in 2024. However, at the same time, exports from China to ASEAN countries have increased, from 14.8% in 2020 to 16.4% in 2024, reaching approximately 586.5 billion USD in 2024, (Figure 2.1). It indicates that the US-China rivalry has led to a re-orientation of global supply chains.

Due to the shifting global supply chain, businesses are diversifying production sites away from China to mitigate risks by adopting a 'China+1' strategy.[2] The 'China+1' strategy allows businesses to relocate or expand manufacturing bases into ASEAN countries, with the purpose of reducing dependency on a single supply hub and maintaining access to both the US and China markets. The ASEAN region becomes a leading option as it offers distinct advantages that attract both global powers. It offers a strategic location in the Indo-Asia-Pacific region that facilitates trade routes for both the US and China. Its attractiveness also comes from its fast-growing market, abundant natural resources, and potential to be a manufacturing hub, combined with favorable trade costs and tariffs, trade competitiveness, and supply chain diversification opportunities.

Moreover, ASEAN is the leading trading partner for both the United States and China. For the United States, ASEAN is its fourth-largest trading partner, making ASEAN one of its key economic partners. In 2024, the two-way trade between the US and ASEAN amounted to $475 billion and $271 billion in the first half of 2025. The US is also the largest extraregional investor in ASEAN, with total Foreign Direct Investment (FDI) in 2023 reaching $74.4 billion. Consequently, ASEAN is also one of China's primary trading partners. In the first half of 2025, the total exports and imports between ASEAN and China reached $429.8 billion. The deepening tie is also evident from a 63.1% increase in ASEAN's imports from China from 2019 to 2024. The tight ties with both the US and China have trapped ASEAN countries in between for years, receiving pressure from both sides.[3] **This condition has given ASEAN countries a challenge to position themselves, also hindering them to continue hedging and balancing strategies between the two parties at varying degrees.**

Now, ASEAN's position in the global value chain is more critical, as it is a critical intermediary in a triangular trading relationship. As seen in Figure 2.2, a surge of exports from China is heading to the leading ASEAN countries, namely Vietnam, Malaysia, Thailand, Singapore, and Indonesia. As the United States aims to reduce dependence on single markets, imports have increasingly shifted toward China+1 partners like ASEAN. However, these trade structures remain highly reliant on China's upstream supply chain. This condition has varied impacts on the conditions for ASEAN countries.

Figure 2.2 Share of Exports by China to selected ASEAN countries in 2020 and 2024 (in %)



Source: ITC Trade Map, LPEM FEB UI calculation

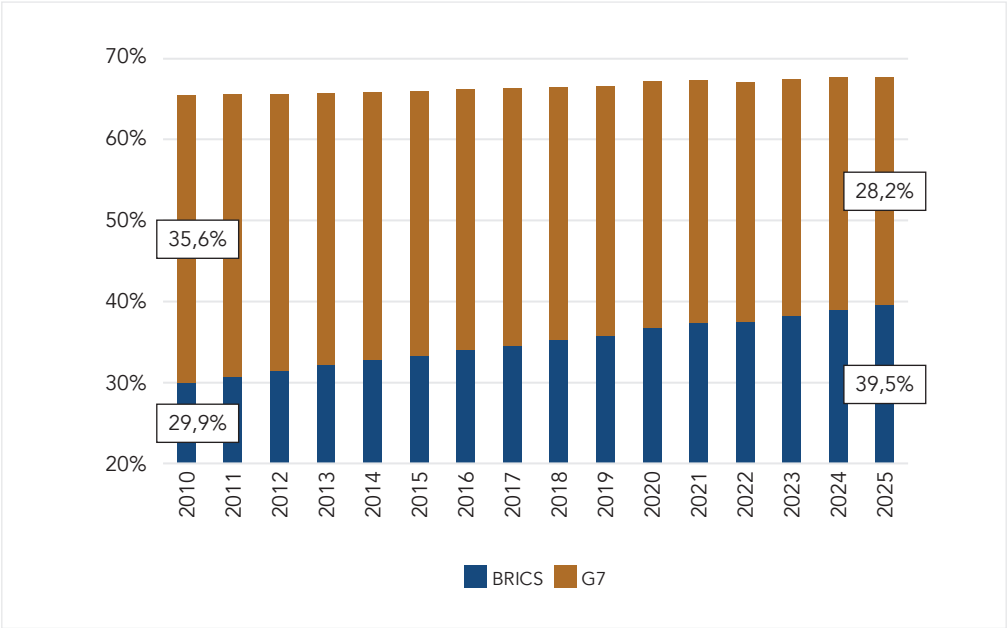
The reallocation of the supply chain has allowed countries like Vietnam and Malaysia to absorb sophisticated manufacturing segments, such as semiconductors and display production, which were formerly based in China.[4] However, the higher share of exports by China may also negatively impact the domestic markets. In Thailand and Indonesia, the import competition is attributed with factory closured and layoffs.[5] **This condition widens the tension between regional integration and industrial resilience, a concern that ASEAN countries must face.**

Rise of The Non-West Bloc

BRICS has evolved from just a theoretical concept into a major diplomatic alliance. Coined in 2001 as BRIC, comprising Brazil, Russia, India, and China, the grouping gained institutional form after the 2008 Global Financial Crisis. It expanded to BRICS in 2010 with the inclusion of South Africa, added Egypt, Ethiopia, Iran, and the United Arab Emirates in 2024, and officially included Indonesia as its tenth member in January 2025.[6] Today, BRICS represents almost 40% of global GDP (PPP),[7] 49% of the world's population, nearly 30% of global oil production, 31.7% of global natural gas production, and over 70% of global coal production. [8] This shift signals a rebalancing of global economic power away from advanced economies toward emerging markets, strengthening the importance of South-South trade and investment channels for countries like Indonesia.

BRICS aims to reshape global governance toward a more multipolar and equitable world order. It advances this agenda by strengthening cooperation among members, challenging Western-led institutions such as the IMF and World Bank, representing the Global South, and advancing de-dollarization by reducing reliance on the US dollar.[9] These efforts are supported by the establishment of the New Development Bank (NDB) and the Contingent Reserve Arrangement (CRA), which together provide alternative development financing and liquidity support outside Western financial frameworks.[10] For Indonesia, BRICS membership expands access to a large and diverse market, alternative financing, and technology collaboration in manufacturing, information technology, pharmaceuticals, and agriculture, supporting a shift toward higher value-added and technology-driven industries. At the same time, wider use of local currency settlement within BRICS and in bilateral trade can lower transaction costs and reduce exposure to US dollar volatility.

Figure 2.3 Share of the World's Total GDP in PPP of BRICS and G7, 2010-2025 (%)



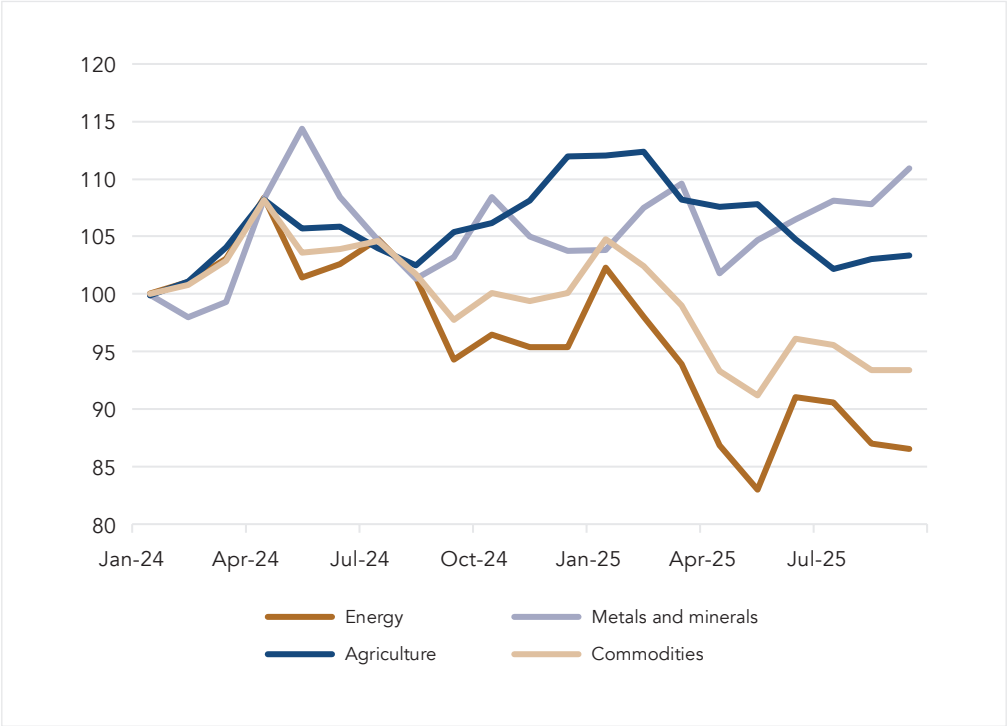
Source: International Monetary Fund (IMF)

The growing economic power of BRICS has surpassed the G7, reflecting a global shift toward a more multipolar economy. The BRICS' share of global GDP (PPP) has risen from 21.46% in 2000 to 39.52% in 2025, surpassing the G7's share since 2016, which fell from 44.48% to 28.22% in the same period (Figure 2.3). BRICS has grown from an emerging-economy alliance into a strategic coalition including key energy producers like Iran and the UAE. This expansion amplifies its bargaining power and strengthens financial alternatives such as the NDB and local currency swaps to challenge Western dominance. At the same time, this shift exposes a mismatch between BRICS' economic contribution and its limited voting power in the IMF, reinforcing calls for institutional reform.[11]

Conflicts and Geopolitical Tensions

Geopolitical tensions continue to pressure global stability and economic confidence. The Middle East has been identified by the United Nations as the most immediate risk of renewed escalation, which could raise oil and food prices, disrupt global supply chains, heighten investor risk aversion, and weaken global growth. The conflict in Ukraine remains highly uncertain, as recent US-Russia and US-EU-Ukraine meetings produced no ceasefire or concrete progress, leaving investment recovery prospects unclear.[12]

Figure 2.4 Commodity Prices (Index: Jan-2024=100)



Source: World Bank, IMF

Energy and commodity markets remain the main transmission channels. Ample oil supply and weak demand have kept downward pressure on energy prices, although Brent oil prices rose by around 5 percent in late October 2025 following new US sanctions on Russian oil companies (Figure 2.4). Global oil production is projected to expand in 2025-2026, while demand growth remains modest due to China's shift toward electric and hybrid vehicles, with upside risks if conflicts disrupt exports or infrastructure.[13] [14]

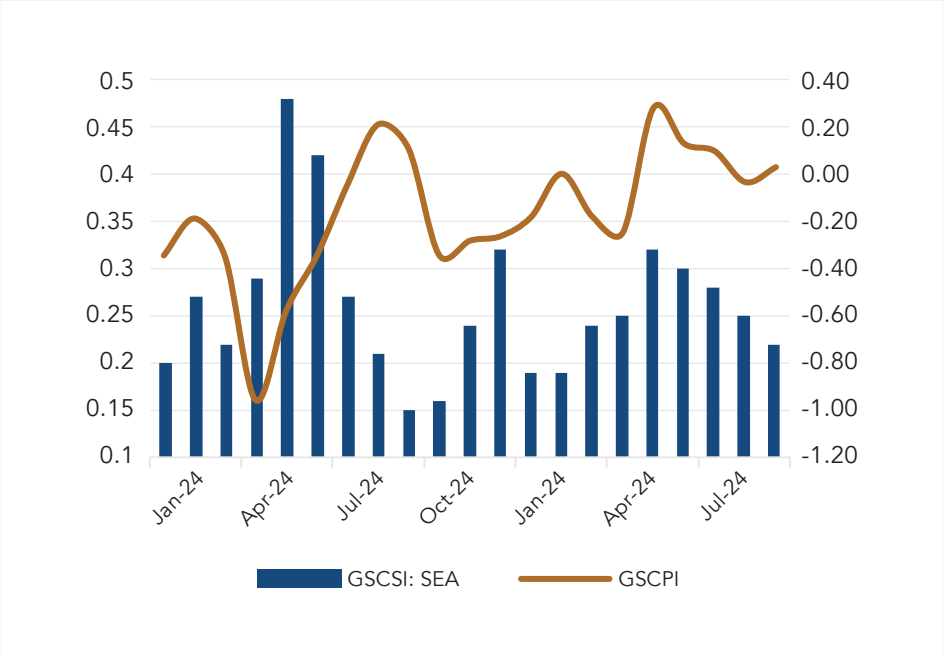
Natural gas markets are broadly balanced, but winter risk remains a story. Global demand rose in early 2025 due to lower renewable generation in Europe and colder conditions in North America, while demand in China and India declined due to weaker industrial consumption and improved renewable output. Global supply expanded, led by higher production in North America, while Russian output fell. Europe's low storage implies elevated liquefied natural gas (LNG) imports through winter 2025-2026, with prices expected to remain broadly stable unless Middle East disruptions occur (Figure 2.4).[15] [16]

Metals and fertilizers are affected by these dynamics. Aluminium output growth is moderating as China, which accounts for around 60% of global production, nears its emissions limit. European production is recovering gradually from smelter closures following the energy price surge triggered by the war in Ukraine, although output remains below pre-2020 levels (Figure 2.4). Fertilizer markets have shifted due to EU tariffs on imports from Russia and Belarus, redirecting supply toward Asia and the Americas. Urea prices are projected to rise by around 30% in 2025 before easing as new capacity becomes available in East Asia and the Middle East, sustaining upward pressure on global agricultural prices (Figure 2.4).[17] [18]

Sanctions, Restrictions, and Supply Chain

Commodity supply resilience remains under strain due to trade restrictions and logistics disruptions. The Global Supply Chain Stress Index (GSCSI) indicates that maritime bottlenecks have eased for Southeast Asia, while the Global Supply Chain Pressure Index (GSCPI) shows a modest increase in logistical pressure, reflecting tighter supply-chain conditions (Figure 2.5).[19]

Figure 2.5 Supply Chain Stress Index (Southeast Asia) and Pressure Index (Global)



Source: Federal Reserve, World Bank

China's export licensing requirements for seven critical rare earth elements and related magnets introduced in April 2025 disrupted global high-technology supply chains, causing a sharp export slowdown in April-May. China's exports rebounded after the US-China trade agreement on 11 June and fully recovered by July with a 5 percent year-on-year increase, but rare earth feedstock prices rose by more than 30 percent, renewing concerns over China's concentration of rare earth processing and the need for supply-chain diversification. [20] [21] [22]

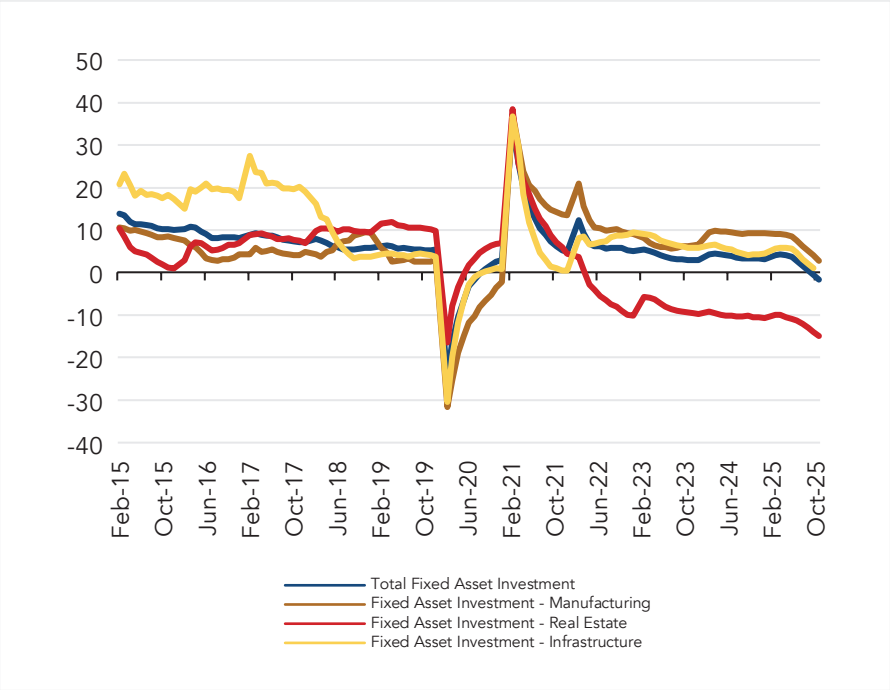
In the energy sector, new US sanctions on Russian oil companies in late October triggered a temporary oil price spike, reversing part of the 14 percent decline in Brent crude recorded in the first nine months of the year. The longer-term impact of these sanctions remains uncertain and emerging and developing economies remain vulnerable through trade disruptions, capital-flow volatility, and weaker investor confidence.[23] [24]

Ongoing instability in Ukraine and the Middle East poses significant risks through energy supply disruptions, higher oil and gas prices, and global inflationary pressures. Prolonged volatility could tighten fiscal conditions and raise borrowing costs for emerging economies, including Indonesia. Fluctuating commodity prices, particularly nickel, coal, and palm oil, also pose challenges for fiscal planning and external stability. A sharp global slowdown in major markets could further weaken Indonesia's exports and investment inflows, while rising protectionism and fragmented technology systems would increase trade costs and reduce competitiveness.

2.2. China's Slowdown

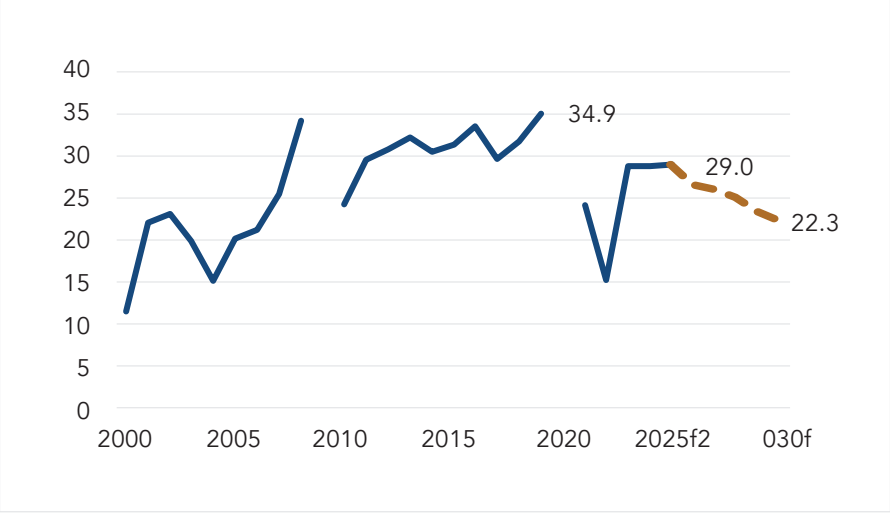
China is projected to shift into a lower-growth regime over the next few years as population ageing, diminishing returns to investment-led growth, and slow progress on structural rebalancing all weigh on potential output. These structural headwinds are already visible in the real economy through softer manufacturing activity and weaker-than-expected consumption, as evidenced by slowing fixed asset investment growth (Figure 2.6) and the projected decline in China's contribution to global growth (Figure 2.7). Given China's role as the top buyer for major base metals, its sluggish domestic demand could spill over into global commodity markets.

Figure 2.6 China's Monthly Fixed Asset Investment, 2015-2025 (YTD Cumulative, %YoY)



Source: National Bureau of Statistics of China (2025)

Figure 2.7 China's Contribution to Global Growth Rate, 2000-2030 (%)*

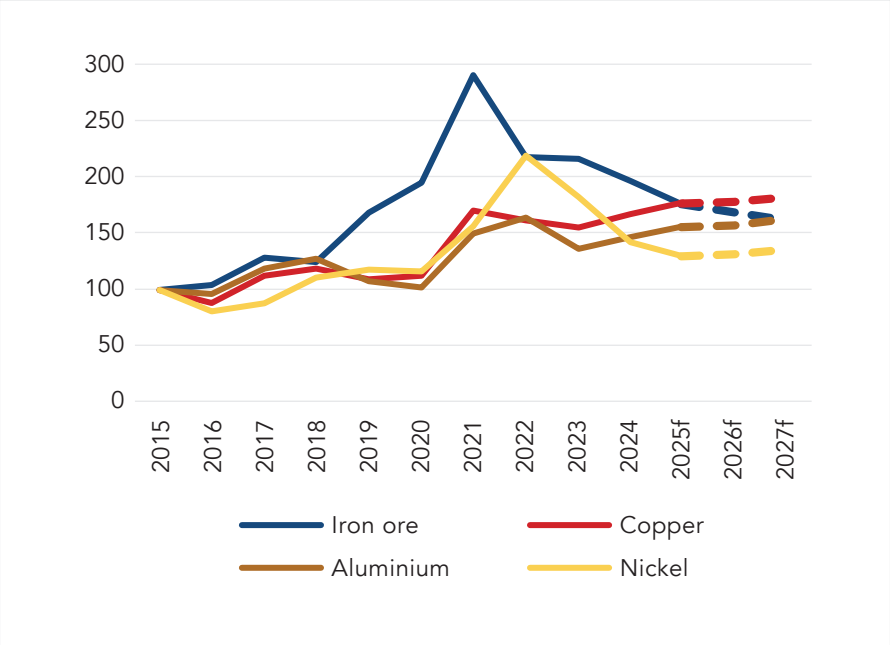


Source: International Monetary Fund (2025), LPEM FEB UI calculation

*Excluding 2009 and 2020, periods marked by global GDP contraction and Chinese expansion.
Source: International Monetary Fund (2025), LPEM FEB UI calculation

As a result, commodity price dynamics are likely to become a less supportive tailwind for resource-based exports. Figure 2.8 shows the projected price trajectories for China's major commodity imports. With China's property and traditional infrastructure cycle fading, iron-ore demand is likely to weaken the most. Copper and aluminum face a more nuanced outlook; they remain structurally supported by electrification and electric vehicle deployment, but their upside is capped by the broader slowdown in construction and manufacturing. Nickel prices are expected to rebound over the next two years, but the recovery is likely to be limited as excess domestic smelting capacity remains unabsorbed, and prices are unlikely to return to their 2022 peaks, offering only partial relief against broader commodity weakness. Beyond China, stricter environmental and sustainability regulations, most notably carbon border adjustments and deforestation-related regulations such as CBAM and EUDR, could also weigh on export growth and margins in 2026 onwards as market access becomes increasingly conditional on compliance with stringent standards.

Figure 2.8 Commodity Price Index for China's Major Imports (2015 = 100)



Source: World Bank (2025)

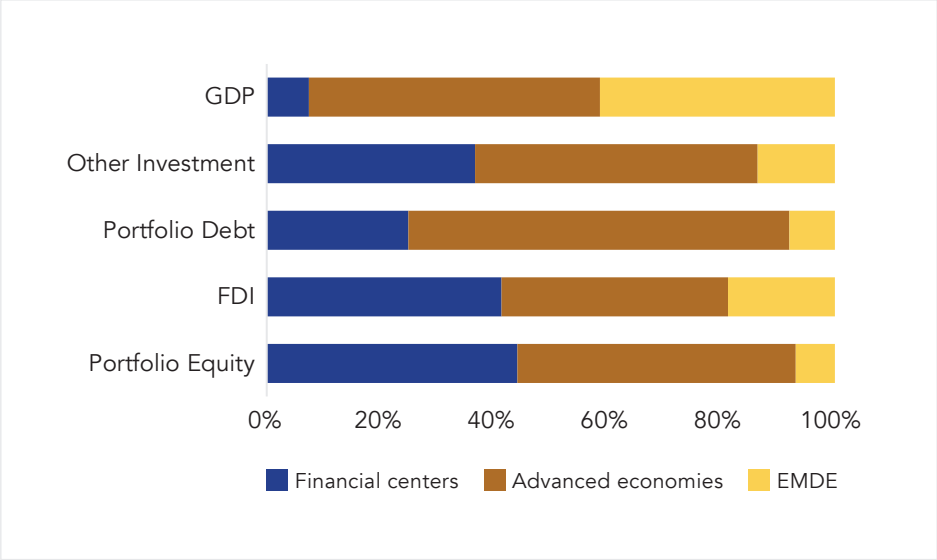
2.3. Global Finance

The external environment offers some relief through lower global interest rates and a gradual return of liquidity, yet the structure of global capital markets, characterized by the dominance of advanced economies as well as the shallow depth of Indonesia's financial market, limits the upside for Indonesia. Global cross-border positions increased from around 20% of the world's GDP in the 1980s to more than 200% of the world's GDP today.[25] Even so, financing is still dominated by advanced economies and is increasing in financial centers.[26] High income countries hold the bulk of global foreign assets and issue most of the instruments that shape the global capital market. Emerging markets account for a rising share of world output, yet remain on the margins of the main cross-border equity and bond markets.

Global Capital Markets and Financial Fragmentation

Despite that geopolitical risk and policy uncertainty remain high, the stock of cross border financial claims continues to rise. Total foreign assets and liabilities reached roughly 376% of world GDP in 2023, up from about 206% in 2000.[27] The size of global bond and equity markets has also expanded, with outstanding bonds around USD145.1 trillion and world equity market value around USD126.7 trillion in 2024.

Figure 2.9 Shares of Outstanding Global External Liabilities by Country Groups, 2023

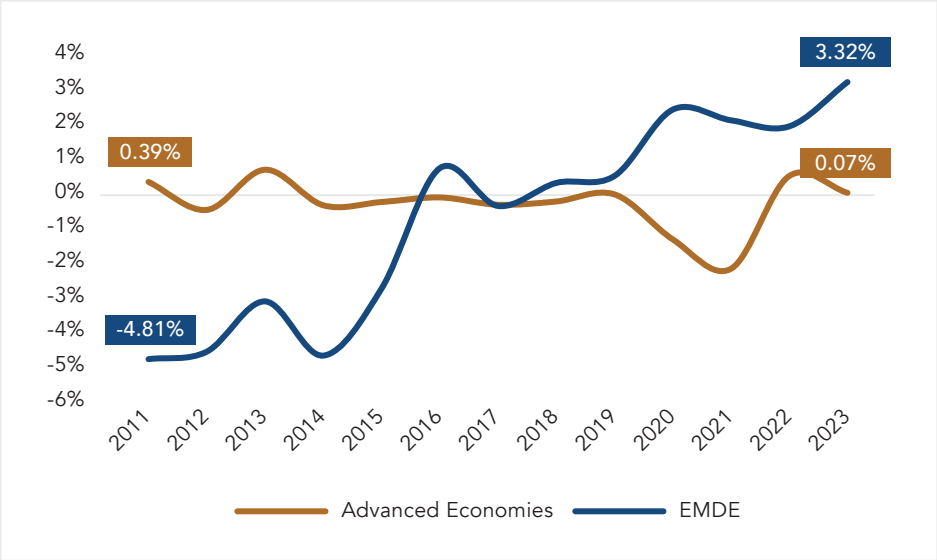


Source: IMF International Financial Statistics (IFS), LPEM FEB UI calculation
Note: EMDE is emerging markets and developing economies. Financial centers are economies for which international financial intermediation (as opposed to end-use of funds) is the main cross-border financial activity

Figure 2.9 shows that the burden and form of external liabilities are very uneven across country groups. Advanced economies and financial centers together account for around 87% of global external liabilities, even though their share of world GDP is much lower. EMDEs, despite accounting for about 41% of world GDP, hold only about 13% of global external liabilities. This means that most of the cross-border transactions and pricing decisions that shape global finance remain on the balance sheets of borrowers in advanced economies and financial centers.

Overall Net International Investment Position (NIIP) shows that the US is the main net-debtor in global markets, while, along with some major advanced economies such as the UK, Australia, and Japan, the overall NIIP of advanced economies is hovering around net zero debt. Meanwhile, EMDEs have transformed themselves from net-debtor to growing net-creditor overtime (see Figure 2.10). This reversal is spurred by accumulated current account surplus as well as growing reserves in recent years.[28]

Figure 2.10. Net International Investment Position (NIIP) by Country Groups (% GDP)



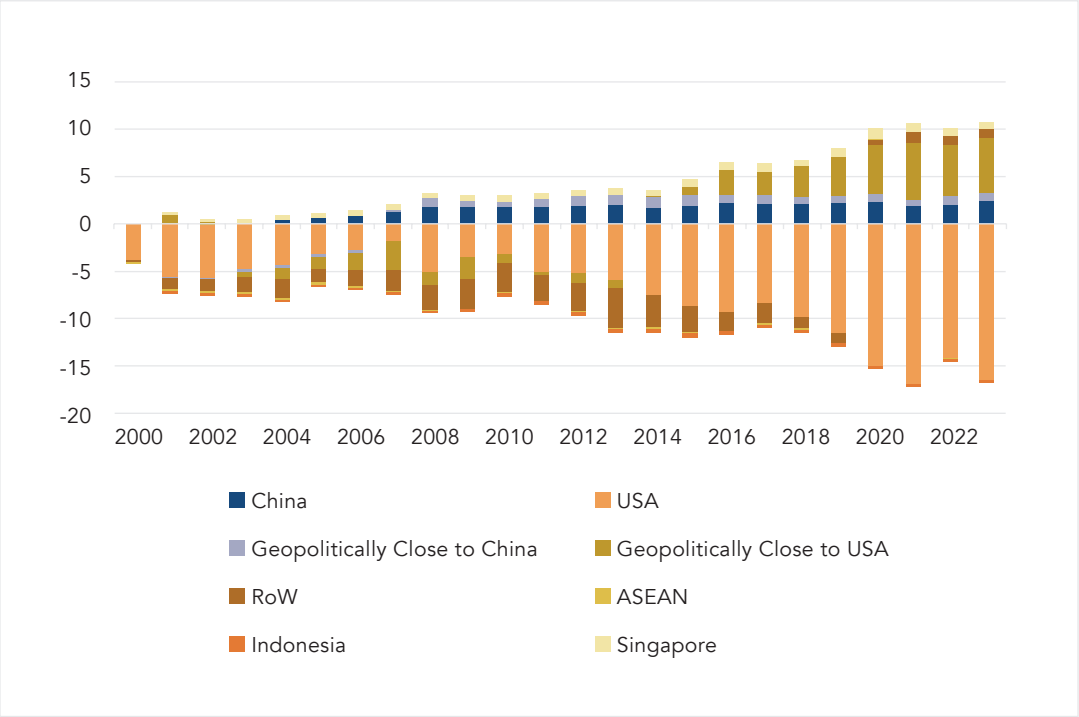
Source: IMF International Financial Statistics (IFS), LPEM FEB UI calculation

In terms of global currency use, the US dollar continues to dominate global bond markets, with a share of about 45% in outstanding bonds and 43% in new issuance in Q2 2025.[29] The euro sits in the second place at around 40%. The renminbi has gained some ground but remains small, with a share of roughly 0.8% in outstanding bonds and 1.5% in new issuance. There are quarters where the renminbi share edges up by 0.03 percentage points in outstanding bonds and 0.82 percentage points in new issuance, yet there is no clear break that would signal a structural shift. The evidence so far offers little sign of an imminent reversal in dollar dominance.[30]

The global financial landscape is not immune to geopolitical and geoeconomic tensions. The outcome is financial fragmentation that exposes the global financial market in two channels. First, financial fragmentation poses the world with a risk that the financial system has a weaker ability to contain a crisis. Second, the financial fragmentation creates misallocation of financial assets.

On the risk side, investors reassess currency, credit, and policy risk as geopolitical pressure persist while differences in productivity growth across the globe expose the world with limited buffer to absorb shocks. The dollar remains the anchor of reserve portfolios, but the share of other currencies in global official reserves has increased from around 29% in Q1-2000 to 43% in Q1-2025 over the last 25 years. As growth in Europe and China is expected to slow, while growth in EMDEs is likely to be uneven, gains from financial integration in the form of risk diversification may be limited. Indeed, differences in productivity performance across regions along with financial fragmentation can exacerbate this risk. With the dominance of the USD in cross-border assets, shocks that hit dollar markets, e.g., the potential of an AI-bubble to burst, may be propagated fast as well.

Figure 2.11 Geopolitical Fragmentation on NIIP (% GDP)



Source: External Wealth of Nations, LPEM FEB UI calculation

The allocation of global safe assets is increasingly driven by geopolitical alignment rather than traditional market fundamentals, implying worsening misallocation of financial assets. A smaller share of US government debt is now held by China, whose share of foreign holdings fell from about 20.3% in 2015 to 7.9% in 2025. At the same time, the share held by major foreign holders geopolitically close to the US (e.g., Japan, the United Kingdom, Belgium, Luxembourg, France, Canada, Ireland, Norway, South Korea, and Germany) increased to around 80.4%. This reflects a mix of strategic decisions and portfolio rebalancing. For countries that do not issue reserve currencies, including Indonesia, this shift supports the dependence on decisions taken in a small group of financial centres. Amidst this vivid investment reallocation that is less determined by market fundamentals such as rates of return and more by political factors, the room for EMDEs, including Indonesia, to close gaps through capital markets alone remains narrow.

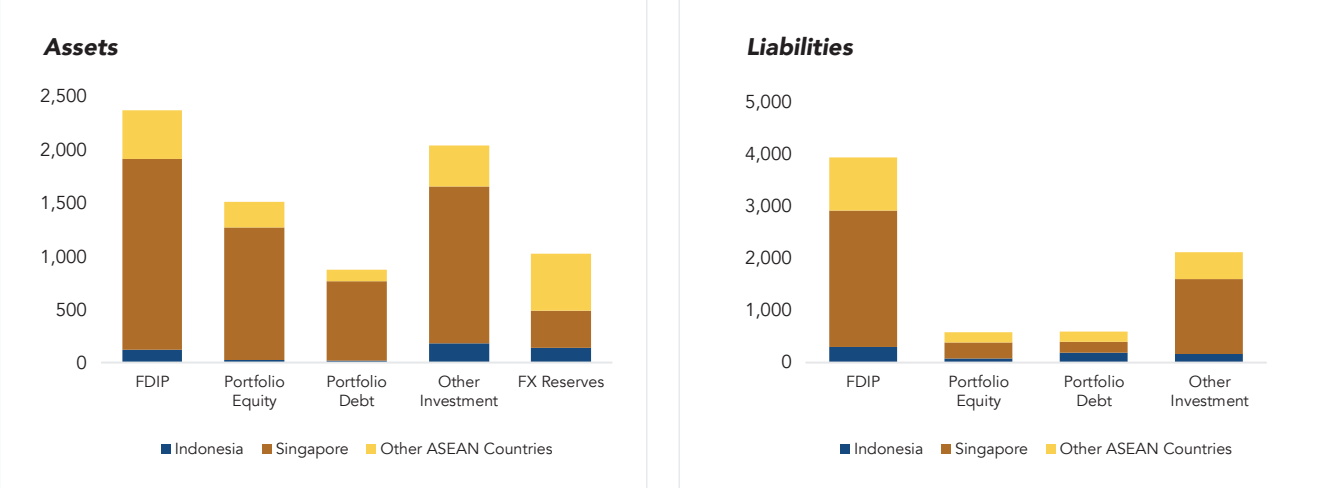
The global pattern of financing safe assets has shifted significantly, driven increasingly by geopolitical alignment rather than market fundamentals. Figure 2.11 shows that a smaller share of US government debt is now held by China, whose holdings fell from about 20.3% in 2015 to 7.9% in 2025. Conversely, the share held by major foreign holders geopolitically close to the US (e.g., Japan, UK, Eurozone, Canada, South Korea) increased to around 80.4%. This vivid investment reallocation implies that capital flows are now less determined by rates of return and more by strategic decisions taken in a small group of financial centres. For countries that do not issue reserve currencies, including Indonesia, this narrows the room to close financing gaps through capital markets alone.

ASEAN in the Global Capital Market

Within ASEAN, Singapore is a regional financial hub with deep markets and a large stock of cross border positions with most of the regional transactions passing through its balance sheet. The rest of ASEAN relies far more on FDI and other investment such as bank lending and cross border deposits rather than on stocks and bonds flows. This means that Singapore anchors the ASEAN's financial intermediation, while most other ASEAN countries receive finance through corporate groups and banks rather than through broad capital markets.

For ASEAN excluding Indonesia and Singapore, FDI accounts for about 52% of total external liabilities and other investments for 26%. Portfolio equity and debt combined represent only 20% of total external liabilities. Bond and equity markets are small, and issuer bases are narrow, so even when foreign investors want exposure to these economies, they often have only a few listed instruments to buy. This shows that external exposures work mainly through multinational firms and bank lending rather than deep capital markets, which makes financial flows more sensitive to corporate and banking conditions in source countries.

Figure 2.12 External Assets and Liabilities of Indonesia and Other ASEAN Countries, 2023 (USD billion)



Source: IMF International Financial Statistics (IFS); LPEM FEB UI calculation

2.4. Implications of the Global Trends for the Indonesian Economy

We have laid out three key current global trends: geopolitical and geoeconomic fragmentation, China's slowdown, and readjustments in the global financial market. In this subsection, we provide analysis on the implication of these trends to the Indonesian economy. We take into account that the three trends are linked one to another and hence may have simultaneous impact on Indonesia. In order to complement our outlook on the performance of Indonesia's economy in 2026, we illustrate each mechanism channel that the three global trends expose the economy with downside or upside risks.

Geopolitical rivalry, sanctions, and increasing global fragmentation weaken external demand and raise uncertainty. Both channels act as downside pressure to Indonesia's GDP growth through slower export growth and relatively stagnant commodity prices. Exports also face dual pressures from China's structural slowdown and stricter market-access conditions, e.g., sanctions, CBAM, and EUDR, that increase compliance costs. Meanwhile, fragmented supply chains and export controls

on strategic inputs further constrain productivity by limiting technology diffusion and increasing production inefficiencies.

Moreover, **the slowdown of China's economy also poses a direct risk to the Indonesian economy.** Lower demand from China will suppress commodity prices, which could negatively affect Indonesia's exports globally, especially on coal and CPO commodities. Furthermore, weaker China's demand would also decrease Indonesia's export as China is Indonesia's main export market with a share of 23.5% of Indonesia's total export. In addition, due to the escalation of trade war, China will reallocate a share of its export away from the US and there is a potential that China will direct its products into ASEAN markets, including Indonesia. Considering this possibility, Indonesia's import from China could considerably rise, especially for manufactured and intermediate goods, reducing industrial utilization and narrowing the trade balance. Both downward pressure to Indonesia's export and potential surge of imports create pressure to trade surplus. In addition, the trade diversion due to trade war may include higher import competition to Indonesia's labor-intensive industries which creates pressure to the labor market.

Besides affecting trade patterns, **the escalation of the US trade war might trigger investment reallocation.** Such reallocation creates not only a downside risk for Indonesia in terms of reshoring, but also upside risk in terms of higher investment inflows from China seeking investment potential in Indonesia.

Beyond China's effect, **heightened global uncertainty and stagnant growth of commodity prices transmit to the domestic economy via financial and demand channels, dampening credit growth and household consumption as firms and households adopt precautionary behavior amid weaker income prospects.** FDI becomes more selective, favoring destinations with higher regulatory predictability, while risk premiums rise for long-term investment. External shocks feed into inflation primarily through energy, food, fertilizer, and imported input prices, while safe-haven dynamics affect asset prices.

The global declining trend of policy rates with relatively tame inflation risk may continue encouraging Indonesia's policy rate to follow this trend, and thus provide expansionary monetary stimulus. Yet, increased global risk aversion and interest rate differentials amplify exchange rate and portfolio flow volatility, complicating macroeconomic stabilization and further constraining fiscal space through weaker revenue performance, higher subsidy needs, and rising debt-servicing pressures.

3. DOMESTIC OUTLOOK**

Summary of Key Findings

i. Despite maintaining growth of around 5%, Indonesia's economy has experienced a long-term slowdown driven by weakening investment combined with the declining role of manufacturing and other high-value added sectors.

ii. Indonesia's economic growth has been distributed less equally, suggested by the divergence between GDP growth and real wage growth, alongside a shrinking middle class.

iii. In the past decade, Indonesia's productivity has been decreasing, both in capital and labor.

iv. Indonesia's economic growth structure has been shifting to low productivity sectors and relies more on seasonal factors to achieve higher growth.

v. Inflation remains manageable, as a combination of declining purchasing power and supply stabilization efforts by the Government.

vi. Indonesia's business and investment climate has been worsening. This is illustrated by the recent contractions of FDI growth in 2025.

vii. Limited growth of investment is translated into stagnant quality jobs creation; thus, hampering the potential rebound of purchasing power.

viii. Indonesia's financial deepening remains shallow, limiting the efficacy of monetary transmission into the real sector.

ix. Indonesia needs to expand its export destination amidst the trade war.

x. Indonesia's consumption base is becoming more fragile as the middle class shrinks while the aspiring middle class expands, indicating downward mobility and limited upward transition, with a larger share of households clustered just above vulnerability.

xi. Household consumption is increasingly sustained by balance-sheet strain rather than income growth, reflected in low savings, rising debt servicing, slowing consumption credit, and growing financial stress, pointing to structurally weak consumption momentum in 2026.

xii. Indonesia's fiscal space is structurally constrained by weak revenue mobilization and rising debt service, with a persistently low tax-to-GDP ratio, contracting tax revenues despite steady growth, and a growing share of public resources absorbed by interest payments.

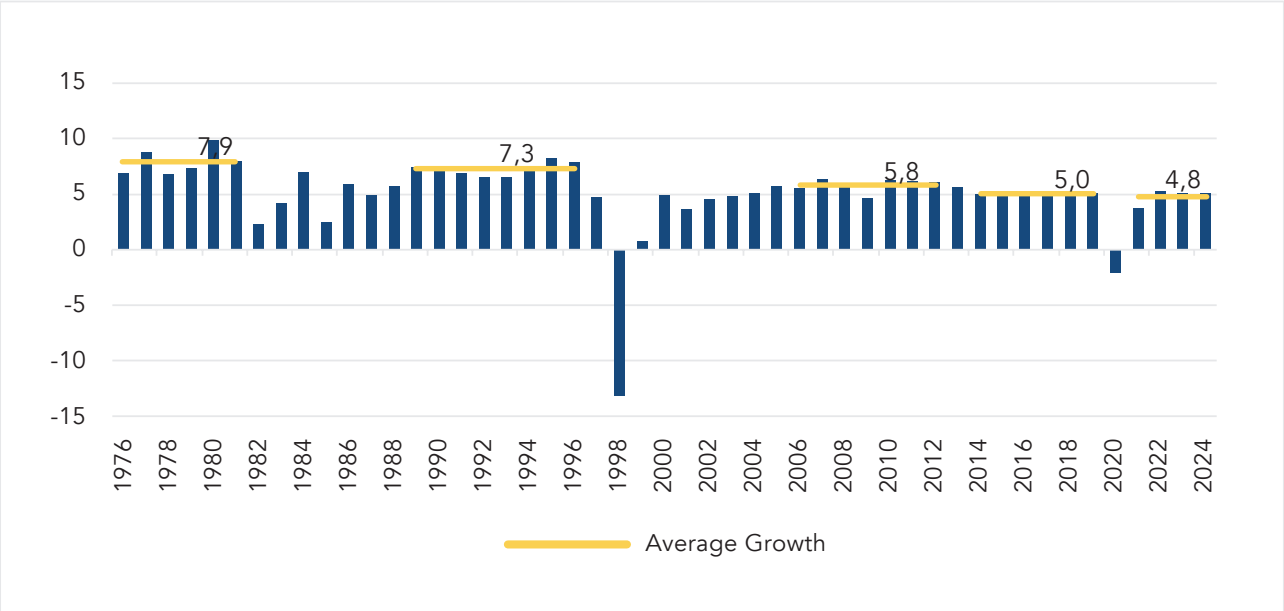
xiii. Expenditure reallocation is squeezing growth-enhancing spending with cuts to capital expenditure and regional transfers occurring combined with large allocations to MBG and Danantara.

** The analysis does not include the impact of natural disaster in Sumatera, Bali and Kalimantan, and the US-Venezuela conflict.

3.1. Economic Growth

While still growing at about 5% (YoY) in the past decade, Indonesia's economic growth has been gradually slowing (Figure 3.1). With an average growth of nearly 8% during the 1970s and 1980s period, Indonesia is currently struggling to even grow 5%. The downward trajectory of Indonesia's economic growth is attributed to the shifting characteristics of the source of growth and its compositions. From the expenditure side, the contribution of investment has been less significant than in the previous decades. Meanwhile, from the production side, the share of low value-added sectors has been increasing.

Figure 3.1 Indonesia's GDP Growth 1976-2024 (%)

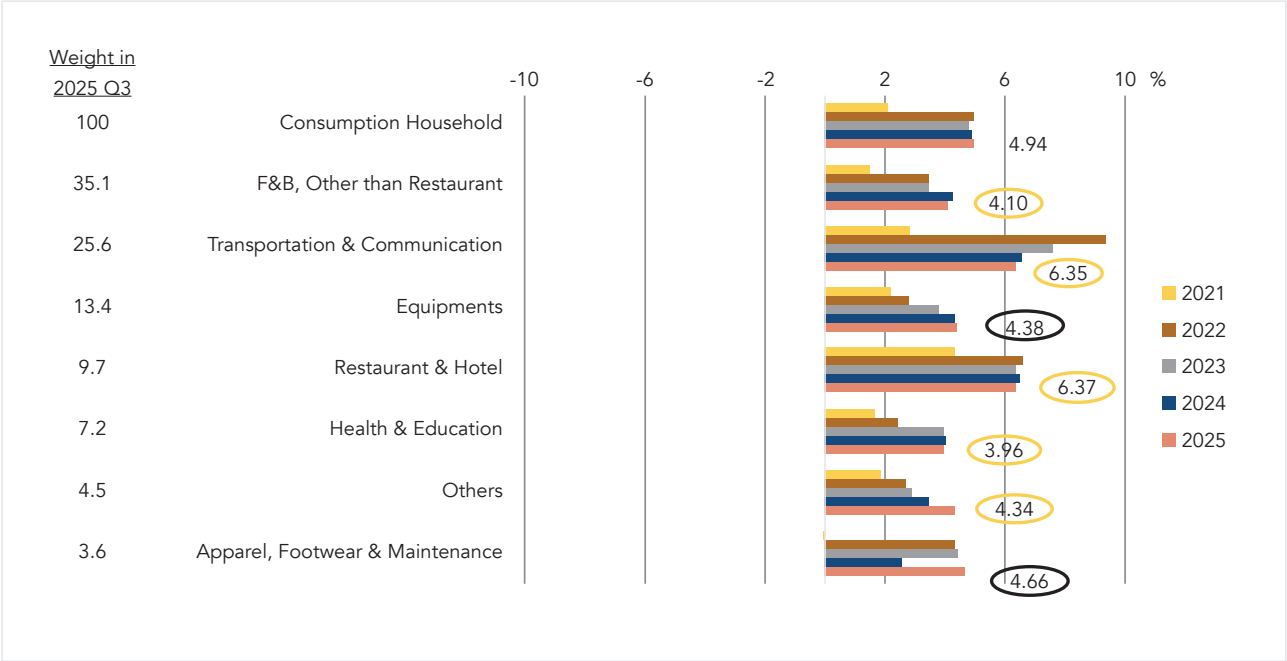


Source: Statistics Indonesia (2025)

To enhance economic growth engine, a country needs to shift its economic structure from a consumption-based economy and more towards production-based ones to escape the growth stagnancy. However, currently Indonesia is still leaning towards the consumption-based economic activity. Breaking down GDP component from expenditure side, the growth components fairly reflect overall Indonesia's characteristic as a massive market with around 280 million populations and being the fourth most populous country in the world. In 2025, household consumption contributes to around 52% of economic activity.

As the biggest component of Indonesia's GDP, consumption activity in Indonesia is dominated by daily subsistence (Figure 3.2). The contribution of food consumption, transportation, and communication accounts for more than 60% of Indonesia's household consumption.

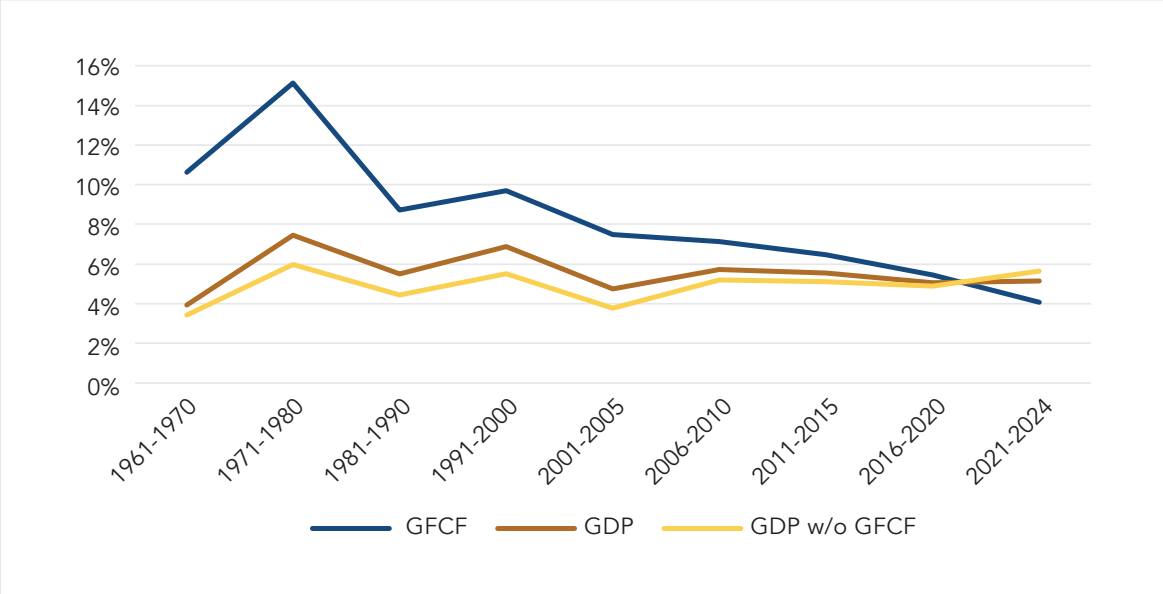
Figure 3.2 Growth and Share of Household Consumption and Its Components (%)



Source: Statistics Indonesia (2025)

While having a large consumer base does not necessarily hamper growth, the lack of productive activity plays a part in a rather stagnant GDP growth of Indonesia. From the 1960s until the early 1990s, gross fixed capital formation (GFCF) or investment grew at a double-digit rate. Furthermore, investment was consistently pulling up overall GDP growth until 2020. However, in the last few years, investment as a growth engine has been weakening and has grown below the overall economic growth (Figure 3.3).

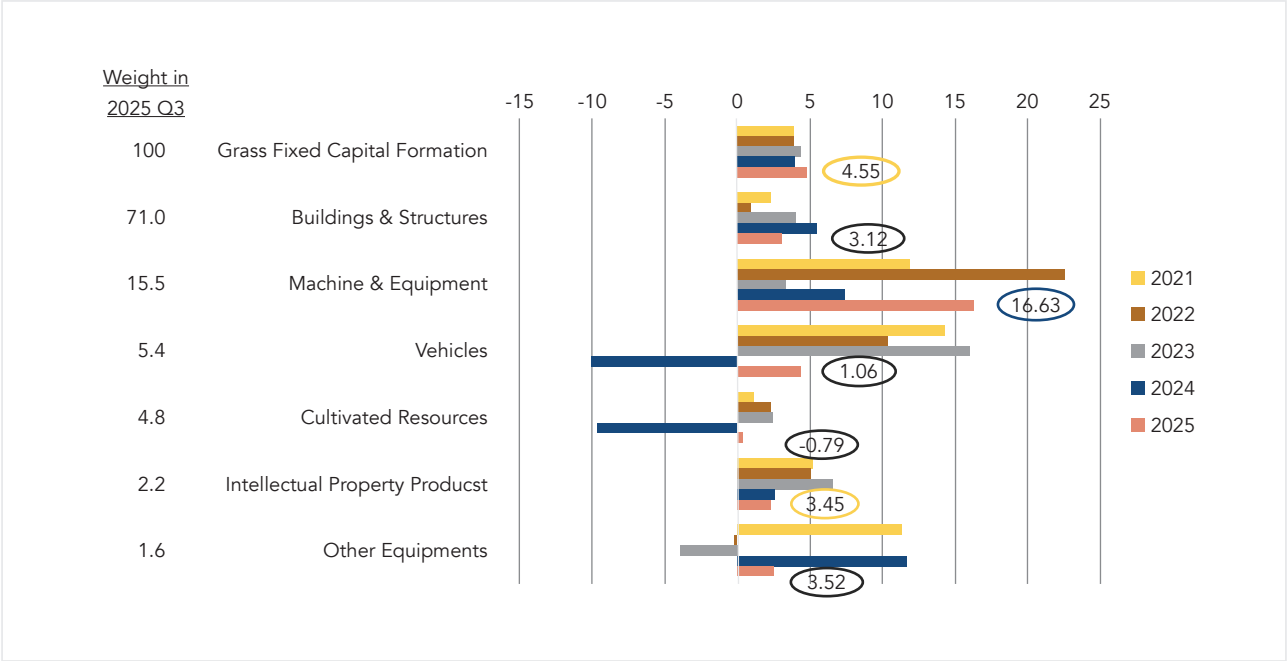
Figure 3.3 Growth of GDP and Investment (YoY)



Source: Statistics Indonesia (2025)

Based on its components, investment in Indonesia is dominated by physical investment, such as buildings and structures (71% of overall investment) as well as machine and equipment (15%). On the other hand, investment in the form of intellectual property products only accounts for 2% of overall investment activity in Indonesia (Figure 3.4).

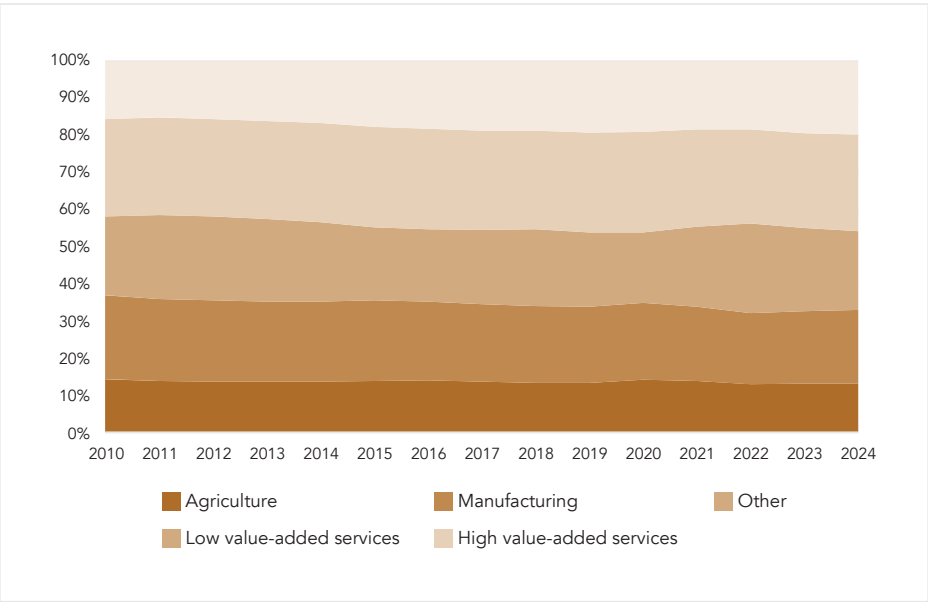
Figure 3.4 Growth and Share of Gross Fixed Capital Formation and Its Components (%)



Source: Statistics Indonesia (2025)

Furthermore, export share in Indonesia's GDP in 2025 is around 31%. While still maintaining trade surplus for years, Indonesia's export share reflects the domestic productions still have room for improvement for competitiveness in the global market. In comparison, Thailand's export share to GDP is 70%, while Malaysia's share is 71% and Singapore's share is 179%.[31]

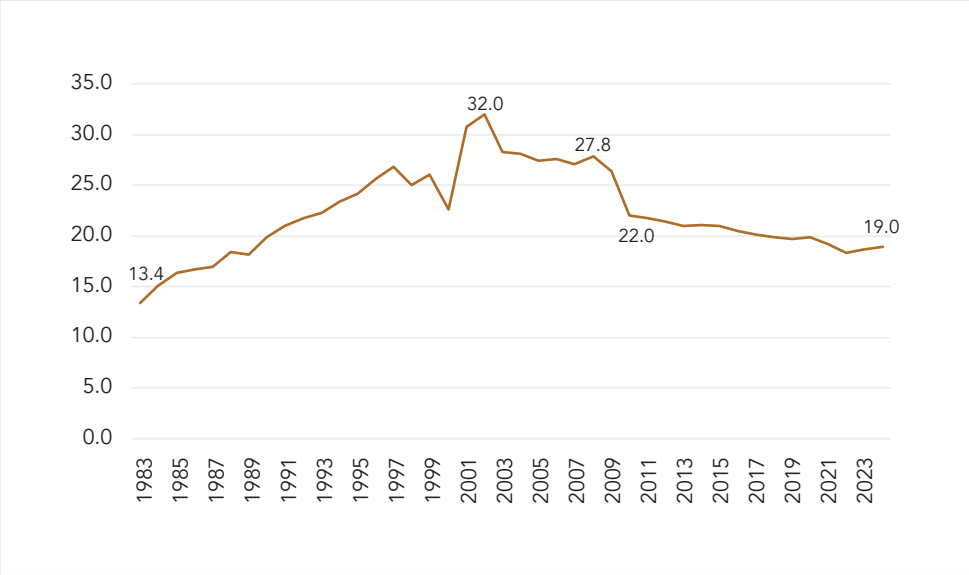
Figure 3.5 GDP Components by Sector



Source: Statistics Indonesia (2025)
Sector classification: Low-value added services comprise wholesale and retail trade, accommodation, food and beverages activity, public administration, education, health and social work, and other services; High-value added services include transportation and storage, information and communication, financial and insurance activity, real estate, and business services; Others cover mining and quarrying, construction, electricity and gas supply, and water supply, waste, and recycling.

From a sectoral perspective, manufacturing is still the biggest contributor to economic growth with a share of almost 20% of overall economic activity. However, the bigger picture indicates that aggregate low value-added sectors still dominate Indonesia's economy (Figure 3.5). This is illustrated by the share of agriculture sector that amounts to around 13% in 2024 and the total share of low value-added services sectors which accounts for almost 26% of economic share. Comparatively, high value-added service sectors only contribute 20% to overall economic activity.

Figure 3.6 Manufacturing Sector Value-Added (% of GDP)

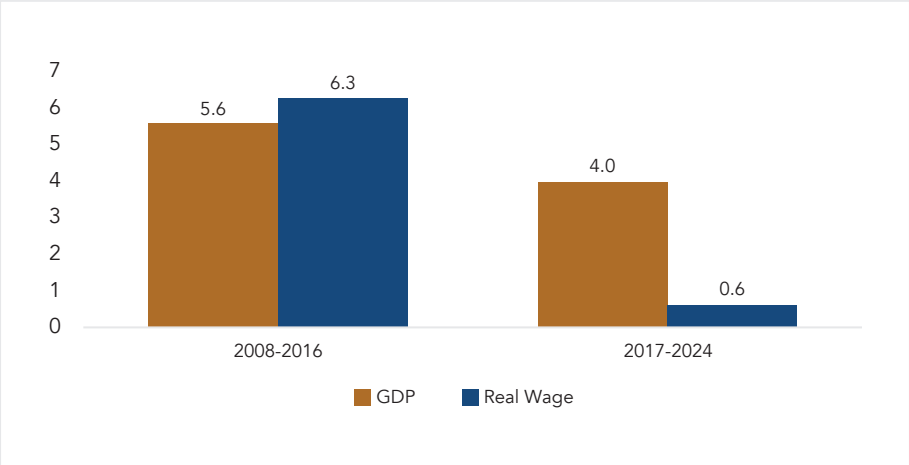


Source: World Bank (2025)

The overall figure indicates that Indonesia's economic growth engine is not contributed by the productive, high value-added sectors. While still accounts as the biggest sector in Indonesia, manufacturing sector has been growing below the overall GDP growth for the past two decades (Figure 3.6) due to various factors, including weakening investment climate, declining productivity, and lack of meaningful progress on structural reform. Consequently, the manufacturing sector has been substantially declining from around 32% in the early 2000s to less than 20% in 2024. If it persists, Indonesia is at serious risk of premature deindustrialization.

For decades, Indonesia's economy has not been able to transition away its source of growth from natural commodities. During early 1970s, Indonesia's GDP growth was fueled by the oil boom and during 2010s was promoted by coal and palm oil. Currently, Indonesia's economic growth has been driven by nickel, coal, and palm oil. This is reflected by the growth of related subsectors in agriculture, mining, and manufacturing. Persistent reliance on commodity-based industrialization puts Indonesia in a vulnerable position in the commodity cycle. Without meaningful transition from its reliance on natural commodities and focusing on high value-added sectors, GDP might stagnate and continue to struggle achieving growth of 5%.

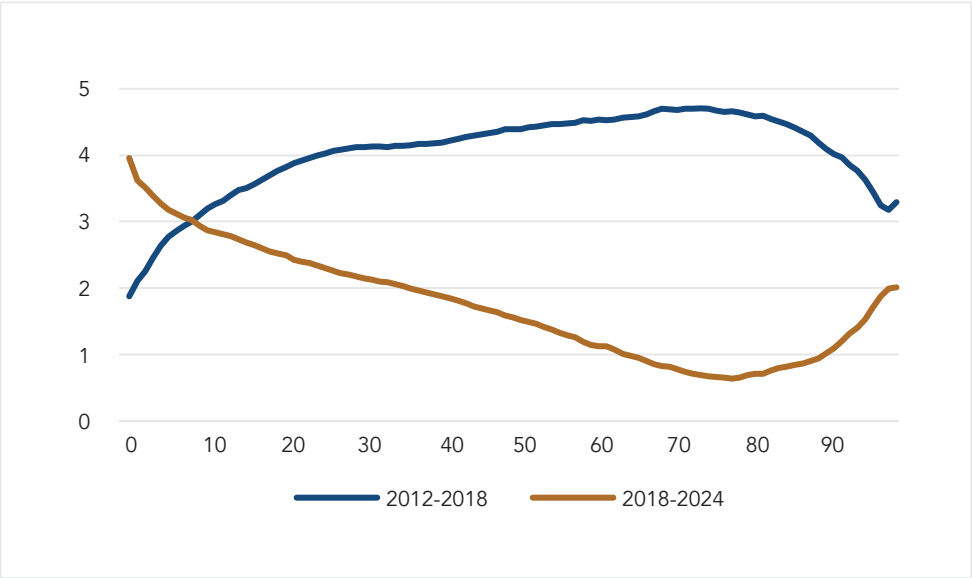
Figure 3.7 Real Wage and GDP Growth in Indonesia (%)



Source: Statistics Indonesia (2025); LPEM FEB UI calculation.

Indonesian economic growth has been getting less inclusive in the past few years. During the period of 2008-2016, real wages grew by around 6.3% annually, surpassing average GDP growth of around 5.6%. This suggested that GDP growth creates more welfare towards workers than capital owners and economic pie were distributed more evenly (Figure 3.7). However, this trend reversed during the period of 2017-2024, in which economic growth has been more concentrated on the capital owners. During this period, economic grew on average at 4.0% per year yet average annual real wage growth was only 0.6%, suggesting that majority of additional economic value-added went to the capital owners rather than general labors.

Figure 3.8 Growth Incidence Curve



Source: Statistics Indonesia (2025); LPEM FEB UI calculation.

A rather unequal distribution of growth in economic value-added is also apparent in the household income distribution. As shown, by growth incidence curve, majority of the middle class are experiencing the highest growth compared to the high-level income household during 2012-2018. However, this trend reversed during 2018-2024 as middle-income populations experienced the lowest income growth while high-income households experienced substantially higher income growth (Figure 3.8).

3.2. Productivity

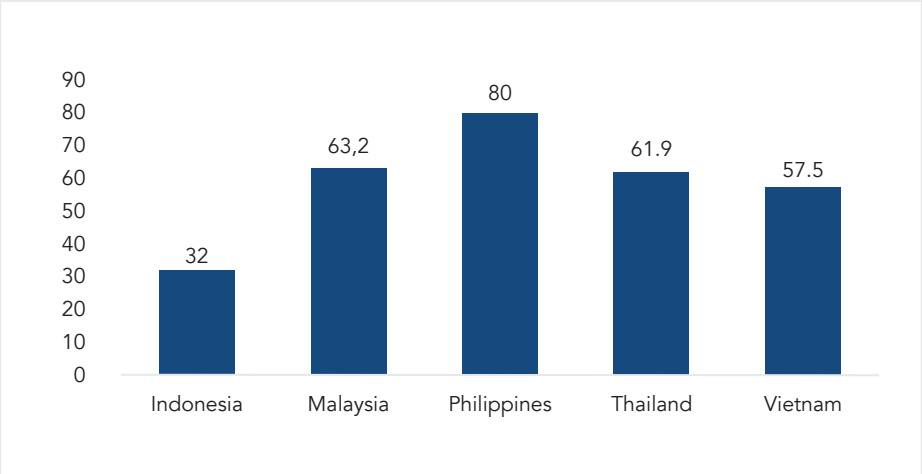
The global supply chain is becoming more fragmented, triggered by geopolitical rivalry and protectionist policies. This fragmenting global supply chain could serve as a golden opportunity for Indonesia, as it pushes firms to relocate from old manufacturing hubs to new manufacturing areas, one of which is ASEAN.

However, Indonesia keeps losing this global trade war compared to other ASEAN countries. In 2018, the share of companies that moved production from China to Indonesia is really low compared to Thailand and Vietnam. The factors that hinder Indonesia from maximizing this opportunity are business regulation, infrastructure gap, and low labor productivity.[32] A study by the World Bank provides evidence that Indonesian firms have to allocate 20% of their time to process government regulations, while companies in Vietnam only need 10% of their time, and even less for companies in Thailand. This condition implies that firms in Indonesia have to allocate more time and funds to government regulation, which further burdens the ease of doing business. Furthermore, the infrastructure gap plays a crucial role, as businesses that move goods in and out of Indonesia have to allocate high logistics costs reaching 24% of GDP, while it's only 13% in Thailand, making it costly with a really slow mobility.

Consequently, a lower labor productivity significantly hinders Indonesia from attracting manufacture reallocation. Firm labor productivity in Indonesia has declined, from 7,530 USD per worker in 2015 to 5,336 USD per worker in 2023.[33] Indonesia's labor productivity growth on average is only 2.6%, significantly lower than other leading ASEAN countries.[34] This lower labor productivity condition cannot be compensated by cheaper labor force, as the longer time to complete work potentially wasted the funding spent. This discrepancy has hindered Indonesia in attracting manufacture reallocation, while other countries like Vietnam has built a more productive labor force with higher quality of workers in critical sectors, like electronics, successfully attracting manufacture reallocation in the high-tech sectors.

Indonesia's also experiencing a technological falling behind compared to other ASEAN peers due to its lack of an overarching industrial policy to support businesses.[35] Indonesia face difficulties in accelerating technology transfer, as its main channels, Foreign Direct Investment (FDI) is significantly decreasing in 2025. FDI easing is mainly allocated in secondary and tertiary activities, implying Indonesia is losing attractiveness as a destination for long-term foreign capital. As a consequence of this condition, Indonesia is losing its competitiveness in the global market. In 2022, Indonesia recorded the lowest share of Medium and High-Tech exports compared to leading ASEAN countries (Figure 3.9). It signals the urgency for Indonesia to accelerate technological advancement in order to catch-up with peer ASEAN countries.

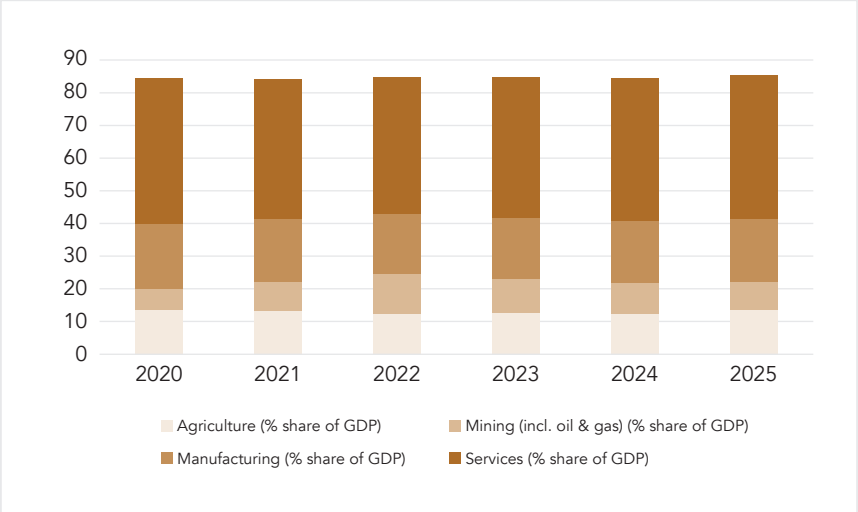
Figure 3.9 Medium and High-Tech Exports from Leading ASEAN Countries in 2022



Source: APO & Ministry of National Planning (2025)

The lagging technology transfer is worsened by the weakening manufacturing sector. The manufacturing sector is very crucial to Indonesia's economy, as it is one of the leading sectors contributing to Indonesia's economic development and providing formal employment. However, there has been a persistent declining trend of manufacturing sector contribution to Indonesia's GDP from 19.87% in 2020 to 19.02% in 2025. Meanwhile, the services sector dominates the GDP contribution consistently from 2020 to 2025 (Figure 3.10).

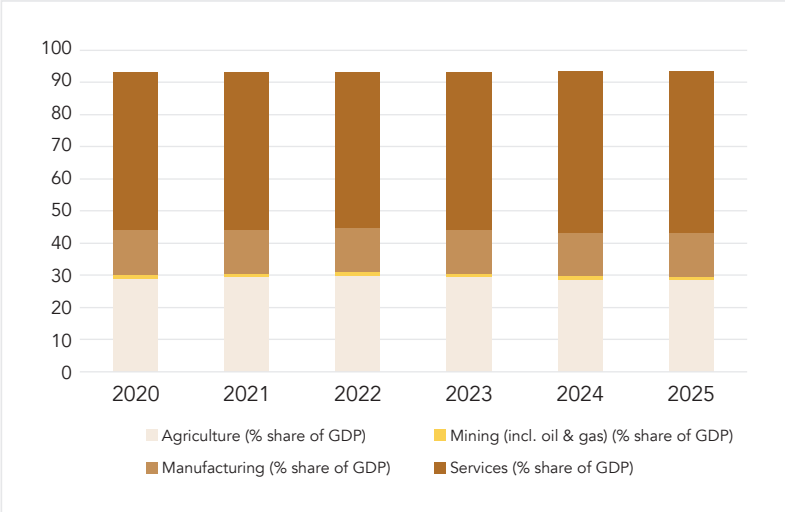
Figure 3.10 Indonesia GDP by Sector from 2020 to 2025 (in %)



Source: Statistics Indonesia (2025); LPEM FEB UI calculation.

The declining condition of manufacturing sector is also seen on the decreasing share of employment from the manufacturing sector, from 14% in 2020 to 13% in 2025 (Figure 3.11). Moreover, the average annual workforce growth in manufacturing sector over the last five years was only 0.8%.[36] Meanwhile, the higher percentage of employment is shown by services (50%) and agriculture sector (29%) in 2025, surpassing manufacturing sector consistently from 2020. This means that the capacity of Indonesia's manufacturing sector to provide formal employment for educated workforce is very limited.

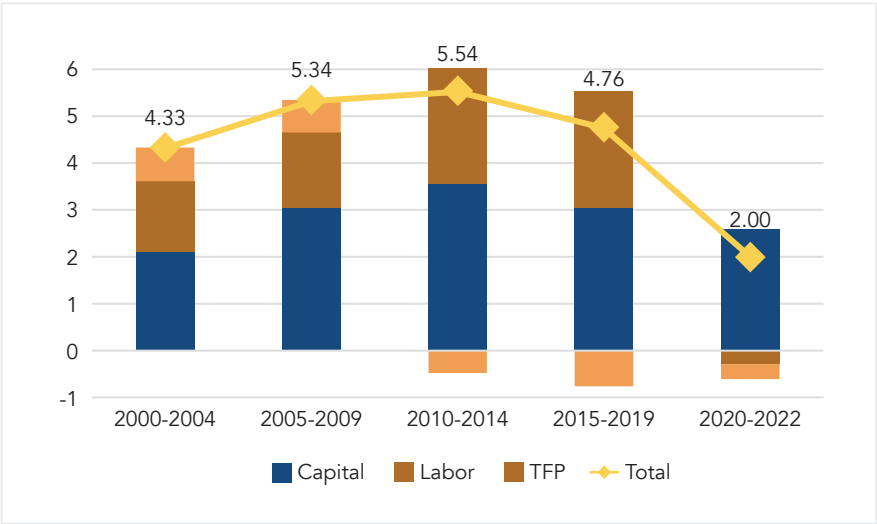
Figure 3.11 Share of Employment by Sector in Indonesia 2020-2025 (in %)



Source: Labor Force Survey, Statistics Indonesia; calculations by LPEM FEB UI.

As a consequence, the majority of employment is created in the informal sector. This is seen from the slight increase of informal workers, from 42.1% in 2024 to 42.2% in 2025, while the proportion of formal workers decline from 58.0% in 2024 to 57.8% in 2025 (Figure 3.11). The huge proportion of informal sector acts as an obstacle that hinders Indonesia in improving its productivity at a national level structurally.

Figure 3.12 Decomposition of Output Growth

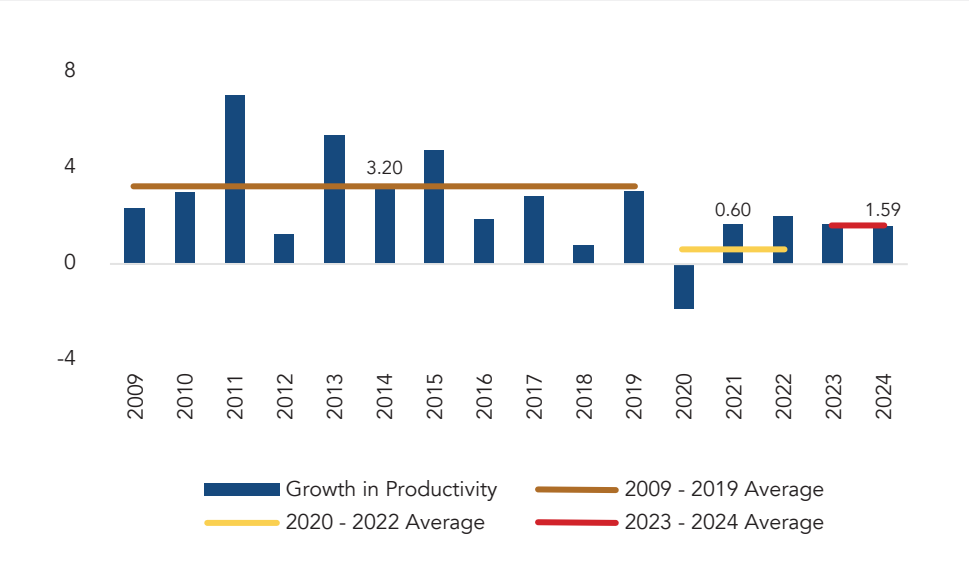


Source: APO Data (2023).

Productivity is measured by decomposing Indonesia's economic growth into three components: capital accumulation (capital stock), increase in quantity of labor and quality of human capital (labor), and increase in overall productive efficiency (total factor productivity/TFP. Figure 3.12 shows that capital accumulation performs as the primary source of growth. **However, contribution from the TFP and labor input has been fluctuating and roughly decreasing over two last decades. In fact, the contribution from TFP consistently declined, falling below zero from 2010 until 2022.**

A worsening condition of productivity is also evident from Indonesia's labor productivity growth in the last decade. Although Indonesia has made a quick recovery from the negative labor productivity growth during the COVID-19 pandemic, a decreasing trend of labor productivity growth is shown over the past three years. Labor productivity growth reached 2% in 2022, but it reduced to 1.63% in 2023, and further to 1.55% in 2024 (Figure 3.13). This declining trend may be attributed to two main factors: a decrease in total output and labor hoarding. The increasing share of labor in low value-added sectors and informal employment may also contribute to this condition. As labor productivity has been showing a declining trend over the last decades, Indonesia should be concerned on the long-run trend.

Figure 3.13 Growth in Labor Productivity (in %)



Source: Labor Force Survey, Statistics Indonesia

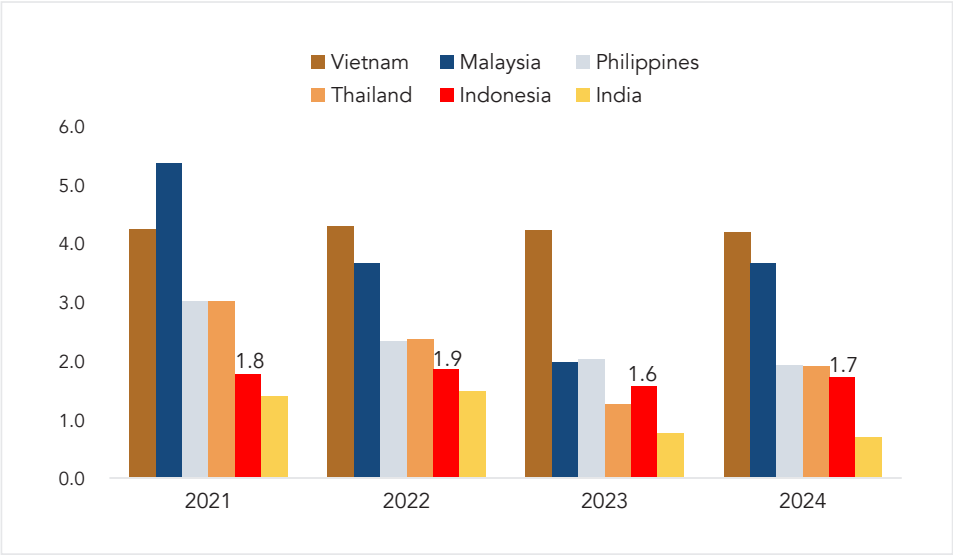
With the combination of the slow technology transfer and the weakening manufacturing sector, Indonesia's economic growth has shown deceleration in the last few years. By decomposing Indonesia's economic growth into three components, we provide evidence that capital accumulation dominates while TFP's contribution decreases to Indonesia's economic growth, indicating a lower productive economy. The decreasing contribution from productivity of labor and overall efficiency (TFP) has become the main concern, due to its significant contribution to Indonesia's GDP growth deceleration in the last few years. A study found there's a strong correlation between output and TFP, estimated a coefficient of 0.89.[37] This highlights the growing crucial role of TFP in sustaining economic growth and indicates that Indonesia is at a critical point in shifting from input-driven development to TFP-led growth economy.

3.3. Foreign Direct Investment

FDI remains an important source of capital for Indonesia, but the recent trend and composition of FDI inflows give reasons for caution. Net FDI inflows in 2024 were around USD24.11 billion, equivalent to 1.7% of GDP and have stayed within the 1.6 to 2.2% of GDP range recorded in recent years. It is showing stability in aggregate but limited acceleration in financial integration, making its share of global FDI stand near 1.5% and its share within ASEAN is about 10.1%. Yet, relative to peers, inflows are modest when scaled to economic size. As Figure 3.14 shows, neighboring countries have relatively higher net FDI-to-GDP (FDI intensity) compared to Indonesia. This is a common thread in openness measures

that larger economies tend to have a lower ratio of trade openness and financial integration due to the sizable domestic market. When we compare this financial integration measure to India, a country with large population similar to Indonesia, our FDI intensity is higher.

Figure 3.14 Net Inflows of FDI, % of GDP



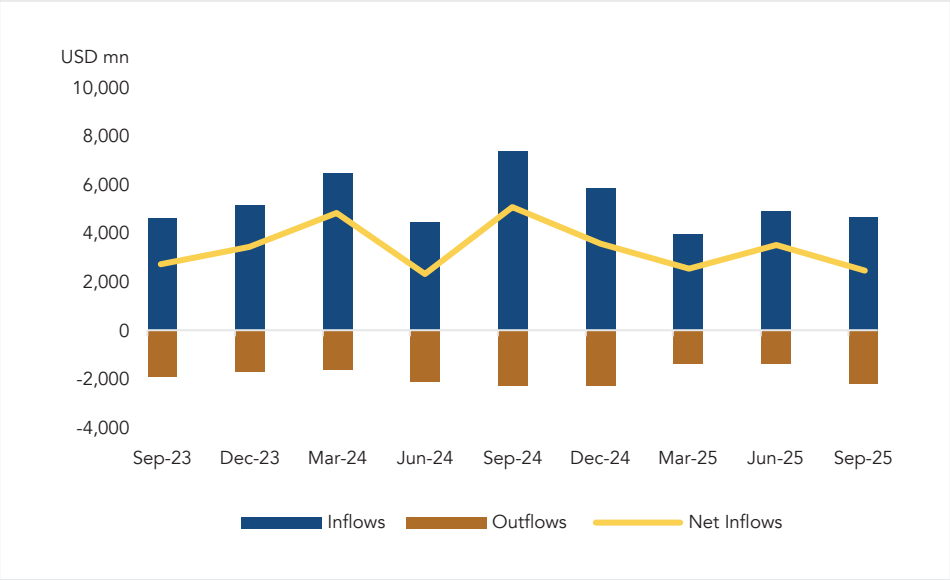
Source: BoP (BPM6), LPEM FEB UI calculation

Moreover, Indonesia's FDI intensity is below that of Vietnam at 4.2% of GDP and Malaysia at 3.7% of GDP, countries where foreign-invested firms have a larger role in trade and export activities. The benchmark matters since Vietnam's higher FDI intensity is paired with far deeper trade integration. Indonesia's trade-to-GDP was only 42.6% in 2024, close to India at 44.7%. In contrast, Vietnam's ratio was around 174% of GDP, while Malaysia and Thailand were 137% of GDP. This implies that Vietnam's economic structure converts FDI into export capacity at a scale that differs from Indonesia's more domestically oriented economy.

Recent quarterly flow data show a more concerning shift with visible contraction of FDI inflow in place. In Q3-2025, Indonesia's direct investment inflows (using BoP's BPM6 definition) weakened relative to earlier quarters. Net inflows declined to around USD 2.46 billion, the lowest points in the recent years, as inflows softened while outflows remained sizeable. As a result, cumulative net inflows over Q1 to Q3 2025 fell to USD 8.55 billion, well below USD 12.27 billion in the same period last year (see Figure 3.14). The decline was driven primarily by weaker inflows, which contracted by 26.3% (YoY), while outflows declined by a smaller rate of 18.2% (YoY).

Investment realization data from the Ministry of Investment and BKPM provide a complimentary perspective. Realized FDI in Q3-2025 was about IDR 212 trillion, down 8.9% (YoY) from around IDR 233 trillion in Q3-2024. These project-based realization figures are not directly comparable to balance of payments flows, since they measure committed project spending rather than cross border financing. Even so, the two datasets point in the same direction. Implementation remains substantial, but net external financing from FDI is weakening and appears less supportive in 2025.

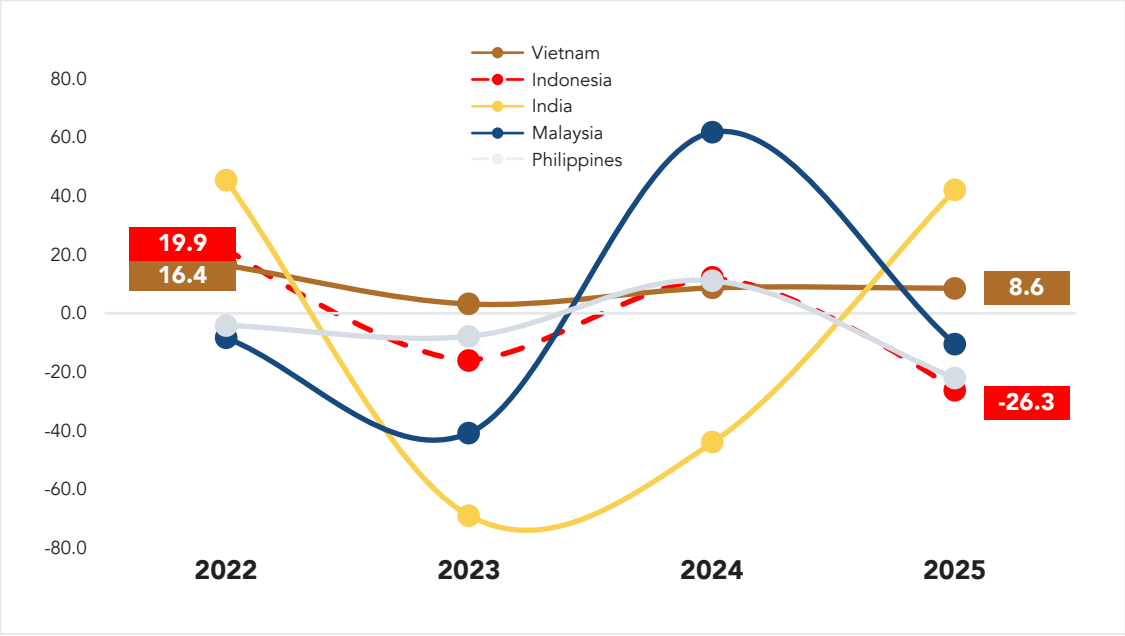
Figure 3.15 Indonesia's Direct Investment Flows



Source: BoP (BPM6), LPEM FEB UI calculation

The peer comparison strengthens the perspective on the direction of FDI, showing inertia in the growth of FDI inflows to Indonesia. As shown in Figure 3.15, while Indonesia recorded a contraction in 2025, Vietnam still posted growth of 8.6% (YoY). Malaysia and the Philippines also softened, but their declines were less severe than Indonesia's. This signals that FDI has not withdrawn uniformly from the region. Rather, it appears to be reallocated toward destinations perceived as more predictable in policy settings, stronger real comparative advantage in sectors being reallocated, and more reliable in project execution. For Indonesia, the decline reflects a sharper loss of momentum in foreign risk appetite at a time when peers have been more resilient.

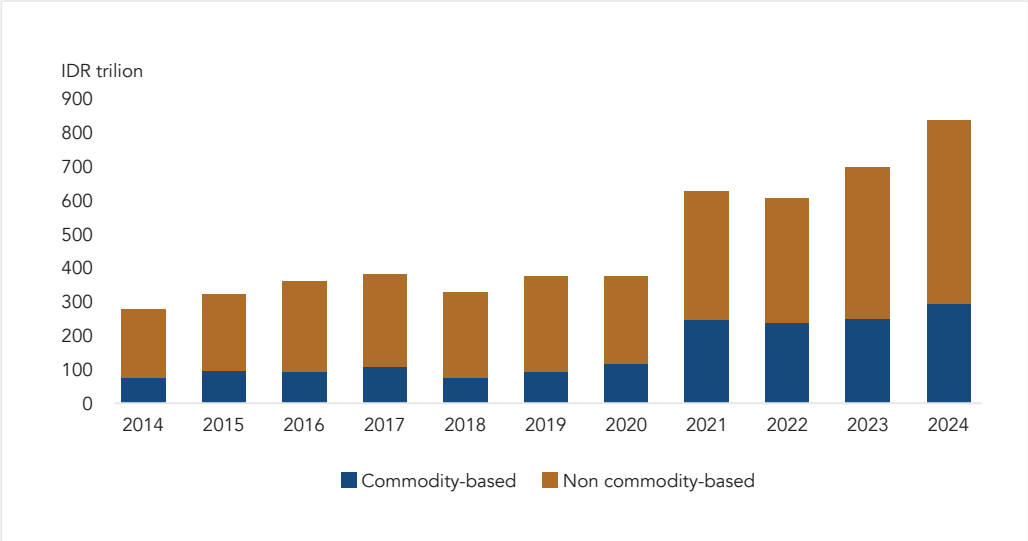
Figure 3.16 Growth of Direct Investment Inflows, % (YoY)



Source: BoP (BPM6), LPEM FEB UI calculation

Indonesia's sectoral composition of FDI remains dominated toward commodity-based and natural resources activities. Mining and metal processing receive about 35.6% of total inflows in January-September 2025. Non resource manufacturing accounts for only around 1.54%, while modern services such as finance, information technology, and business services accounted for about 8.4%.[38] This concentration increases exposure to commodity price volatility and leaves limited foreign capital for export-oriented manufacturing and modern services that could deepen value chains and boost innovation as well as productivity growth. For most non-natural resource-based firms, external funding still relies on domestic banks and retained earnings rather than new foreign investors, which slows progress on diversification.

Figure 3.17 Indonesia's FDI Inflows: Commodity-based vs Non Commodity-based (IDR trillion)

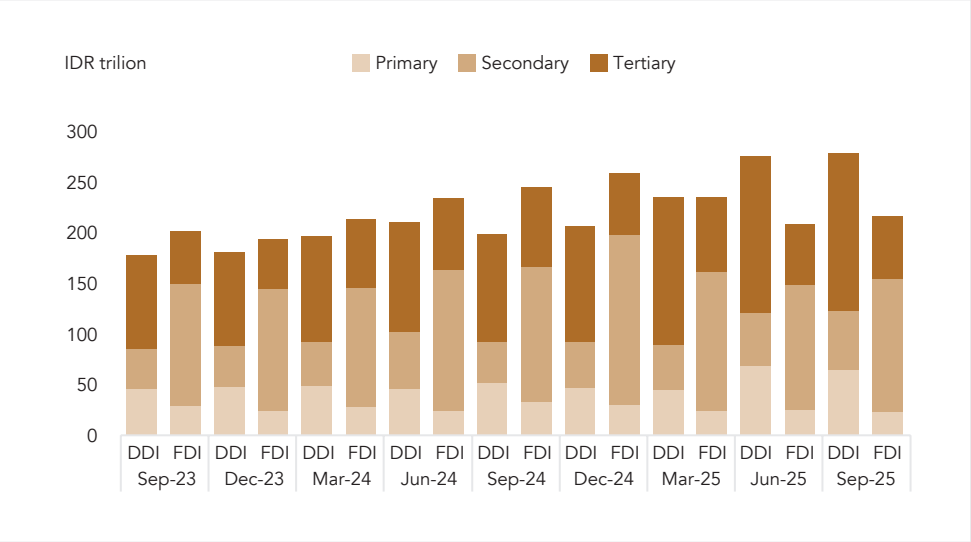


Source: BKPM; LPEM FEB UI calculation
Note: Commodity-based consists of mining sector and manufacturing sector related mining products, basic metal processing, and manufacturing related to agriculture products; the total FDI excludes constructions- and housing-related investment

More recent data for Q1 to Q3 2025 show that the steepest decline in FDI occurred in the primary and the tertiary sector, which went down around 13.7% and 12.8% (YoY) as shown in Figure 3.17. By comparison, the secondary sector still recorded growth. However, much of the realized growth in manufacturing remains closely tied to commodity related down streaming, rather than diversification into higher value added, non-commodity manufacturing segments. One of the main contributors of Indonesia's FDI, China, has invested heavily in Indonesia's mineral and mining sectors, specifically nickel, given its role in EV battery supply chain.

In this time of financial fragmentation and geopolitical tension, it is not clear yet whether Indonesia can turn this investment reallocation phase into a strong gain or at least mitigate the harm of this financial misallocation. Lower global rates on their own are not enough to trigger a surge in FDI. Investors place greater weight on regulatory predictability, energy policy, and environmental standards. In that environment, Indonesia appears as a sizeable market with strong resource-based opportunities, but not yet as a diversified production base on the scale of some regional peers.

Figure 3.18 FDI and DDI in Indonesia, by Sectors



Source: BKPM; LPEM FEB UI calculation

The World Bank's Business Ready framework stresses that FDI competitiveness depends on public service delivery and operational efficiency, not only on written rules. Indonesia has made progress in digital licensing and facilitation, but investors still report uncertainty around sector regulations, local content requirements, and frequent trade policy shifts. Reducing these frictions is critical to attracting more diversified, non-commodity-based FDI.

For 2026, the baseline for FDI is stable inflows supported by lower global interest rates, but with continued dispersion across sectors and source countries. In an upside scenario, deeper global easing and stronger regional supply chain investment lift greenfield projects, particularly where industrial infrastructure is strong. In a downside scenario, geopolitical escalation or a sharp commodity downturn delays investment decisions and raises risk premia for long horizon projects. To capture the reallocation opportunity, Indonesia needs to reduce policy uncertainty and strengthen execution capacity, so it competes on predictability rather than fiscal incentives.

3.4. Trade Performance

Exports

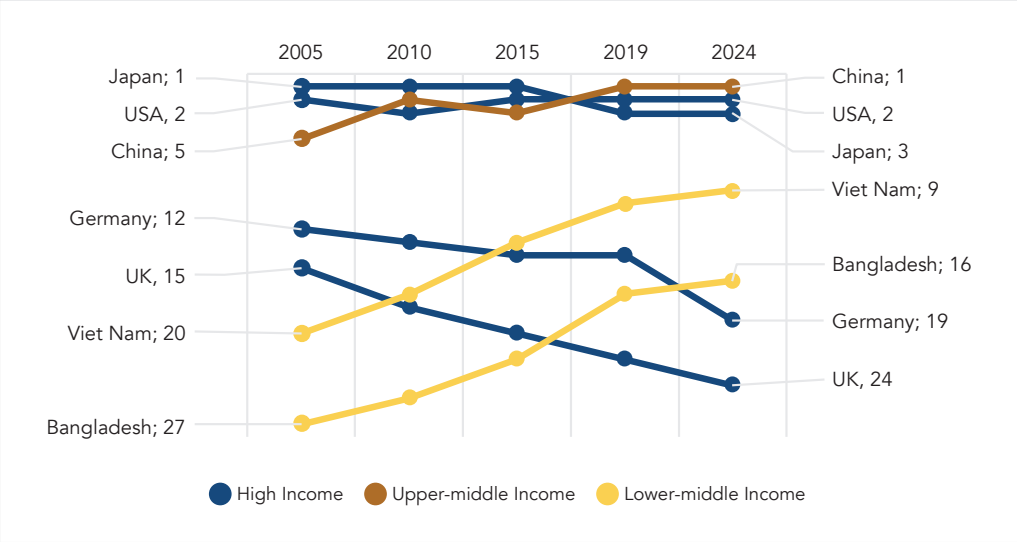
2025 marks Indonesia's fifth consecutive year of trade surplus since the pandemic, but the surplus is likely to narrow in 2026. Export values were temporarily supported by front-loading behavior ahead of President Trump's sweeping tariffs, yet cyclical pressures mount and external headwinds are building. Slowing global demand, volatile commodity prices, and rising trade frictions could collectively weigh on Indonesia's external position and reduce the buffer provided by net exports.

Indonesia's economy has grown steadily over the past decade, but it has lagged the faster-growing regional peers that have scaled up more quickly in global production networks. On a compound basis, Indonesia's GDP expanded at 4.1% annually between 2015 and 2024, broadly overperforming several mature economies. Nonetheless, this growth profile trails the more rapid

growth recorded in China, India, and Viet Nam. In trade terms, the faster-growing peers have generally been more successful at moving into higher value-added manufacturing and capturing greater value in regional supply chains.

This growth has been accompanied by a market reorientation of Indonesia's trade patterns toward emerging Asia. Over the past decade, exports to China surged 315%, alongside strong growth to Viet Nam (246%) and the Philippines (174%), while growth to Japan remained modest (15%). While this reflects Indonesia's integration into regional supply chains, the increasing reliance on China heightens exposure to China's economic trajectory. At the same time, Indonesia's presence in high income markets has gradually declined.

Figure 3.19 Indonesia's Export Destinations, 2005-2024

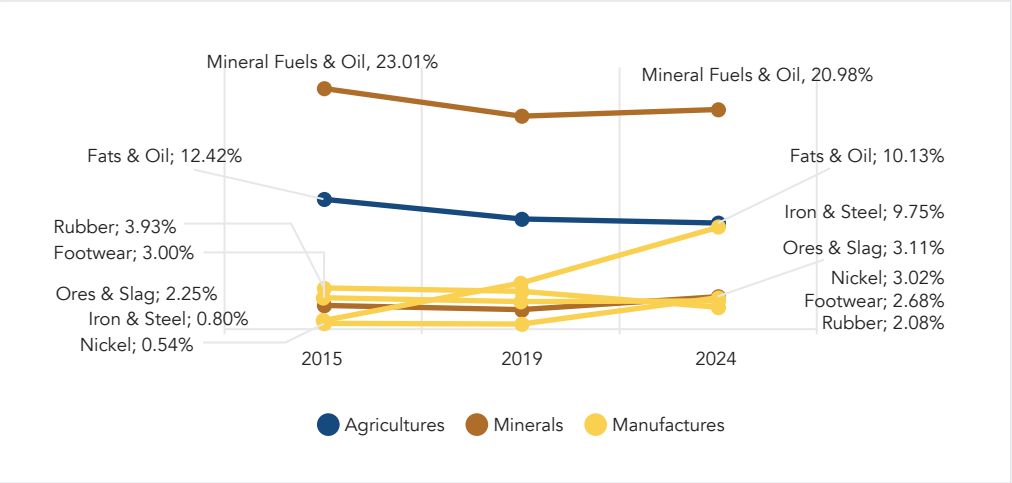


Source: International Trade Center (2024)

Indonesia's export structure remains heavily concentrated in resource-based commodities, with only gradual diversification into higher-value categories. Mineral fuels, palm products, iron and steel, and nickel-related goods still account for a substantial share of export revenues. Although higher-value products such as electrical machinery and processed metals have expanded, the overall basket remains commodity-heavy.

A key structural constraint is that Indonesia remains positioned largely in lower value-added segments of global value chains, often closer to assembly and processing rather than higher-value activities. Evidence from value-added trade and global value chain diagnostics indicates that Indonesia's participation in global value chains is relatively low and, in some segments, has been declining.[39] This helps explain why export performance can look strong in gross terms while domestic value capture, productivity spillovers, and resilience to price cycles remain limited.

Figure 3.20 Indonesia's Export Dynamics, 2015-2024 (% of Total Exports)



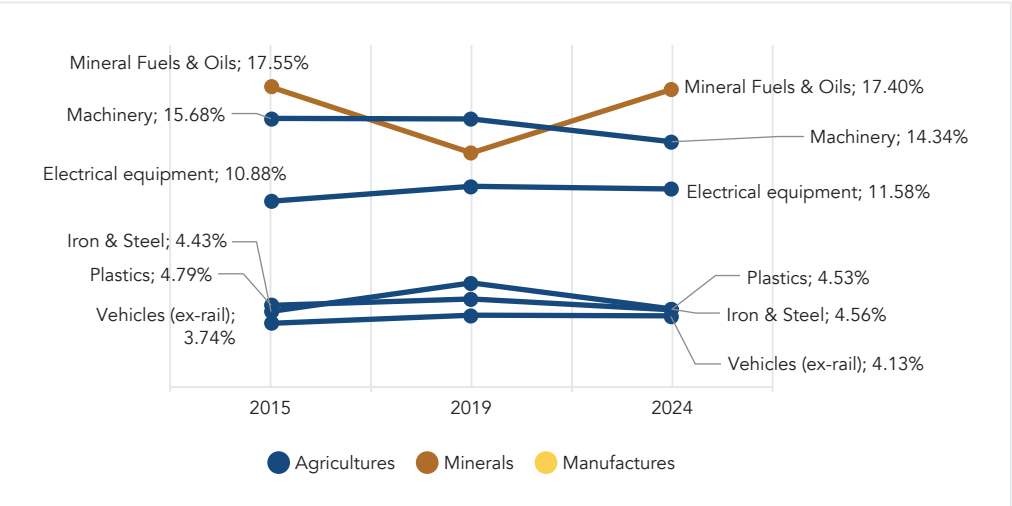
Source: International Trade Center (2024)

Import

On the import front, Indonesia's product structure continues to be dominated by capital and intermediate goods. Machinery, electrical equipment, plastics, iron and steel, and vehicles consistently account for a large share of total imports. The persistence of this structure suggests that Indonesia's imported intermediaries and capital equipment to sustain downstreaming and manufacturing activity.

Energy imports remain a key swing factor for Indonesia's import bill, and lower oil prices could provide partial relief in 2026. While volumes of fuel and energy imports tend to be relatively inelastic in the short run, price movements have outsized effects on nominal values. With global oil prices projected to ease in 2026, the energy import bill is likely to decline in value terms, providing partial relief to the overall trade balance even if non-energy imports remain elevated.

Figure 3.21 Indonesia's Import Dynamics, 2015-2024 (% of Total Imports)



Source: International Trade Center (2024)

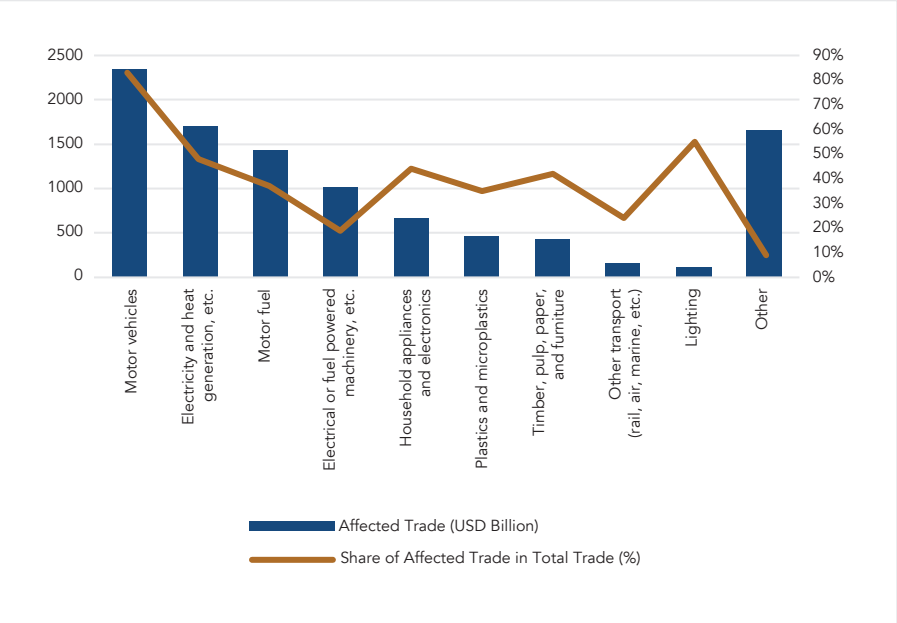
Import concentration is rising and China has become systemically important as a supplier across key categories. Between 2015 and 2024 Indonesia's top 10 import products accounted for roughly two-thirds of total imports, rising from 67% to 71% (and even holding the 2024 top 10 basket fixed, those products still represent around 68% of 2015 imports). Within this concentrated basket, China's weight has increased markedly: for machinery (24% of total imports), China's share rose from about one-third in 2015 to over one-half in 2024; for electrical equipment (20%), from 40% to 53%; for plastics (5%), from 15% to 33%; and for vehicles (4.5%), from 9% to 33%. This shift indicates not only higher import penetration from China, but also increasing supplier dependence in critical production inputs.

Market Access Constraints: External and Domestic Non-Tariff Measures

Climate and environment related non-tariff measures are increasingly raising export and production costs for Indonesian industries. Global data shows that climate related NTMs account for 26.4 percent of affected global trade, despite representing only 2.6 percent of total measures and 3.5 percent of covered products, highlighting their disproportionately large impact. Major export markets are enforcing stricter environmental rules that increase costs for products such as steel, nickel, and palm oil through tighter carbon and traceability requirements. Exporters now face more complex testing, certification, and labeling procedures, along with new cross border data rules that raise logistics and compliance expenses and reduce Indonesia's.

Climate-related NTMs disproportionately affect key energy and manufacturing sectors that dominate Indonesia's export structure. Sectors such as motor vehicles, electricity and heat generation, motor fuels, and electrical machinery face the highest exposure to climate-related trade measures, with a large share of affected global trade value. These sectors encounter rising compliance costs, which translate into increased production expenses and higher global prices. Plastics, pulp and paper, timber, and household electronics are also increasingly targeted, expanding the range of affected Indonesian export categories. As these measures intensify, investment and production patterns are shifting toward greener sectors, pressuring Indonesia to accelerate environmental adaptation and regulatory alignment.

Figure 3.22 Trade Affected by Climate Change Related Non-Tariff Measures, by Sector



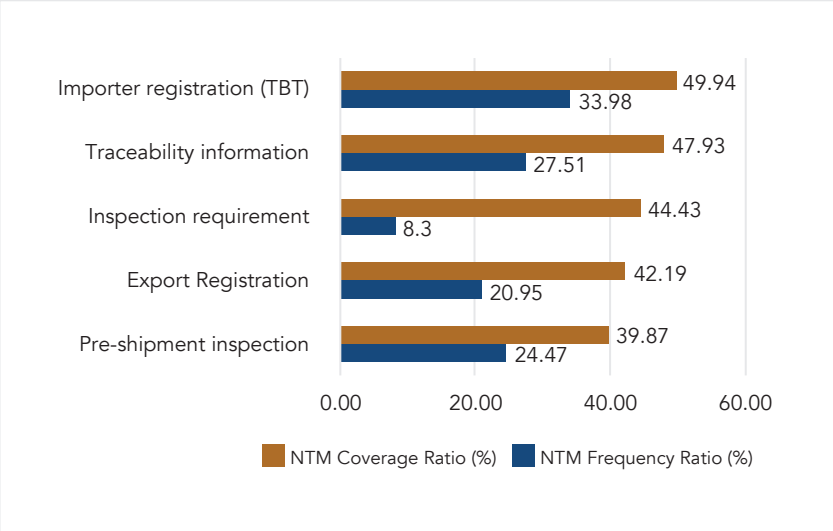
Source: UNCTAD, 2024

Sanitary and phytosanitary (SPS) and technical barriers to trade (TBT) measures are increasingly driving up Indonesia's export costs by imposing stricter requirements on testing, certification, labelling, traceability, and data reporting. These measures add multiple cost layers and can extend export processing times by several weeks. The CBAM will enter its definitive phase on January 1, 2026, compelling Indonesian exporters in carbon-intensive sectors to provide verified emissions data and manage the cost of CBAM certificates. The EU Deforestation Regulation (EUDR) will also become legally binding starting December 30, 2026, for large and medium firms and December 30, 2026, for micro and small enterprises, requiring geolocation-based due diligence and precise coordinates for raw material sourcing.

Trade performance is affected not only by non-tariff measures in export destination markets, but also by domestic non-tariff measures that reduce the competitiveness of exporters relying on imported inputs. Figure 3.23 highlights the top five non-tariff measures (NTMs) applied by Indonesia to inbound goods, including licensing requirements, traceability obligations, and physical inspections. These measures cover a substantial share of traded goods and impose additional costs on firms, both in time and financial terms. For importers, such measures can delay customs clearance, increase uncertainty, and complicate production planning, particularly for firms dependent on in-time delivery of inputs. For exporters operating in global value chains, higher costs and delays in securing imported inputs can raise costs and reduce competitiveness.

Indonesia's domestic content rules and mandatory halal compliance significantly increase operational costs and reduce competitiveness for firms across strategic and regulated sectors. Domestic content requirements add additional cost burdens for firms in strategic sectors. TKDN rules in information technology and energy force companies to rely on local inputs that are often more expensive or less efficient than imported alternatives. Mandatory halal certification, testing, and audits for imported food, beverages, cosmetics, and pharmaceuticals further raise compliance costs and lengthen approval timelines. As a result, production becomes costlier and less competitive compared with regional peers, especially for industries that depend on advanced technology and high-quality inputs.

Figure 3.23 Top 5 NTMs Applied by Indonesia for Inbound Goods



Source: WITS (2024)

Free Trade Agreements, International Cooperation and Negotiations

Indonesia's expanding FTA network is expected to accelerate growth by boosting exports, investment, and industrial competitiveness. New agreements such as IEU-CEPA and IC-CEPA are projected to reduce tariffs on key export lines including textiles, fisheries, and base metals, helping increase export volume and margins. GTAP results show that the 90.4% scenario delivers stronger improvements across GDP, exports, and investment, with GDP rising 0.194% (Rp42.92 trillion), exports up 0.885% (Rp43.47 trillion), and investment increasing 0.182% (Rp22.27 trillion).[40] By 2026-2027, Indonesia is expected to benefit from deeper market access across Europe, the Middle East, and Africa.

Figure 3.24 Indonesia's FTA: From Implementation to Expansion (2025-2026)

Indonesia's Free Trade Agreements:
From Implementation to Expansion (2025-2026)

	Implemented FTAs/CEPAs/PTAs	
1	Indonesia-Japan EPA	EPA
2	Indonesia-Pakistan PTA	PTA
3	Indonesia-Chile CEPA	CEPA
4	Indonesia-Mozambique PTA	PTA
5	Indonesia-Korea CEPA	CEPA
6	Indonesia-EFTA CEPA	
7	ASEAN Trade in Goods Agreement	FTA
8	ASEAN-India FTA	FTA
9	ASEAN-Japan FTA	FTA
10	ASEAN-China FTA	FTA

	FTAs/CEPAs/PTAs Under Negotiation	
1	Indonesia-EU CEPA	CEPA
2	Indonesia-Canada CEPA	CEPA
3	Indonesia-Tunisia PTA	PTA
4	Indonesia-Egypt PTA	PTA
5	Indonesia-Morocco CEPA	PTA
6	Indonesia-South Africa	FTA
7	ASEAN-Canada FTA	
8	ASEAN-Gulf Cooperation Council (GCC)	FTA
9	Indonesia-Bangladesh PTA	PTA
10	ASEAN-Japan FTA	FTA

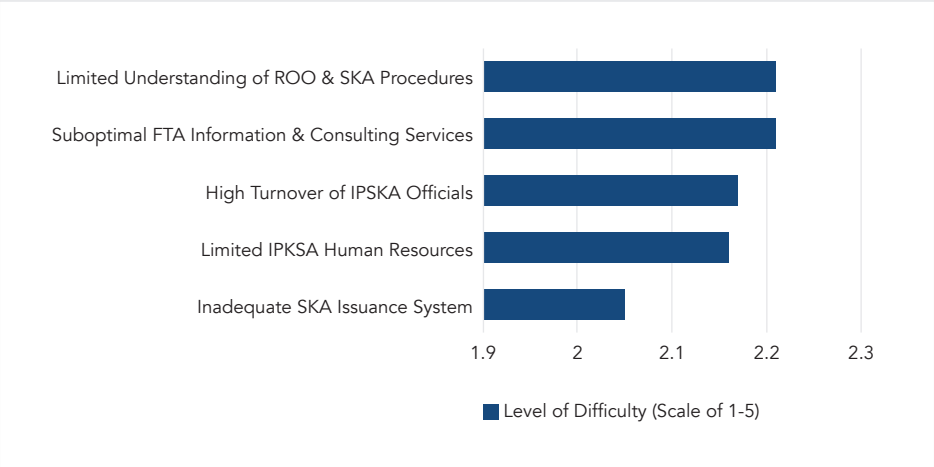
- 19 trade agreements implemented (ASEAN and Asia-Pacific focus)
- 10+ new agreements under negotiation (EU, Canada, Middle East, Fast, Africa)
- Expected to boost 2026 growth through tariff cuts and expanded market access

Source: Ministry of Trade (2025)

However, the government must remain cautious when pursuing new FTAs because existing agreements generate highly varied impacts. An evaluation study by LPEM and the Ministry of Trade shows that regional FTAs such as ACFTA, AIFTA, ATIGA, and AKFTA deliver the strongest trade gains, reaching 170-230%, while bilateral FTAs like IP-PTA (14.8%) and IJEPA (14.7%) produce smaller but still positive effects.[41] The study also identifies negative outcomes for ICCEPA and IACEPA, driven by trade diversion during the COVID-19 period and the long distance between Indonesia and Chile, which increases transport costs.

Despite these advantages, Indonesian exporters still face significant challenges in utilizing FTAs due to administrative and knowledge gaps. Studies show that exporters struggle with understanding rules of origin, preparing documentation, and navigating SKA issuance procedures. Human resource limitations, long service times, and low-quality support systems further complicate FTA utilization. Officials responsible for SKA processing frequently rotate, creating inconsistencies in guidance. These obstacles highlight the urgent need for capacity building and streamlined procedures to fully realize the benefits of Indonesia's growing FTA network.

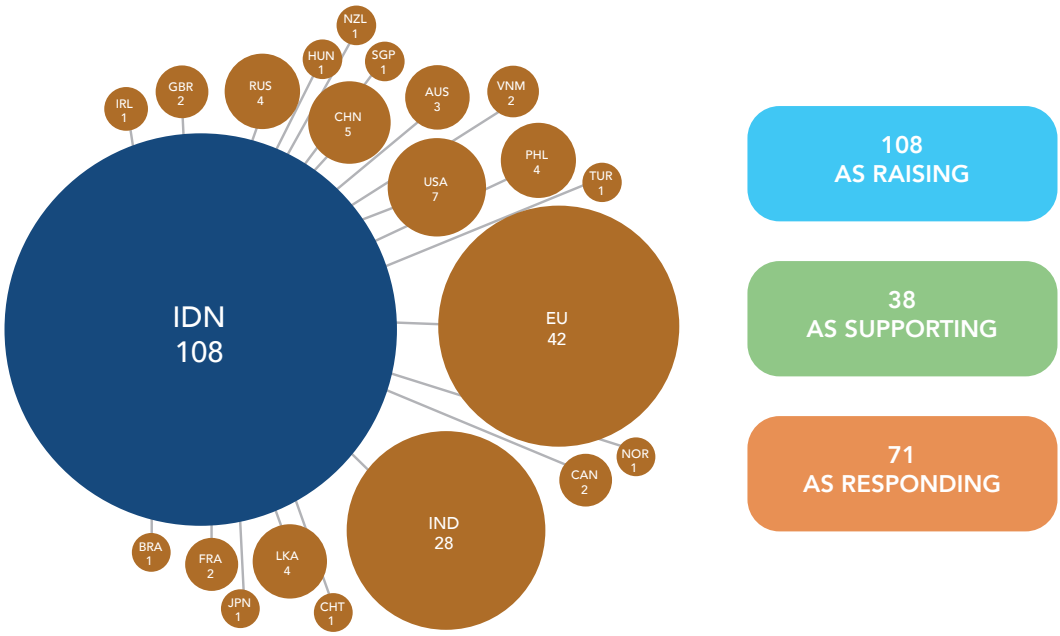
Figure 3.25 Top 5 Level of Difficulty of FOO/SKA



Source: LPEM and Directorate General of Customs and Excise Studies (2024)

Indonesia needs to harmonize non-tariff measures and strengthen rules of origin to improve FTA utilization. To accelerate NTM alignment, Indonesia should expand Mutual Recognition Agreements across strategic FTA sectors. Harmonizing technical, sanitary, phytosanitary, and environmental standards, together with smoother alignment with CBAM and EUDR, reduces compliance burdens, lowers cost-push risks, and creates a more predictable export pipeline. At the same time, rules of origin and cumulation provisions under ASEAN and RCEP deepen production integration by allowing regional inputs to qualify for origin, making it easier for firms to source components across Asia without losing tariff preferences. Full-cumulation ROO can further enhance Indonesia's regional supply-chain integration, but this requires strong digital infrastructure and skilled human resources

Figure 3.26 Mapping Indonesia's Trade Concerns and Partners in the WTO



Source: WTO (2024)

Indonesia's active role in the WTO enhances its capacity to safeguard market access and defend domestic policies. As one of the most active developing-country members, Indonesia has raised 108 STCs, responded to 71, and supported 35, demonstrating balanced multilateral engagement. WTO participation helps Indonesia navigate global tariff risks, green standards, and rising trade tensions while protecting export competitiveness. It also provides mechanisms to challenge unfair measures and prepare for potential new tariff pressures, including "Trump 2.0" actions. As SPS and TBT measures grow worldwide, WTO engagement remains essential for ensuring Indonesia's long-term trade resilience.

ASEAN provides Indonesia a coordinated platform for tariff response, supply-chain adjustment, and regional harmonization. Within ASEAN, Indonesia leverages agreements such as RCEP and ATIGA to align tariff reduction schedules, streamline customs procedures, and coordinate responses to shifting global trade policies. This regional coordination helps Indonesia anticipate US tariff escalations, adapt supply chains, and strengthen collective bargaining power in external negotiations. Deeper ASEAN integration also enhances trade facilitation through shared standards, faster border procedures, and more predictable regulatory environments. These benefits position Indonesia to integrate more effectively into regional production networks and strengthen its export competitiveness.

APEC serves as Indonesia's diversification channel to reduce dependence on China and build new trade pillars with advanced Pacific economies. Indonesia uses APEC 2040 cooperation to deepen ties with the United States, Japan, and Pacific partners through digital trade frameworks, logistics connectivity, and green-investment initiatives. By expanding partnerships beyond China, Indonesia reduces exposure to US-China tensions and gains access to higher-value markets and technologies. APEC cooperation also supports long-term competitiveness by promoting inclusive, sustainable, and innovation-driven trade practices.

Indonesia's ongoing OECD accession process is expected to generate substantial economic benefits, although it requires significant effort to align with standards applied by advanced economies. In model simulations, GDP growth is projected to increase by 0.78 ppts in the short run and 0.92 ppts in the medium run, supported by stronger investor confidence. Investment growth is also estimated to rise by 1.22-1.78 ppts, alongside around USD 87.7 billion in additional investment by 2028.[42]

Box A. Best Practices in Utilizing Free Trade Agreements (FTAs)

Thailand's experience shows how strong institutional readiness and industrial alignment can maximize the benefits of FTAs and boost export performance. Thailand recorded an 8.4 percent year-on-year increase in FTA-utilized exports, reaching US$60.25 billion (about $190 per person in the US) in 2025, reflecting how deeply its automotive and electronics sectors are integrated into regional value chains. Firms benefit from well-established local supply chains that make rules-of-origin compliance easier and increase value-added. **Early adoption of electronic customs and digital certificates of origin has reduced compliance costs to below 1 percent of export sales, enabling even SMEs to access preferential tariffs**. The government's active support, through HS classification assistance, ROO guidance, and targeted training, further strengthens firm-level capability and institutionalizes FTA utilization.

Vietnam's trajectory demonstrates how broad and deep FTA integration, combined with domestic capability building, can drive sustained export competitiveness. Viet Nam's "extent before depth" strategy has expanded the country's participation in regional and mega-regional FTAs while gradually deepening commitments on NTBs, services, standards, and digital trade. **The government improves firms' connectivity to global value chains through supplier development programs, supply-chain financing, and a business environment focused on reducing compliance costs**. Viet Nam also accelerates its shift to higher value-added activities by removing barriers to services trade, strengthening data flows, and enhancing intellectual property protection. This combination of market access and domestic reforms enables Viet Nam to integrate more deeply into complex production networks and capture greater domestic value-added.

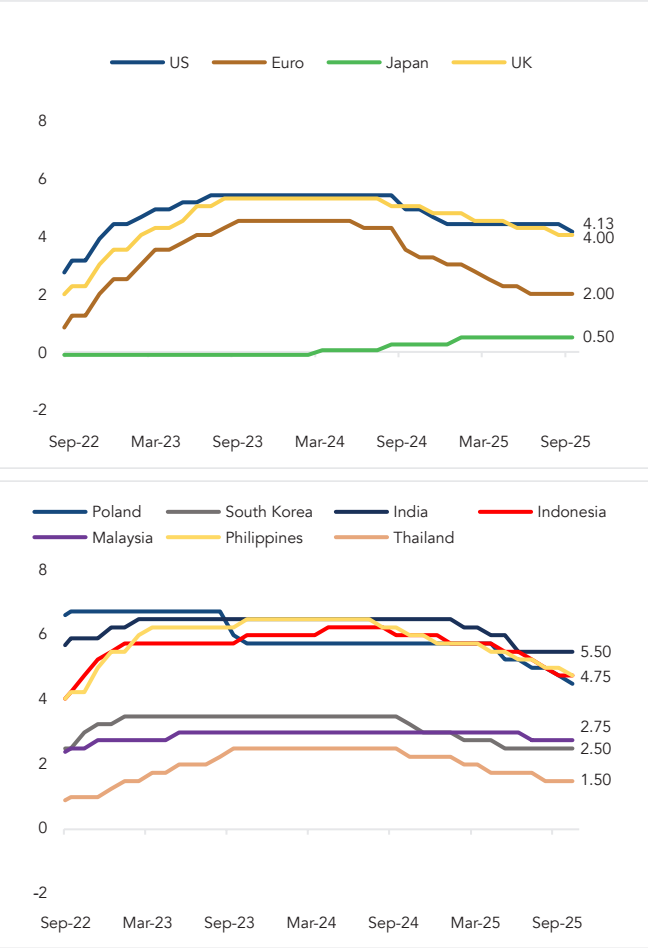
Indonesia can draw clear lessons from Thailand and Viet Nam on how to translate FTAs into real export gains through institutional strengthening and deeper value-chain integration. Both countries show that FTAs only deliver meaningful benefits when firms can meet rules-of-origin requirements, navigate administrative procedures with ease, and integrate into competitive local supply chains. For Indonesia, this means accelerating full digitalization of customs and certification systems, expanding ROO and HS classification support, and improving sector-specific training to reduce firm-level compliance barriers. Indonesia must also strengthen domestic supply-chain depth, especially in automotive, electronics, machinery, and agro-processing, so that firms can increase value-added and qualify for preferential tariffs. By combining better institutions with stronger industrial capabilities, Indonesia can maximize the benefits of its expanding FTA network and improve export competitiveness.

3.5. Exchange Rate and Portfolio Flows

Exchange Rate

In 2025, Indonesia faced a global environment that offered some relief yet still produced volatility through the global dollar cycle. Advanced economy policy rates peaked at about 5.375% in the US and 4.250% in the EU, then declined to around 4.125% and 2.000%, respectively (see Figure 3.27). We note that the Bank of Japan has recently increased its rate, but there is no clear guarantee that such unprecedented action will persist. At the same time, core inflation in these economies has eased. This creates room for a gradual expansion of global liquidity, even if real yields remain above pre-pandemic levels.

Figure 3.27 Policy Rates in Some Advanced and Emerging Economies (in %)

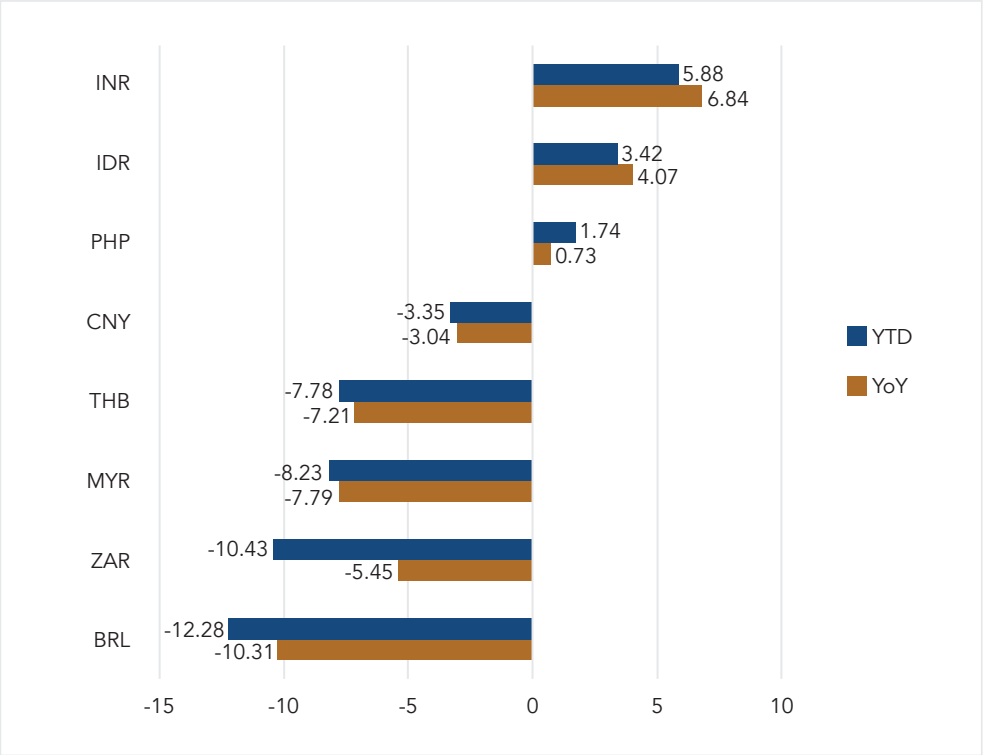


Source: Federal Reserves, European Central Bank, Bank of Japan, Bank Indonesia, and other selected central banks; LPEM FEB UI calculation

Bank Indonesia has followed the global easing cycle and has cut the policy rate. From January to September 2025, the policy rate fell from 5.75% to 4.75%, a reduction of 100 basis points, while core inflation stayed muted (see Figure 3.27). Domestically, the easing was facilitated by subdued core inflation and contained price pressures, providing room for policy support to growth. Such easing supported growth, but it also took place in a setting monetary transmission is limited and the rupiah remained exposed to the global dollar cycle and to episodic risk repricing.

The foreign exchange dynamics did not fade just because policy rates started to ease. When uncertainty rises, investors tend to move toward dollar assets and emerging market currencies often weaken. Figure 3.28 shows the rupiah depreciated by around 3.42% (YTD) and 4.07% (YoY), placing it among the weaker performers in the peer comparison. During one of the sharper stress episodes in March 2025, even BI intervened across the spot foreign exchange market, the bond market, and domestic non deliverable forwards (DNDF) to stabilize conditions as the Rupiah neared its weakest levels since the Asian Financial Crisis of 1998. The implication is that currency pressure can persist even when the global policy rates turn more supportive, because the dominant driver is often the dollar cycle and sudden risk repricing rather than domestic inflation dynamics alone.

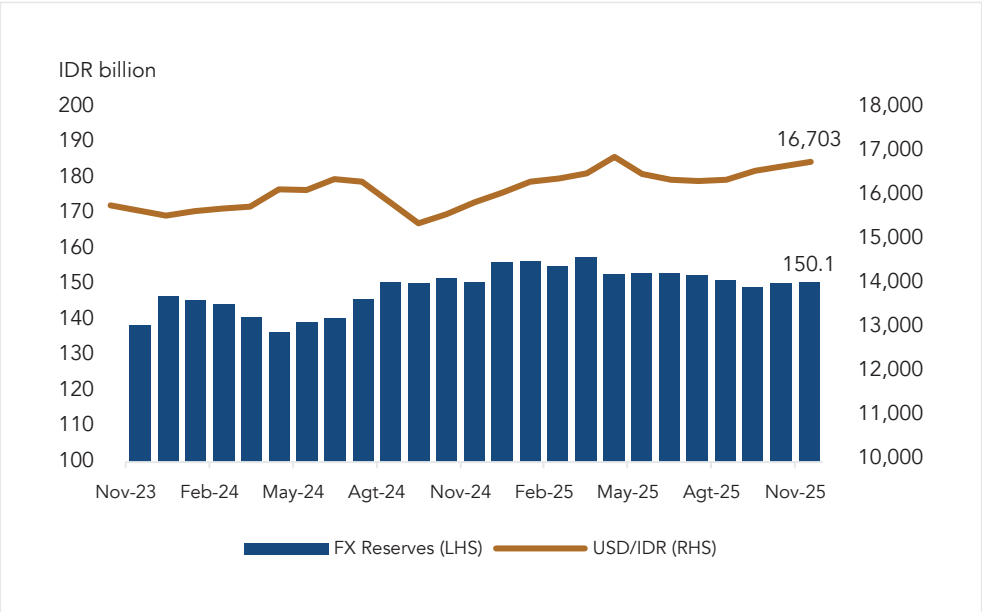
Figure 3.28 Depreciation Rate of Emerging Economy Currencies against the USD as of December 2025 (%)



Source: Investing.com; LPEM FEB UI calculation

Foreign exchange reserves acted as Indonesia's buffer, which helped limit all tail risks. Despite pressure on the Rupiah, Figure 3.29 shows that foreign exchange reserves remained large and even rose slightly from USD 149.9 billion at the end of October 2025 to USD 150.1 billion at the end of November 2025. BI assessed this level as sufficient to cover around six months of imports and government external debt servicing. These buffers and active market operations support confidence, but they do not fully remove exchange rate sensitivity to global shocks.

Figure 3.29 Foreign Exchange Reserves and USD/IDR



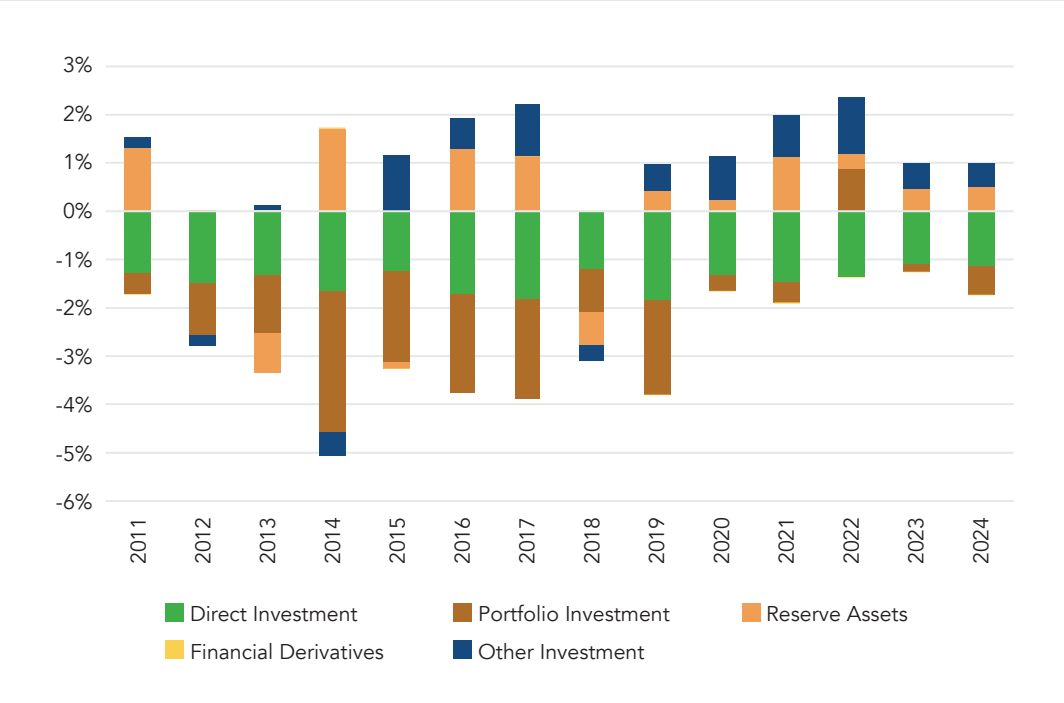
Source: Bank Indonesia; LPEM FEB UI calculation

For Indonesia, the relevant structural issue is that global pricing and hedging conditions remain anchored in US dollar markets. USD-denominated markets matters because Indonesia is still a net debtor economy, so valuation and funding conditions for rupiah assets remain associated to foreign risk appetite**.** In this context, the question is not whether the Rupiah can avoid volatility at all, but whether external positions and policy credibility are strong enough to prevent temporary pressure from turning into a broader stability problem.

Portfolio Flows

Indonesia's net international investment position remains in deficit, at around 19.3% of GDP in 2023 or about USD260,967 billion, although this is a clear improvement from a deficit of 40.7% of GDP a decade ago. The improvement has been supported by reserve accumulation from trade surpluses and more cautious external borrowing. Reserves rose, while net portfolio and other investment liabilities have fallen relative to GDP. In short, Indonesia has a safer external structure than in past cycles, but it has not moved into the group of net creditor countries. Its access to global capital still depends on the willingness of foreign firms, banks, and portfolio investors to hold rupiah assets and fund local projects.

Figure 3.30 Composition of Indonesia's Net International Investment Position (% GDP)



Source: IMF International Financial Statistics (IFS); LPEM FEB UI calculation

Relative to peers, Rupiah tends to be more sensitive than currencies of economies with deeper domestic capital markets and larger institutional investor bases, such as Malaysia. At the same time, policy credibility and reserve buffers have helped limit the tail risks that can emerge in frontier markets with weaker anchors. The reserves were mainly driven by commodity dominated export earnings. Commodity upturns strengthen the current account and support the Rupiah through larger foreign exchange inflows. Downturns can weaken external buffers and increase reliance on portfolio financing. Policy measures to strengthen onshore foreign exchange liquidity, including export earnings retention requirements for natural resource exporters, aim to reduce this vulnerability.

Indonesia enters 2026 with slightly stronger macro buffers than in earlier stress episodes, but the Rupiah and local asset prices remain sensitive to shifts in global risk sentiment. A stronger US dollar, driven by geopolitics and uncertainty, tends to compress risk appetite and raise hedging costs. As a result, portfolio flows become more pro cyclical and can reverse quickly during global risk off episodes, transmitting stress into the exchange rate, yields, and equity prices.

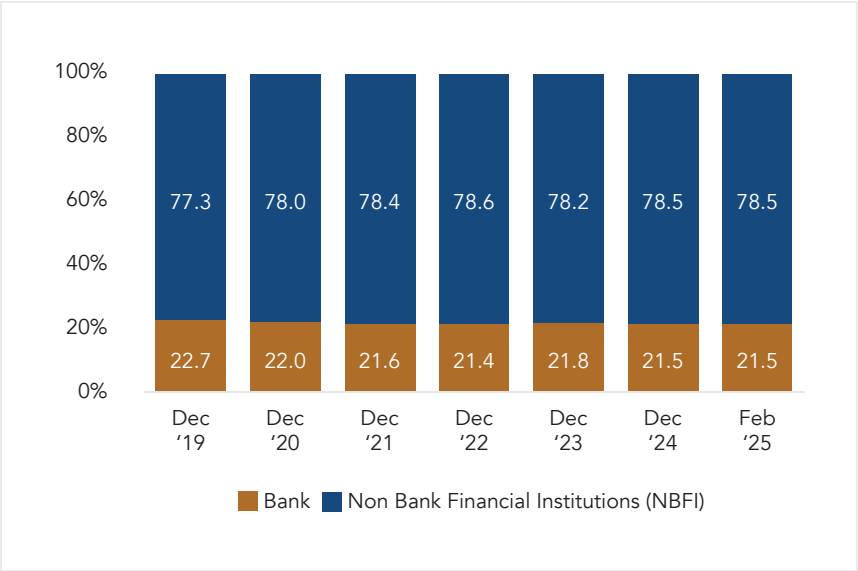
The 2026 outlook presents a picture of relative stability, though it remains persistently sensitive to global shocks, particularly those that strengthen the US dollar. While foreign reserves remain adequate and BI deploys multiple instruments to manage volatility, the global dollar cycle retains the capacity to trigger sharp portfolio moves. This persistent vulnerability implies that reliance on reserves alone is insufficient. It necessitates a structural shift to deepen domestic financial markets, which currently lack the capacity to absorb volatile inflows effectively.

Financial Depth

Indonesia's exposure to the global finance cycle is shaped not only by its external balance sheet structure, but also by the depth of its domestic financial market. Portfolio flows, particularly in debt instruments, tend to respond fast to global risk repricing. When domestic markets are thin, these shifts can translate into larger price swings in domestic yields and the exchange rate.

Domestic financial depth in Indonesia remains modest relative to ASEAN peers. Stock market capitalization is about 55% of GDP, compared with a median of about 75% in a peer group. Government bonds outstanding are roughly 28% of GDP, while corporate bonds amount to only about 2% of GDP. This implies that shifts in portfolio allocation, whether domestic or foreign, are concentrated in a narrower asset base.

Figure 3.31 Bank vs Non-Bank Financial Assets to Total Financial Assets (%)



Source: Bank Indonesia

The limited size of the corporate bond market also shows that firms rely mainly on bank lending and retained earnings. This keeps the financial system more bank centered and weakens the pass through from global easing to domestic financing. The proportion of bank assets continued to rise, reaching 78.5% of total financial assets in February 2025 from 77.3% in December 2019. At the same period, the assets of Non-Bank Financial Institutions (NBFI) share declined to 21.5% from 22.7% of total financial assets as shown in Figure 3.31. As a result, private financing may remain tighter even when global interest rates fall.

Thin financial markets also reflect limited breadth of investable instruments. In equities, a limited set of large and liquid stocks carries a disproportionate share of trading and index exposure. In bonds, liquidity clusters in benchmark government securities, while non benchmark tenors and corporate trade far less. Even when macro-outlook is supportive, it is hard for investors to scale exposure without pushing prices, so adjustments occur through wider spreads and larger yield moves rather than smooth rebalancing across many instruments.

Limited liquidity amplifies the constraints presented from the shallow financial market. When risk sentiment turns, foreign investors can reduce exposure to rupiah assets, and the adjustment spills into yields and the exchange rate because foreign exchange and bond markets are linked through hedging and cross asset allocation. In deeper markets, broader participation absorbs these shifts. In thinner markets, however, selling pressure translates into higher yield volatility and wider exchange rate moves.

Overall, thin markets raise risk premia and slow the price response to shifts in global conditions. This limits the scope for market-based funding to take over from bank credit even if global interest rates move in the next few years.

In 2026, lower global policy rates reduce pressure on cost of funds, but the benefits may be limited without deeper domestic financial markets. In the baseline scenario, yield ease only gradually, with volatility episodes when global positioning turns, because liquidity is concentrated and the investable instruments remain narrow. In the upside case, continued growth of domestic institutional investors and more corporate issuance broadens the market, improving shock absorption. Realizing this upside would likely require supportive policy levers, including the expansion of pension funds and insurance assets under management, targeted tax incentives to encourage market participation, and the development of repo and hedging instruments to deepen liquidity and risk management.

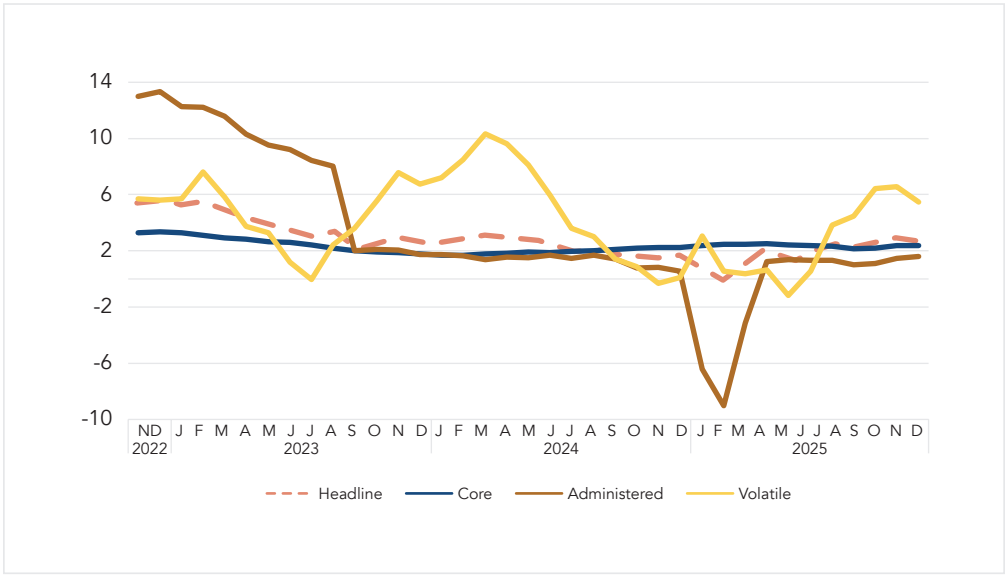
3.6. Inflation

Indonesia's inflation dynamics in 2025 continue to reflect the structurally supply-driven nature of price formation. Headline inflation is shaped not only by food and administered prices, but increasingly by movements in global commodity prices, specifically metal prices, which enter the consumer basket through specific channels. Recent inflation outcomes illustrate that underlying price pressures remain contained, even as headline inflation rises from exceptionally low levels earlier in the year. By the final quarter of 2025, headline inflation stabilized at around 2.7% (YoY) to 2.9% (YoY), a level that remains moderate by historical standards but masks important compositional shifts in inflation drivers.

Core inflation remained consistently lower than headline inflation throughout 2025, hovering around 2.3% (YoY) to 2.4% (YoY) toward the end of the year (Figure 3.32). This gap between headline and core inflation signals that recent price pressures are not broad-based. Instead, they are concentrated in specific commodity-related components. Weak demand-pull pressures continue to

characterize the economy. As explained in another section, this suggests uneven household purchasing power, limited real wage growth, and persistent labor market informality. These conditions constrain firms' pricing power and limit the transmission of cost shocks into generalized inflation, reinforcing the view that underlying inflation momentum remains subdued.

Figure 3.32 Inflation Rate (%, YoY)



Source: Statistics Indonesia

Food prices continue to play a dominant role in shaping headline inflation volatility. The food, beverages, and tobacco category, one of the largest components of the consumer price index, recorded inflation of close to 5% (YoY) in October 2025, contributing more than one percentage point to headline inflation. Subsequent moderation in volatile food prices led to a slight easing in headline inflation in November. This pattern is consistent with historical CPI decomposition, which shows that food price spikes account for the bulk of short-term inflation movements in Indonesia, while their impact on core inflation remains limited. Seasonal factors, weather disturbances, and distribution bottlenecks continue to generate episodic supply shocks, which tend to dissipate as supply conditions normalize.

In 2025, however, inflation dynamics have been increasingly influenced by developments in gold prices, which emerged as an important but often underappreciated contributor to headline inflation. Gold prices rose sharply over the course of the year, driven by global factors such as heightened geopolitical uncertainty, sustained demand for safe-haven assets, and expectations of prolonged global financial volatility. International gold prices increased by more than 20 % (YoY) in 2025, reaching historical highs. In Indonesia, this surge translated directly into higher prices for gold jewelry, which is explicitly included in the CPI basket under personal goods.

The inflationary impact of gold prices is particularly relevant in the Indonesian context, where gold jewelry plays a dual role as a consumption good and a store of value. CPI data show that the gold jewelry component recorded double-digit year-on-year inflation during several months in 2025, making it one of the fastest-growing price items in the consumer basket. Although its weight in the CPI is smaller than that of food, the magnitude and persistence of gold price increases meant that gold contributed non-negligibly to headline inflation. In periods when food inflation moderated, rising gold prices helped keep headline inflation elevated, altering the usual pattern in which food dominates inflation outcomes.

Importantly, gold-driven inflation differs fundamentally from demand-driven price pressures. The rise in gold prices reflects global asset-market dynamics rather than domestic consumption strength. Higher gold prices do not signal overheating in household demand; instead, they reflect increased precautionary savings behavior and portfolio reallocation toward safe assets. As a result, the inflationary impulse from gold prices operates through a narrow CPI channel and has not spill over into broader goods and services prices. This is consistent with the continued stability of core inflation despite sharp increases in gold jewelry prices.

Administered prices continued to shape inflation through discrete level effects. Adjustments to regulated prices, including electricity tariffs and transportation-related costs, generated temporary increases in headline inflation during certain months in 2025. CPI data show that these adjustments tend to have a front-loaded impact, raising inflation sharply in the month of adjustment before fading in subsequent periods. As in previous episodes, these price changes did not translate into sustained inflation acceleration, reinforcing the interpretation that administered prices affect the price level rather than the inflation trend.

External cost pressures also played a role, though their transmission to inflation remained muted. Exchange rate movements and global commodity prices influenced domestic prices for imported goods, but the pass-through to inflation was limited. Even during periods of currency pressure, inflation responses were modest, reflecting firms' absorption of higher costs and the weak demand environment. The contrast between the strong pass-through from gold prices and the weaker pass-through from other imported goods highlights the unique role of gold as both a consumer item and an investment asset in Indonesia's CPI.

Taken together, inflation developments in 2025 highlight a shift in the composition of headline inflation drivers. While food prices remain the primary source of volatility, gold prices have emerged as an additional and quantitatively meaningful contributor. This helps explain why headline inflation remained elevated even when food inflation temporarily eased. At the same time, the persistence of low core inflation confirms that these pressures remain narrowly concentrated and do not reflect generalized inflationary momentum.

Looking ahead toward 2026, Indonesia's inflation outlook remains broadly stable but subject to continued volatility from commodity-related components. On the demand side, structural conditions suggest limited risk of sustained inflation acceleration. Labor market data indicate that employment growth remains concentrated in informal and low-productivity sectors, constraining aggregate wage growth. Without a significant improvement in productivity, cost-push inflation from labor is expected to remain subdued.

On the supply side, food prices will continue to pose episodic risks, particularly in the context of climate variability and structural constraints in agricultural production and distribution. Gold prices represent an additional source of uncertainty. If global financial uncertainty persists, gold prices may remain elevated, continuing to exert upward pressure on headline inflation through the jewelry component of the CPI. However, as in 2025, such pressures are likely to remain segmented and unlikely to propagate into core inflation.

Overall, Indonesia's inflation outlook toward 2026 is characterized by low underlying inflation combined with headline volatility driven by specific commodities, notably food and gold. The emergence of gold prices as a meaningful inflation driver in 2025 highlights the importance of examining CPI composition rather than relying solely on aggregate inflation figures. Inflation in Indonesia remains best understood

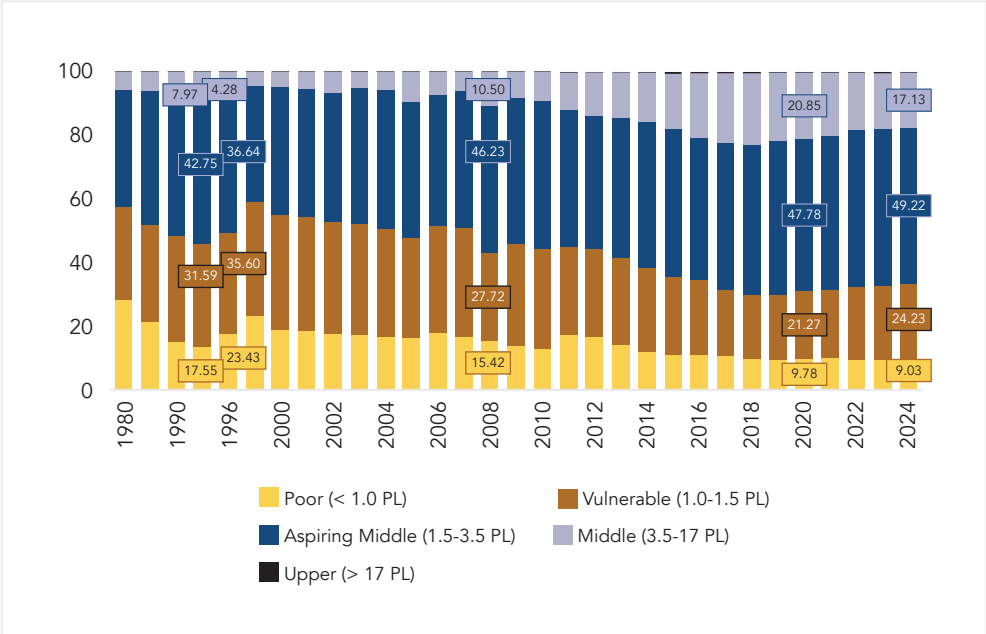
as a structurally driven phenomenon, where supply-side and asset-price-linked shocks shape short-term outcomes, while underlying inflation remains anchored by weak demand and limited pricing power. Considering these factors, inflation is expected to remain well within BI's target range of 1.5% to 3.5%.

3.7. Consumption and Credit

Household consumption growth remains slower than GDP, but the divergence has steadily narrowed over time. Public concern over eroding purchasing power has intensified over the year of 2025. This concern is economically consequential because household spending contributes more than half of Indonesia's total output, so prolonged weak household demand would directly weigh on growth and welfare outcomes.

As of 2024, 9.03% of Indonesia's population remains below the national poverty line (see Figure 3.33). The population profile is heavily skewed toward lower income groups, with around 9% classified as poor, 24% as vulnerable, and 49% in the aspiring middle class (see Figure 3.33). As a result, only about one in five Indonesians can be considered as middle-income class or above. The three bottom segments face the earliest and strongest erosion of purchasing power when prices of essentials such as food, fuel, or public transport rise. Their household spending is dominated by basic necessities, and their savings buffers are limited, leaving little room to absorb cost increases without adjusting consumption.

Figure 3.33 Population by Class (%)

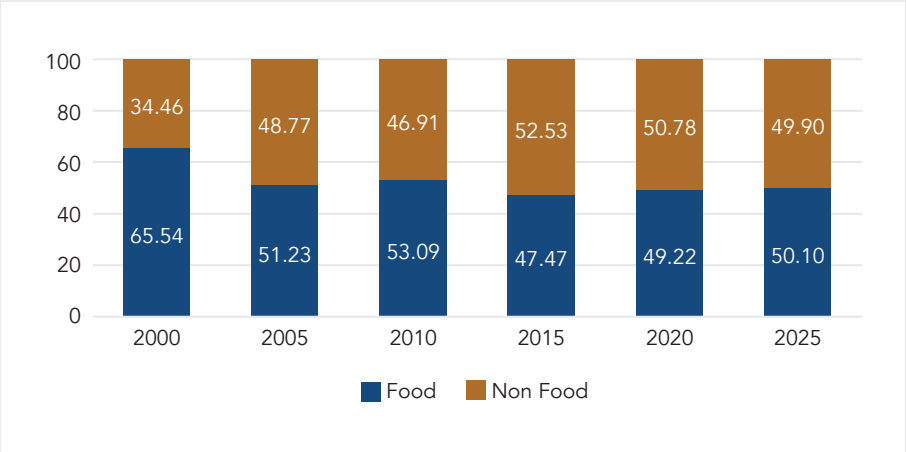


Source: Statistics Indonesia; LPEM FEB UI calculation.

The aspiring middle class has emerged as the largest single group, representing approximately 49% of the population in 2024. Although they have moved beyond poverty, their economic position remains fragile. Persistent increases in staple food or energy prices can halt their progress, reduce discretionary outlays, and dampen the domestic consumption dynamics that have supported recent growth. At the same time, poor and vulnerable households still account for roughly one-third of the population. Even small declines in real income among these groups could push large numbers back below the poverty line, exacerbating inequality and placing additional strain on social cohesion.

The structure of household spending provides a useful lens to assess purchasing power. Rising food shares across most income groups point to renewed pressure on household purchasing power. At the aggregate level, the share of food expenditure declined steadily from 65.54% in 2000 to 47.47% in 2015, before turning upward and reaching 50.10% in 2024 (see Figure 3.34). This reversal indicates a renewed shift toward essential consumption.

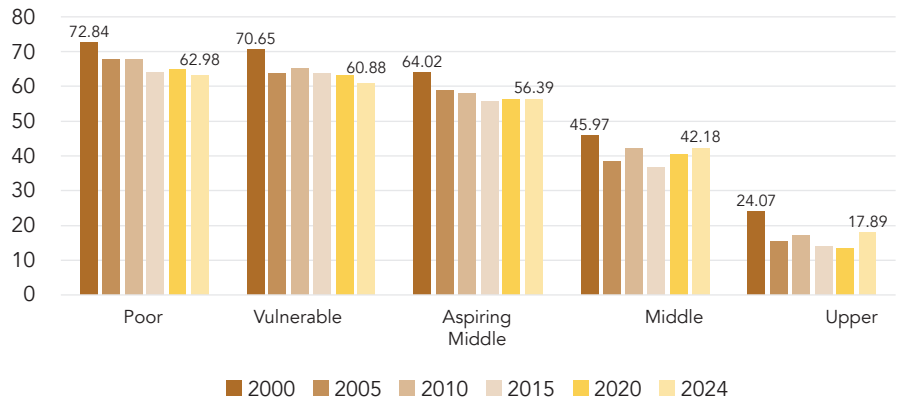
Figure 3.34 Food and Nonfood Expenditure (%)



Source: Statistics Indonesia; LPEM FEB UI calculation.

Disaggregation by income group reinforces this signal that essential consumption remains dominant in household consumption basket. Among poor and vulnerable households, food expenditure shares have eased modestly over the 2000-2024 period but remain persistently high, exceeding 60% of total spending. This level suggests limited flexibility in consumption choices of the poor and vulnerable groups despite gradual improvement.

Figure 3.35 Share of Food to Total Expenditure



Source: Statistics Indonesia; LPEM FEB UI calculation.

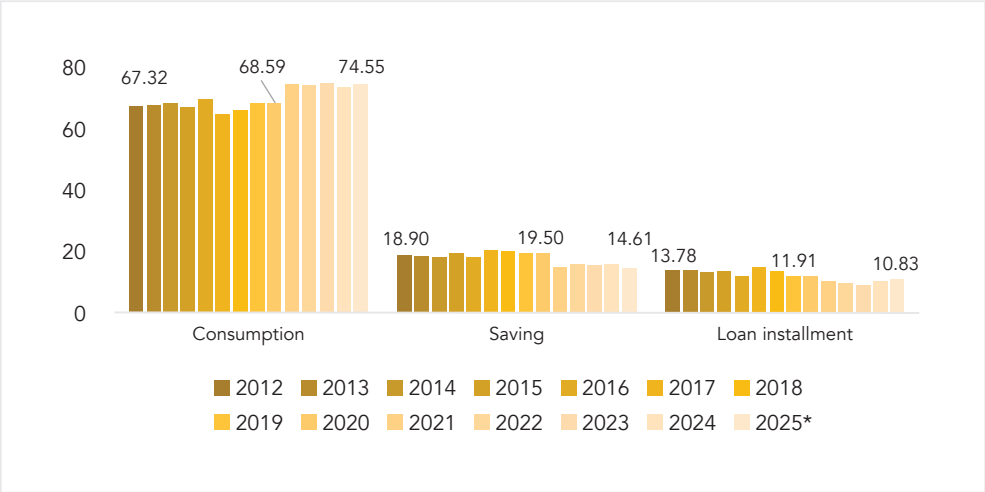
In contrast, higher income groups exhibit a clear break from their earlier trend with visible increase in food consumption in recent years. For the aspiring middle class, the food share declined from 64.02% in 2000 to 55.66% in 2015, then increased again to 56.39% by 2024 (see Figure 3.35). The middle class follows the same pattern, with food expenditure falling from 45.97% to 36.60% over 2000-

2015, before rising to 42.18% in 2024. Even among upper income households, where food accounts for less than one fifth of total expenditure, the share increased from 13.82% in 2015 to 17.89% in 2024.

The broad-based rise in food expenditure shares among aspiring middle-, middle-, and upper-income households is consistent with their limited coverage by social assistance programs. More fundamentally, the shift implies that households outside the poor and vulnerable groups are allocating a larger portion of income to necessities, reducing room for discretionary spending. This pattern points to a more widespread weakening of purchasing power, extending beyond traditionally protected or resilient segments of the population.

Recent consumption resilience has increasingly been financed by savings drawdowns and higher debt servicing. Household income utilization data shed light on the mechanisms behind mounting purchasing power pressures. Over 2012-2025, the proportion of income devoted to consumption rose from 67.3% to 74.6%, while the shares allocated to savings and loan repayments moved in the opposite direction (see Figure 3.36).

Figure 3.36 Household Income Use (%)



Source: Bank Indonesia; LPEM FEB UI calculation.
Note: The 2025 average is from Jan-May

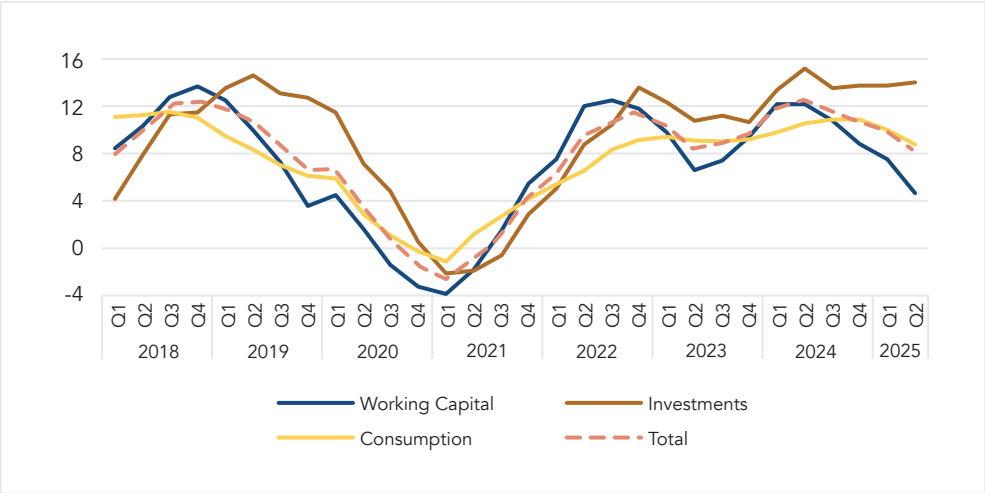
The impact of short-term stress is most visible in the peak of pandemic in 2021. At the height of COVID-19 restrictions and economic contraction, the consumption share jumped to 75%, while the savings rate dropped sharply to 14.7%. As household incomes were falling at the time, this pattern indicates that households drew down accumulated buffers to sustain basic spending needs.

Importantly, adjustment in consumption has not fully reversed despite the economy has started to recover after the pandemic crisis. By early 2025, the consumption share remained elevated at 74.6%, with only a marginal retreat from its pandemic peak, while the savings rate slipped further to 14.6% (see Figure 3.36). This persistence suggests that recent consumption growth has been supported less by rising incomes and more by continued reductions in savings. At the same time, debt obligations have taken up a growing share of household income. Loan repayments increased from 9.0% in 2023 to 10.8% in Q1-2025 (see Figure 3.36).

Consumption credit continued to lose momentum, reinforcing signs of weakening household demand. As shown on Figure 3.37, overall credit growth slowed to 8.36% (YoY) in Q2-2025 from 9.91% (YoY) in Q1-2025, driven mainly by weaker consumption credit and a moderation in working capital

credit. Consumption credit growth decelerated to 8.76% (YoY) in Q2-2025 from 10.00% (YoY) in the previous quarter. This slowdown is closely aligned with pressures on household purchasing power, as indicated by the decline in the Consumer Confidence Index, which averaged 119.0 in Q2-2025, down from 124.9 in Q1-2025.

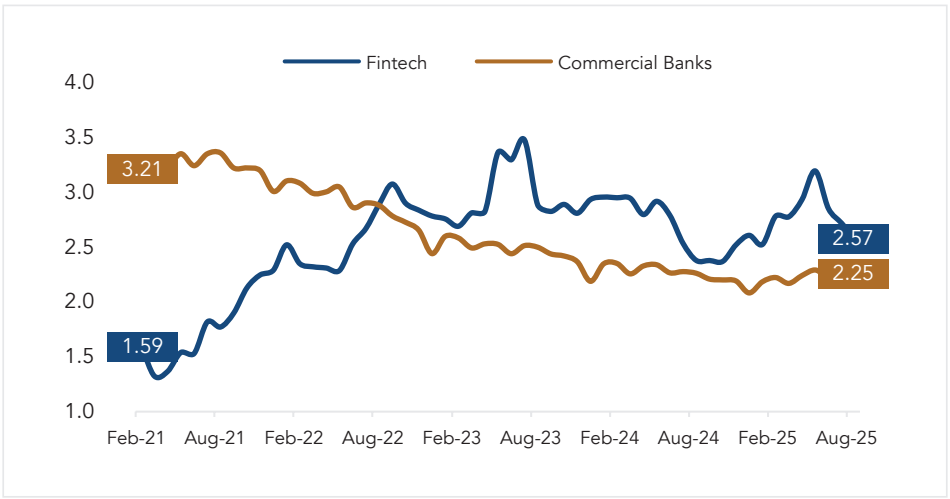
Figure 3.37 Credit Growth



Source: Bank Indonesia; LPEM FEB UI calculation.

On the non-bank financial institutions side, fintech lenders and buy-now pay-later schemes are expanding fast. Their outstanding credit has reached around IDR87 trillion in August 2025, which is comparable to 0.01% of total bank credit. These platforms help households and SMEs that have limited access to banks, yet this financing opportunities come with higher lending rates and simpler credit checks that weaken risk assessment. Reported non-performing loan ratios are around 2.57% for fintech portfolios compared with 2.25% for commercial banks. Nevertheless, limited disclosure of fintech lenders means the actual level of risk may be higher.

Figure 3.38 Non-Performing Loans of Fintech vs. Commercial Banks (%)



Source: Bank Indonesia, Indonesia Financial Services Authority (OJK); LPEM FEB UI calculation

At the same time, signs of stress in household balance sheets are increasing. Transactions linked to online gambling are estimated at around IDR359 trillion throughout 2024[43], and survey evidence suggests that a notable share of households report gambling related losses.[44] These developments erode savings and shift credit demand toward non-productive uses.

Taken together, household consumption is expected to remain subdued in 2026. With household consumption accounting for more than half of GDP, weak consumption implies that overall economic growth will rely more on investment and government expenditure. Consumption momentum remains constrained by weak real income growth, rising cost-of-living pressures, and limited expansion in formal employment. At the same time, consumption is unlikely to receive strong support from credit as credit growth is expected to remain moderate. With savings rates already low and a rising share of income devoted to loan repayments, households have limited capacity to rely on additional borrowing to sustain spending, reinforcing the likelihood that domestic demand in 2026 will remain steady but structurally weak rather than accelerating. From a fiscal perspective, weaker consumption growth may temper indirect tax revenues, particularly VAT, reducing automatic revenue gains as well as implying the importance of public expenditure reprioritization.

3.8. Labor Market Performance

Indonesia's labor market performance towards 2026 is determined by external pressures and domestic structural changes impacting unemployment, job quality, and household purchasing power. External pressures include global policy uncertainty, geopolitical risks, and rising trade barriers projected to lower world economic growth.[45] These dynamics dampen international trade while driving the relocation of global supply chains. One of which is reflected in the surge of Chinese exports to ASEAN countries, **thus opening opportunities** for the region as a manufacturing hub. Despite these shifts, Indonesia has struggled to translate global rebalancing into sustained and high-quality job creation. Looking ahead to 2026, unemployment is expected to remain broadly stable, but vulnerable in job quality, with employment growth likely concentrated in low-productivity sectors unless industrial competitiveness, labor-intensive investment, and skills upgrading are strengthened.

Amid those regional opportunities, Indonesia faces challenges, as it continues to lag behind other ASEAN countries, particularly Vietnam in capturing export market shares from China. In addition, Vietnam ranks as the second-largest exporter to China within ASEAN.[46], [47] This challenge arises due to several factors, including Vietnam's more transparent and predictable non-tariff measure regulations, which make trade navigation easier, thus supporting export performance.[48] Moreover, Vietnam's trade competitiveness is strengthened through its cheap labor force,[49] compared to Indonesia's, thus Vietnam has overcome Indonesia in maintaining share of labor-intensive exports (manufacturing).[50] Indonesia is also experiencing technological lag compared to Vietnam due to its lack of an overarching industrial policy to support businesses in climbing the technological ladder.[51]

Another external pressure arises from China's industrial overcapacity, which has triggered a flood of cheap products into the global market, including Indonesia.[52] This condition has severely impacted the domestic textile and garment industries, triggering mass layoffs as local companies are unable to compete. This situation indicates that global competition in labor-intensive sectors is narrowing the opportunities for creating quality jobs in Indonesia without significant improvements in logistics efficiency, trade policy, and production cost competitiveness.

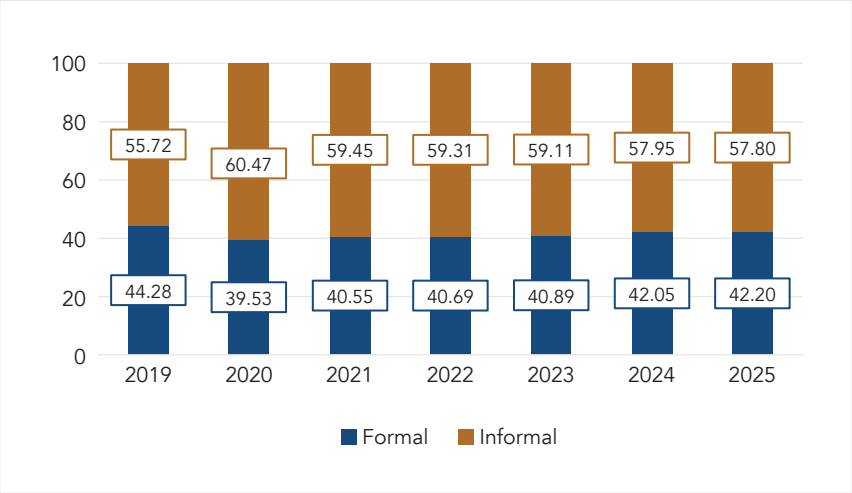
Amid relatively stable growth, Indonesia's economic structure has continued to shift.* The agricultural sector's share of GDP declined from 13.93% in 2015 to 13.18% in 2024, though it remains

* Sector classification: Low-value added services comprise wholesale and retail trade, accommodation, food and beverages activity, public administration, education, health and social work, and other services; High-value added services include transportation and storage, information and communication, financial and insurance activity, real estate, and business services; Others cover mining and quarrying, construction, electricity and gas supply, and water supply, waste, and recycling.

a major employer, with its employment share falling from 32.88% to 28.18%. Manufacturing's GDP share also dropped from 21.67% to 19.84%, while its employment share rose slightly, indicating limited productivity gains. Low-value-added services experienced a slight decline in their GDP share but saw a rise in employment, confirming their role as key employment generators. Meanwhile, high-value-added services expanded in both output and employment, signaling a gradual shift toward higher-productivity activities.

Labor market conditions remain broadly stable. From August 2024 to August 2025, the unemployment rate inched down from 4.91 to 4.85 percent, but the number of unemployed stayed around 7.46 million, showing limited job creation. Labor force participation remained steady, and urban unemployment continued to be higher than the national average, indicating slower job growth in cities. Since 2021, formal employment has continued to increase slightly, reaching 42.20% in 2025 (Figure 3.39), while underemployment increased and full-time work declined, pointing to persistent informality and weak job quality. By 2024, informal employment in rural areas continued to rise, while in urban areas it initially declined but later increased again with the expansion of gig-economy platforms and micro-enterprise activities. The biggest shift within informality is the movement of workers out of agriculture into low-value-added urban services like retail, accommodation, and personal services, which offer only slightly higher productivity and wages.

Figure 3.39 Proportion of Formal and Informal Workers (%), 2019-2024



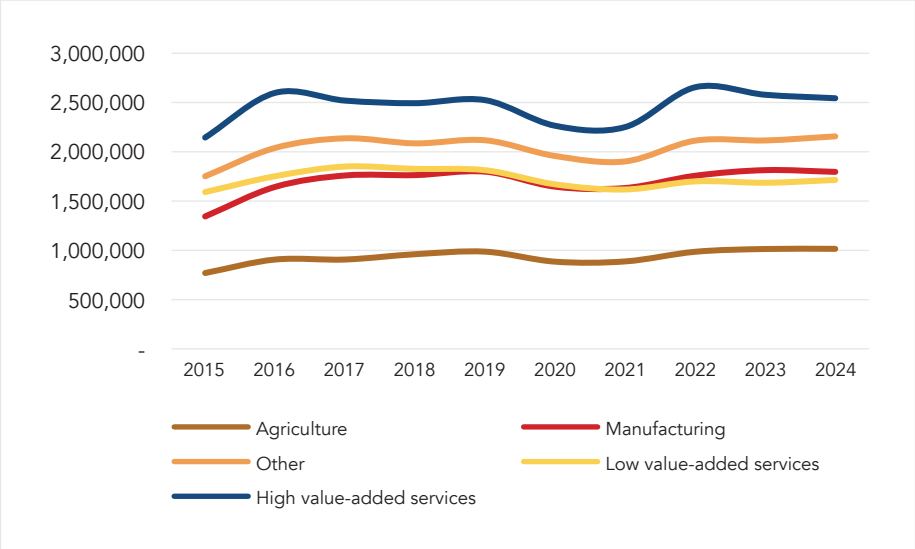
Source: Statistics Indonesia; LPEM FEB UI calculation

Although labor market indicators generally appear stable, underlying dynamics show limitations in job creation.[53] Layoffs have tripled in the last three years, reaching 78,000 cases in 2024 and over 42,000 cases in the first half of 2025. Unemployment remains very high among the youth group, especially those aged 15-24 years, reaching over 16 percent, while unemployment among high school/vocational graduates reached 8%, indicating high competition for entering the workforce despite being specifically educated for industrial needs. The creation of 3.6 million new jobs up to February 2025 was largely concentrated in low-wage sectors. This continued concentration of employment in low-productivity and low-wage sectors can limit improvements in household purchasing power.

Real wage trends mirror sectoral productivity patterns. Although real wages rose steadily between 2010 and 2024, income gaps persist across sectors (Figure 3.40). High-value-added services consistently offer the highest wages, reflecting their higher productivity. Manufacturing wages have

increased but only surpassed those in low-value-added services after 2021. Agriculture remains at the bottom of the wage distribution, employing many workers but generating limited income growth.

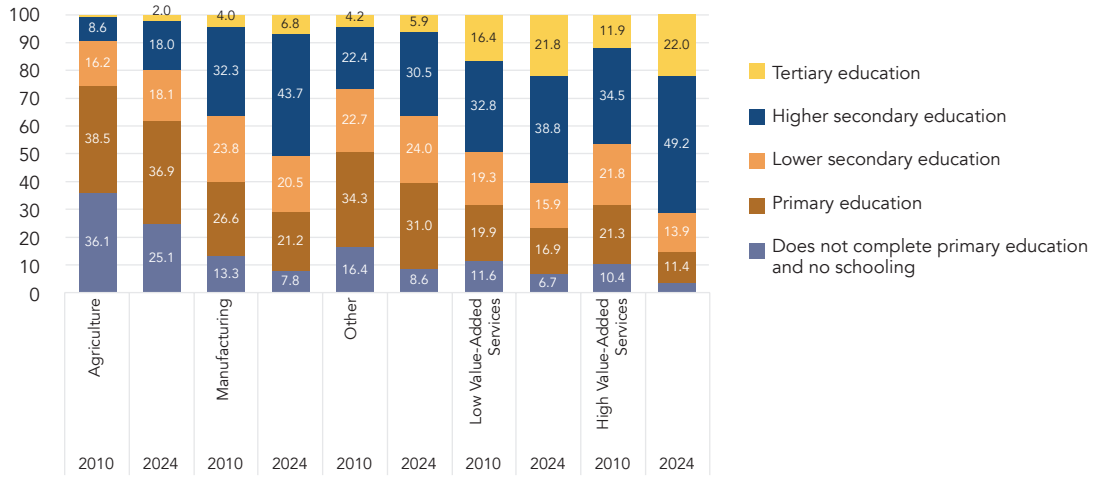
Figure 3.40 Real Wage by Sector (IDR), 2015-2024



Source: Statistics Indonesia; LPEM FEB UI calculation
Note: Real wages are obtained by dividing nominal wages by the consumer price index

High-quality job creation could potentially be driven by investment in labor-intensive industries, but Indonesia's investment trend is moving in the opposite direction.[54] In recent years, particularly since the implementation of the downstreaming policy in 2020, investment has focused heavily on capital-intensive extractive sectors. Although total investment value has surged, the number of jobs created per trillion rupiah of investment continues to decline, signalling that investment growth is not generating a proportional demand for labor. This highlights Indonesia's reliance on capital-intensive industries, which provide relatively few jobs.

Figure 3.41 Worker's Educational Attainment by Sector (%), 2010 and 2024



Source: Statistics Indonesia; LPEM FEB UI calculation

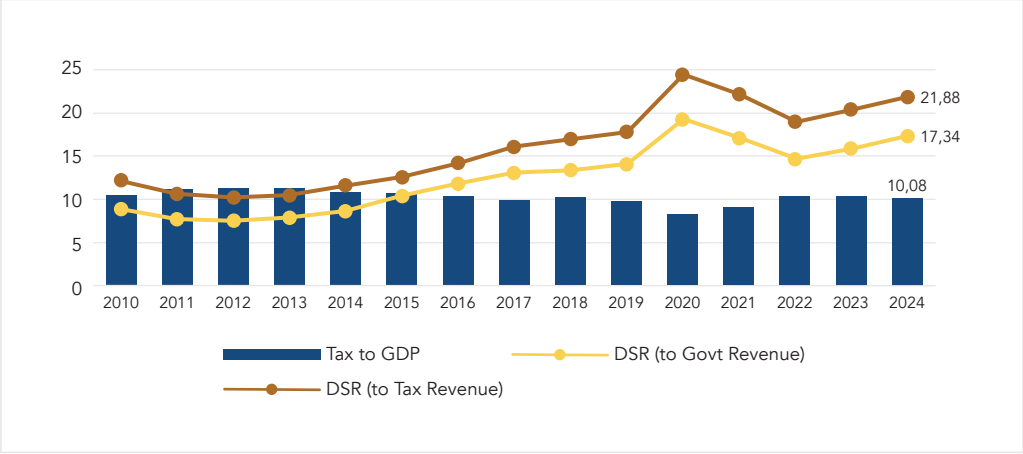
Wage differences across sectors partly reflect variations in workers' educational attainment. In agriculture, about 75% of workers in 2010 had only primary or less education, declining to 62% in 2024, but the sector remains dominated by low-skilled labor, limiting productivity growth (Figure 3.41). In contrast, high-value-added services consistently employ more educated workers, with the share of those holding upper secondary or tertiary education rising from 46% in 2010 to over 71% in 2024. Low-value-added services and manufacturing show similar upward trends, though from lower bases. Overall, sectors with better-educated workforces tend to offer higher wages and stronger productivity.

3.9. Fiscal

Indonesia's fiscal space is increasingly constrained by structurally weak revenues, rising debt service, and expenditure reallocation that limits growth-enhancing spending. At the central government level, Indonesia faces two closely linked challenges: persistently weak revenue mobilization and growing pressure on the composition of public spending. Government revenue performance has shown little improvement over time. The tax-to-GDP ratio has trended downward since 2008 and has remained stuck at around 10% since 2014 (see Figure 3.42). This weak performance reflects structural issues, including a large share of workers outside the tax system, a high presumptive tax threshold, a complex cigarette excise structure, and limited productive spending to support long-term growth.[55] Looking ahead, the downward pressure on the tax ratio is likely to persist in 2026.

Recent revenue realization further underscores these constraints. As of 30 November 2025, total state revenue reached approximately IDR 2,351.5 trillion, equivalent to around 82.1%[56] of the full-year target, compared with about 89%[57] of the annual target achieved over the same period in 2024. While revenue collections typically strengthen in December, the weaker realization by end-November suggests that achieving the full-year revenue target may be more challenging than in the previous year. Looking ahead, the 2026 revenue target is set at IDR3,153.6 trillion,[58] representing an increase of roughly 5% relative to the 2025 revenue target. Achieving this target will require a meaningful strengthening in revenue mobilization and policy execution, particularly in light of softer revenue performance throughout most of 2025.

Figure 3.42 Tax to GDP & Debt Service Ratio (%), 2010-2024



Source: Bank of Indonesia; LPEM FEB UI calculation
Note: Excise duties & Duties on Land and Building are excluded from tax income

The disconnect between economic activity and tax revenue performance has become increasingly evident. In 2025, GDP growth remained close to 5%, yet tax revenues contracted by 3.9% as of October, highlighting renewed strain on the revenue base despite stable macroeconomic conditions.[59]

Weak revenue mobilization has led to sustained fiscal deficits. Outside the COVID-19 period, deficits have remained below the 3% of GDP ceiling mandated by fiscal rules, but this apparent discipline masks rising financing pressures. With government bond yields hovering around 6%, Indonesia faces higher borrowing costs than many peer economies. These costs increase interest payments and crowd out fiscal space that could otherwise be used for productive expenditures, particularly capital spending.

As a result, debt servicing has absorbed a growing share of public resources. Debt service ratios have risen structurally since the mid-2010s, with a sharp step-up during the pandemic and only partial normalization afterward. In the early 2010s, debt service remained manageable, with ratios to government revenue generally below 10% and ratios to tax revenue around 10-12% during 2010-2014 (see Figure 3.43). Pressures intensified from 2015 onward as revenue performance weakened. The deterioration peaked in 2020-2021, when the debt service ratio to government revenue surged to 19.28% in 2020 and remained high at 17.12% in 2021, while the ratio to tax revenue spiked to 24.44% and 22.19%, respectively. Although revenue recovery in 2022 brought some relief, debt servicing has remained structurally elevated. By 2024, debt service absorbed 17.34% of government revenue and 21.88% of tax revenue, significantly higher than pre-pandemic levels, further compressing fiscal space. Looking ahead, debt service is expected to continue consuming a sizable share of government resources. Unless offset by stronger revenue performance or lower borrowing costs, the high share of resources devoted to debt servicing will limit government's capacity to expand growth-enhancing spending in the coming years.

Against the backdrop of tight revenues and rising debt service, expenditure reallocation has added another layer of constraint. With Presidential Instruction (Inpres) No. 1/2025, the government reallocated IDR306 trillion, or about 8.5% of the 2025 budget. This policy reduced central government spending by IDR256 trillion and transfers to regional governments by approximately IDR50 trillion. The reallocated funds will mainly support two programs: the Free Nutritious Meals Program (MBG) with IDR71 trillion, and the creation of the Indonesian Sovereign Wealth Fund (Danantara), though its exact funding amount is still uncertain. Sovereign wealth funds are commonly used, for example by Malaysia, Singapore, to pool state assets, improve long-term returns, and support strategic investment objectives. In principle, Danantara is intended to optimize investments and operations across state-owned enterprises. However, in the short-term, the creation of Danantara introduce fiscal trade-offs.

The government claims that the budget reallocation, presented as "budget efficiency," will stimulate economic growth. However, it may instead slow growth for several reasons. First, establishing Danantara requires additional public spending while reducing revenue, as the government will forgo dividends from state-owned enterprises. While the fund is intended to support long-term investment and asset optimization, its near-term effects on growth will depend on project selection, implementation capacity, and governance arrangements. In particular, there is a risk that Danantara-led investments could crowd out private investment if projects overlap with commercially viable sectors or rely heavily on state-backed financing. The multiplier effects of projects in Danantara's pipeline are also uncertain, especially if investments are capital-intensive, slow to execute, or yield limited productivity gains in the short run. Moreover, until there is greater clarity on the fund's governance framework, project pipeline, and risk-sharing mechanisms, investor sentiment may remain cautious, potentially dampening private investment rather than crowding it in. As a result, while Danantara may support growth over the longer term, its contribution to near-term economic momentum is likely to be uncertain

and may come at the cost of tighter fiscal and investment conditions. Second, cuts to capital expenditure make it more difficult to achieve higher growth. Third, human capital programs such as MBG take years to generate measurable benefits. Moreover, data from the 2024 National Economic Survey indicate that 15% of the population faces food insecurity, suggesting that a universal free-meal program could misallocate resources, reduce productive spending, and lead to food waste. Finally, a universal scheme would increase food demand and push up prices, especially for volatile commodities. With food inflation already at 4.99% (YoY) in October 2025, low-income households would be hit hardest. Targeted cash transfers might be needed to protect them, but this would require either cutting other expenditures or expanding the budget deficit, both of which could constrain economic growth.

Fiscal tightening has also spilled over to the regional level. Efficiency drives in the 2025-2026 budgets have led to a substantial reduction in Transfers to Regional Governments (TKD). Under the 2026 State Budget, TKD is set at around IDR693 trillion, down about 29.3% from roughly IDR 919 trillion in 2025.[60] Regional leaders and observers, including KPPOD, warn that this cut, equivalent to roughly IDR227 trillion less than the prior year's allocation, risks squeezing regional budgets that rely heavily on transfers for basic services and capital expenditure. In some cases, regional transfers have fallen by approximately 18-25% (YoY), forcing local governments to adjust their planning and spending priorities, and potentially eroding their ability to finance public services, pay personnel, and maintain infrastructure without increased local revenue mobilization.[61]

3.10. Climate Risk

One of the most pertinent issues faced by Indonesia's economy is the economic growth target and the climate target. In terms of long-term agenda, Indonesia aims to gain a 'high-income country' status by 2045. To achieve this, Indonesia needs to grow its economy by 6% for 20 years or by 7% for 17 years. Having the current growth trend of about 5%, Indonesia needs to massively boost its economic engine to reach an adequate growth level to stay on the trajectory towards a high-income country by 2045. On the other hand, Indonesia has set another equally ambitious target in the long-run: achieving net-zero emission (NZE) by 2060 or earlier. NZE target suggests that, going forward, Indonesia needs to consistently and substantially reduce its emission production.

Maintaining a steady economic growth rate of around 5% over the past two decades has come at a high environmental cost for Indonesia. This growth has relied heavily on coal consumption, extensive fossil fuel use, and large-scale deforestation, all of which have contributed to environmental degradation. Such damage increases the country's vulnerability to natural disasters. The severe floods that struck three provinces in Northern Sumatra in late November 2025, claiming more than 1,000 lives, illustrate this risk. Natural disasters of this scale affect the economy through multiple channels: they disrupt supply chains, reduce demand in affected regions as households and businesses experience income losses, and force governments to allocate larger budgets for emergency response and economic recovery. To this day, we have yet to understand the size, economic and social, of the disaster that would potentially affect Indonesia's economy.

In terms of achieving the climate agenda, such as Net Zero Emission (NZE) by 2060, Indonesia focuses more on the mitigation effort, and several investments have been made in various sectors to reduce carbon emissions. This is promising as lots of potential investors are also interested in investing in green sectors.[62] In the energy sector, investment in solar panels, geothermal, wind, and hydropower has made progress. 100 GW National Solar Power Program was announced in 2025, as an addition to Cirata floating solar power plant that has been operational since 2023. Similarly,

several geothermal power plants in Lumut Balai and Ijen already enter its operational phase since 2025. However, pushing for more development of renewable energy in Indonesia faces its own challenges as Indonesia is currently having oversupply in electricity. In 2024, Indonesia has 36.7 thousand GWh of electricity oversupply. [63]

In addition, Indonesia's mitigation strategy continues to rely heavily on the land sector, particularly through the Forestry and Other Land Use (FOLU) Net Sink 2030 target, which pledges net negative emissions of 140 $MtCO_2e$ by the end of the decade. However, the credibility of this target has been called into question due to conflicting development priorities, such as food estate expansion and large-scale bioenergy projects.[64] While the pursuit of food and energy security is legitimate, the current approach risks accelerating deforestation and jeopardizing the feasibility of reaching net sink status. Alternative development strategies, such as electrifying transport demand rather than relying on high biofuel blending targets, could deliver energy security without driving large-scale forest loss.

However, the effort on the climate mitigation is somehow not being matched on the climate adaptation aspect. Despite being the third most disaster-prone country in the world,[65] Indonesia is still facing a big gap between disaster risk and implemented mitigation efforts. Although vulnerable areas are widespread, anticipation and preparedness in many regions remain low. This indicates that mitigation measures are not evenly distributed and are still insufficient compared to the needs based on the risks faced. Currently, only 15.1% of all regions (provinces) have such mitigation systems in place.[66] This means that there are still many areas in Indonesia that are not prepared and are at high risk of experiencing significant impacts during disasters. There are at least five provinces with the lowest mitigation systems in Indonesia, namely West Sulawesi, Bangka Belitung Islands, Riau Islands, North Kalimantan, and Southeast Sulawesi. These five provinces have an average basic mitigation system in only 37 villages/sub-districts within their regions. This figure is very low since each of these provinces has an average of at least 400 villages/sub-districts.

Box B. Economic Expectations and Perceptions among Key Stakeholders

Three complementary focus group discussions (FGDs) were conducted as part of this exercise. The first brought together economists from banks, securities firms, and research institutions. The second engaged several large domestic firms across key sectors. The third involved chambers of commerce and international institutions, including development partners and foreign business representatives. Polling conducted before and after the economists' FGD provides a quantitative snapshot of expectations, while the three discussions provide qualitative inputs reflecting the views expressed by each group.

Overall, polling results show that expectations for Indonesia's economic outlook in 2025 and 2026 remain broadly stable. For 2025, respondents' GDP growth estimates are clustered in the range of 4.9-5.1%. For 2026, expectations span a wider range of 4.6-5.9%, with most responses concentrated between 5.0-5.2%. During the discussion, economists referred to policy execution, domestic demand conditions, and fiscal transmission as factors shaping their views on the outlook. Domestic firms noted that business expectations depend on policy clarity and investment certainty. Chambers and international institutions discussed Indonesia's growth outlook alongside developments in the global economy, including moderating global growth and ongoing fragmentation in trade and investment.

Perceptions of downside risks remain strong and largely unchanged following the discussion. Polling results identify policy uncertainty, weak budget planning and execution, and deterioration in consumer confidence as the most frequently cited risks both before and after the FGD. Economists discussed slowing real wage growth, rising informality, and uneven fiscal transmission as ongoing domestic challenges. Domestic firms emphasized frequent regulatory changes, inconsistent enforcement across agencies, and legal risks faced by decision-makers as factors affecting investment decisions. Chambers and international institutions highlighted regulatory fragmentation, local enforcement issues, and uncertainty arising from policy implementation.

Views on fiscal capacity reflect a cautious assessment. Polling results indicate that confidence in the government's ability to support growth through the APBN is concentrated in the low to moderate range. Economists discussed constraints related to budget execution and fiscal effectiveness. Domestic firms noted slow disbursement, uncertainty over the composition and execution of non-ministerial spending, governance concerns related to new institutions such as Danantara, and coordination challenges involving central government, SOEs, and subnational entities. Chambers and international institutions referred to the quality and composition of spending, rising debt service obligations, and limited fiscal flexibility in the event of shocks.

Assessments of Indonesia's investment climate in 2026 focus primarily on institutional and macroeconomic factors. Polling results show that the regulatory and legal environment is viewed as the most important factor, followed by macroeconomic and financial stability and human capital and labor market competitiveness. Domestic firms discussed unpredictable enforcement, lengthy permitting processes, and concerns over legal accountability as factors influencing investment decisions. Chambers and international institutions pointed to high-cost economic conditions affecting large and export-oriented firms, restrictions on imports and production inputs, and uneven application of local content and certification requirements.

Across the discussions, structural reform priorities repeatedly referred to the business climate and regulatory quality, fiscal reform, and human capital development. Economists discussed the importance of strengthening supply-side capacity. Domestic firms referred to bureaucratic behavior, corruption, extortion, coordination challenges, and investment decision delays. Chambers and international institutions emphasized productivity, competition, capital allocation, the role of SOEs in certain markets, financial deepening, and constraints affecting labor-intensive manufacturing.

Trade agreements such as CEPA and FTAs are generally viewed as having a moderate positive impact on Indonesia's economic growth in 2026, as reflected in the polling results. Economists discussed trade agreements in the context of domestic demand conditions. Domestic firms noted that the benefits of trade agreements vary across firms. Chambers and international institutions highlighted low utilization of FTAs, particularly in manufacturing and among MSMEs, citing regulatory frictions, supply-side readiness, and limited integration into global value chains.

4. CATALYSTS FOR OPTIMIZED GROWTH: 3CS

Sustaining higher, more resilient growth requires more than incremental policy adjustments. It depends on a set of mutually reinforcing foundations that shape how firms invest, workers become productive, and markets allocate resources. This chapter frames these foundations through three interlinked pillars that we offer to call the 3Cs for 3 Catalysts: Certainty, Capability, and Capital. Importantly, these pillars are deeply integrated and must be advanced together. Progress in one catalyst will strengthen the others. While shortcoming in any pillar can undermine the overall growth and development process.

Certainty refers to the institutional environment that supports investment, and long-term planning, particularly the rule of law and policy predictability, reducing uncertainty and transaction costs that allow domestic and foreign firms to commit capital to long-horizon, productivity-enhancing investments. **Capability** captures the improvement in the quality of human capital and productivity. This is not only about years of schooling, but the health, skills, and adaptability needed to utilize technology and move into higher value-added activities. **Capital** reflects the effectiveness of market mechanisms in allocating resources toward the most productive firms, enabling competition, entry, exit, and creative destruction. It also emphasizes on addressing structural financing costs and increasing access to long term fundings.

Weakness in any one of these dimensions constrains the others, producing low investment, shallow productivity gains, and persistent growth stagnation. Strengthening all three simultaneously is therefore central to unlocking a more robust, productivity-driven growth path.

4.1. Certainty: Rule of Law

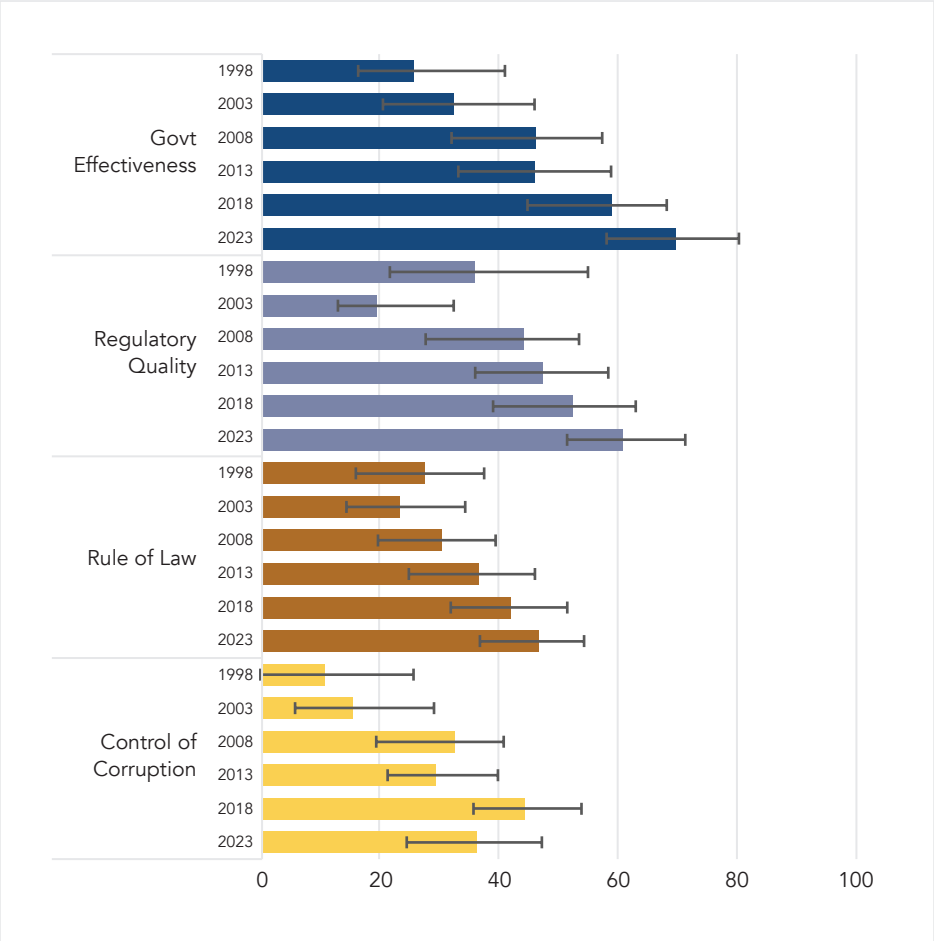
Rule of law is one of the core foundations of a democracy, as it is the institutional layer that turns political authority into predictable rules, credible commitments, and ultimately a platform for sustained growth. In the institutional economics literature, rule of law is treated as a key manifestation of deeper institutional quality, how well a state protects property rights, constraints arbitrary power, and enforces contracts, and cross-country work shows that these features are strongly associated with higher income levels and investment.[67], [68] When the legal system strongly protects firms against at-will expropriation and enables consistent contract enforcement, government can offer a stable policy framework that firms trust. In such an environment, firms are willing to invest in long-horizon, productivity-enhancing projects instead of keeping capital in low-risk, low-return uses.

For individual firms, weak rule of law shows up as contract risk and policy volatility, and there is now solid evidence that this uncertainty depresses investment. Spikes in policy uncertainty are followed by lower investment, employment, and output in policy-sensitive sectors.[69] Similarly, higher policy uncertainty is associated with significantly lower capital expenditure, especially in firms with irreversible investments or heavy exposure to government spending.[70]

Indonesia has moved a long way from the turbulence of the late 1990s, but its rule of law and governance scores have now plateaued in the middle of the global distribution. In the 2025 World Justice Project Rule of Law Index, Indonesia scores 0.52, ranking 69th out of 143 countries and 9th out of 15 in East Asia and the Pacific. World Bank governance data show Indonesia's rule of law hovering in

the mid-30s and regulatory quality around 60 (Figure 4.1). An intertemporal analysis reveals that while regulatory quality has improved overall, the indicator has seen stagnation since 2008. This contrasts with the rule of law metric, which remains a persistent issue characterized by wide confidence intervals across the timeline.

Figure 4.1 Indonesia's Governance Indicator (in n-th percentile)



Source: World Bank Governance Indicator (2025)

At the level of day-to-day business decisions, these institutional weaknesses are felt as dense, volatile regulation that acts like a "structural productivity tax." Between 2020 and 2024, central government issued more than 3,000 regulations annually, with more than 70 percent coming from ministries and agencies; 2024 alone saw 152 laws and 200 presidential regulations, forcing firms to absorb new obligations with short transition periods.[71] IBC notes that post-licensing compliance, recurring reporting, inspections and technical standards, has become the heaviest burden, especially for SMEs and describes these dynamics as a drag on productivity and firm scaling. Indonesia's B-Ready profile shows relatively modest scores on the formal regulatory framework and operational efficiency, with the latter being noticeably lower. Indonesia also trails behind its regional competitors when it comes to business entry time: it takes 43 days and 34% of GNI per capita to register a domestic firm versus 15 days and zero cost in Singapore. For investors, this combination of complexity and rapid rule changes is essentially policy uncertainty by another name.

These governance frictions are intertwined with state dominance and limited technocratic capacity in policymaking, which distort competition and weaken the credibility of reforms. Studies of Indonesia's political economy point to the heavy role of state-owned enterprises and politically

connected business groups, with a warning that dominant SOEs and "synergy" strategies can create entry barriers and conflict with principles of competitive neutrality.[72] Work on the political economy of policymaking highlights persistent weaknesses in civil service recruitment, training, and analytical capacity, which limit the ability of technocrats to push through evidence-based reforms and to evaluate the cumulative impact of new rules.[73]

For Indonesia's next growth phase, strengthening rule of law is therefore not an abstract governance agenda but a macro-critical growth strategy. Given the evidence that contract enforcement, protection from arbitrary state action and stable policy frameworks are central to investment and productivity, any effort to crowd in private capital, whether for green industrial policy, downstreaming, or digital infrastructure, will be constrained if firms continue to face thick rulebooks, frequent regulatory shocks, and inconsistent enforcement. Narrowing this gap requires fewer, better-designed regulations; stronger judicial and enforcement institutions that apply rules consistently to both private firms and state entities; and a more technocratic policy process that can credibly commit to reforms over the political cycle.

Policy certainty ultimately depends on a credible rule of law. Firms and businesses must be able to operate within a clear legal framework that protects compliance and good-faith decision-making. When businesses comply with regulations or when professionals act in accordance with best practices and the business judgment rule, they should not be subject to disproportionate legal consequences. In the absence of these safeguards, we may see firms and businesses become more risk-averse and less likely to innovate. This issue with the uncertain rules of the game may limit business dynamism.

4.2. Capability: Investment in Human Capital

Sustained economic growth is determined by productivity, which growth depends critically on human capital: the health, skills, and learning quality of the workforce that enable technology adoption, innovation, and movement into higher value-added activities. Higher levels of human capital are associated with greater worker productivity and stronger long-term economic performances across countries.[74]

For Indonesia, investment in human capital has become increasingly central to sustaining growth because the traditional drivers of expansion are losing momentum. The demographic dividend is beginning to peak, and growth is becoming more dependent on productivity improvements rather than factor accumulation. At the same time, Indonesia's development strategy increasingly relies on more capital-intensive manufacturing, downstream processing, and modern services, all of which require a workforce with stronger cognitive, technical, and adaptive skills. In this context, capital deepening without commensurate improvements in education quality, health, and skills formation yields diminishing returns, limiting productivity growth and slowing structural transformation.

Available evidence confirms that Indonesia human capital outcomes relative to its stage of development. The World Bank's Human Capital Index estimates that as of 2020, a child born in Indonesia will be 54% as productive when they grow up as they could be if they enjoyed complete education and full health. This is lower than the average for the East Asia & Pacific region (59%) and Upper Middle-Income countries (56%). This implies that Indonesia is foregoing a substantial share of potential future productivity relative to economies at similar income levels. Unless human capital outcomes improve, lower workforce productivity will continue to weigh on long-term growth and slow income convergence despite continued investment and capital accumulation.

The Human Capital Index suggests that Indonesia's human capital shortfall is driven primarily by weak outcomes rather than limited access. Despite high school enrolment and relatively strong child survival rates, learning-adjusted years of schooling remain low, indicating that time spent in school does not translate into foundational skills at scale. In parallel, persistent child stunting reduces cognitive development and future work capacity, permanently lowering lifetime productivity and eroding the returns to subsequent education spending. As a result, Indonesia enters adulthood with a workforce that is less prepared to complement capital-intensive growth, limiting productivity gains and slowing structural transformation.

Closing Indonesia's human capital gap must begin early, where losses are most costly and least reversible. High rates of child stunting and uneven access to early childhood development services reduce cognitive capacity before children enter school, permanently lowering future productivity. Evidence shows that early-life health and nutrition strongly shape learning ability, labor market outcomes, and lifetime earnings, making early childhood interventions among the highest-return investments in human capital. Scaling targeted nutrition, health, and early learning programs, particularly in lagging regions, would prevent irreversible productivity losses and raise the effectiveness of all subsequent education spending.

Indonesia has largely achieved universal access to basic education, yet weak learning outcomes indicate that years of schooling do not translate into foundational skills at scale. Low proficiency in literacy and numeracy constrains workers' ability to adopt new technologies and limits productivity growth as the economy becomes more complex. Improving teaching quality, curriculum relevance, and accountability for learning outcomes is therefore critical. Reorienting education spending toward teacher effectiveness and student performance, rather than enrolment alone, would strengthen foundational skills and improve the productivity of future cohorts.

Beyond basic education, stronger alignment between skills formation and industrial transformation is essential. The Indonesian government has supported revitalization of vocational education and training to better match industry needs, encouraging vocational institutions to work directly with employers to improve job prospects for graduates. Expanding targeted skills training and language certification for vocational students preparing to work abroad also aligns workforce capability with international labor market requirements. The government have repeatedly emphasized the need for stronger synergy between education/training institutions and industry partners to produce skills that meet labor market demand.[75]

In parallel, Indonesia can leverage its industrial estates and special economic zones (SEZs) as platforms for upgrading tertiary education and applied skills. Current policy frameworks for SEZs include explicit focus on technology and human resources development, with potential for collaborative arrangements between universities and industry inside SEZ.[76] For example, the establishment of Edutek Medika Internasional KEK in BSD, which incorporates higher education and research activities including operations by Monash University, highlights how special zones can integrate education and industry.[77]

Overall, Indonesia's human capital challenge is less about expanding coverage and more about improving the productivity of existing investments across the life cycle. A dual track approach is therefore required: early investments to prevent irreversible losses in future cohorts, alongside aggressive short- and medium-term strategies to reskill existing workers and align education and training systems with industrial upgrading. Strengthening early childhood outcomes and learning quality in basic education would raise the effectiveness with which health and education spending translates into workforce capability.

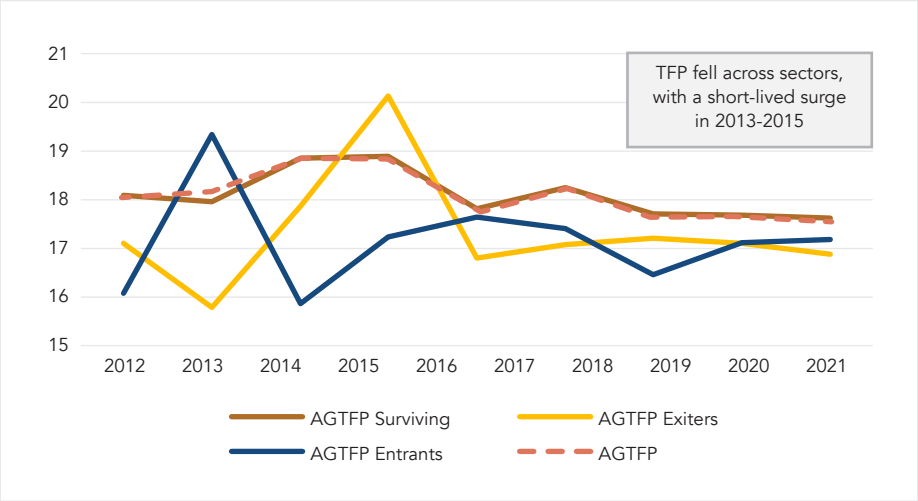
Critically, all these progresses in capabilities aspect will only materialize under meritocratic systems. A system that will allocate opportunities, jobs, and opportunities based on skills and performance rather than connections. Moreover, it is also important to ensure the complementarity between human capital and physical investments. These combinations will increase returns to capital and potentially support a productive business and economic environment.

4.3. Capital: Creating Competitive Market and Better Access to Finance

Creating a competitive market ecosystem is also another primary catalyst required to break the current economic growth stagnation of 5% through addressing bottlenecks that limits productivity growth. Drawing on the productivity decomposition framework, aggregate productivity growth is fundamentally driven by two components: the Within Effect, where firms improve internal efficiency through innovation, and the Between Effect, where resources are reallocated toward better-performing companies via market competition.[78] In a healthy ecosystem, market mechanisms facilitate Creative Destruction, a process where efficient new entrants displace unproductive legacy firms, thereby continuously raising the economy's efficiency frontier.

Recent empirical data from Indonesia's priority manufacturing sector suggests a serious disruption in this transmission mechanism that leads to firm dynamics supportive for creative destruction. Findings from a study reveals a worrying structural anomaly in national business dynamics.[79] The statistical surge in Total Factor Productivity (TFP) observed between 2013 and 2015 was proven to be superficial: it was not driven by firms becoming more productive, but rather by unhealthy changes in market composition. Crucially, the data shows that companies exiting the market (exiters) actually possessed higher productivity levels than the new entrants (Figure 4.2). This phenomenon indicates a clear case of selection failure, where economic pressures eliminate productive companies while newcomers fail to bring superior technological capacity to the table.

Figure 4.2 Aggregate Productivity, Indonesia Manufacturing Sector



Source: Lufti et al. (2025)

Furthermore, a decomposition of growth sources highlights a fundamental transition from innovation-led growth to growth driven merely by shifts in market share.[80] While productivity growth during the 2011-2015 period was driven primarily by improvements in firms' internal efficiency (positive within effect), the 2017-2021 period saw the growth engine switch entirely to market reallocation among existing players (incumbents), whereas internal efficiency actually declined. This condition implies that Indonesia risks becoming trapped in a phase of Destructive Creation, where market dominance is determined by the persistence of incumbents rather than efficiency, and where high barriers effectively block the emergence of competitive new innovators.

To reverse this trend and restore the dynamics of true Creative Destruction, structural reform targeting the roots of market inefficiency is essential. Adopting policy recommendations from Javorcik et al. (2012), the priority must be to improve market selection quality by lowering asymmetric entry and exit barriers. This also requires increasing trade openness and participation in the global value chains. In addition, industrial incentives should be redesigned to reward measurable efficiency gains rather than firm size or political connections. Effective competition enforcement is also necessary, so that market access benefits efficient and innovative firms.[81]

Reforming institutional framework in order to improve market's contestability is also essential to sustain Creative Destruction. This starts with strengthening institutional integrity by upholding the rule of law, ensuring open and fair competition, and fostering decentralized innovation ecosystems as preconditions for Creative Destruction. At the same time, asymmetric barriers to firm entry and exit need to be reduced so that incentives to stay should be realigned to higher-productivity firms.

Encouraging firms to innovate is also a key component in boosting productivity growth. As innovation is a risky business, nurturing competitive market provides transparent incentive signals for firms. Firms can then take better risk calculation in taking investment in innovation. In order to encourage innovation-driven productivity growth, intellectual property rights must be effectively enforced. In addition, with limited public budget for research and development, collaborative work between the private and the public sector to design evidence-based and performance-driven industrial policy is an avenue worth to unveil.

Another important aspect that will help Indonesia's growth trajectory is access to finance. The latest data from the World Bank Enterprise Survey in 2023 suggests that three major obstacles faced by Firms in Indonesia are: access to finance, corruption, and crime. Around 29% of firms answered access finance as their main problem. This number is significantly higher compared to other countries like Vietnam (21%), India (22%), and Malaysia (16%).

Addressing capital availability will be paramount. Firms' ability to finance investment in physical capital and human capital is central to their performance as well as economic growth. However, as the World Bank Enterprise Survey notes, not all firms in Indonesia have access to finance. Some must pay higher costs because of financial frictions and distortions. Addressing misallocation in access to finance increases productivity and output at the aggregate level.[82]

Furthermore, as innovation needs capital, access to finance that encourages innovation in the private sector should be expanded, especially for innovative small and medium-sized enterprises so that productive firms can enter, scale up, and compete on merit. These efforts need to be complemented by sustained investment in education and skill-building to develop a workforce capable of continuous technological adaptation and firm-level innovation.

Therefore, in order to boost Indonesia's economic trajectory in 2026, our catalyst also suggest to address access to capital and finance that will help firms in Indonesia to become more productive and contribute more towards the economy.

Beyond market contestability, innovation incentives, and access to finance, Indonesia's growth trajectory will also depend on social capital, namely the networks, norms, and trust that facilitate coordination and cooperation for mutual benefit.[83] In an economy where productivity gains require firms to innovate, partner, and scale, trust functions as a practical input that reduces coordination costs and strengthens cooperative behavior across firms, workers, communities, and government. Trust shapes the strength of social ties and the feasibility of collaboration, and its formation is not automatic. Moreover, social capital is sensitive to political and social forces operating through prevailing institutional arrangements.[84] When institutions are credible and consistently applied, trust becomes more durable and networks become more productive, supporting cooperation that complements formal market mechanisms rather than substituting for them.

Social capital matters because regional development is not driven by economic variables alone. A distinctive feature of each region is the embeddedness of noneconomic factors, including social and cultural relations manifested in social capital, which can shape local development performance.[85] In practical terms, strengthening social capital should be treated as an enabling condition for the reforms outlined above. Institutional reforms that uphold rule-based governance and predictable enforcement can help rebuild trust, while place based coordination platforms can convert existing networks into mechanisms for productive collaboration, such as partnerships that link firms with research institutions, training providers, and local governments. By reinforcing trust and cooperation within and across regions, social capital can help Indonesia translate competitive market reforms and expanded financing into real productivity gains, broader participation in innovation, and more resilient growth.

5. RECOMMENDATIONS

Indonesia's economy is expected to grow at around 5 percent in 2026, with macroeconomic stability broadly intact, supported by contained inflation and still-adequate external buffers. However, this stability masks underlying structural weaknesses. Domestic demand is losing momentum as household consumption softens, investment growth slows, and productivity gains weaken amid persistent resource misallocation. Achieving stronger and more sustainable growth in 2026 will therefore require targeted and credible policy action. This report outlines a set of policy recommendations for both government and private sector to address these challenges. These recommendations are composed using the 3 Catalysts concept that has been elaborated in the previous section: Certainty, Capability, and Capital. Certainty underpins both Capability and Capital, as human capital development and investment require predictable rules, credible institutions, and legal protection.

5.1. For Government

Fiscal Policy

Indonesia's fiscal challenge is increasingly a structural problem rather than a cyclical issue. Despite stable economic growth around five percent, revenue mobilization remains weak, with the tax-to-GDP ratio persistently stagnate below ten percent. This reflects low tax buoyancy driven by a narrow effective tax base, widespread informality, complex excise structures, and administrative inefficiencies. As a result, fiscal space is limited and vulnerable to shocks, constraining the government's ability to finance productivity-enhancing investment.

Fiscal policy should therefore be anchored in a medium-term revenue strategy centered on base broadening and compliance rather than rate increases. Strengthening tax administration, simplifying excise systems (e.g., tobacco) and improving enforcement among higher-income individuals and corporations are key priorities. Digitalization should be leveraged to gradually integrate informal economic activity into the formal tax system. Without revamping tax buoyancy, fiscal sustainability will remain fragile even under moderate growth.

On the expenditure side, recent reallocations have reduced the share of productive spending. Greater emphasis on large social programs and state investment initiatives has coincided with cuts to capital expenditure and transfers to regional governments. At the same time, the government still have to fund energy subsidies and interest rate subsidies (e.g., KUR, FLPP) that comprise a significant amount of government spending. While social objectives are important, these shifts risk weakening medium-term growth, especially when food inflation remains elevated and human capital programs yield returns only over long horizons. Fiscal policy should prioritize high-multiplier spending, such as infrastructure, logistics, education, and health, while redesigning social programs to be better targeted and fiscally efficient.

Rising debt service further tightens constraints. With interest payments absorbing a growing share of revenue, active debt management is essential to prevent crowding out of productive expenditure. At the subnational level, sharp reductions in transfers risk undermining service delivery and local investment, calling for a transfer framework that protects core functions while strengthening incentives for local revenue mobilization and project quality.

Monetary Policy

Monetary policy remains accommodative, but its effectiveness is constrained by weak transmission mechanisms. Policy rate cuts and liquidity injections have supported near-term demand, yet lending rates have adjusted only marginally and credit growth remains subdued. This reflects structural features of the financial system, high risk aversion, wide interest spreads, and shallow money markets, rather than insufficient liquidity.

Preserving monetary credibility requires clearer institutional boundaries. It is important to uphold the independence of Bank Indonesia as a central bank. Close coordination between monetary and fiscal authorities can be justified in periods of stress, but without explicit guardrails, it risks blurring the distinction between monetary operations and fiscal financing. Transparent rules defining objectives, instruments, and exit conditions are essential to anchor expectations and maintain exchange-rate stability. Moreover, any changes in the government regulations related to financial sector (e.g., P2SK) should not create new distortions that may weaken market confidence.

Improving transmission should be a priority. Persistently wide spreads point to underdeveloped interbank, repo, and bond markets with limited price discovery. Deepening these markets would strengthen pass-through, reduce reliance on quantity-based measures, and allow monetary policy to operate more effectively through prices.

Inflation dynamics support a cautious but flexible stance. Price pressures remain largely supply-driven, dominated by food and commodity-linked components, while core inflation stays subdued due to weak demand and stagnant real wages. Monetary policy should therefore remain supportive of growth while coordinating with fiscal and structural measures that address supply-side bottlenecks beyond the reach of interest rates.

Financial Sector Policy

Indonesia's financial system is stable but insufficiently deep to support higher and more inclusive growth. Credit to GDP remains low, lending is heavily collateral-based, and banks' risk appetite is narrow. As a result, productive firms, particularly SMEs and non-commodity manufacturers, face financing constraints, while liquidity does not translate into investment. Addressing the high cost of capital is essential as it has become a major issue in the country's financial sector.

Financial sector policy should focus on improving credit allocation. Strengthening credit infrastructure through better credit registries, use of alternative data, and greater reliance on cash-flow-based lending would reduce information asymmetries and enable banks to lend to viable firms with limited physical collateral. These reforms would also improve monetary transmission.

Household pressures have increased reliance on high-cost consumer credit, particularly through online lending and pay-later platforms. While these products expand access, they also risk eroding household balance sheets and crowding out savings. Stronger consumer protection is needed, including standardized disclosure, tighter affordability assessments, and adequate provisioning, in order to prevent consumption-driven debt cycles.

Beyond banking, underdeveloped non-bank financial institutions limit long-term financing options. Expanding corporate bond markets, strengthening pension and insurance sectors, and developing

securitization frameworks would provide alternative funding channels for infrastructure, housing, and green investment, reducing overreliance on bank credit.

Structural Policy

Structural constraints are the most binding limitation on Indonesia's medium-term growth. Persistent reliance on commodity-based activity, weak productivity gains, and limited diversification reflect institutional weaknesses rather than a lack of investment. Structural reform must therefore focus on strengthening the rule of law, reducing excessive state dominance, curbing rent-seeking behavior, and labor market rigidities.

Improving the rule of law is central to enhancing investment climate. Regulatory complexity, inconsistent enforcement, and discretionary interpretation raise transaction costs and uncertainty. Priorities include standardized licensing, transparent rule-making, and stronger dispute resolution mechanisms to ensure credible enforcement of contracts and property rights. Facing the current financial fragmentation and reshoring, the government can include strategic investment policy as industrial policy to attract more investment in labor-intensive as well as innovation-driven sectors.

Reducing excessive state dominance is equally important. While state involvement can be catalytic, excessive state dominance through SOEs and state investment vehicles, e.g., Danantara, risks crowding out private initiative and distorting competition when these state-owned firms are allowed to use uncompetitive corporate actions and received non-performance based discriminatory preferential. Structural reform should rebalance the state's role toward regulation and facilitation, strengthen competition policy, and ensure a level playing field in access to finance, land, and licenses for all firms. State also needs to give clear signals to private sectors that competition will be preserved and the presence of state investment vehicles, such as Danantara, will not distort the market competition and structure.

Policies that aim to reduce rigidities and minimum wage misalignment are needed to address the issues in the labor market, e.g., low investment in skills and mismatch. Employment regulations should be made more predictable and act to reduce uncertainty around severance pay. Moreover, the minimum wage policy should be a transparent, rule-based formula that will link wage adjustment to productivity and local economic conditions, which will allow greater differentiation across different regions and sectors. Finally, labor market policy such as active labor market programs (e.g., wage subsidies, apprenticeships, and upskilling or reskilling) would help the adjustment costs borne by jobseekers during the job-search period while also support job creation.

Rent-seeking further undermines competitiveness. Complex non-tariff measures and overlapping compliance requirements divert resources toward regulatory arbitrage rather than productivity. Simplifying regulations using a risk-based approach, digitizing procedures, and limiting discretionary authority would reduce costs and improve transparency. Strong governance is also essential for managing the green transition, as credible and consistent enforcement of sustainability standards reduces compliance uncertainty.

Indonesia also needs to leverage economic cooperation that will help us to navigate the uncertain global trade activities. Moreover, effort to adopt OECD framework will push the country to introduce significant improvement in our policymaking such as governance, rule of law, transparency, environment, and anti

corruption. At the same time, Indonesia also needs to evaluate several NTM measures that act as trade barriers which will increase cost for business.

In sum, Indonesia's suboptimal growth ceiling is constrained by institutional weaknesses. Without stronger rule of law, appropriate division of roles between state and private sector, and sustained efforts to eliminate rent-seeking, investment will remain commodity intensive with limited productivity gains. Structural reform must therefore focus on fixing misallocations and bottlenecks.

5.2. For Private Sector

Indonesia's private sector operates in an environment marked by moderating investment, softening household purchasing power, rising import penetration, and weakening productivity performance. While many structural constraints require government intervention, firms can take several immediate, practical steps to strengthen competitiveness and improve resilience.

1. Diversify customer segments toward more resilient demand pockets
   Consumption patterns show that the middle-income segment is experiencing the sharpest erosion in purchasing power, while higher-income groups remain more stable. Firms may consider repositioning their offerings by reshaping product mixes, bundling value-for-money options, or expanding offerings to segments less affected by declining real income, including potential export markets.
2. Manage input costs through supplier diversification
   Rising import dependence, particularly on inputs sourced from China, heightens exposure to supply and price volatility. Businesses can mitigate risks by diversifying sourcing channels, consolidating procurement volumes, and securing medium-term contracts that provide price stability. Cooperative purchasing through industry associations can also yield scale benefits.
3. Invest selectively in workforce capabilities
   The decline in labor productivity underscores the need for focused skill upgrading. Firms should prioritize training in operational efficiency, digital tools, and technical maintenance. These targeted interventions deliver quick productivity gains while supporting longer-term competitiveness.
4. Prepare for emerging climate and sustainability requirement
   Indonesia's growth path must align with the commitment to achieve net-zero emissions by 2060. Businesses can begin with foundational steps such as tracking energy use, improving resource efficiency, and maintaining basic emissions records. Early adaptation to sustainability standards will help firms secure access to export markets and emerging sources of green finance.

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