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Indonesia Development Update

Indonesia Economic and Development Outlook 2026: Why Five Percent Growth Is No Longer Enough for a Rising Economy

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Abstract

The year 2026 represents a potential inflection point for Indonesia's economic and development trajectory. After half a decade of post pandemic recovery, Indonesia has managed to preserve macroeconomic stability and sustain growth at around 5 percent. Yet this level of growth is increasingly insufficient for a rising middle-income economy facing structural constraints, technological disruption, environmental risks, and intensifying global uncertainty. Drawing on recent regional trends and insights from the World Development Report 2025, this paper argues that Indonesia's core challenge is no longer growth per se, but the quality and composition of that growth. Regional deceleration in East Asia and the Pacific, rising trade protectionism, policy uncertainty, and automation driven labour market polarization form a fragile external backdrop for 2026. Domestically, Indonesia remains constrained by slow productivity growth, shallow industrialisation, high informality, skill mismatches, and continued dependence on primary commodities. The second year of the new administration introduces ambitious initiatives such as Free Nutritious Meals and mineral and agricultural downstreaming, which hold significant potential but also demand stronger fiscal discipline, environmental safeguards, and labour competency standards. The floods in Sumatra in 2025 further underscore the rising economic costs of weak environmental governance. This outlook concludes that without a decisive shift toward standards-based development encompassing infrastructure, human capital, labour markets, and environmental management Indonesia risks remaining stable without leaping forward. In this context, 2026 may determine whether Indonesia escapes stagnation or consolidates a higher quality development path.

Keywords: Outlook 2026, Structural Transformation, Labor Market, Development Economics, Economic growth quality.

I. Introduction

The year 2026 should not simply pass as another date on Indonesia's economic calendar, it carries the potential to become a turning point, a moment when the country decides whether to remain comfortable with "good enough" growth of around 5 percent, or to be bold and upgrade the quality of that growth so it truly drives higher productivity, broader prosperity, and stronger social and environmental resilience.

The regional picture provides an important backdrop. The October 2025 edition of the East Asia and Pacific Economic Update shows that East Asia and the Pacific grew by only about 4.8 percent in 2025, which is far below the historical trend of 6 to 7 percent before the pandemic. For 2026, regional growth is projected at only 4.3 to 4.5 percent, still above the global average, but clearly no longer the "Asian miracle" of two decades ago (World Bank, 2025).

At the same time, the World Development Report 2025 underlines that the key for developing countries to escape the middle-income trap is not only headline growth, but also the construction of "standards for development", including standards for infrastructure, environmental protection, the digital economy, and labor skills and competencies (World Development Report, 2025). The combination of regional trends and this agenda on standards will strongly shape Indonesia's direction in 2026.

II. A Recovery That Never Fully Ended

Over the past five years, the regional economy moved from pandemic recession toward a fragile normalisation. On paper, growth charts turned upward again in 2021 and 2022, yet the engine of recovery has never truly regained its earlier speed. Three major pressures explain this pattern.

First, trade protectionism. The United States implemented "reciprocal tariffs" that raised import duties for most of its Asian trading partners, including many East Asia and Pacific economies. World Bank simulations show that this new tariff package can sharply reduce exports from East Asia and the Pacific to the US and depress real incomes in several economies, even though the eventual impact on national GDP is dampened because exporters can divert some trade to other markets and the domestic value added embedded in exports to the US is relatively small compared with national GDP in many countries (World Bank, 2025).

For Indonesia, Malaysia, Thailand, Vietnam, and the Philippines, the impact is felt through a decline in new orders. Countries that depend more on exports of electronics and semiconductors are relatively better protected, while those that rely on textiles and other labor-intensive products are hit harder.

Second, policy uncertainty. A media based global policy uncertainty index reached its highest level since 1997 in mid 2025. When fiscal, monetary, and trade policy directions are difficult to anticipate, firms tend to hold back investment and hiring. World Bank estimates show that a one percentage point decline in growth in G7 countries can reduce growth in developing East Asia and Pacific economies by about 0.6 percentage points in the following year (World Bank, 2025).

Third, technological change in the labour market. The rapid adoption of industrial robots in the ASEAN five has created a new dynamic. A study cited by the World Bank shows that in Vietnam, an additional one robot per one thousand workers in a district can raise employment and wages for skilled workers by around 6 to 9 percent, while at the same time lowering the average wages of less educated workers by about 2 to 4 percent. At the regional level, between 2018 and 2022, robot adoption is estimated to have created around 2 million new formal sector jobs for skilled workers, but also displaced about 1.4 million less skilled workers who were then mostly absorbed into the informal sector (World Bank, 2025).

The World Development Report 2025 stresses that without strong competency standards and training systems, technology in developing countries tends to deepen the divide between skilled and unskilled workers rather than closing it (WDR 2025).

In the midst of these shocks, China as the largest economy in the region is no longer running at high speed. Growth in China is projected to decline from around 4.8 percent in 2025 to 4.2 percent in 2026, constrained by a weakening property sector, slowing exports, and increasingly limited fiscal space as public debt rises (World Bank, 2025).

In short, the regional outlook in 2026 can be described as moderate but fragile, moderate in terms of numbers, fragile in terms of risks.

III. Indonesia 2020 to 2025, Stable but Not Yet Leaping

In this unsettled landscape, Indonesia appears relatively stable. After contracting in 2020, the economy recovered and recorded 5.3 percent growth in 2022, then moved in the range of around 5 percent throughout 2023 to 2025. World Bank projections for Indonesia show growth of 4.8 percent in 2025 and 4.8 percent in 2026, slightly below the long-term potential that is often estimated at above 5 percent (World Bank, 2025).

So far the macroeconomic foundation has been preserved fairly well. The budget deficit has been pushed back below 3 percent of GDP since 2023, inflation has remained relatively low, the rupiah exchange rate has avoided extreme volatility, and the financial system is in a cautious position. Yet behind this stability, an important question remains, why has growth not broken through to a higher and more inclusive level.

The answer lies in structure. Labour productivity has grown slowly, industrialisation is not deep, and the economy still depends heavily on primary commodities such as coal, crude palm oil and unprocessed or semi processed minerals. Downstreaming has indeed begun, but the base is still narrow and has not fully transformed the labour market.

At the same time, household consumption remains the main engine of growth. Commodity exports face price fluctuations, while investment, both foreign and domestic, is still constrained by global uncertainty and regulatory barriers at home.

At this point, the message of the World Development Report 2025 becomes highly relevant. Without reliable infrastructure standards, clear regulatory standards, and robust labour competency standards, middle income economies will struggle to move up the ladder (WDR 2025). Indonesia already has growth, but does not yet have enough standards to turn that growth into a genuine leap.

IV. 2026, The Second Year of a New Administration

The year 2026 will be the second year of the new administration and it carries a more aggressive development agenda. Three prominent programs will strongly influence the direction of the economy.

The first is the Free Nutritious Meals program. If it aims to reach millions of students at various education levels, this program can generate large new demand in the food, agriculture, livestock and logistics sectors. In the short term, it can be felt through higher incomes for farmers and food related micro enterprises, while in the long term it can improve nutrition and productivity among the younger generation. However, the sheer scale of the program also requires fiscal discipline, stronger procurement systems, and effective oversight to prevent leakages that would erode its impact.

The World Development Report 2025 highlights the importance of food standards and logistics systems in large scale social programs, so that such interventions are not only large in terms of budget, but also effective in outcomes (WDR 2025).

The second is the mineral and coal downstreaming agenda. Indonesia has encouraged the construction of dozens of smelters for nickel, bauxite and copper in recent years. The contribution of processed nickel exports has risen sharply and altered the structure of manufacturing exports. Yet as we enter 2026, the global battery and electric vehicle industry is showing signs of overcapacity, especially in early stage processing. In the midst of trade tensions and tighter rules of origin, downstreaming is no longer sufficient if it stops at ingots and ferronickel. The challenge is to move up the value chain into higher end products such as precursors, cathodes and electric vehicle components.

Here the concepts of technology standards and environmental standards from WDR 2025 become directly relevant. Downstream projects must meet global standards for emissions, energy efficiency and sustainability if Indonesian products are to be accepted in international markets (WDR 2025). Smelters that ignore environmental standards risk facing trade sanctions and market rejection.

The third is agricultural downstreaming, especially in palm oil, food and bioenergy. This sector holds significant potential for job creation and export earnings. Downstreaming palm oil into biodiesel, oleochemicals and functional food products can reduce dependence on imported energy and industrial inputs. However, challenges in land governance, deforestation, and increasingly strict global sustainability standards require that every step in downstreaming be guided by clear environmental safeguards.

The World Development Report 2025 notes that developing countries should build tiered standards, a ladder of standards that allows businesses to gradually move toward global benchmarks without abruptly shutting down upstream sectors (WDR 2025). This is very relevant for palm oil and other agricultural commodities in Indonesia.

V. Sumatra Floods in 2025, An Alarm from Nature

The downstream and expansion agenda arrives at the same time as a harsh warning from nature. The major floods in Aceh, North Sumatra and West Sumatra in 2025 showed that the cost of neglecting environmental management is far higher than the cost of preventing disasters. In a matter of days, thousands of houses were damaged, infrastructure was cut off and economic activity came to a standstill.

Forest degradation in upstream areas, lax spatial planning and overly permissive land use permits in the past have all increased hydrological vulnerability. If the old development pattern is maintained, every rainy season can turn into a potential disaster season.

Therefore, as we move into 2026, economic policy can no longer be separated from environmental policy. Law enforcement on violations of spatial plans, watershed rehabilitation, stronger green fiscal instruments and the integration of disaster risk management into regional development plans all need to move in parallel with industrial downstreaming and infrastructure expansion.

WDR 2025 reminds policymakers that ignoring environmental standards means accepting the risk of much higher long term economic costs (WDR 2025).

VI. Labour Market, Where Are the Quality Jobs

The 2025 World Bank reports paint a sombre but honest picture of the regional labour market. On average, labour force participation in East Asia and the Pacific is high, yet many workers remain trapped in low productivity sectors. At the regional level, the middle class has indeed expanded, but in many countries, including Indonesia, the number of people living in "vulnerable" status is still larger than those who are firmly in the middle class (World Bank, 2025).

For Indonesia, several points stand out.

First, youth unemployment. Around one in seven young Indonesians aged 15 to 24 is unemployed, one of the highest ratios in the region (World Bank, 2025). This clearly indicates that the education and training system is not well aligned with labour market needs, while formal job creation has been too slow.

Second, informality. More than 58 percent of Indonesian workers are employed in the informal sector, selling goods on the streets, working as daily labourers or becoming self-employed without adequate social protection. Over the past two decades, much of the movement of workers out of agriculture has gone into low paid informal services rather than into modern, high productivity manufacturing.

Third, productivity. Compared with Malaysia, Thailand and China, labour productivity in Indonesia remains behind. During the 1990s and early 2000s, many countries in the region enjoyed a structural bonus as workers moved out of low productivity sectors into modern manufacturing and services. Now that process has slowed, and workers are more likely to move into low productivity services such as small-scale construction and petty trade.

Fourth, skill gaps in the age of automation. Robots and automation in Indonesian factories have raised the demand for skilled workers, including engineers, technicians and advanced machine operators, while reducing demand for workers with basic skills. Without a clear reskilling strategy, technology will widen the gap between those who are skilled and those who are left behind.

Fifth, labour regulation. Compared with advanced economies, severance pay rules in Indonesia remain relatively high, even after recent reforms. For some employers, this raises the perceived risk of hiring permanent staff, which encourages the use of short term contracts and outsourcing.

The World Development Report 2025 emphasises that in the midst of technological disruption, developing countries need strong human capital standards, competency frameworks, certification systems and mutual recognition mechanisms, so that reskilling and vocational training programs can actually support modern industrialisation (WDR 2025).

Heading toward 2026, Indonesia's labour market strategy needs to rest on three pillars, better skills and digital literacy, faster creation of quality jobs in modern sectors and stronger active social protection, from job loss insurance to integrated digital employment services.

VII. 2026 as a Possible Turning Point

Amid global slowdown, policy uncertainty and technological pressure, Indonesia still has the chance to maintain growth of around 5 percent in 2026. However, this figure will only be meaningful if it comes together with better quality, higher productivity, lower inequality, more decent work and stronger environmental protection.

This requires political courage to shift public spending away from short term subsidies toward productive investment in infrastructure, education, health and research, to improve environmental governance so that the disasters of 2025 are not repeated, to reform the labour market and the education system so they are aligned with a digital and automated economy, and to accelerate diversification from raw commodities toward higher value manufacturing and modern services.

The World Development Report 2025 describes standards as "the quiet catalyst of development", a catalyst that works silently, yet determines whether a country can move up or remain stuck in stagnation (WDR 2025).

If the difficult decisions are taken now, the year 2026 can be remembered as the moment when Indonesia stopped being merely "stable" and began to truly leap forward. If not, we risk entering a new decade with growth that simply moves in place, sufficient to survive, but not enough to catch up.