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Indonesia – Resilience check

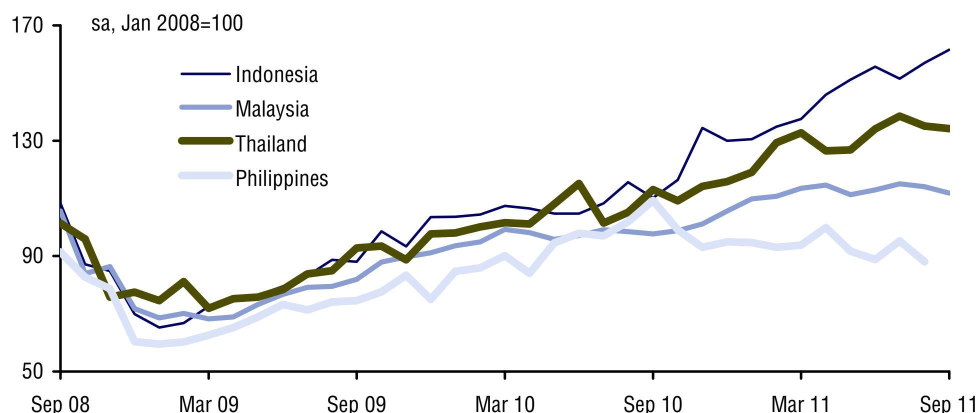
INDONESIA'S RESILIENCE CONTRASTS WITH DOWNWARD REVISIONS ACROSS ASIA

Resilience of the Indonesian economy was a key theme in the Viewpoint section of our 4Q11 *Eye on Asian Economies*, Arise Indonesia**. We predicted that 6.5% real GDP growth in 2011 would be sustained in 2012, with an acceleration to 7% in 2013. Indonesia's strong 3Q11 GDP release has kept our forecast on track, especially notable since our forecasts for most other Asian economies have been revised down.**

Indonesia's large domestic economy has conferred higher resilience relative to Asia's export driven, cyclical economies. Paradoxically then, Indonesia's outperformance this year has been most visible in the external sector with its sustained export uptrend contrasting with stalled export trends in the other Emerging Asean economies (Figure 1), a reflection of its high commodity share in total exports. Indonesia's expanding consumer market and rich supply of resources will confer a significant advantage in attracting FDI. This will be a key factor underlining Indonesia's continued resilience given the prospect of declining FDI flows into the region as global financial markets face rising uncertainty and increased risk aversion.

Anthony Nafte

Figure 1: Export trends in emerging Asean



Source: CEIC, CLSA Asia Pacific markets

INVESTMENT DRIVER REMAINS INTACT DESPITE SOFT GROWTH IN 3Q11

Indonesia's 3Q11 GDP release is discussed in Section 1. Despite disappointing investment growth, we maintain our view for investment to drive growth higher over the next two years. We argue for the large FDI flows over the last two years to be sustained. Section 2 looks at the reasons for Indonesia's export outperformance, highlighting Indonesia's rising coal exports to China as a key export driver in recent years. Stress resilience to global financial instability was

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assessed in our **Macro stress test** (*Triple-A*, October 2011) with specific indicators relevant to Indonesia revisited in Section 3. Indonesia's vulnerability stems from its poor policy implementation with no convincing indication of its infrastructure programme gaining significant traction since the release of its Master Plan in May 2011. This issue and the outlook for policy are discussed in Sections 4 and 5.

Investment spur for 6.5% GDP

Indonesia is on track for 6.5% GDP growth in 2011

Real GDP growth was sustained at 6.5% QoQ annualised in 3Q11, matching the pace in 2Q11. This has kept our 2011 real GDP forecast on track for 6.5%. In contrast, we have revised down our forecasts for the other Emerging Asean economies where monthly indicators have signalled weak 3Q11 GDP releases. Indonesia has demonstrated resilience both in the domestic and external sectors.

Expanding consumer market and resources are the magnets for FDI

Private consumption has grown consistently above 5% QoQ annualised in the first three quarters, a step up from the average annual 4.6% growth rate of the previous five years. Indonesia's expanding consumer market, with projections out to 2030 from the Brookings Institution (Figure 2), will be one of the key attractions, along with resources, ensuring sustained foreign investment.

Figure 2: Middle class consumption - Top 10 countries (global share)

2009	%	2020	%	2030	%
United States	21	China	13	India	23
Japan	8	United States	12	China	18
Germany	6	India	11	United States	7
France	4	Japan	6	**Indonesia**	**4**
United Kingdom	4	Germany	4	Japan	4
Russia	4	Russia	3	Russia	3
China	4	France	3	Germany	2
Italy	3	**Indonesia**	**3**	Mexico	2
Mexico	3	Mexico	3	Brazil	2
Brazil	3	United Kingdom	3	France	2

Source: Homi Kharas, Brookings Institution

Urbanisation will continue to drive construction investment

We were disappointed by slowing investment growth in 3Q11. In perspective though, investment growth was still reasonably strong at 5% QoQ annualised from 12% in 2Q11. The investment to GDP ratio at 31.6% in 2011 (first three quarters) was only marginally down from 32.2% in 2010, contrasting with the much lower investment to GDP ratios in Thailand at 24.7%, Malaysia 20.3% and the Philippines 20.2% (2010 estimates). Urbanisation has been the main spur for investment primarily through residential construction. This will remain a key investment driver given the expected 19 – 20 million rise in the urban population over the next 10 years (United Nations Desa estimate). Even with the faster growth in machinery & equipment investment (Figure 3), reflecting gradual expansion of the manufacturing sector, the construction share of total investment remains dominant at 73%.

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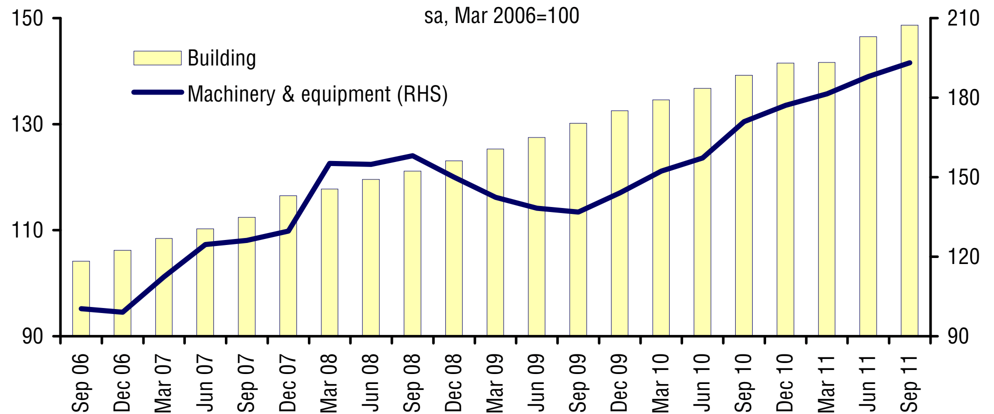
Figure 3: Investment - Building vs. machinery & equipment

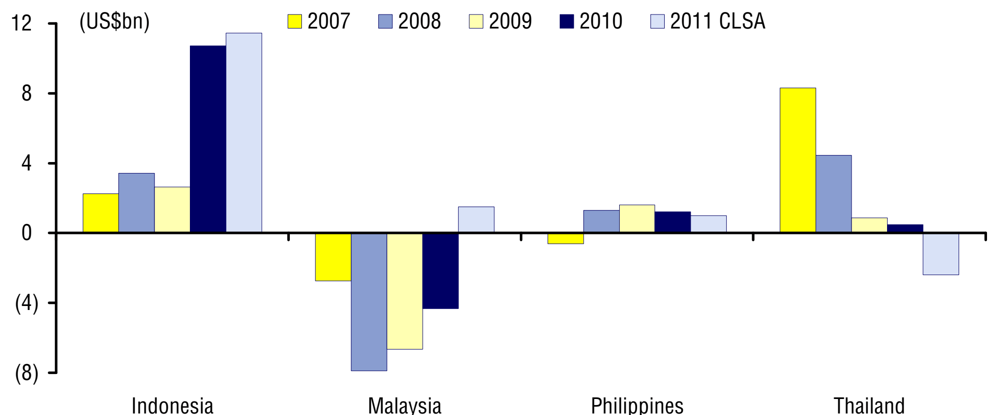


Source: CEIC, CLSA Asia Pacific markets

Indonesia FDI surge stands out in Emerging Asean

Our forecast for sustained real GDP growth at 6.5% in 2012, despite the global downturn, and for accelerating growth to 7% in 2013 relies on investment as the primary growth driver. However, this assumes minimal contribution from public infrastructure investment with no convincing indication yet of efficient deployment of public spending. Instead, we have been encouraged by the surge in Indonesian FDI over the last two years which contrasts with lower FDI in the other emerging Asean economies (Figure 4).

Figure 4: Net FDI in Emerging Asean (2007-2011 and the five year average)



Five year average	US$bn
Indonesia	6.1
Malaysia	(4.0)
Philippines	0.9
Thailand	2.3

Source: CEIC, CLSA Asia Pacific markets

Urgent need for stepped up development will sustain FDI inflows

Arguably though, FDI is cyclical and will decline in Indonesia as the global downturn deepens. FDI estimates for 3Q11 are not yet available but resilience was evident in the realised foreign investment data with sustained 18% YoY growth in 3Q11. FDI in the resources sector has only really picked up in the last two years but there is a compelling argument for sustained inflows. With rising GDP growth, Indonesia's expanding domestic demand for resources can

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no longer be met with existing supply, along with the increasing demand from China, India and the rest of Asia. The urgent need for stepped up development and exploration will steer government policy, which had been previously obstructive, to facilitating foreign investment.

Coal and the China connection

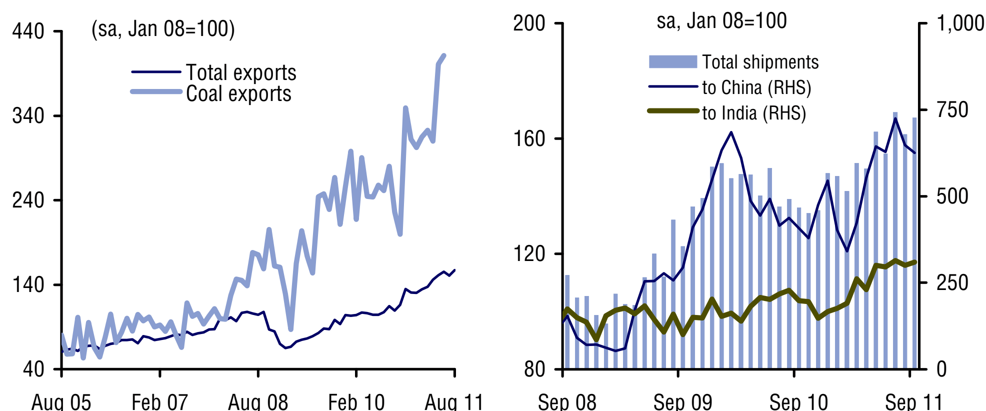
HIGH COMMODITY CONTENT HAS SUPPORTED INDONESIAN EXPORT GROWTH

Indonesia exports have continued to trend up while exports from the other Emerging Asean economies have turned down (Figure 1). Indonesia's rich resource sector and high commodity content suggest continued resilience for its exports in 2012 (see *Triple-A*, **Asian trade: China connection, November 2011**). Indonesia is better placed to withstand a decline in industrialised country demand given the near 50% share of commodities in total exports and the fact that 48% of its exports go to Asia (excluding Japan).

COAL HAS BEEN A KEY DRIVER OF INDONESIAN EXPORTS

Coal is one commodity, in particular, which has contributed significantly to Indonesia's export outperformance this year (Figure 5, left side). The coal share of total exports has increased to 12.2% (mid-2011 estimate), up 4.5ppt from 2008. China and India have been the key drivers of Indonesia's rapidly expanding coal exports (Figure 5, right side). China's share of Indonesia coal exports has increased to 25% this year (first nine months) from only 7% in 2008. India's share has increased to 21% this year from 13% in 2008.

Figure 5: Indonesian coal exports to China and India



Source: McCloskey Coal Report, CEIC, CLSA Asia Pacific Markets

Stress test for crisis resilience

RESILIENT ECONOMY BUT NOT IMMUNE IN A GLOBAL FINANCIAL CRISIS

Indonesia's economy will prove resilient in a global downturn, we believe, but as demonstrated in September this year, its financial markets and exchange rate are not immune in a global financial crisis when investors turn risk averse. That said, our **Macro stress test** 2011 (*Triple-A*, October 2011) showed that Asian balance sheets, Indonesia included, were sound. Portfolio capital flight and consequent asset price weakness should be viewed by long term investors as a buying opportunity.

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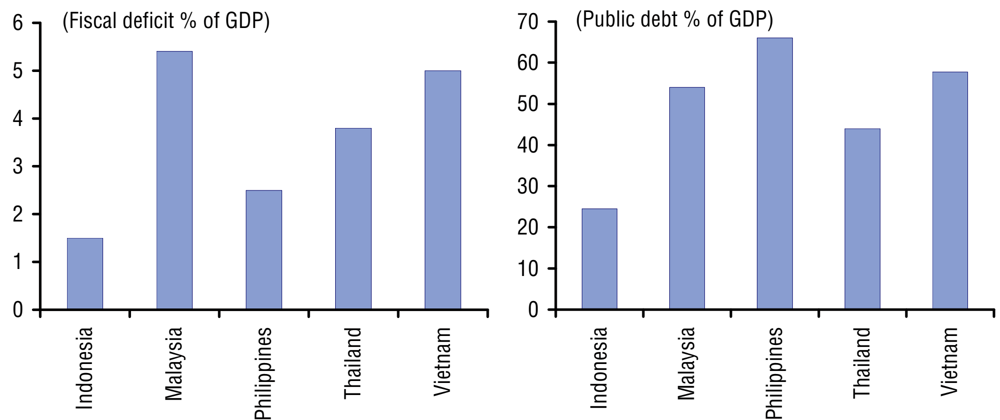
LOWEST FISCAL DEFICIT AND PUBLIC DEBT IN EMERGING ASEAN

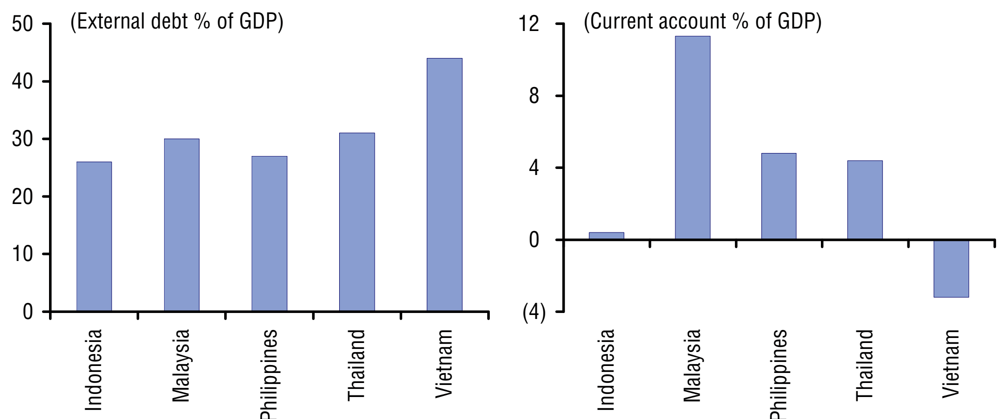
Some of the stress indicators underlining Indonesia's resilience are illustrated in Figures 6 and 7. Its fiscal deficit and public debt to GDP ratios are the lowest among the Emerging Asean economies with this year's fiscal deficit likely to be well below the official 2.1% of GDP target (albeit due to delayed deployment of public spending). Low external debt and limited foreign liability exposure of the banking sector are key points of contrast with the 1997/98 Asian crisis.

Figure 6: Asean stress indicators – Fiscal deficit and public debt as % of GDP



Source: CEIC, CLSA Asia Pacific Markets

Figure 7: Asean stress indicators – External debt and current account as % of GDP



Source: CEIC, CLSA Asia Pacific Markets

NARROWING CURRENT ACCOUNT SURPLUS OFFSET BY RISING FDI FLOWS

The current account surplus has been narrowing though, with the large trade surplus offset by the widening services and income deficits. Sustained domestic demand growth will, on our projections, push the current account into deficit in 2012. This will not be a major concern though, if as we have argued, sustained FDI inflows continue to support the balance of payments (Figure 8).

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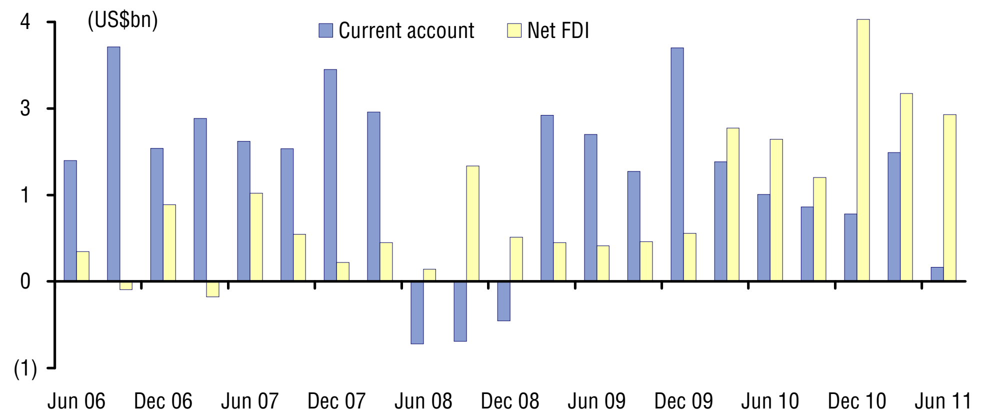
Figure 8: Current account vs. net FDI (USD bn)



Source: CEIC, CLSA Asia Pacific markets

Achilles' heal: Poor implementation

No improvement in policy implementation

Poor policy implementation, weak institutions and endemic corruption are Indonesia's key vulnerabilities. Keeping the fiscal deficit to GDP ratio below the 2.1% target for 2011 enhances Indonesia's crisis resilience. However, this has been achieved by failure to deploy budgeted capital expenditure. In 2010, infrastructure spending was only 86% of the budgeted allocation. In 2011, the disbursement rate for capital expenditure was only 26% after the first eight months. Infrastructure deficiencies will be an increasing constraint on growth, arguing for public funds to be diverted from wasteful energy subsidies to infrastructure financing. However, a rise in infrastructure funding will be of little use unless there is efficient implementation with maximum transparency to prevent misappropriation of public funds.

A new champion of restructuring

President SBY's cabinet reshuffle in October was a lost opportunity dashing hopes of a more efficient and committed team to accelerate infrastructure development. That said, the appointment of Dahlan Iskan, previous head of state power company PLN, as the new SOE minister, is seen by our CLSA Jakarta team as a positive force for restructuring. Along with rationalisation of the SOE sector, Mr Dahlan has said he will expedite toll road construction. Aside from occasional breakthroughs though, most recently the airport to Nusa Dua elevated toll road project in Bali with construction to commence in 1Q12, toll roads and other infrastructure projects have proceeded at a snail's pace.

Implementation, not financing, has been the major constraint

Land acquisition (the expected approval date has been constantly pushed forward by 3 months), parliamentary obstruction and misappropriation of funds, limited regional government capacity and regulatory uncertainty have been persistent problems stalling infrastructure development. Implementation, rather than financing has been the major constraint. The World Bank's assessment of decentralisation concluded that increased

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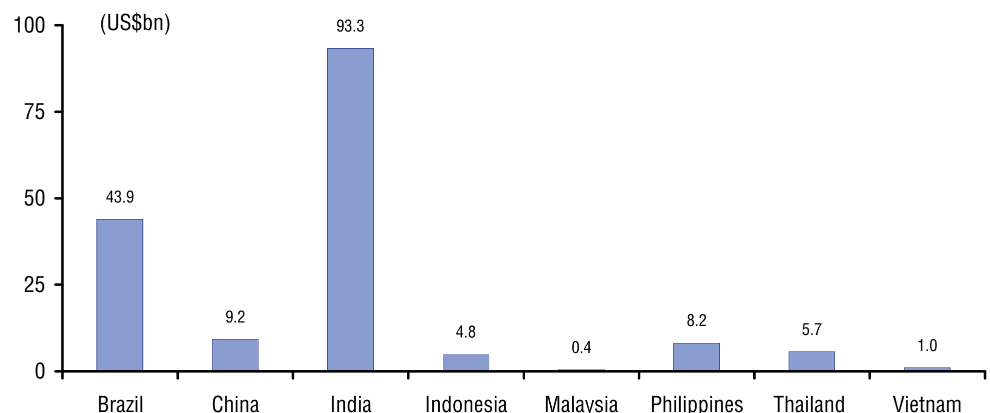
spending by regional governments has yielded little improvement in service delivery outcomes. This is worrying given that half of core public spending is under sub-national government control. Regional funds have largely been spent on government administration instead of their intended purpose of promoting education, infrastructure and health.

Private investment in infrastructure: India vs Indonesia

Private public partnerships (PPP) have been employed as the latest strategy to spur infrastructure development. PPPs are currently in vogue across the region which exposes an obvious shortcoming. In a risk averse investment climate it will be increasingly difficult to secure scarce private sector funding. There is a telling comparison between India and Indonesia in their capacity to attract private sector investment in infrastructure between 2008 and 2010 (Figure 9). This has been an important factor contributing to Indonesia's failure to match the faster GDP growth rates achieved by India.

Figure 9: Private sector investment in infrastructure (2008-2010)



Source: World Bank and PPIAF, PPI Project Database. (http://ppi.worldbank.org)

Monetary: Tread with caution

Band Indonesia is intent on cutting rates despite ample liquidity

Bank Indonesia (BI) was the most reluctant of the Asian central banks to hike interest rates during the monetary tightening cycle but the first to initiate interest rate cuts. Moreover, it has signalled further rate cuts if inflation continues to trend down. We think that BI should be less aggressive in easing policy. There is ample liquidity even after the large portfolio outflow in September which led to a USD10.1bn decline in foreign reserves (Figure 10, left chart). Broad M2 money supply was growing at 19% and credit growth at 25% QoQ annualised in September (Figure 10, right chart). Stabilisation of portfolio flows in October was evident from the marginal USD0.1bn decline in foreign reserves.

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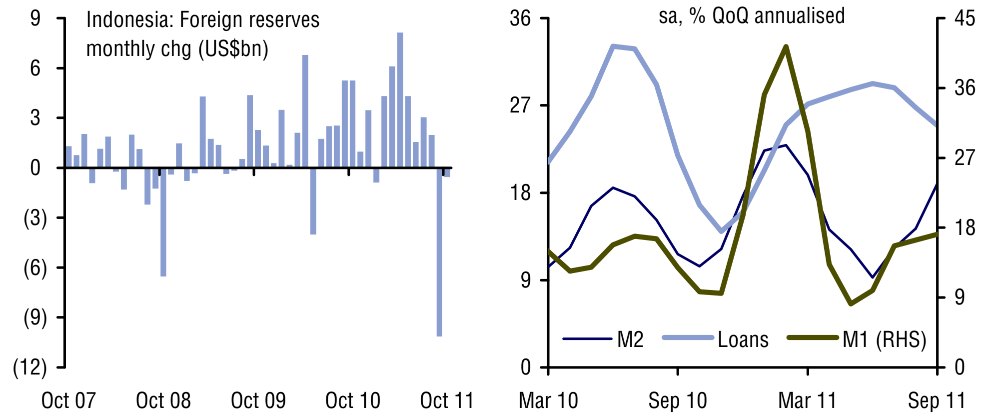
Figure 10: Foreign reserves MoM change (USD bn) Money supply and credit trends

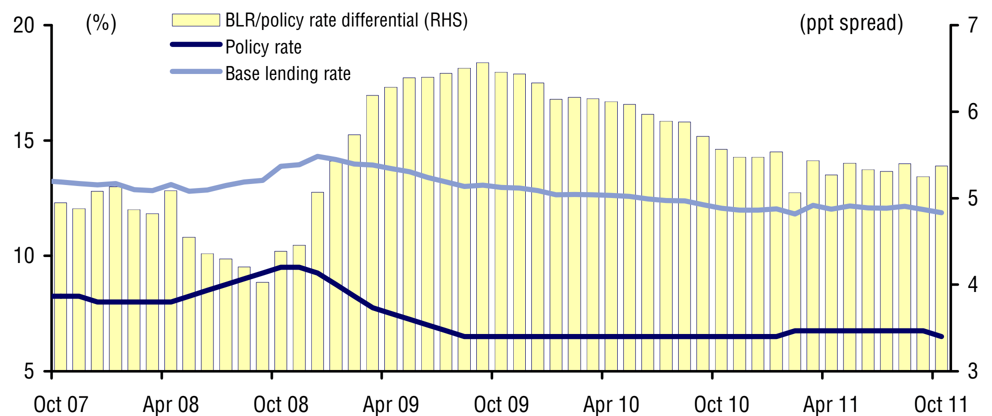


Source: CEIC, CLSA Asia Pacific markets

China's share of emerging ASEAN's exports will continue to expand

Loose liquidity conditions have had interesting implications. It has hampered development of the interbank market with the larger banks reluctant to lend at prevailing low rates. The smaller banks have had to bid up deposit rates in order to secure funding. Loose liquidity conditions have also weakened the transmission between the policy rate and money market rates. This issue should be addressed by Bank Indonesia prior to further interest rate cuts. Last month's 25bp policy rate cut was followed by a smaller 13bp cut in the banks' base lending rates as the banks strive to widen their interest margins. The current base lending to policy rate spread at 530bp is 120bp below the late 2009 peak (Figure 11).

Figure 11: Bank Indonesia policy rate vs. base lending rate



Source: CEIC, CLSA Asia Pacific markets

Strong exchange rate stance would be more reassuring

The fundamental argument for BI to proceed cautiously is the latent inflation threat. The continuing inflation downtrend, from the 7% peak at end-2010 to 4.4% in October 2011, and positive real interest rates (unlike most of the other Asian economies) has made BI comfortable about cutting rates. However, with the economy growing above trend for the last six quarters, the positive output gap has widened (Figure 12). Admittedly, the correlation between Indonesia's output gap and inflation has not been very convincing. However, in a robust

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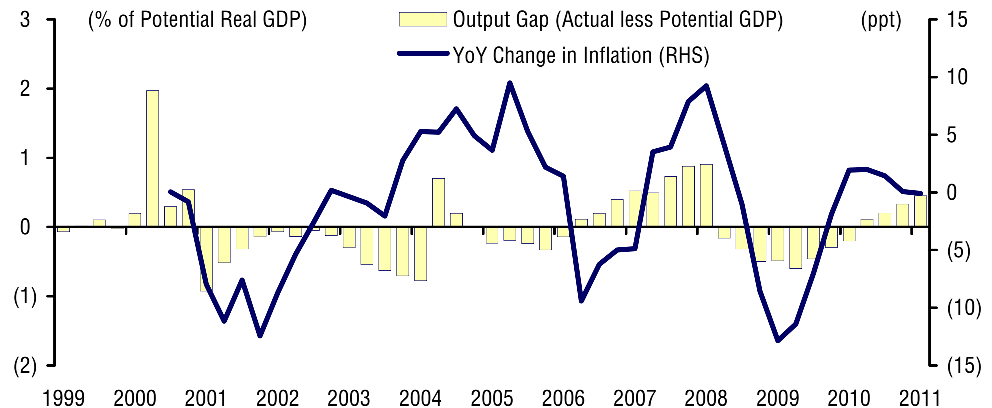
domestic demand environment, Indonesia's deficient infrastructure and consequent high distribution costs, leave it exposed to food and other price pressures. Bank Indonesia would send a more reassuring policy signal, particularly desirable give the prevailing uncertainty in the global financial markets, by maintaining a strong exchange rate stance for inflation control.

Figure 12: Indonesia output gap and inflation



Source: CEIC, CLSA Asia Pacific markets

Reinforcing its advantage

Indonesia has the advantages that will confer resilience in a global downturn. Improved policy implementation would reinforce this advantage while regulatory certainty and a tougher line on corruption would promote continued high FDI inflows.

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