Country update **INDONESIA**

Summary

Indonesia's economy has shown great resilience and economic growth is expected to be around 6% this and next year. The booming local economy and sluggish external economy has pushed the current account balance into deficit, but lavish foreign investment flows are largely able to cover this deficit. However, it makes the country more vulnerable to changing investor sentiment. Meanwhile, the political situation is less bright with the reform drive grinded to a halt and the ruling PD party connected to several corruption scandals. The ruling coalition is not expected to make huge strides in the coming year with parliamentary and presidential elections expected in 2014. In two of the three major parties the discussion on who should be the presidential candidate has started, but the outcome remains unclear for now. The lack of clear candidates makes it difficult to predict the policy path of Indonesia after the 2014 elections.

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Indonesia

National facts	
Type of government	Republic
Capital	Jakarta
Surface area (thousand sq km)	1,905
Population (millions)	243.0
Main languages	Bahasa Indonesia, English, Dutch, local dialects.
Main religions	Muslims (86%) Protestant (6%) Roman Catholic (3%)
Head of State (president)	Susilo Bambang Yudhoyono
Head of Government	Susilo Bambang Yudhoyono
Monetary unit	Indonesian rupiah (IDR)

Economy		2011
Economic size	*bn USD*	*% world total*
Nominal GDP	847	1.23
Nominal GDP at PPP	1125	1.42
Export value of goods and services	222	1.01
IMF quotum (in mln SDR; 2011)	2079	0.96
Economic structure	*2011*	*5-year av.*
Real GDP growth	6.5	5.7
Agriculture (% of GDP)	15	14
Industry (% of GDP)	47	47
Services (% of GDP)	38	38
Standards of living	*USD*	*% world av.*
Nominal GDP per head	3448	32
Nominal GDP per head at PPP	4579	37
Real GDP per head	1638	20

Social and governance indicators	rank / total
Human Development Index (rank)	124 / 187
Ease of doing business (rank)	128 / 185
Economic freedom index (rank)	115 / 179
Corruption perceptions index (rank)	100 / 183
Press freedom index (rank)	146 / 178
Gini index (income distribution)	34.0
Population below $1.25 per day (PPP)	18.06

Foreign trade			2011
Main export partners (%)		*Main import partners (%)*	
Japan	17	China	15
China	11	Singapore	15
Singapore	9	Japan	11
US	8	South Korea	7

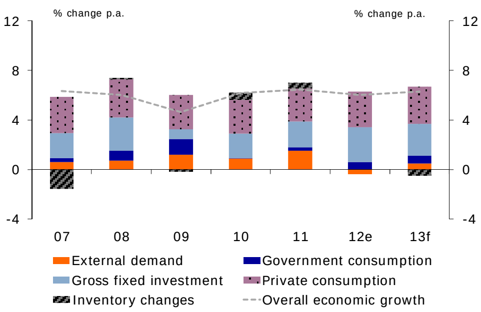
Main export products (%)	
Mineral fuels, lubricants & related materials	34
Machinery & transport equipment	13
Crude materials, inedible, except fuels	12
Animal & vegetable oils, fats & waxes	11
Main import products (%)	
Machinery & transport equipment	32
Mineral fuels, lubricants & related materials	23
Manufactured goods	15
Openness of the economy	*2011*
Export value of G&S (% of GDP)	25
Import value of G&S (% of GDP)	25
Inward FDI (% of GDP)	2.4

Source: EIU, CIA World Factbook, UN, Heritage Foundation, Transparency International, Reporters Without Borders, World Bank.

Introduction and update

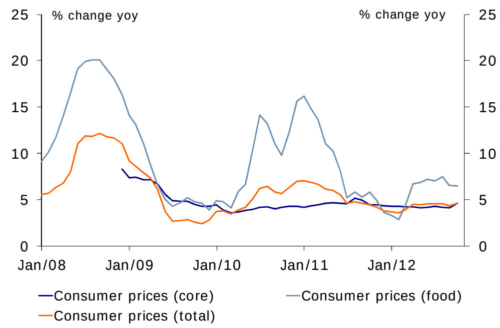
With 6.2% year-on-year growth in the third quarter of 2012, the economic boom in Indonesia continues. While it was the lowest reading in two years and slightly lower than the 6.4% growth in the second quarter, it was also the eighth consecutive quarter of 6%+ growth. Private consumption remained the pillar under this strong real GDP growth with a 5.7% growth (yoy). Also investment growth stayed robust at 10.0% yoy. Full year growth above 6% is in the cards, which was forecast in our Country Risk Report of July 2012. Going forward, economic growth is expected to remain strong, with growth around 6% in 2013. Sluggish external demand will weigh on the performance of Indonesia, but Indonesia is a relatively closed economy, rendering it less sensitive than several other Asian countries. Still, if the global economy derails, this will spill over into Indonesia too.

Figure 1: Economic growth



Source: EIU

Figure 2: Inflation



Source: Reuters EcoWin

Another downside risk to economic growth stems from inflation, especially rising food and fuel prices, as this would eat into the spending capacity of Indonesia's consumers. Currently, inflation is still within the 3.5-5.5% target range of the central bank, coming down from 5.4% in 2011, on the back of a good local rice harvest and declining international prices. Next year, inflation is expected to be 5.5-6%, which could trigger a tightening round by the central bank. As private consumption is supported by strong credit growth (currently around 26%), a tighter monetary policy could affect economic growth, although the transmission mechanism is far from perfect.

Over 2010/11, food and fuel prices were quite volatile, much to the dismay of the population. While the growing middle class is becoming less sensitive to food price increases, many Indonesians still spend a substantial part of their budget on food and fuel. The proposal to decrease the fuel subsidies early 2012 triggered widespread protests and the government withdrew its proposal. In exchange, it managed to get permission from parliament to increase fuel prices should global oil prices stay 15% above USD 105/barrel for six months. As the government intends to cut their subsidy bill in the next year, price increases in energy are possible in the coming year. Despite the need to clean up the subsidy bill, which will amount to about 3.5% of GDP this year, the fiscal situation of Indonesia is healthy. The budget deficit is expected to be around 2% of GDP and public debt will be close to 25% of GDP in 2012.

Political manoeuvring started ahead of 2014 elections

The next parliamentary and presidential elections will be in 2014. While the political power in Indonesia is concentrated in the presidential office, the parliamentary elections will be closely watched too. Currently, the electoral law states that only political parties (or coalitions) with more than 20% of the seats or 25% of the votes are allowed to present a presidential candidate. Even though this law might be changed ahead of the 2014 elections, the nominees are likely to come from one of the three main parties; the (ruling) Democratic Party (PD), Golkar or the Indonesian Democratic Party-Struggle (PDI-P). A recent poll showed that about half of the voters do not know what to vote, if elections were held now, suggesting dissatisfaction with the current politicians. But it also opens up the possibility for a new challenger. Political manoeuvring has started in all parties.

President Yudhoyono of the PD is not allowed to run for a third term and there is no clear successor for him. In Indonesia, political parties are generally centred around a powerful leader, who tends to be wealthy and charismatic. So the lack of a clear successor puts the PD in a difficult situation. The more so since the current lack of reform and several corruption scandals within the PD have eroded the popularity of Yudhoyono and his party. President Yudhoyono was re-elected in 2009 on the reform drive during his first period and on an anti-corruption platform. Neither of which have been successful.

Megawati, former president and daughter of Indonesia's founding father Sukarno, was the PDI-P candidate in the 2009 elections, but she came in second. The distance to Yudhoyono (60.8% vs. 26.8%) showed that she had lost the popular support she once had. Rumour has it that she might not run in 2014, but that her daughter, Puan Maharani, is manoeuvred into place as her heir. The popular support for Puan is still limited. However, in the gubernational elections for Jakarta Joko Widodo, who was supported by PDI-P, won, while the PD-supported candidate lost. These elections are seen as a barometer for the national elections – and if successful in Jakarta, Joko could even vie for the role of presidential candidate.

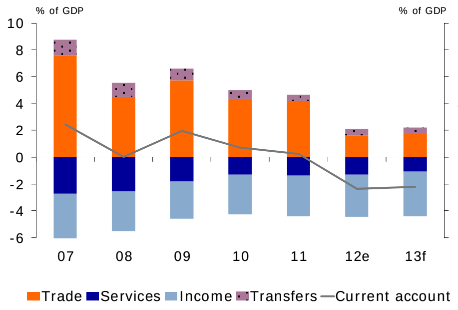
The lack of clear candidates in two of the three main parties makes it difficult to predict the policy path of Indonesia after the 2014 elections. Golkar is expected to nominate its chairman and wealthy business man, Aburizai Bakrie, as its candidate. If he wins, this is not likely to bode well for social and political reforms, as Bakrie is known to defend the vested interests. Meanwhile, the ruling coalition, which includes the PD and Golkar, is not expected to make huge strides in the remaining time. The differences on the necessity, speed and shape of reforms will benefit the status quo. The landmark Land Acquisition Law, for example, passed parliament in December 2011, but is still to be implemented. If activated, the new law would make infrastructure investment easier and is expected to help much needed infrastructure development.

External position weakens, but not worrying yet

As the Asian crisis hit Indonesia hard, imports fell rapidly and the current account balance turned from a deficit in the 1990s to a surplus in 2000s. A fast growing export sector kept the current account balance in surplus. However, this year, the current account balance is expected to become a deficit again. A booming domestic market is boosting demand for imported goods, while the weak global economy is hurting the export sector. Moreover, the lavish inflow of foreign direct investment in the past years is now pushing the deficit on the income balance. The current account balance is expected to drop from +0.2% of GDP in 2011 to -2.5% of GDP in 2012 and around -2% of GDP in 2013. While the Indonesian government is trying to move the country's export sector up the value chain, which would in theory lead to higher value added and thus more export revenues, the current account balance is expected to stay in deficit in the medium term.

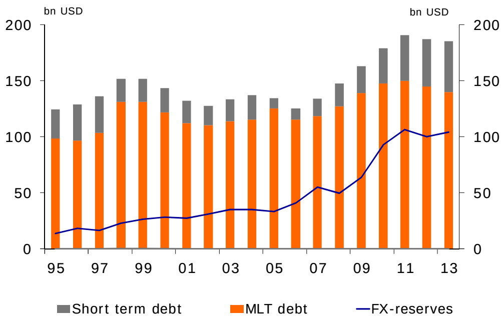
A substantial part of Indonesia's external financing needs comes from direct foreign investment (FDI). Investors hope to benefit from the natural resource abundance of Indonesia, a booming middle class and strong economic growth. The recent changes in laws on mining and agricultural trade, which include export bans and operational restrictions, have not scared investors yet, as seen by the record FDI inflow in 3Q12 (USD 6.1bn, +22% yoy). However, investors will surely keep a close eye on domestic developments.

Figure 3: Current account balance



Source: EIU

Figure 4: External debt and FX reserves



Source: EIU

Foreign direct investment and portfolio inflows (PI) are able to cover for the bulk of the current account deficit. This year, net investment flows (FDI + PI) are estimated at USD 14.5bn, compared to a current account deficit of USD 20.7bn. While in 2010 and 2011, portfolio flows were as large or larger than FDI, it is expected that FDI will be much larger in 2012 and 2013. However, this will strongly depend on the developments in the eurozone and the US. This dependence on external developments also indicates a key weakness of Indonesia. The withdrawal of foreign capital was one of the main reasons why the Asian crisis hit Indonesia so hard. Admittedly, the focus is currently more on Europe and the US and on countries with a large fiscal imbalance (which Indonesia does not have). But, the lavish inflow of portfolio investment in the past years worries, especially as about a third of public debt is held by foreign parties.

Countering this risk is the improved external debt position. The level of foreign debt dropped from a peak of 142% of GDP in 1998 to 20% of GDP this year. Moreover, the foreign exchange (FX) reserves increased rapidly over the past decade and now cover more than half of total external debt. FX reserves are expected to be USD 100bn end-2012, with total external debt at USD 187bn. While these developments are comforting, the level of short-term debt has been rising fast in the past years. Next year, short-term debt (USD 45bn) is expected to be about a quarter of total external debt. In the run up to the Asian crisis, short-term debt was also about 20-25% of total foreign debt. A major difference now is that FX reserves more than twice covers the short-term debt needs, while this was far from the case end 1990s when reserves were only half of the short-term debt.

Indonesia

Selection of economic indicators	2007	2008	2009	2010	2011	2012e	2013f
Key country risk indicators							
GDP (% real change pa)	6.3	6.0	4.6	6.2	6.5	6.0	6.3
Consumer prices (average % change pa)	6.3	9.9	4.8	5.1	5.4	4.5	5.7
Current account balance (% of GDP)	2.4	0.0	2.0	0.7	0.2	-2.4	-2.2
Total foreign exchange reserves (m USD)	54976	49597	63563	92908	106539	99950	104180
Economic growth							
GDP (% real change pa)	6.3	6.0	4.6	6.2	6.5	6.0	6.3
Gross fixed investment (% real change pa)	9.3	11.9	3.3	8.5	8.8	11.6	10.2
Private consumption (real % change pa)	5.0	5.3	4.9	4.7	4.7	5.2	5.4
Government consumption (% real change pa)	3.9	10.4	15.7	0.3	3.2	7.0	7.7
Exports of G&S (% real change pa)	8.5	9.5	-9.7	15.3	13.6	3.5	5.8
Imports of G&S (% real change pa)	9.1	10.0	-15.0	17.3	13.3	5.5	6.0
Economic policy							
Budget balance (% of GDP)	-1.3	-0.1	-1.6	-0.7	-1.1	-2.4	-1.7
Public debt (% of GDP)	31	29	26	26	24	25	24
Money market interest rate (%)	6.0	8.5	7.2	6.0	5.6	3.9	4.8
M2 growth (% change pa)	19	15	13	15	16	18	14
Consumer prices (average % change pa)	6.3	9.9	4.8	5.1	5.4	4.5	5.7
Exchange rate LCU to USD (average)	9141	9699	10390	9090	8770	9348	9648
Recorded unemployment (%)	9.1	8.4	7.9	7.1	6.6	6.7	6.3
Balance of payments (m USD)							
Current account balance	10492	125	10629	5146	2069	-20730	-21510
Trade balance	32754	22916	30931	30627	35348	14100	16870
Export value of goods	118014	139606	119646	158075	201473	199120	213220
Import value of goods	85259	116691	88715	127448	166125	185020	196350
Services balance	-11842	-12998	-9741	-9324	-11822	-11380	-10660
Income balance	-15524	-15156	-15140	-20789	-25667	-27650	-32160
Transfer balance	5103	5364	4578	4630	4212	4190	4450
Net direct investment flows	2254	3418	2629	11107	10437	13000	16000
Net portfolio investment flows	4298	-2423	5225	10873	1517	1560	2410
Net debt flows	4923	11265	14566	14456	5216	-1960	560
Other capital flows (negative is flight)	-7631	-17668	-18571	-11490	-5312	2450	6550
Change in international reserves	14336	-5283	14478	30092	13926	-5680	4020
External position (m USD)							
Total foreign debt	133847	147622	162850	179064	190666	187130	185450
Short-term debt	15448	20488	24050	31255	40664	42450	45460
Total debt service due, incl. short-term debt	33908	36822	45367	53348	59008	68700	69530
Total foreign exchange reserves	54976	49597	63563	92908	106539	99950	104180
International investment position	-169168	-147755	n.a.	n.a.	n.a.	n.a.	n.a.
Total assets	97539	80324	n.a.	n.a.	n.a.	n.a.	n.a.
Total liabilities	266707	228079	n.a.	n.a.	n.a.	n.a.	n.a.
Key ratios for balance of payments, external solvency and external liquidity							
Trade balance (% of GDP)	7.6	4.5	5.7	4.3	4.2	1.6	1.7
Current account balance (% of GDP)	2.4	0.0	2.0	0.7	0.2	-2.4	-2.2
Inward FDI (% of GDP)	1.6	1.8	0.9	1.9	2.1	2.4	2.5
Foreign debt (% of GDP)	31	29	30	25	23	21	19
Foreign debt (% of XGSIT)	95	89	115	97	82	81	74
International investment position (% of GDP)	-39.1	-29.0	n.a.	n.a.	n.a.	n.a.	n.a.
Debt service ratio (% of XGSIT)	24	22	32	29	25	30	28
Interest service ratio incl. arrears (% of XGSIT)	4	3	3	3	2	2	2
FX-reserves import cover (months)	6.0	4.1	6.8	7.3	6.4	5.5	5.4
FX-reserves debt service cover (%)	162	135	140	174	181	145	150
Liquidity ratio	128	116	131	130	124	109	109

Source: EIU