Country report **INDONESIA**

Summary

Based on strong economic growth (6.5% in 2011), solid public finances, and a balanced current account, Indonesia's star has been rising. Moody's and Fitch have upgraded Indonesia back to investment grade. However, Indonesia's structural problems are still large and progress is slow. The government of President Yudhoyono seems unable to push through reforms to improve the business climate and improve the infrastructure. Some progress might be seen now that the new land acquisition law has been adopted. Moreover, several new mining policies could support Indonesia's long-term goal to move up the value chain. However, the way the policies were designed triggered strong feelings of protectionism and nationalism. In light of the upcoming 2014 elections, more of similar rhetoric can be expected, as well as less cooperation between the major coalition parties. Meanwhile, Indonesia has a comfortable external position, although the country is sensitive to changes in investor sentiment and the associated reversal of hot money flows.

Things to watch:

- Presidential and general elections in 2014
- Progress on structural reforms
- Hot money flows and changes in investor sentiment

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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)	129 / 183
Economic freedom index (rank)	115 / 179
Corruption perceptions index (rank)	100 / 183
Press freedom index (rank)	146 / 178
Gini index (income distribution)	36.8
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 and related materials	34
Machinery and transport equipment	13
Crude materials, inedible, except fuels	12
Animal and vegetable oils, fats and waxes	11
Main import products (%)	
Machinery and transport equipment	32
Mineral fuels, lubricants and related materials	23
Manufactured goods	15

Openness of the economy	2011
Export value of G&S (% of GDP)	26
Import value of G&S (% of GDP)	24
Inward FDI (% of GDP)	2.3

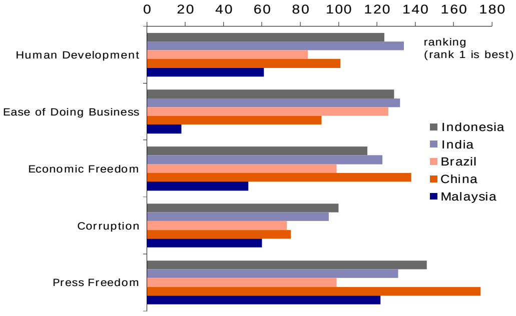
Source: EIU, CIA World Factbook, UN, Heritage Foundation, Transparency International, Reporters Without Borders, World Bank.

Economic structure and growth

Stretching across thousands of islands, Indonesia is vast and divers. The country is home to 243 million people of which more than 80% is Muslim. With an average income of USD 4,579 per year (in PPP terms) and 18% of its population living below the poverty line, Indonesia faces some significant structural challenges. This is also reflected in its Human Development Index, where the country ranks 124 out of 187. Despite Indonesia's challenges, the country has been lauded in past years for its macroeconomic stability with strong economic growth, a favorable fiscal position and a balanced current account. Recently, Fitch and Moody's rewarded Indonesia with a one notch upgrade to BBB- and Baa3, respectively. This means that Indonesia is back in the investment grade category, a status that it lost during the Asian crisis of 1998.

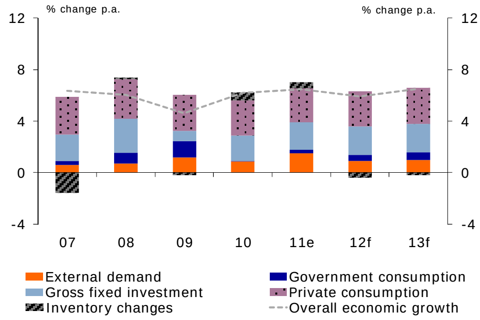
The economy of Indonesia is dominated by the industrial sector, which accounts for almost half of total GDP, while the services sector generates about 38% of GDP. The oil and gas industry is the single-largest industry in Indonesia (around 10% of GDP), while the agricultural sector is the largest employer as it provides jobs to almost half of the population (and accounts for 15% of GDP). Indonesia benefits from its abundant natural resources, which include coal, gas, oil, timber, gold, silver and palm oil. A decline in oil production made Indonesia a net oil importer in 2005 and triggered its exit from the OPEC in 2008. Coal and gas have become the new strengths – Indonesia is the world's largest exporter of coal. The export mix is dictated by commodities, followed by manufactured products (electronics, textiles, etc.). The bulk of exports go to Japan, China and Singapore. In a drive to divert exports away from unprocessed commodities towards processed products, the government has proposed several plans. Among others, it is seriously considering a ban on the export of raw minerals as of 2014, to promote investment in processing in Indonesia (more on these policies in the next section).

Figure 1: Social indicators



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

Figure 2: Economic growth



Source: EIU

Economic growth has been remarkably resilient in the face of global turmoil since 2008, largely due to the relatively closed nature of the Indonesian economy. Real GDP growth hovered between 5% and 6% in the past years, even though it dipped slightly in 2009 to a still solid 4.6%. Economic growth is expected to be at around 6% in 2012 and 2013, close to the 15-year high of 6.5% in 2011. The main drivers of growth will continue to be strong private consumption and fixed investment growth, while external demand is expected to decrease on the back of slower global growth and lower commodity prices. An accommodative monetary policy and increasing wages are likely to support consumption and investment. The latter also benefits from the strong foreign investment flows into Indonesia.

The financial sector in Indonesia consists of a wide variety of organizations, ranging from a few large commercial banks to a wide variety of local, rural banks and Islamic banks. State influence is present, but relatively limited and the financial sector is open to foreign investment. Currently, eight of the eleven largest banks in Indonesia are foreign-owned. The financial sector performed well during the global credit crunch due to a benign slowdown in the Indonesian economy and the dominant use of domestic funding. Banks in Indonesia tend to use whole-sale and foreign funding on a limited basis, which should to a large extend shield them from an escalation of eurozone problems. The Tier 1 capital of the ten large banks was 13.2% in September 2011. The system-wide average NPL is currently at historic lows of 2.4% end-2011, as can be expected with a strong economic growth rate. Moreover, if the currency would depreciate strongly this could hamper the repayment capacity on foreign currency loans (16.3% of total loans, end-2011).

Political and social situation

The political power in Indonesia is concentrated in the presidential office, with the president acting as head of state and head of government. The president also appoints the government. The legislative power is vested in a tricameral structure, with the 560-seat People's Representative Council (DPR) having the tasks generally appointed to parliament. In the presidential elections of 2009, President Yudhoyono was reelected with 60% of the votes on promises to continue his social and political reform drive. In the legislative elections in the same year, Yudhoyono's Democratic Party (PD) became the largest party with 21% of the votes, ahead of Golkar and Indonesia Democracy Party of Struggle (PDI-P), which both gained 14% of the votes. The DP formed a broad, six-party coalition with both Islamic and secular parties, including Golkar and PDI-P. The next presidential and parliamentary elections are expected in 2014, in which President Yudhoyono is constitutionally barred from running for a third time. As there is no clear successor for him within the PD, significant political maneuvering and lobbying in the party is expected, which will create some degree of political uncertainty. Although it is too early to tell who will have the best chance of winning the presidential elections, it will likely be a candidate from one of the three large parties, PD, Golkar and PDI-P. As all three parties are both part of the coalition and are each other's main competitors, this does not bode well for decision making until 2014.

President Yudhoyono was reelected in 2009 with a comfortable majority, but has since lost popularity. He is increasingly portrait as a lame duck that is unable to push the reform drive forward as he did during his first term. His coalition has a two-thirds majority in parliament, but lacks a common ground, as there are large differences on the necessity, speed and shape of reforms. Moreover, the president is losing credibility on critical issues such as fighting corruption. The DP was involved in a corruption scandal that put the former DP treasurer in jail for five years. The limited progress on these reforms is unfortunate, as Indonesia needs to boost its business climate and infrastructure to lift the country to the next level.

Bright economic figures and rating upgrades cannot conceal that the social situation in Indonesia still faces considerable issues. Strong economic growth supports a gradual increase in GDP per capita, but poverty and (hidden) unemployment are still widespread. Moreover, outbursts of violence between population groups with different ethnic and/or religious background, as well as between locals and foreign companies extracting natural resources remain very present in throughout Indonesia. The government has been criticized for the failure to address those ethnic/religious and mining-related outbursts. Also related to the tension is the administration's action to fighting religious extremism, as lack of action has questioned commitment to this topic. This is said to be the result of keeping peace within the broad coalition that includes Islamic and secular parties. While physical security is endangered at a local level, the regional issues seem no threat to the overall stability of Indonesia.

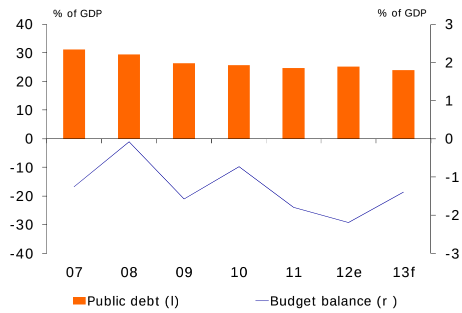
Economic policy

In 2011, the government presented a medium-term growth strategy called the Master Plan for Acceleration and Expansion of Indonesia's Economic Development. Raising per capita income to USD 15,000 in 2025 from USD 3,400 now is central in this plan and it defines the current low added value of production, poor infrastructure and inadequate skill endowment as key challenges to achieving this goal. The recently approved land acquisition law and a series of proposals and laws regarding the mining sector (more on that below) are in line with this strategy. Meanwhile, the anti-corruption drive seems to have slowed and the country still faces some hefty challenges when it comes to reducing red tape and clarifying cumbersome and contradictory legislation. The 2014 elections might put a coalition at the helm that is able to speed up the process again, but expectations that the current coalition will make any substantial progress are low.

With the importance of the mining sector and the drive to move up the value chain in mind, the government devices a series of proposals and laws. These includes a cap on foreign ownership of mines (51% owned by Indonesians after 10 years), a moratorium on export of unprocessed minerals (as of 2014), and a 20% export tax on 65 types of raw minerals (to prevent companies frontloading in light of the ban on unprocessed minerals exports). The push to invest in processing and refining capacity is a welcome step in Indonesia's development, as it will force the country to move up the value chain, and is part of the government aim to achieve valid environmental and developmental goals. These include addressing illegal mining, preventing over-exploitation of resources and the mentioned development of a local processing industry. However, the way to realize these objectives has received (international) criticism, as the current policies raise red flags with investors, fearing nationalism and protectionism. This would further complicate the operational environment for foreign investors in the mining sector. Other sectors, such as manufacturing and banking, are also facing protectionist legislation. While ahead of the 2014 elections more nationalist rhetoric might be popular to attract votes, the mining policies do not seem to be designed just as an election stunt. It is not expected that they will be overturned after the elections, also when another party will become the largest party, which is rather realistic. However, the government also seems to realize that foreign investment is very welcome, therefore some exemptions and extension of deadlines are likely. Moreover, the natural resource wealth of Indonesia is likely to continue to attract foreign direct investment (FDI) anyway, but the recent negative news seems to have a downward effect on portfolio investment.

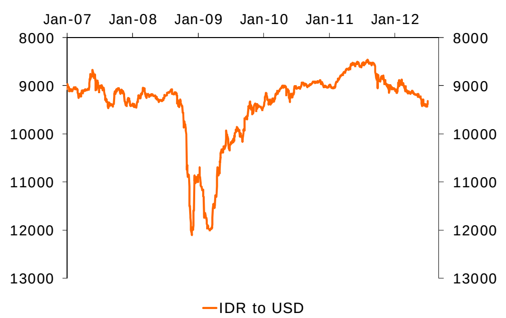
Indonesia is lauded for its solid public finances. Indeed, with a fiscal deficit less than 2% of GDP per year in the past decade and the public debt level at 25% of GDP (end-2011), Indonesia's figures are envied by many countries around the world. However, there is more to Indonesia's fiscal situation. The phrase "smaller-than-expected increase in capital spending" is rather common and points towards the government's weak ability to implement projects. Moreover, the subsidy bill is large and the tax base is rather small. In 2011, the fiscal deficit came in at 1.8% of GDP (targeted 2.1% of GDP), on the back of weak capital spending and stronger revenues, even though the government spend IDR 294.9tr (or 4% of GDP) on subsidies. For the 2012 budget, the government targets a fiscal deficit of 1.5% of GDP and aims to reduce the subsidy bill to allow extra spending on development and social transfers. The price of subsidized fuel has been hotly debated recently. The government planned a 33% fuel price hike in April, but backtracked after strong protests, both on the streets and from coalition parties. In a second round, the government agreed to raise the subsidized fuel prices if the reference crude oil price breached USD 120.75 per barrel in a six-month moving average. However, even if this threshold is reached, the government might, in a populist move, decide against a fuel hike, in light of the upcoming 2014 elections. It is therefore unlikely that the subsidy bill will decrease quickly and whether or not the overall fiscal deficit will overshoot its 2012 target strongly depends on the global oil prices. The recent decline in oil prices are expected to support Indonesia's fiscal budget.

Figure 3: Public finances



Source: EIU

Figure 4: Exchange rate



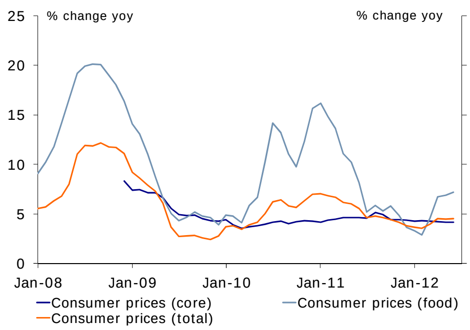
Source: EIU

Public debt is expected to stay at a rather low 25% of GDP in 2012 and 2013. For this year, the government aims to finance its borrowing needs by placing bonds worth USD 12bn in the domestic market and another USD 3bn in the international capital markets. Considering the recent upgrade to investment grade and the general positive view on Indonesia by the market, this should not pose a problem. A 30-year, USD 1.75bn global bond was well over-subscribed in January 2012. Still, the government has developed contingency plans, as it is well aware of the risk of a sudden reversal in investor sentiment. With deposits in the domestic banking sector worth USD 11bn, created by borrowing more than necessary in the past years, the government has ample reserves. Moreover, support from multilaterals was tested in early 2009, when Indonesia arranged a multi-billion contingency financing facility. Currently, about a third of government bonds are held by foreign investors.

Investor sentiment about Indonesia has been rather resilient over 2011, if measured by the volatility of the Indonesian rupiah (IDR), although it has increased in the past months. The rupiah depreciated strongly late 2008 during the global financial crisis, but has since recovered to pre-crisis levels. Since the third quarter of 2011, the rupiah has been on a depreciating path again, but at a much more moderate pace. Together with the short-lived revival in the first months of 2012, the image emerges that the rupiah more reflects changes in global market sentiment than in Indonesia's reputation. However, Bank Indonesia (BI, central bank) is concerned about the volatility of the rupiah, because although the recent changes might not have been as large as in 2008/09, they were still significant. The rupiah lost 10% of its value against the USD since the peak in July 2011. In response, BI has announced several measures to stem the volatility, for example through the USD term deposit launched in June.

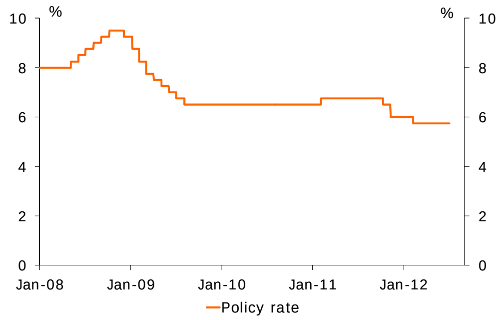
Headline inflation in Indonesia declined over the course of 2011, from 7% year-on-year in January 2011 to 3.6% yoy in January 2012. The fall in headline inflation was largely due to a dramatic fall in food price inflation during 2011. Lately, food prices have been increasing again and headline inflation is therefore expected to increase again too, to an average level of 5% in 2012. This would keep inflation just within the 3.5% - 5.5% target of the central bank. Core inflation has been floating between 4% and 5% year-on-year since early 2010. The lower headline inflation provided BI with some room to cut policy rates. Between September 2011 and February 2012, the central bank cut its policy rate from 6.75% to 5.75% in three steps. Considering that economic growth has been strong, this seemed rather preemptive, but the central bank is worried about the effects of the weak global economy on the Indonesian economy. Going forward, the central bank is likely to pause its loosening cycle in light of the slowly rising inflation, although another rate cut is also possible if economic growth is affected by a weakening world economy.

Figure 5: Inflation



Source: EIU

Figure 6: Policy rate



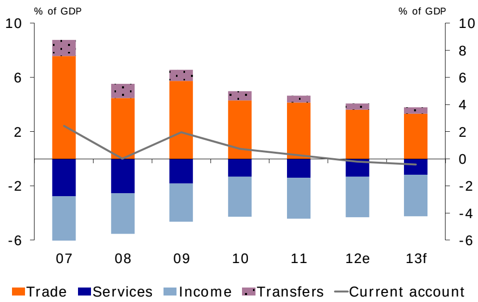
Source: EIU

Balance of Payments

Commodity producers, be it in the mining, gas and oil or agricultural sector, leave their mark on the current account balance of Indonesia. They are responsible for the bulk of the exports. In

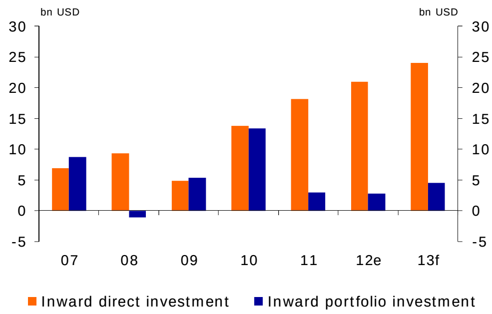
2011, 34% of total exports were accounted for by mineral fuels (oil and gas), 12% by crude materials (minerals and coal) and 11% by animal and vegetable oils (palm oil). As a result, the trade balance of Indonesia shows a large surplus each year. In the past years, this surplus has been decreasing, as the import bill has been rising due to growing average income as well as investment-related imports. The trade balance is expected to have a surplus of 3.6% of GDP this year, down from 4.1% of GDP in 2011. The income balance is determined by the commodity exporting sector as well, as this balance shows a deficit because foreign investors repatriate the proceeds of their investments. In the coming years, therefore, the deficit on the income balance is expected to rise, as foreign investment inflows have been strong in the past years. The services and transfers balances show, respectively, a small deficit and a small surplus. The transfers balance is largely determined by remittances from workers going to Singapore and other countries to work, mostly as household servants. The surplus on the transfer balance is expected to be around 0.5% of GDP in 2012, the same as last year. Overall, the current account balance of Indonesia used to show a surplus, but this surplus has been shrinking in the past years, mostly due to the narrowing surplus on the trade balance. In 2012, the current account balance is expected to show a small deficit of less than 1% of GDP, while in the coming years it is likely to hover around zero.

Figure 7: Current account balance



Source: EIU

Figure 8: Foreign investment



Source: EIU

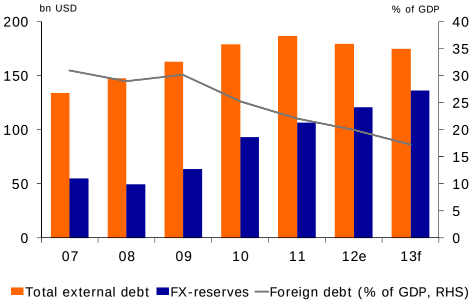
Indonesia is a popular destination for foreign investment. The business climate might be difficult at times, but the natural resource abundance, large domestic market and relative open capital account make the country attractive. Inward direct investment tends to be larger than inward portfolio investment. Outward investment is growing, but still smaller than inward investment. In 2011, foreign direct investment (FDI) inflows amounted to USD 18.2bn or 2.1% of GDP. Portfolio inflows are more volatile. In fact, Indonesia is seen as one of the Emerging Markets most sensitive to changes in investor sentiment and is therefore vulnerable to a reversal of hot money flows (FDI is generally stickier, as this is tied up in longer-term projects). Portfolio inflows dropped to USD 2.9bn (0.3% of GDP) in 2011 from USD 13.3bn in 2010. For 2012 and 2013, levels similar to 2011 are expected, although inter-annual fluctuations can be significant. Moreover, changes in global investor sentiment and responses to local policies, such as new mining laws, can send portfolio flows leaving the country, as happened in 2008.

External position

The combination of current account surpluses, ample foreign investment inflows and strong economic growth has created a comfortable external position for Indonesia. Total external debt has fallen from levels close to 100% of GDP, just after the Asian crisis, to 22% of GDP end-2011, and is expected to decrease further to around 20% and 17% of GDP by the end of 2012 and 2013, respectively. When looking at new external debt (i.e. debt inflows), the high and rising portion of short-term debt is, however, a point of slight concern. It goes back to Indonesia's sensitivity to changes in investor sentiment.

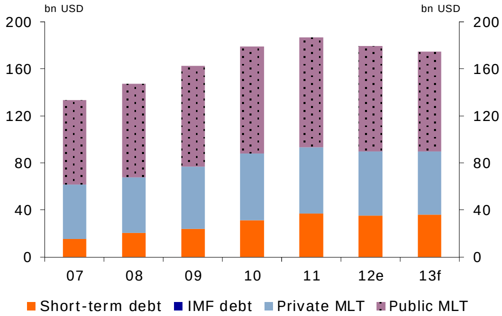
The foreign exchange (FX) reserves of Indonesia have seen a rapid increase in the past years. The FX reserves are expected to more than double between 2007 and the end of this year, from USD 55bn to USD 121bn. This means that while FX reserves covered only 40% of total external debt in 2007, it is now close to 70%. With values of almost 7 months and 124%, the import cover and liquidity ratio, respectively, also reflect Indonesia's comfortable external position.

Figure 9: External debt and FX reserves



Source: EIU

Figure 10: External debt stock



Source: EIU

Rabobank

Indonesia

Selection of economic indicators	2007	2008	2009	2010	2011e	2012e	2013f
Key country risk indicators							
GDP (% real change pa)	6.3	6.0	4.6	6.2	6.5	5.9	6.5
Consumer prices (average % change pa)	6.3	9.9	4.8	5.1	5.4	5.2	6.3
Current account balance (% of GDP)	2.4	0.0	2.0	0.7	0.2	-0.2	-0.4
Total foreign exchange reserves (mln USD)	54976	49597	63563	92908	106539	120940	136260
Economic growth							
GDP (% real change pa)	6.3	6.0	4.6	6.2	6.5	5.9	6.5
Gross fixed investment (% real change pa)	9.3	11.9	3.3	8.5	8.8	9.2	8.8
Private consumption (real % change pa)	5.0	5.3	4.9	4.7	4.7	4.9	5.2
Government consumption (% real change pa)	3.9	10.4	15.7	0.3	3.2	5.5	7.5
Exports of G&S (% real change pa)	8.5	9.5	-9.7	15.3	13.6	7.1	9.6
Imports of G&S (% real change pa)	9.1	10.0	-15.0	17.3	13.3	6.8	9.8
Economic policy							
Budget balance (% of GDP)	-1.3	-0.1	-1.6	-0.7	-1.8	-2.2	-1.4
Public debt (% of GDP)	31	29	26	26	25	25	24
Money market interest rate (%)	6.0	8.5	7.2	6.0	5.6	5.2	5.9
M2 growth (% change pa)	19	15	13	15	16	13	15
Consumer prices (average % change pa)	6.3	9.9	4.8	5.1	5.4	5.2	6.3
Exchange rate LCU to USD (average)	9141	9699	10390	9090	8770	9159	9231
Recorded unemployment (%)	9.1	8.4	7.9	7.1	6.6	6.7	6.3
Balance of payments (mln USD)							
Current account balance	10492	125	10629	5146	2069	-2020	-4230
Trade balance	32754	22916	30931	30627	35348	32460	34060
Export value of goods	118014	139606	119646	158075	201473	213790	241230
Import value of goods	85259	116691	88715	127448	166125	181330	207170
Services balance	-11842	-12998	-9741	-9324	-11822	-11820	-11900
Income balance	-15524	-15156	-15140	-20789	-25667	-26960	-31040
Transfer balance	5103	5364	4578	4630	4212	4290	4650
Net direct investment flows	2254	3418	2629	11107	10437	13000	16000
Net portfolio investment flows	4298	-2423	5225	10873	1517	1560	2400
Net debt flows	4923	11265	14566	14456	1416	-5290	-1340
Other capital flows (negative is flight)	-7631	-17668	-18571	-11490	-1512	7060	2290
Change in international reserves	14336	-5283	14478	30092	13926	14310	15120
External position (mln USD)							
Total foreign debt	133847	147622	162850	179064	186866	179510	174830
Short-term debt	15448	20488	24050	31255	36864	35320	36350
Total debt service due, incl. short-term debt	33908	36822	45367	53348	59008	64790	62060
Total foreign exchange reserves	54976	49597	63563	92908	106539	120940	136260
International investment position	-169168	-147755	-217201	-289266	n.a.	n.a.	n.a.
Total assets	97539	80324	99943	133118	n.a.	n.a.	n.a.
Total liabilities	266707	228079	317143	422384	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	3.6	3.4
Current account balance (% of GDP)	2.4	0.0	2.0	0.7	0.2	-0.2	-0.4
Inward FDI (% of GDP)	1.6	1.8	0.9	1.9	2.1	2.3	2.4
Foreign debt (% of GDP)	31	29	30	25	22	20	17
Foreign debt (% of XGSIT)	95	89	115	97	81	73	63
International investment position (% of GDP)	-39.1	-29.0	-40.3	-40.9	n.a.	n.a.	n.a.
Debt service ratio (% of XGSIT)	24	22	32	29	25	26	22
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	6.7	6.7
FX-reserves debt service cover (%)	162	135	140	174	181	187	220
Liquidity ratio	128	116	131	130	124	124	127

Source: EIU