Country update

INDONESIA

Summary

After growing 4.5% in 2009, the economy is back to its pre-crisis growth level of around 6%. Downside risks to growth are a lower than expected global growth, a reversal of foreign capital flows, and/or a bursting asset bubble. Good growth figures and relative high interest rates have attracted part of the global excess liquidity to Indonesia. Although some is very welcome long-term direct investment (FDI), most is short-term portfolio inflow. A change in global investor sentiment or tightening of monetary policy in western countries could trigger a reversal of the foreign capital flows. Another risk of the hot money capital inflow is the creation of asset bubbles. A reversal of foreign capital flows would have a negative effect on the rupiah. Food prices have increased rapidly in the past months, but total inflation is still low by historic standards. However, a steady increase of inflation in the next months is expected. The much needed progress in the social and political area has been limited lately. The government is increasingly criticized for lack of action.

Things to watch:

- Creation of asset bubbles and/or reversal of short-term capital flows
- Inflation pressure (second-round effects, food and energy prices, depreciation of rupiah)
- Progress on social reforms

Author: **Reintje Maasdam**
Country Risk Research
Economic Research Department
Rabobank Nederland

Contact details: P.O.Box 17100, 3500 HG Utrecht, The Netherlands
+31-(0)30-21-31403
R.Maasdam@rn.rabobank.nl

Indonesia

National facts	
Type of government	Republic
Capital	Jakarta
Surface area (thousand sq km)	1,905
Population (millions)	240.3
Main languages	Bahasa Indonesia, English, Dutch, local dialects.
Main religions	Muslim (86%) Protestant (6%) Roman Catholic (3%)
Head of State (president)	Susilo Bambang Yudhoyono
Head of Government (prime-minister)	Susilo Bambang Yudhoyono
Monetary unit	Indonesian rupiah (IDR)

Economy		2010
Economic size	*bn USD*	*% world total*
Nominal GDP	707	1.14
Nominal GDP at PPP	1026	1.39
Export value of goods and services	170	0.91
IMF quotum (in mln SDR)	2079	0.96
Economic structure	*2010*	*5-year av.*
Real GDP growth	6.1	5.6
Agriculture (% of GDP)	15	14
Industry (% of GDP)	47	47
Services (% of GDP)	38	39
Standards of living	*USD*	*% world av.*
Nominal GDP per head	2909	30
Nominal GDP per head at PPP	4222	36
Real GDP per head	1553	19

Social and governance indicators	rank / total
Human Development Index (rank)	108 / 169
Ease of doing business (rank)	121 / 183
Economic freedom index (rank)	116 / 179
Corruption perceptions index (rank)	110 / 178
Press freedom index (rank)	117 / 178
Gini index (income distribution)	37.58
Population below $1.25 per day (PPP)	29%

Foreign trade			2009
Main export partners (%)		*Main import partners (%)*	
Canada	16	China	16
Mexico	10	Canada	14
China	9	Mexico	10
Japan	9	Japan	7

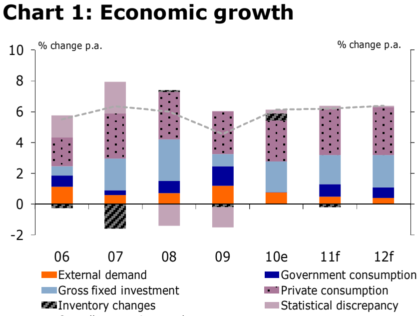
Main export products (%)	*2010*
Automotive vehicles, engines & parts	15
Consumer goods (non-food), excl automotive	9
Capital goods (excl automotive)	6
Industrial supplies & materials	7
Main import products (%)	*2010*
Consumer goods (non-food), excl automotive	73
Capital goods (excl automotive)	16
Industrial supplies & materials	11
Openness of the economy	*2010*
Export value of G&S (% of GDP)	24
Import value of G&S (% of GDP)	21
Inward FDI (% of GDP)	1.8

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

Introduction and update

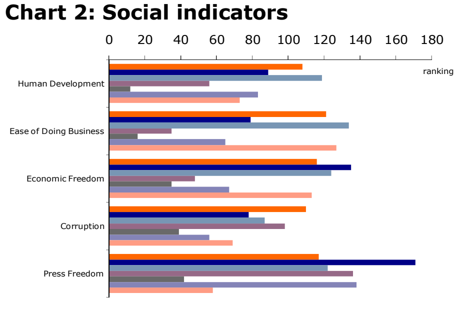
Helped by the large domestic market, the economy of Indonesia was relatively untouched by the global economic crisis. After growing 4.5% in 2009, the economy seems back to its pre-crisis growth level of around 6%, as expected in the November 2010 Country Risk Report. Full year growth in 2010 was 6.1% and in 2011/12, growth is expected to be 6-6.5%. Private consumption, the main driver of growth, is expected to accelerate slightly in 2011 on the back of growing wages and employment. Consumer confidence is currently strong and well above the demarcation line of 100. Last year, the export sector benefitted from the global recovery, but export growth is likely to level off in 2011. Downside risks to economic growth are a lower than expected global growth, a reversal of foreign capital flows, and/or a bursting asset bubble (see also next page). Structural issues continue to hamper Indonesia's progress towards a higher growth level.

Chart 1: Economic growth



Source: EIU

Chart 2: Social indicators



Source: UN, World Bank, Heritage Foundation, Transparency International, Reporters Without Borders (NB: 1 is best).

Reform progress limited

The much needed progress in the social and political area has been limited lately. President Yudhoyono won the 2009 elections on his reform drive, but the pace has slowed since. In an attempt to keep the six-party coalition at peace, President Yudhoyono and his Democratic Party have often chosen for the line of least resistance. This has raised questions on the ability and willingness to stand up against vested interests and anti-democratic forces, and to pursue reforms. A positive move was the appointment of Mr. Martowardojo as Minister of Finance in June 2010. He is seen as less confrontational than his reform-oriented predecessor, but still has a track record of standing up against vested interests.

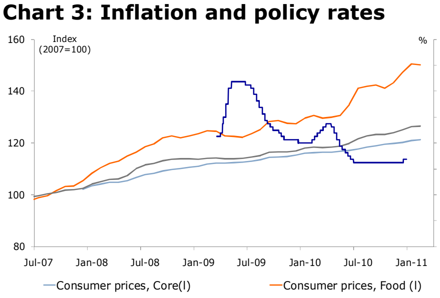
Although progress has been made in the past years, complex issues such as poverty, corruption, democratization, poor infrastructure, and deforestation warrant more action. Also, economic oriented reforms, such as labor market flexibility and cutting red tape, and social issues, such as cohabitation of different population groups, require attention. In January, interreligious tension flared up, resulting in three men killed and several Christian churches burned. The number of attacks on Christian churches increased from 12 in 2009 to 75 in 2010. In this case, but also more in general, the government is increasingly criticized for lack of action – while the government's tolerance of criticism seems to be shrinking.

Rising food prices are not just bad news

Increasing food prices are also felt by Indonesia's population. As poorer families tend to spend more on food, increasing food prices have a large impact. The prices of rice and especially of hot peppers have increased rapidly in the past months. Core inflation, without food and energy, has remained rather benign, but will probably break the central bank's 5% target soon. Despite rising food prices, the headline (total) inflation was only 5% in 2010 and is expected to be around 7% in 2011. This is relative low by historic standards, but upward pressure is certainly present. Besides second round effects, higher pressure could arise from higher oil prices, even higher food prices and a depreciation of the Indonesian rupiah. High food and oil prices could also affect the fiscal situation of Indonesia, considering the large amount of subsidies. However, with an expected budget deficit of 1.3% of GDP the government has some room to spare.

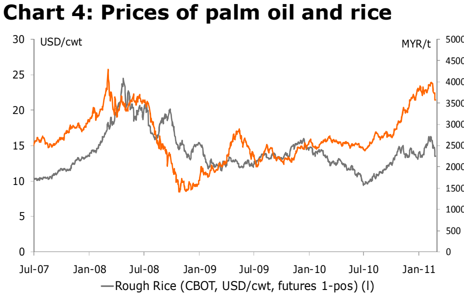
In February 2011, Bank Indonesia, the central bank of Indonesia, increased its policy rate in response the increasing inflation. After aggressively cutting rates in 2009 and another round in the first half of 2010 to stimulate the economy, the Bank Indonesia had kept the rates unchanged. Besides inflation, the central bank is also very concerned with economic growth, the appreciation of the rupiah and inflow of foreign capital. Therefore, aggressive monetary policy tightening does not seem to be likely (as this would slow growth and attract capital), but some rate hikes should be expected.

Chart 3: Inflation and policy rates



Source: Ecowin

Chart 4: Prices of palm oil and rice



Source: Ecowin

Rising food prices are not just bad news. Indonesia is the world's largest producer and second largest exporter of palm oil. The price of palm oil, which is widely used in cosmetics and processed food, increased by around 50% in the past six months. Moreover, several multinationals and local producers have recently announced investments in downstream production in Indonesia. High prices have helped. But probably the higher export tariffs – Indonesia increased export taxes on crude palm oil from 3% to 25% in the past year – also helped to promote investment in downstream production. The new investments, worth USD 1.2bn so far, are good news for Indonesia. It will help to Indonesia to move up the palm value chain.

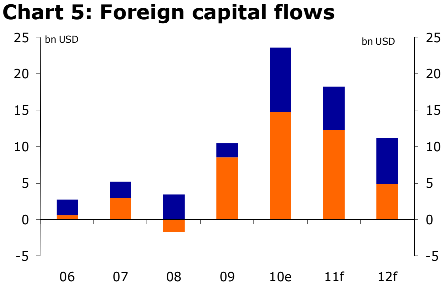
Foreign capital overflows Indonesia

Posting good growth figures and having relative high policy rates and a liberal capital account has made Indonesia attractive for foreign capital. Foreign capital inflows (FDI and portfolio) more than doubled from USD 10.4bn in 2009 to USD 23.6bn 2010 and are expected to stay high at around USD 18bn in 2011. In light of Indonesia's shallow domestic market and huge investment needs, the foreign capital flows are very welcome. However, although some is long-term direct investment (FDI), most is short-term portfolio inflows. The drawback of short-term capital inflows is that by nature they can quickly be reversed. A change in global investor sentiment or tightening of the loose monetary policy in western countries could trigger a reversal. Another risk of hot money inflows is the creation of a bubble, if capital is invested in non-productive assets, such as the stock market or real estate. The Jakarta stock exchange increased by 76% over 2009 and another 43% in 2010, suggesting that at least part of the foreign capital is invested in stocks rather than production capacity.

The rapid accumulation of foreign reserves provides some buffer. The FX reserves are expected to nearly double from USD 63bn to USD 110bn between 2009 and 2011. This year's reserves would cover two thirds of Indonesia's foreign debt or 7 months of imports.

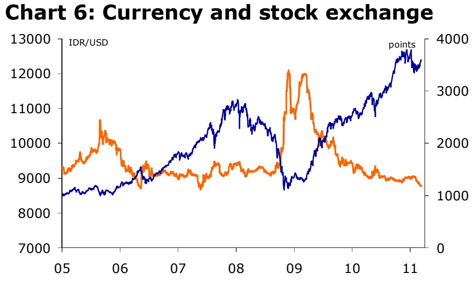
On the back of economic growth and foreign capital inflows, the rupiah has been appreciating. After a strong depreciation early 2009, during the financial crisis, the currency is now back to pre-crisis level. The short-term path of the rupiah depends on continued strong economic growth (pushing hte currency up) and potential reversal of foreign capital flows (which would push the currency down).

Chart 5: Foreign capital flows



Source: Ecowin

Chart 6: Currency and stock exchange



Source: Ecowin

Indonesia

Selection of economic indicators	2006	2007	2008	2009	2010e	2011f	2012f
Key country risk indicators							
GDP (% real change pa)	5.5	6.3	6.0	4.5	6.1	6.2	6.4
Consumer prices (average % change pa)	13.1	6.3	9.9	4.8	5.1	7.3	6.1
Current account balance (% of GDP)	3.0	2.4	0.0	2.0	1.0	1.3	1.1
Total foreign exchange reserves (mln USD)	41103	54976	49597	63563	91812	110970	120770
Economic growth							
GDP (% real change pa)	5.5	6.3	6.0	4.5	6.1	6.2	6.4
Gross fixed investment (% real change pa)	2.6	9.3	11.9	3.3	8.5	8.0	8.8
Private consumption (% real change pa)	3.2	5.0	5.3	4.9	4.6	5.3	5.5
Government consumption (% real change pa)	9.6	3.9	10.4	15.7	0.3	9.5	8.1
Exports of G&S (% real change pa)	9.4	8.5	9.5	-9.7	14.9	9.4	9.6
Imports of G&S (% real change pa)	8.6	9.1	10.0	-15.0	17.3	10.9	11.1
Economic policy							
Budget balance (% of GDP)	-1.0	-0.7	-0.6	-1.6	-0.8	-1.3	-1.1
Public debt (% of GDP)	33	31	28	27	26	24	23
Money market interest rate (%)	9.2	6.0	8.5	7.2	6.1	7.3	8.3
M2 growth (% change pa)	15	19	15	13	15	13	17
Consumer prices (average % change pa)	13.1	6.3	9.9	4.8	5.1	7.3	6.1
Exchange rate LCU to USD (average)	9159.3	9141.0	9699.0	10389.9	9088.3	8927.3	8965.4
Recorded unemployment (%)	10.3	9.1	8.4	7.9	7.1	6.7	6.6
Balance of payments (mln USD)							
Current account balance	10860	10492	125	10743	6948	10400	10080
Trade balance	29661	32754	22916	35132	35888	39330	40200
Export value of goods	103528	118014	139606	119481	154623	180400	201410
Import value of goods	73867	85259	116690	84348	118735	141070	161210
Services balance	-9875	-11842	-12998	-14110	-15087	-15520	-16090
Income balance	-13790	-15524	-15156	-15140	-18804	-18400	-19180
Transfer balance	4863	5103	5364	4860	4952	5000	5150
Net direct investment flows	2188	2254	3418	1929	8871	5950	6400
Net portfolio investment flows	575	2934	-1755	8543	14737	12280	4830
Net debt flows	137	7618	5082	2252	2181	1510	540
Other capital flows (negative is flight)	-5903	-8962	-12154	-8989	-3844	-11090	-12140
Change in international reserves	7857	14336	-5283	14478	28893	19050	9710
External position (mln USD)							
Total foreign debt	132512	142638	150851	156739	160952	164470	164240
Short-term debt	20547	27456	26565	31294	34087	35570	35860
Total debt service due, incl. short-term debt	42100	43352	49606	49777	54266	57080	59400
Total foreign exchange reserves	41103	54976	49597	63563	91812	110970	120770
International investment position	-136856	-169418	-147754	-218425	n.a.	n.a.	n.a.
Total assets	74432	97289	80325	98066	n.a.	n.a.	n.a.
Total liabilities	211288	266707	228079	316491	n.a.	n.a.	n.a.
Key ratios for balance of payments, external solvency and external liquidity							
Trade balance (% of GDP)	8.1	7.6	4.5	6.5	5.1	4.8	4.4
Current account balance (% of GDP)	3.0	2.4	0.0	2.0	1.0	1.3	1.1
Inward FDI (% of GDP)	1.3	1.6	1.8	0.9	1.8	1.2	1.2
Foreign debt (% of GDP)	36	33	30	29	23	20	18
Foreign debt (% of XGSIT)	107	101	91	110	90	78	70
International investment position (% of GDP)	-37.5	-39.2	-29.0	-40.5	n.a.	n.a.	n.a.
Debt service ratio (% of XGSIT)	34	31	30	35	30	27	25
Interest service ratio incl. arrears (% of XGSIT)	4	4	3	4	3	2	2
FX-reserves import cover (months)	5.2	6.0	4.1	6.8	7.4	7.6	7.3
FX-reserves debt service cover (%)	98	127	100	128	169	194	203
Liquidity ratio	117	121	109	128	131	136	135

Source: EIU