Indonesia's Current Prospects

The Economy

With growth over 6%, the Rupiah strengthening, FX reserves at historic highs, direct investment levels steadily increasing and commodity prices stable to strengthening, the Indonesian economy is very strong and the prospects for steady growth for the next two to three years are very high.

This prognosis is also strengthened by the fact that badly needed infrastructure investment, stalled for years by government indecision and infighting, is now moving ahead, albeit at a rate that is far from optimal.

June exports rose for the ninth straight month, up 31.0% (y/y), on top of a 37.4% gain in May. June imports also rose robustly, up 47.6% after a 30.6% gain in May, reflecting higher levels of investment and domestic demand. The overall trade surplus was $0.6 billion.

Also, as the world's biggest producer of thermal coal and palm oil, Indonesia is benefiting from large capital inflows and strengthening demand for raw materials in China.

Indonesia's local-currency bonds have earned investors 15% this year after an increase of 22% in 2009, the best performances among HSBC indices tracking Asia's 10 largest economies excluding Japan. Indonesia's dollar-denominated debt is is the leading gainer this year, up 13% so far.

The only cloud on the immediate horizon is inflation. The 6.22% YoY figure through end July heightens this fear. The increase was mainly led by food and processed food, with prices rising 14.14% and 8.24% respectively. Some of the July increase was seasonal as prices began their usual advance ahead of the Idul Fitri holiday (10-11 September). Prices are likely to be flat after Idul Fitri, if they follow their usual pattern, so the rate should slow in September and October at least.

While a strong rupiah helps soften imported inflation, high domestic growth with increasing demand has its own inflationary momentum. Although dollar-based, higher global commodity prices will also work their way into the domestic economy even though a stronger rupiah will muffle their immediate impact somewhat.

Higher commodity prices, especially for oil, also increase the cost of subsidies which now account for about 20% of the national budget.

The government's announced intention to reduce these subsidies is also a Damocles sword hanging over the market. Historically the government has waited too long to adjust subsidized prices because of strong political resistance, so when adjustments do come, they are large and disruptive, usually driving inflation over 10%

The inflation threat is, thus, quite real. Having held the prime reference rate steady at 6.5% for the last 12 months while its slower growing neighbors have increased theirs, Bank Indonesia (the central bank) definitely seems behind the curve. This is particularly worrisome as rate increases historically have taken significantly longer to affect inflation in Indonesia than is usually the case in most other markets.

Aside from inflation, this very positive picture is also colored by numerous sectoral problems and issues. Investment in many sectors, from mining, oil and gas to pharmaceuticals and security services – to name just a few – provide many examples where investment is blocked or hindered by bad policy, often with nationalist overtones.

Bearing these factors in mind, we are holding our semi-annual forecast GDP growth rate at 6.0% for 2010, as we forecast last April. We have, however, been too pessimistic on the Rupiah/USD throughout the year, and are now strengthening our year-end forecast to 9000, from 9,500 in April.

As for 2011 we are raising our growth forecast to 7% and inflation forecast to 8%. We do not see BI raising its 6.5% reference rate this year, but we see it rising to at least 7.5% in 2011. We expect the Rupiah/USD to end 2011 in the 8500 – 9000 range as growth should remain strong and higher interest rates will attract more foreign inflows.

Politics

The current political scene is quite stable, particularly when compared with the turmoil generated by the attack on former Finance Minister, Sri Mulyani in late 2009 and early 2010 which culminated in her resignation in May.

The attack on Mulyani was reaching its peak when we made our semi-annual forecast last April. At the time we said we could not see Sri Mulyani in the finance post for another year. While we did not anticipate her imminent departure (May 5th), we did say that we didn't see her ouster as having an serious effect on the economy, bar a possible short term weakening of the stock market and the Rupiah. And we favored Agus Martowardojo as the best possible replacement because of his success in reforming Bank Mandiri and his reputation for toughness and integrity.

In the event, Mulyani's sudden resignation could not have come at a worse time because it coincided with the explosion of the Greek debt crisis which roiled global markets. Nevertheless, Indonesian markets held firm. While the Rupiah and the JCI (Jakarta Composite Index) both weakened briefly, they have since recovered to multi-year highs. This provides strong testament to both the inherent strength of the economy and the market's approval of her replacement, the tough-minded Agus Martowardojo who had spent the last several years restoring the balance sheet and the credibility of Indonesia's largest bank, government-owned Bank Mandiri.

There is still something of a political stalemate in parliament and major reform initiatives are not to be expected. By the same token, the current lethargic parliament is equally unlikely to pass much damaging legislation. Thus, the remaining four years of the current administration should be quite similar to the past six which have been conducive to solid domestic growth driven by strong foreign exchange inflows due to commodity exports and both direct and portfolio investment inflows.

The major cloud on the political horizon is the uncertainty surrounding the 2014 presidential election when SBY finishes his second and final term. The constitution limits a president to two terms so SBY will be ineligible to stand again. The cloud emerges because there are no clear front runners. The likelihood is that the election will be closely contested. A narrow margin of victory could give rise to serious electoral challenges.

In 2009 there were about 4 million questionable votes in the presidential election. Given SBY's wide margin of victory, however, the number was immaterial. In a close result where the courts may be called upon to determine a winner (like the Florida case involving George Bush and Al Gore in 2000), there is reasonable doubt that the courts have the respect or credibility to have any decision peacefully accepted by the losers. The election is, fortunately, almost four years away, so there is ample time for the situation to become clearer, but the magnitude of the potential problem is such that it deserves this early warning.

The Bottom Line

The economy is doing well and has both the fundamental strength and the momentum to allow us to expect steady growth for the next three years. The only serious worry at this point is that inflation in 2011 could reduce buying power and keep GDP growth below 7%. Even in this scenario, however, growth prospects remain at least a very respectable 6% plus.

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