Arcadia Market Commentary

July 2009

Indonesia's Economic Outlook

In 2001, Jim O' Neill, the chief economist of Goldman Sachs Group Inc, predicted that the BRICs may overtake the combined $30.2 trillion GDP of the G7 by 2027. On June 12 2009, credit rating agency Moody's Investors Service has upgraded Indonesia's sovereign credit rating outlook to positive from stable, citing the country's strong economic potential and effective fiscal policy. Morgan Stanley published a report about Indonesia on the same day. It stated that political stability, improved government finances and a natural advantage from demography and commodity resources are likely to unleash Indonesia's growth potential. It also forecasted that Indonesia's economic growth may accelerate to 7% starting in 2011, providing a case for its inclusion in the so-called BRIC economies along with Brazil, Russia, India and China. With reference to World Bank's report "INDONESIA ECONOMIC QUARTERLY" and Goldman Sachs' report "The N-11: More Than an Acronym", this article discusses both the current economic development and the long term economic outlook of Indonesia.

According to Morgan Stanley's report, the political stability and buoyant domestic demand will help boost expansion in the USD 433 billion economy. The Southeast Asia's largest economy may grow 60% in the next 5 years to USD 800 billion due to a stable administration, lower capital costs and a government plan to spend as much as $34 billion to build roads, ports and power plants by 2017. But it still lags behind the BRIC economies in the quality of higher education, which is crucial in moving the economy up the value-added ladder.

Indonesia is the world's 4th most populated nation with about 240 million people. Near 52% of the population lived in urban areas, concentrating mostly on the island of Java, which is one of the most densely populated regions in the world. It has young population and the age structure is similar to Brazil, with about 28% population aged from 0 to 14, 66% aged from 15 to 64, and 6% aged 65 or above. The population growth rate is 1.14%, which is slightly lower than Brazil (1.2%). Goldman Sachs estimated that the population of Indonesia will rise to 313 million in 2050, which will be higher than Brazil (228 million) and Russia (109 million). Indonesians aged 20-54 are an important segment of the labor and consumer markets, as they account for about 75% of the total gross income. A burgeoning population, population density in urban areas and the age structure are encouraging news for foreign firms interested in Indonesian market.

Indonesia is one of the most mineral-rich countries in the world, with significant deposits of gold, copper, silver, tin and coal. It's among the world's leading coal producers and plans to double its coal use by 2025, mostly to generate electricity. Besides, it's one of the world's main oil producers, although the production has fallen in recent years. It also has great potential for renewable energy, especially geothermal, which can help sustain the long term economic growth.

Indonesia's current economic slowdown has come relatively later and been more moderate than for many countries. GDP growth slowed from 6.4% y-o-y (Q4 2008) to 4.4% y-o-y (Q1 2009), which is better than expected. For 2008 as a whole the Indonesian economy expanded by 6.1%, only slightly below 2007's 6.3%. In the first quarter this year, externally focused sectors continued to be impacted by the global slowdown, while domestic demand rebounded on buoyant consumer confidence, stable retail prices and renewed investor confidence. Private consumption, which accounts for 60% of GDP, remains strong. The government stimulus package (USD $6.9 bn) which included cash transfer and higher salaries for civil servants, together with the spending relating to the April legislative election and the upcoming presidential election in July are main factors which support the consumption.

Inflation has slowed sharply with the fall in commodity prices. Consumer prices did not move from November 2008 to April, reducing the year-on-year inflation rate to 7.3% from a peak of over 12% in September. The inflation rate has fallen even more for poorer households whose consumer basket has a greater weight in food. Consumer inflation expectations are now at their lowest level since early 2005, when actual inflation was running close to 5%. Lower inflation and the deteriorating global economy have prompted Bank of Indonesia to lower its policy rate by 225 basis points from December to May, after a proactive anti-inflationary stance through Q3 2008. On the other hand, with lower prices for food and fuel, the personal disposable income has not fallen as sharply as expected.

Lower global commodity prices and global demand compression have hit Indonesia's exports and imports. Indonesia's merchandise trade surplus declined from USD 5.8bn in Q3 2008 to USD 4.6bn in Q4, but recovered somewhat in the first months of 2009. Despite the global downturn, Indonesia's external position remains sound. Both the current account and capital flows were in substantial surpluses in Q1 2009, lifting the balance of payments surplus to USD 4 bn. After declining by close to USD 10 billion in September and October, foreign reserve have subsequently been relatively stable rising slowly from USD 50 bn to 56.7 bn at the end of April, equivalent to over 4 months of imports and official debt repayments.

Indonesian bankers became more conservative in line with tightening global financial conditions. New lending has been cut and some new customers have had difficulty accessing credit. Besides, larger banks typically more liquid and smaller banks facing problems. Nevertheless banking sector indicators continue to be relatively robust and the nation's largest banks reported higher net profits in the first quarter of 2009.

Indonesia's public finances are strong, allowing policy makers to quickly move to offset the global downturn's effects. In 2008 the budget deficit was just 0.1% of GDP. Parliament approved an accelerated revised 2009 budget, with a 2.5% deficit target and 1.5% stimulus package. The revised budget seeks to stimulate demand, expanding government spending on infrastructure, and lowering taxes for specific sectors, in addition to already programmed reductions in tax revenues.

We believe the resilience of domestic demand will likely remain the bedrock to Indonesia's growth recovery. Its GDP growth rate is expected to be the third highest in the G20 after China and India, which will provide support for domestic corporate earnings and the stock market. Furthermore, as we expect the revival of commodity, the impact of the Indonesian economy, and subsequently financial market performance, will be positive, as commodity stocks cover almost 20% of the stock market capitalization.

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