Indonesia Economics Update

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Macroeconomic Developments

• Growth
• Balance of Payments, Monetary Policy and Inflation
• Capital market and exchange rate
• National budget and subsidies
After Years of Inefficiency, Indonesia Emerges as an Economic Model

JAKARTA — After years of being known for inefficiency, corruption and instability, Indonesia is emerging from the global financial crisis.
The economy has gained its growth momentum marked by four quarters of accelerating growth.

Sources: BPS via CEIC
Government spending was disappointingly low but investment remained robust

![Graph showing GDP, Private Consumption, Government Consumption, and Investment from Q1 2009 to Q2 2010.](image)

Sources: BPS via CEIC
Investment growth was driven by strong machinery and equipment investment.

Sources: BPS via CEIC
After the GFC, net trade growth has become negative

Sources: BPS via CEIC
Real exchange rate (REER) has increased slightly more than the nominal rate (NEER)

Sources: IMF
Non-tradable sector grows faster than the tradable sector after the AFC

Growth of Tradables and Non-tradables Sectors
(% p.a.)

-25 -20 -15 -10 -5 0 5 10
Dec-94 Dec-96 Dec-98 Dec-00 Dec-02 Dec-04 Dec-06 Dec-08 Dec-10

Tradables
Non-tradables
Growing concern about weak manufacturing sector growth

Sources: BPS via CEIC
Commodity exports have increased significantly:

Palm Oil

Sources: BPS via CEIC and World Bank
Commodity exports have increased significantly: Coal

Sources: BPS via CEIC and World Bank
While manufacturing exports seem stagnant:
Textile, garments, footwear and electronics

Sources: BPS via CEIC and World Bank
Balance of payments is in surplus and foreign reserves increase

Sources: BI, Note
Capital market and exchange rate trends show growing investors’ confidence in the economy.
Inflation has increased but no sign of tightening monetary policy

Sources: BI
National budget has been expanding but there is still room for fiscal expansion

Sources: MoF
Energy subsidy is expensive. It is much larger than public spending on infrastructure.

Sources: MoF
Need strong political will to reduce current subsidy and spend more on infrastructure

Sources: MoF

<table>
<thead>
<tr>
<th>Year</th>
<th>Total Subsidies</th>
<th>Infrastructure</th>
</tr>
</thead>
<tbody>
<tr>
<td>2008</td>
<td>24%</td>
<td>8%</td>
</tr>
<tr>
<td>2009</td>
<td>15%</td>
<td>8%</td>
</tr>
<tr>
<td>2010</td>
<td>18%</td>
<td>10%</td>
</tr>
<tr>
<td>2011</td>
<td>15%</td>
<td>12%</td>
</tr>
</tbody>
</table>
POLITICAL DEVELOPMENTS

• Declining enthusiasm for fight against corruption?
  – Sentence remission for convicted corruptors
• Lapindo mudflow disaster
  – All-but-forgotten, cf BP in Gulf of Mexico
• Establishment of the National Economic Committee and the National Innovation Committee
Redenomination of the rupiah

• BI foreshadows redenomination of the rupiah:
  – Ease of transactions and simplification of bookkeeping
  – National pride—currency with too many zeros indicates history of weak monetary management!
• Rp new 1 = Rp old 1000 (why not 10,000 = ± $US1?)
• Transition period 2013-15 (both currencies circulate, freely exchangeable in both directions)
• From 2016, only new rupiah issued (but old rupiah can still be exchanged at the banks with new rupiah)
• Past history of redenomination/devaluation that caused losses to public
• Hence, very important to explain that redenomination is not wealth confiscation
Slow growth of manufacturing sector since Asian Financial Crisis

- After AFC, little investment in manufacturing sector. Why?
- Relocation of foreign manufacturing firms in labour-intensive industries to Vietnam and other lower-wage countries
  - Exacerbated by Labour Law of 2003 (raised labour costs)?
- ‘Dutch Disease’ effect of rapid rise in world commodity prices and consequent rupiah (real) appreciation?
  - Booming commodity-based exports have negative impact on other exports (and import substitutes, especially non-commodity manufactures)
Slow growth of manufacturing sector since Asian Financial Crisis

• Poor logistics (especially poor infrastructure) increase costs of inputs and transport for manufactured products
  – One response: 1st phase of railway construction from Jababeka Industrial Estate to Tanjung Priok port
• Some Good News: Indonesia’s relatively low dependence on manufactured exports made it less vulnerable to GFC
  – Manufactured exports more affected by global slowdown than primary exports
  – But: will weak manufacturing hold back further recovery, and more rapid poverty reduction?
Worsening traffic congestion in Jakarta

• SBY’s three suggestions:
  • Build more flyovers, underpasses, and a Mass Rapid Transit system as in Bangkok
    – Monorails and metros (underground trains) ?
  • Build a new capital city, like Canberra or Brasilia
    – But these weren’t built to deal with traffic congestion!
    – Why would this succeed when Jakarta has failed?
    – Building new capital city is extremely expensive
  • Retain Jakarta as capital, but build a new administrative capital, like Putrajaya in Malaysia
    – Is it realistic or desirable to separate the government sector from business/commercial/residential areas?
Worsening traffic congestion in Jakarta

• Current ‘solution’: ‘Three-in-one’ rule
  – ‘Jockey’ payment is just like a toll payment, but not to government

• New call for strictly enforcing ban on motor vehicles using express busways
  – But this is a predictable response when there are far too few express buses, so that busways not fully utilised

• Much better (partial) solution: electronic road pricing (like in Singapore)
  – Payment goes to government; revenue can be used to improve road infrastructure

• Further solution: Much higher taxes on ownership of motor cars, like in Singapore, but need much better and expanded public transport
  – Again, revenue can be ploughed back into improving infrastructure
Investment climate

- Indonesia’s poor investment climate is still of concern to overseas operations of Japanese manufacturers (biggest foreign investors in non-oil and gas sector and financial sector)
- Major issues mentioned in JETRO, Jakarta, annual surveys:
  - Lack of security and social stability (mentioned by 41.7% of surveyed firms)
  - Underdeveloped infrastructure (35.4%)
  - Unclear execution of legal system (27.1%)
  - Difficulty in recruiting local managers (27.1%)
  - Rising labour costs (27.1%)
Japanese Manufacturing Companies Planning to Maintain/Expand/Scale Back or Withdraw Operations in Medium Term (% of respondents)

- **Thailand**: Maintain present level (95), Expand (5)
- **Indonesia**: Maintain present level (85), Expand (15)
- **Malaysia**: Maintain present level (75), Expand (25)
- **Philippines**: Maintain present level (80), Expand (20)
Country rankings in *Doing Business 2010* (among 183 economies surveyed)

<table>
<thead>
<tr>
<th>Country</th>
<th>Rank</th>
</tr>
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<tbody>
<tr>
<td>Singapore</td>
<td>1</td>
</tr>
<tr>
<td>Hong Kong, China</td>
<td>3</td>
</tr>
<tr>
<td>Thailand</td>
<td>12</td>
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<tr>
<td>Malaysia</td>
<td>23</td>
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<tr>
<td>China</td>
<td>89</td>
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<tr>
<td>Vietnam</td>
<td>93</td>
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<tr>
<td><strong>Indonesia</strong></td>
<td><strong>122</strong></td>
</tr>
<tr>
<td>India</td>
<td>133</td>
</tr>
<tr>
<td>Philippines</td>
<td>144</td>
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</tbody>
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Indonesia’s ranking in *Doing Business 2010* (among 183 economies surveyed)

<table>
<thead>
<tr>
<th>Category</th>
<th>Indonesia</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overall Ease of Doing Business</td>
<td>122</td>
</tr>
<tr>
<td>Starting a business</td>
<td>166</td>
</tr>
<tr>
<td>Construction permits</td>
<td>61</td>
</tr>
<tr>
<td>Employing workers</td>
<td>149</td>
</tr>
<tr>
<td>Registering property</td>
<td>95</td>
</tr>
<tr>
<td>Getting credit</td>
<td>113</td>
</tr>
<tr>
<td>Protecting investors</td>
<td>41</td>
</tr>
<tr>
<td>Paying taxes</td>
<td>126</td>
</tr>
<tr>
<td>Trading across borders</td>
<td>45</td>
</tr>
<tr>
<td>Enforcing contracts</td>
<td>124</td>
</tr>
<tr>
<td>Closing business</td>
<td>142</td>
</tr>
</tbody>
</table>
Little FDI in manufacturing in Q1 2010

Agriculture: 2%
Mining: 19%
Manufacturing: 18%
Services: 61%
Mining investment

• Three counterproductive obligations imposed on foreign mining companies (reflecting ‘resource nationalism’)

1. Certain % of mining output for domestic market
   – Equivalent to protection to local downstream manufacturers

2. After only five years of operations, foreign companies should divest 20% to State or Regional government-owned enterprises
   – Reversing the sensible, but politically unpopular, trend to privatisation
   – Will result in rent capture by politicians, government officials and the management of SOEs

3. Foreign mining companies have to set up domestic processing facilities to ‘increase local value added’
   – Will increase processing costs, reducing the realized value to Indonesia from these natural resources
Thank You