

Indonesia: still growth opportunities to be tapped

Johanna Melka

In the short term, the main risk for the Indonesian economy is a tightening of US monetary policy, which could place downward pressure on the rupiah. In the medium term, the country risks getting stuck in a “middle income trap”. The first risk is presumably small. Indonesia has consolidated its macroeconomic fundamentals over the past five years, and its external vulnerability has been sharply reduced. The second risk is higher. To transform itself into a high income country, Indonesia must follow South Korea’s growth model by developing its manufacturing sector. Yet the lack of infrastructure and a low-skilled population are hampering its development and its integration in global value chains. After President Widodo took power in 2014, numerous reforms have been launched. His re-election in 2019 would allow Indonesia to continue along this track.

Since Joko Widodo took power in 2014, Indonesia has consolidated its economic situation, although growth has slowed. Macroeconomic imbalances are narrowing, the country’s external vulnerability has declined sharply, and the business environment has improved thanks to the government’s major reform efforts. As a result, the tightening of US monetary policy poses less of a threat to Indonesia today than it did in 2013. At the time, the simple prospects of a US key rate increase sent the rupiah plunging by more than 20% against the dollar, despite forex interventions by Indonesia’s central bank to stabilise the currency. Since 2015, in contrast, Indonesia has shown strong resilience to the international economic and financial environment.

A bigger risk looms in the medium term: Indonesia risks getting stuck in a middle income trap – its large active population ages without transforming the country into a high-income one – which would weigh on public finances. Despite the country’s demographic advantage, its medium-term growth prospects are still modest, especially with regard to the country’s level of development. With per capita GDP estimated at USD 3700 in 2017, Indonesia still ranks among the so-called “lower middle income” economies. To become a “high income” economy, it must follow the growth model of the other Asian countries, like the one pioneered by South Korea, by significantly developing its manufacturing sector. So far, however, manufacturing’s contribution to Indonesian growth has been small, and is tending to decline. These results reflect Indonesia’s low competitiveness compared with the other ASEAN countries. A low-skilled active population, poor infrastructure and cumbersome regulations undermine Indonesia’s competitiveness and attractiveness. To counter these headwinds, President Joko Widodo’s government has launched major reforms since he took power in 2014. His re-election in April 2019 would allow Indonesia to continue along this track.

Consolidation of macro-economic fundamentals since 2014

Since 2015, Indonesia has shown strong resilience to the international economic and financial environment. Its macroeconomic fundamentals and the business climate have improved. Acknowledging these strong

improvements, the rating agencies Standard & Poor’s and Fitch upgraded their sovereign ratings for Indonesia in May 2017 and February 2018, respectively. Although Indonesia is still exposed to the external environment, it is less vulnerable today than it was five years ago to an upturn in risk aversion among foreign investors.

A more solid structure for public finances

Over the past five years, the fiscal deficit has been held well below the government’s ceiling of 3% of GDP. According to the ministry of finance’s preliminary estimates for 2017, the fiscal deficit narrowed to only 2.5% of GDP, even though revenues as a share of GDP declined to 12.3%, compared with 15.5% five years earlier. In comparison, in the other ASEAN countries the ratios ranged from 16.3% of GDP in Malaysia to more than 23% of GDP in Vietnam¹.

The fiscal deficit was brought under control through ongoing cutbacks in spending, which accounted for only 14.7% of GDP in 2017, down from 17.3% in 2012. Yet the government also managed to optimise the structure of spending. It reduced the share of “non-productive” expenditure (notably subsidies, starting in 2014²) by more than 6 percentage points of GDP while increasing infrastructure investment. To reduce the poverty, the president also increased the share of funds transferred to the regions, so that local governments could target the assistance measures more effectively.

At the same time, a drop in oil prices triggered a sharp decline in oil and gas revenues (which declined by 2.8 percentage points of GDP in the period 2012-16), which the government offset by setting up a tax amnesty programme for funds repatriated from abroad. Amnesty generated the equivalent of 1.1% of GDP in additional revenues between July 2016 and March 2017. The big question today is whether this programme will have a positive impact on tax collection on top of the “regularisation” effect.

¹ In 2017, the IMF estimated fiscal revenues in Thailand and the Philippines at 21.9% and 19.5% of GDP, respectively.

² Subsidies accounted for only 1.3% of GDP in 2017, down from 3.8% of GDP in 2014.



Indonesia: public finances

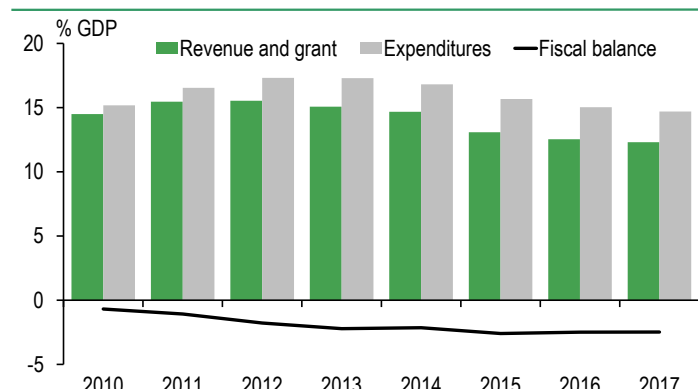


Chart 1

Sources: MoF, CEIC

Thanks to strong fiscal discipline, Indonesia is one of the least indebted countries in Asia. In 2017, government debt was estimated at 28.5% of GDP. Yet the debt structure does present some risk: it is especially exposed to forex and interest rate shocks. 80% of the debt is comprised of debt securities with very volatile financing costs. Moreover, nearly 60% of the debt is held by foreign creditors, which creates a major refinancing risk in case there is a new bout of mistrust towards the emerging countries. Even so, 72% of the debt held by foreign investors matures in more than five years. High exposure to foreign investors also creates a foreign currency liquidity risk if foreign investors flee the local currency bond market. Bonds denominated in foreign currencies account for 41% of government debt, which implies the risk of an automatic revaluation if the rupiah depreciates.

Well aware of these risks, Indonesia's monetary authorities have made stabilising the rupiah one of their main monetary policy objectives. Since 2015, the currency's exchange rate has remained fairly stable against a basket of currencies of its main trading partners, and has regained 0.3% against the US dollar.

Less external vulnerability

Today Indonesia is less vulnerable to a change in US monetary policy and to capital flight than it was in 2013 and 2015. In 2013, the simple prospects of a US key rate increase generated fierce mistrust of the emerging countries, and of Indonesia in particular. Capital outflows pushed down the rupiah, which depreciated by more than 20% against the US dollar. At the same time, Indonesian bond yields rose by more than 330 basis points.

The country's external vulnerability has declined substantially since second-quarter 2014, thanks to a sharp reduction in the current account deficit, which dropped to 1.7% of GDP in 2017, compared with 3.1% of GDP in 2013. In February 2018, foreign reserves were equivalent to 1.8 times the country's short-term financing needs (defined as the sum of the current account deficit and debt payable within one year), whereas they were barely enough to cover them once in 2013. As a result, the monetary authorities have more manoeuvring room for forex market interventions to stabilise the rupiah.

The structure of the balance of payments has also improved. Since 2015, foreign direct investment inflows (2.2% of GDP in 2017) have been high enough to cover the current account deficit.

Indonesia: short-term external financing needs and foreign exchange reserves

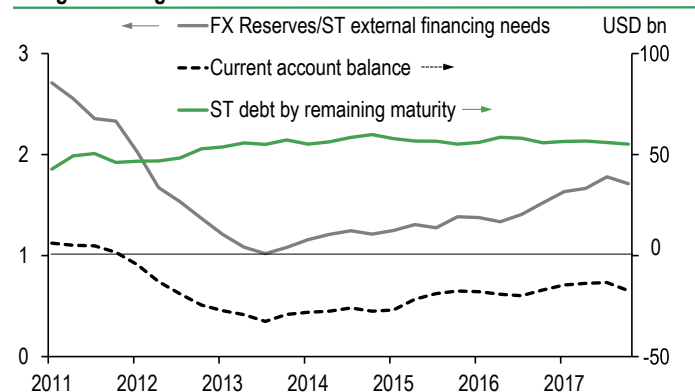


Chart 2

Source: CEIC

Indonesia: balance of payments

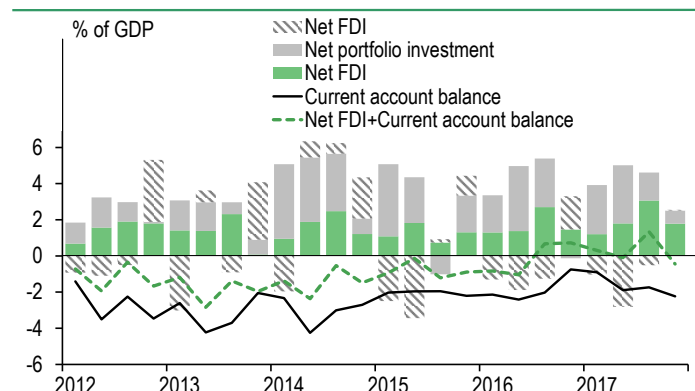


Chart 3

Source: CEIC

Even so, Indonesia is still vulnerable to the international environment. Its trade balance is dependent on commodity price trends, which affect the value of both imports and exports. As net oil importer, Indonesia benefited from the decline in international oil prices through second-quarter 2017 (its oil bill declined by nearly 3 percentage points of GDP). As a major net exporter of commodities excluding oil and natural gas (44% of exports in 2017), revenues are dependent on coal, palm oil and rubber pricing trends. In the short and medium term, the balance of payments deficit should widen slightly due to the rebound in oil prices and the upturn in household consumption during the pre-electoral period. With its poorly developed manufacturing industry, Indonesia must import most of its capital goods. Yet foreign direct investment (FDI) should remain high enough to cover the current account deficit.

The risk of capital flight is the main source of Indonesia's external vulnerability. Although portfolio investment flows have diminished by 0.2 percentage points since 2014, they still accounted for 2.4% of GDP in 2017, and 49% of the country's capital inflows. In stock terms, portfolio

investments comprise 70.7% of Indonesia's net liabilities with non-residents (24% of GDP): government bonds held by non-resident investors account for 6.2% of GDP (41% of tradeable government securities) while equities account for 10.5% of GDP. Major capital outflows similar to the ones seen in 2013 and 2015 would place downward pressure on the rupiah.

Yet the external debt structure has consolidated slightly since 2015. First, private debt accounted for only 16.9% of GDP in 2017, compared with 19.5% of GDP in 2015. Second, refinancing risk has declined. Only 15.5% of debt matures within one year, 5 percentage points less than in 2015. Third, after boosting foreign reserves and reducing short-term debt, foreign reserves now cover 2.3 times debt payable within the next twelve months, compared with only 1.8 times in 2015. Lastly, although the share of external debt denominated in foreign currencies is still very high, it has declined by 5 percentage points to 80% of the external debt, or the equivalent of 27.8% of GDP. Moreover, to reduce the risk of a revaluation of private external debt, Indonesia's monetary authorities have introduced major regulations since 2015 (that were further strengthened in 2016) that require companies to cover their foreign exchange positions³. At the same time, to reduce their foreign exchange risk, state-owned companies began issuing "komodo bonds" denominated in rupiahs and issued on the London Stock Exchange. In 2017, two bonds were issued by Wijaka Karya and Jasa Marga for a total value of USD 700 million. Three other state-owned companies plan to do the same in 2018⁴.

The business climate has improved

The business climate has improved substantially over the past five years, both in terms of the quality of governance and the ease of doing business, even though the country still ranks rather poorly, and trails notably behind Malaysia.

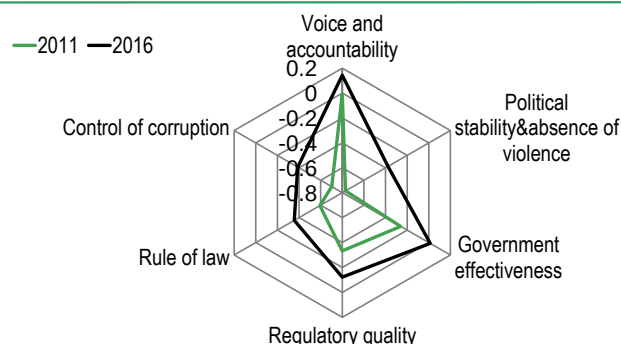
In terms of governance, Indonesia ranked 113th out of 211 countries in 2017, ahead of India, the Philippines and Thailand. It has climbed 24 ranks over the past five years. Respecting the rule of law remains one of the country's biggest weaknesses.

As to the "ease of doing business", Indonesia ranked 72nd out of 190 countries in 2017, a 44-rank improvement in five years. Yet with the exception of the Philippines, the country still ranks last among the ASEAN countries.

Lastly, in terms of competitiveness, Indonesia ranked 36th out of 137 countries in 2017, a 14-rank gain in five years, thanks mainly to the net improvement in the quality of infrastructure. Indonesia's competitiveness continues to be hurt by the poor quality of education, labour market

inefficiency and technological maturity, which explains its lag, notably compared with Malaysia and Thailand.

Indonesia: the governance has improved since 2011

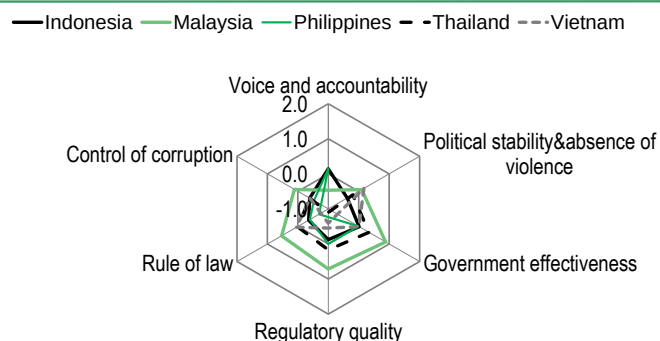


(ranges from approximately -2.5 (weak) to 2.5 (good) governance performance)

Chart 4A

Source: World bank

Governance indicators in ASEAN-5: Indonesia passed ahead of the Philippines and Thailand



(ranges from approximately -2.5 (weak) to 2.5 (strong) governance performance)

Chart 4B

Source: World bank

ASEAN-5 : ease of doing business (ranking out among 200 countries)

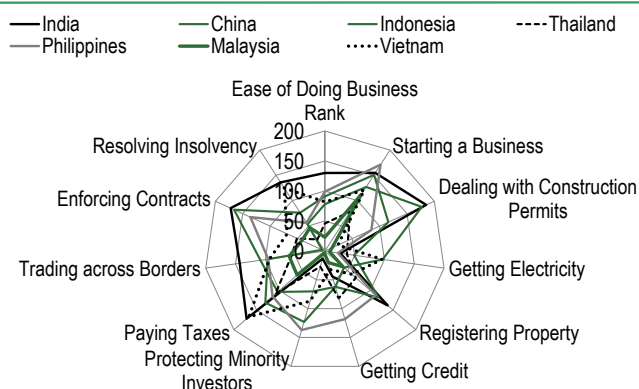


Chart 4C

Source: World bank

³ Only companies with a BB- rating or higher can issue bonds denominated in a foreign currency. They must also have a liquidity coverage ratio (LCR) of at least 70% (i.e. the ratio of short-term assets over liabilities in foreign currencies). 25% of their net forex position must be covered via an Indonesian bank.

⁴ To date, a total of USD 2.7 billion in komodo bonds have been issued. Indonesia benefits from the fact that supranational institutions, such as EBRD and the Inter-American Development Bank, began to issue this type of instrument in 2007.

Growth continues to fall short of government targets

Despite improvements in macroeconomic imbalances and the business climate, economic growth has been somewhat disappointing. At 5.1% in 2017, growth fell well below President Widodo's 7% target, which he set after taking office in 2014. Growth prospects are not very bright either.

Growth has slowed since 2013

Over the period 2013-17, growth averaged 5.1%, down from an average of 6% in 2008-12. This slowdown can be attributed to the decline in the contribution of labour and capital, but also to smaller gains in Total Factor Productivity (TFP) than in the other ASEAN countries. Clearly, Indonesia does not create enough quality jobs and does not invest enough in technological progress.

The Conference Board's breakdown of growth shows that hourly labour productivity gains have slowed by 0.6 percentage points to 3.6% over the past five years. This is 0.5 points less than Thailand, whose level of development is higher than Indonesia's.

Indonesia: distribution of employment by main sectors



Chart 5

Sources: MoF, CEIC

The slowdown in growth reflects the decline in both the quality and quantity of labour. While the unemployment rate hit a low of 5.3% in 2017, the share of precarious jobs (notably in the informal sector) was still over 57% according to the International Labour Office. Moreover, the lack of skilled workers hampered labour mobility from the least productive sectors towards the more productive ones. Manufacturing, a sector that creates jobs with a high level of productivity, failed to absorb the job destructions in agriculture. In five years, less than 3 million jobs were created in industry, 2.4 times less than in the services sector. As a result, the share of employment in the secondary sector⁵ has been relatively stable (21.1% in 2017) while it has increased sharply in the

⁵ Manufacturing, construction, and the distribution of water, gas and electricity. In 2017, manufacturing made up only 14% of employment.

tertiary sector (48% of employment). This tendency hinders labour productivity gains.

At the same time, capital's contribution to growth dropped by 0.3 percentage points. Although infrastructure spending increased strongly, investment in capital goods slowed sharply, especially for goods with a high technology content.

Lastly, TFP growth (i.e. productivity gains generated by a better combination of production factors and/or technical progress) declined by 0.2 percentage points to only 0.4% over the period 2013-17 compared with 1.6% in the Philippines, 1.2% in Thailand, 1.4% in Vietnam and 1.6% in India.

Breakdown of Indonesian GDP growth

	1991-97	2000-07	2008-12	2013-17
GDP growth	7.3	4.9	6.0	5.0
Labour quantity contribution	1.1	1.2	0.9	0.7
Labour quality contribution	0.9	0.5	0.8	0.7
Capital contribution	5.1	2.5	3.4	3.1
TFP growth	0.2	0.8	0.9	0.4

Table 1

Source: Conference Board

Growth prospects appear strong, but are hampered with regard to the country's development

Although Indonesia benefits from a major demographic advantage compared with other Southeast Asian countries, its growth prospects are still being thwarted. To benefit fully from its demographic advantage, the government must develop its manufacturing industry. That will require simultaneous efforts on labour, capital and regulations.

Indonesia has a non-negligible advantage: its active population

In 2017, Indonesia's national statistics office estimated the country's working age population at 192 million, which is more than 73% of the total population. According to UN estimates, alongside the Philippines, Laos and Cambodia, Indonesia is one of the Southeast Asian countries whose active population should continue to grow as a share of the total population through 2030. The IMF estimates that the increase in Indonesia's active population could generate real GDP growth of about 1 percentage point over the period 2020-50.

To generate sufficiently high productivity gains to increase per capita income, the country must develop employment in the manufacturing industry. The International Labour Organisation estimates productivity in the manufacturing sector at USD 14,282 in 2017, compared with USD 8,079 in services. In 2017, the manufacturing sector employed only 14.1% of the labour force, or just 0.2 percentage points more than five years earlier. Over the same period, the service sector's share of employment increased nearly 5 percentage points to more than 48%.



Feeble job creations in the manufacturing sector is mainly due to the sector's slow growth. The ILO estimates the elasticity of employment to growth at 0.77 in industry, 0.57 in services and 0.02 in agriculture.

Growth in the manufacturing sector is not strong enough to generate a big increase in productive employment

Since 2015, the manufacturing sector's contribution to economic growth has declined. In 2017, its contribution was less than 20%, three points less than in 2013.

Indonesia: contribution of main sectors to the economic growth

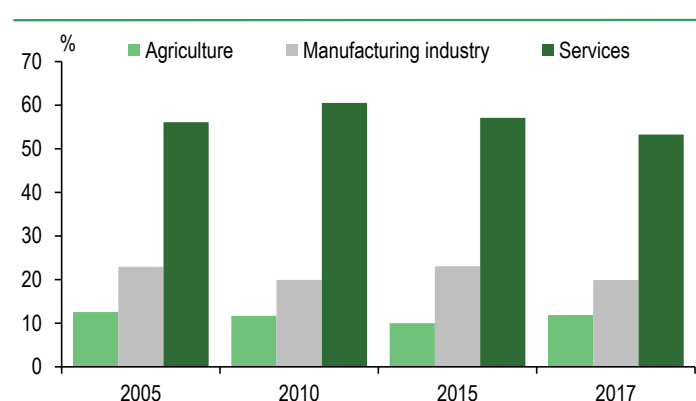


Chart 6 Sources: MoF, CEIC

The manufacturing industry is not very competitive

The loss of competitiveness of Indonesian products over the past fifteen years can be attributed to the slowdown in manufacturing growth. Although, for all products combined, its share of global markets has remained relatively stable over the period 1995-2016, for manufactured products it has declined by 0.2 percentage points, to 0.6% in 2016.

Yet the situation varies by type of export product. Market share has increased for low value-added manufactured goods (low technological intensity), while remaining flat for products with intermediate value added and declining for high value-added goods. Indonesia has been hit by competition with other Asian countries, notably Vietnam, whose market share has increased strongly for low value-added products.

In 2016, Indonesia's revealed comparative advantages⁶ were still concentrated in primary products (agricultural products, metals and fuels) and in highly labour intensive manufactured goods with a low technological content such as the textile sector. Even though the country does not yet have any comparative advantages in technology intensive products, we can see an increase in their export weight (automobile sales, for example). In comparison, China, Thailand, Malaysia, the Philippines and Vietnam all have comparative advantages in technology intensive products.

⁶ The notion of revealed comparative advantage was introduced by Balassa (1965). The country i has a comparative advantage for product j if the following ratio is greater than 1: $RCA_{ij} = (x_{ij}/X_{it}) / (x_{wj}/X_{wt})$, where x_{ij} and x_{wj} are respectively the exports of product j by country i and by the world, and where X_{it} and X_{wt} are the total exports by country i and world exports.

Revealed Comparative Advantage: (RCA above 1 indicates that the country has a revealed comparative advantage)

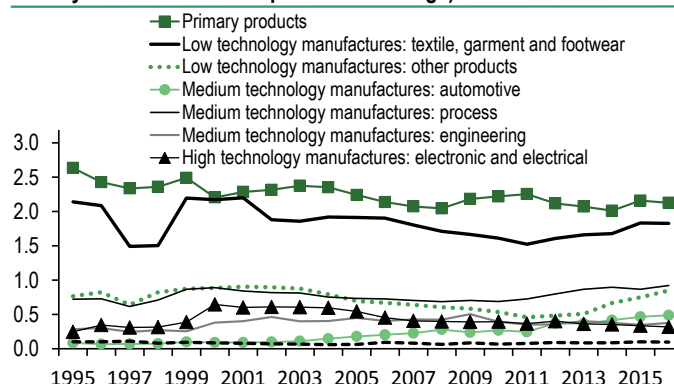


Chart 7 Sources: UNComtrade database, BNP Paribas estimates

Unlike the other Asian countries, Indonesia is not very integrated in the global value chains. Greater integration in global value chains would help boost Indonesia's productivity and could significantly increase the level of income (Kummritz 2016, Taglioni and Winkler, 2016).

In 2014, Indonesia's participation in global value chains⁷ (expressed as a percentage of exports) was estimated at 43% by the OECD-World Bank, compared with a range of between 55% and 60% for Thailand, the Philippines, Vietnam and Malaysia. Moreover, its participation apparently declined between 2011 and 2014. Given its comparatively weak advantages in technology-intensive exports, Indonesia's contribution mainly lies in its forward participation, i.e. the contribution of intermediate products that are used by trading partners for re-export.

Indonesia's participation in Global Value Chains

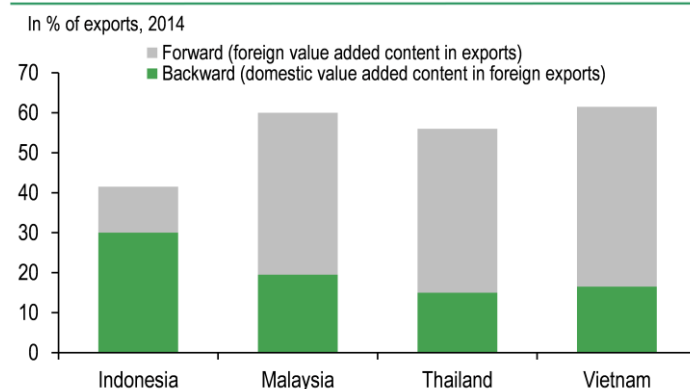


Chart 8 Sources: OECD, WTO, IMF estimates

The structure of Indonesian trade reflects one of the major structural constraints hindering its development: a low-skilled workforce. To increase its competitiveness, especially in products with higher value added, and to increase its participation in the development of global supply chains, Indonesia must increase the skills level of its workers.

⁷ Sum of exported goods using the added value of imported products (backward participation) and exported goods that will be used in the production process of other countries (forward participation) as a share of total exports.

Not enough low-skilled jobs to meet demand

In 2017, 6 out of 10 workers had not completed secondary school, and only 12% had graduate degrees.

Indonesia: distribution of the active population by degree (2017)

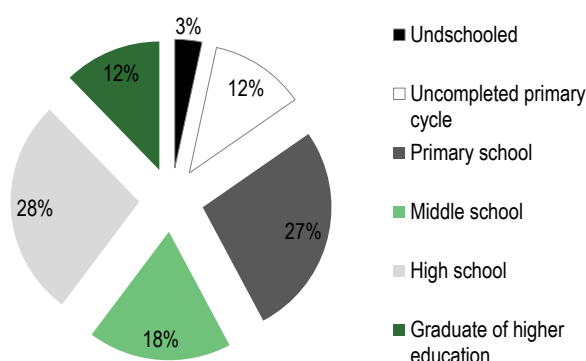


Chart 9

Source: BPS

The lack of skilled workers results in a mismatching of job supply and demand. According to the Asian Development Bank (ADB), only 40% of workers held jobs that matched their skills level in 2015. More than 51% were under qualified, and 8.5% were over qualified.

The low skills level also hinders the transfer of labour from the least productive sectors towards the more productive ones.

To raise the skills level of Indonesian workers, the government adopted a fiscal law in 2003 that calls for 20% of expenditure to be allocated to education. In comparison with the other Asian countries, however, its education expenditure is still moderate. It amounted to only 3.6% of GDP in 2016, compared with World Bank estimates of more than 5% in Malaysia and Vietnam. In the latest PISA survey results, Indonesia still ranks very low⁸, despite net improvements. Indonesian students lag three years behind their Asian neighbours (notably Malaysia, Thailand, and Vietnam). These results can be blamed on the insufficient allocation of financial resources to education, notably by regional and local governments, but also on shortcomings in the quality of teaching.

FDI is smaller than in the other Asian countries, and still concentrated in the mining industry

Another factor that would boost competitiveness, productivity and per capita income is to attract more foreign direct investment (FDI). FDI encourages technology transfers and fosters an upmarket shift in the products produced by a country.

Over the past five years, FDI inflows as a share of GDP have remained stable at about 2.4% of GDP, despite the easing of restrictions on foreign investment since Joko Widodo took power. In 2017, Indonesia attracted less FDI than Vietnam (5.7% of GDP), Malaysia (3.5% of GDP) and Thailand (3.5% of GDP, before the 2014 coup d'état).

⁸ In the 2015 PISA ranking for the Sciences, Indonesia ranked 65th, behind Vietnam (8th), South Korea (11th), Malaysia (47th) and Thailand (57th).

Although the share of FDI has increased sharply in the tertiary sector, it has declined in industry, since the commodity sector is not as attractive during periods when international prices are falling. Even so, the mining sector is still the main recipient of foreign investment (13.6% in 2017).

In manufacturing industry, trends are rather mixed. The machinery and capital goods sector has become more attractive, and the sector received 11.7% of FDI in 2017, compared with only 6.9% in 2004. Inversely, investment in transport vehicles and textiles has dropped off sharply, and the sectors received only 3.9% and 1.2% of FDI, respectively. In the tertiary sector, public utilities for the distribution of water, gas and electricity have become more attractive, as has the real estate sector, which received 13.2% and 8.9% of FDI, respectively, due notably to major infrastructure development programmes.

Several constraints hinder foreign investment and domestic productive investment

On top of the shortage of skilled labour, insufficient infrastructure and restrictive regulations for foreign investors continue to curb inflows of foreign direct investment and productive investment in general.

a. Infrastructure needs are still very high

The country has massive infrastructure needs. The World Bank and the Asian Development Bank estimate infrastructure needs at USD 1,500 billion and USD 1,100 billion, respectively, for the period 2016-30. According to the World Bank, it will take twenty years for the country to close the gap with the other emerging countries, and 44 years to reach the level of infrastructure development found in the advanced economies, assuming that President Widodo's government meets the targets set in its medium-term development plan, an investment programme of IDR 5.4 trillion for the period 2015-19 (USD 415 billion, or the equivalent of 47% of 2015 GDP⁹). Yet low fiscal revenues have sharply restricted the programme's realisation, even though expenditure on fuel subsidies was reallocated to infrastructure spending. According to the World Bank, even if the government devotes 20% of fiscal revenues towards infrastructure spending over the next two fiscal years, spending over the period 2015-19 would still amount to less than IDR 1.5 trillion, or only 27% of the government's target. To circumvent these fiscal constraints, at least in part, the government is calling on state-owned companies to participate. Goldman Sachs estimates that the amounts invested by state-owned companies is equivalent to that of the central government.

Yet the growing use of state-owned companies to finance major infrastructure projects risks increasing the State's contingent liabilities. The financial situation of state-owned companies has deteriorated over the past five years, precisely due to the major increase in their debt to finance government projects. To date, companies are still reporting sustainable interest charges and satisfactory financial results. In the medium term, however, the government will have to find other sources of financing to meet the country's enormous infrastructure needs.

b. The business environment is still restrictive for foreign investors

⁹ National medium-term development plan (RPJMN)



Despite a net improvement in the business climate and the opening of several business sectors to foreign investment, Indonesia's regulatory framework still strains FDI. The lack of transparency, uncertainty over regulatory trends and land acquisition laws are all handicaps. The country continues to rank poorly in terms of enforcing contracts (145th out of 190 countries). One of the key bottlenecks is getting certain measures that favour investment to be applied at the local level. Some local governments are not very inclined to accept foreign investment. Yet the political landscape could be overhauled by regional elections in 2019, with the election of officials that support a more open economy.

c. The economic fabric is still dominated by state-owned companies

Indonesia's economic fabric continues to be dominated by state-owned companies. Looking at Vietnam's experience, it is vital to encourage the development of small and medium-sized enterprises (SME) in order to develop the industrial fabric, favour job creations and boost productivity¹⁰. To achieve this, the Indonesian government needs to follow Vietnam's footsteps and create a more favourable fiscal environment for SME.

Since 2015, Indonesia has shown strong resilience to the international economic and financial environment. Although growth is shackled, public finances are under control, inflationary pressures are contained, the current account deficit is low and the monetary authorities have proven their capacity to stabilise the rupiah. Moreover, even though the business climate is still fragile, it has improved significantly over the past five years.

Under this environment, the short-term risks are moderate for Indonesia's economy. Pressures on the rupiah are likely to remain mild despite the tightening of US monetary policy. If a trade war were to break out between the United States and China, Indonesia is not completely immunised¹¹, but the effects should be limited given its feeble integration in global value chains.

In the medium term, the main risk is the country's capacity to stimulate growth in order to become a high-income country. To achieve this, the government must boost the competitiveness of the manufacturing industry in order to enhance the mobility of the active population from the least productive sectors (like agriculture) towards more productive sectors. It must make use of three leverages: human capital (education), physical capital (infrastructure and productive investment), and cutting red tape. This will not only require the necessary financial resources (by increasing fiscal revenues) but also determination. President Widodo has demonstrated his commitment. His re-election in 2019 would enable the government to continue with reforms, even though there are still some major obstacles at the local level. If his current rival, Prabowo Subianto, were to be elected, the reform movement is unlikely to be

halted, although its pace might be slowed. A key determinant will be the outcome of parliamentary elections, which will be held at the same time.

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¹⁰ In Vietnam, SME contribute 40% of GDP and 50% of employment.

¹¹ 15% of Indonesia's exports are sent to China (the equivalent of 2.2% of GDP).



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