Indonesia: unlocking the potential

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Dara White
Head of Global Emerging Market Equity

Krishan Selva
Client Portfolio Manager

- **Previously Indonesia has been vulnerable to the commodity cycle, but the country is forging a unique path to unlock its economic potential**
- **Government policies have boosted exports, economic growth and attracted much needed long-term investment**
- **The country has witnessed an impressive resurgence, with improved macroeconomic performance and attractive investment opportunities**

It's often cited that the larger a country, the more its economic potential. If this is the case, the economics of land and labour are certainly in Indonesia's favour. It is the fourth most populous country in the world with 282 million people[1], and with ageing demographics making headlines in recent months, Indonesia's is certainly favourable with a median age of 29[2], younger than both China and India. Its young, educated and growing middle class, all 167 million[3] of them, will be vital for the consumption of goods and services which drives economic growth and investment. Furthermore, Indonesia's location between the Pacific and Indian oceans connects East Asia, South Asia and Oceania, making it ideal for trade. In fact, located off Indonesia is the Strait of Malacca, one of the most important shipping lanes in the world. Trade is an essential part of the Indonesian story.

Bucking the Asia trend

The playbook for many Asian economies has been the migration from rural subsistence farming into urban factory work, making goods for export. Indonesia's competitive advantage lies in its abundance of natural resources such as palm oil, coal, iron, steel and nickel, which it has been successful in exporting. During the 2000-2008 commodity cycle the economy grew significantly,

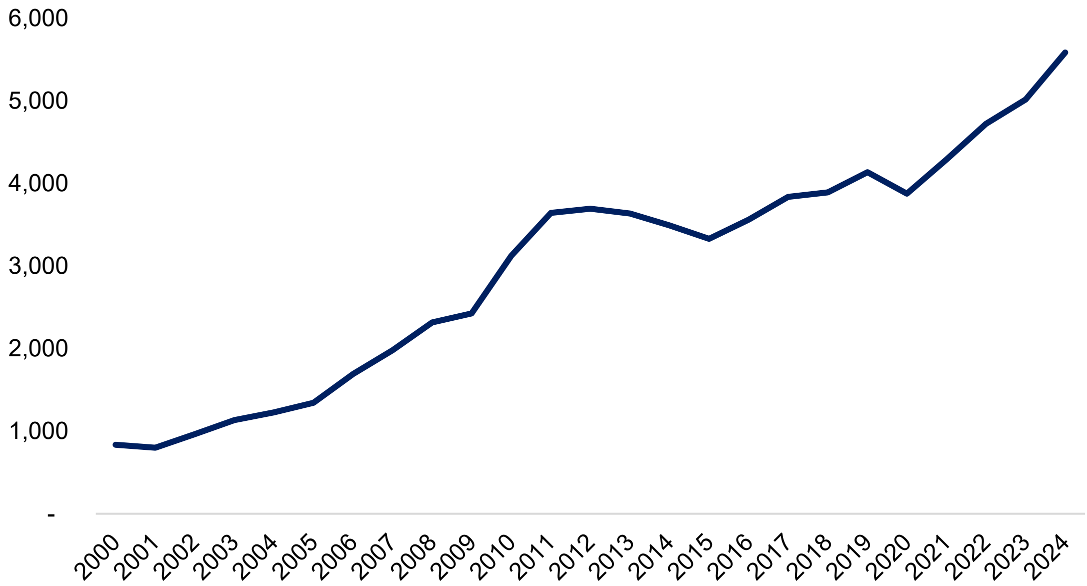
[1] Based on Worldometer elaboration of the latest United Nations data, 30 May 2023

[2] World Economics, May 2023

[3] World Bank, 2023. Concrete middle class accounts for 52 million people, who spend \$7.75-\$38 a day, and aspiring middle class accounts for 115 million people who spend \$3.30-\$7.75 a day

gross domestic product (GDP) per capita increased threefold (Figure 1) and foreign direct investment (FDI) was substantial. However, following the global financial crisis commodity prices plummeted, exports stagnated and FDI slowed materially. The country was too susceptible to the boom-and-bust nature of the commodity cycle and its implications on public spending, specifically education and healthcare, were concerning for its population.

Figure 1: Indonesia GDP per capita (US$), 2000-2024



Source: Bloomberg, as at June 2024. Figures for 2023 and 2024 are forward-looking

For Indonesia to achieve its potential it required a competent government with supportive policies and structural reforms. In 2014 it elected a charismatic leader, Joko Widodo, more commonly referred to as Jokowi. He was a successful businessman before breaking into the political scene at a local level and working his way to the top of government with a reputation for getting things done.

Infrastructure investment lays the foundations for future economic growth and productivity, which in turn can be a catalyst for further FDI. Jokowi has focused his political capital on structural reforms to support economic growth and infrastructure projects and under his leadership there have been some significant infrastructure projects: 18 ports, 21 airports and 17,000km of toll roads have been built[4]. These projects have among other things helped create jobs, lower distribution costs and provide social mobility.

Catalysts for success

One of the key successes under the Jokowi government is the industrial policy of downstreaming, which involves banning the export of low value raw commodities – tin ore in 2014, nickel ore in 2020, with bauxite expected in June 2023 – in favour of exporting finished products, bringing more of the value chain home. Nickel is a great example of how this policy has benefited the economy. Nickel is a key component for electric vehicle (EV) batteries and as

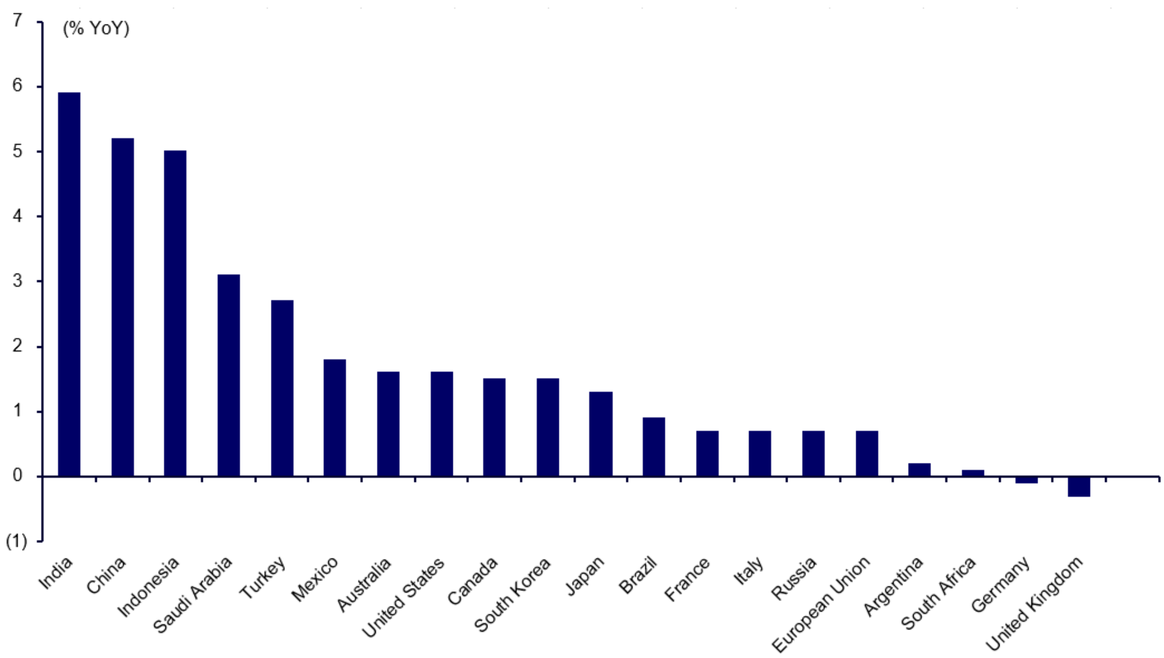
[4] PWC, Jokowi Builds 1,700 km Toll Roads, 2.1 Times the Length of the Previous Era, 29 September 2022

the world's largest producer of nickel, Indonesia is expected to become the fourth largest producer of the "green commodities" used in batteries and power grids which will generate significant revenue for the country.

The Jokowi government's industrial policy has incentivised multinational companies to invest heavily into Indonesia, from building refineries that process raw commodities to setting up a special EV ecosystem fund to help develop this emerging industry. In fact, since the raw nickel export ban, the number of nickel smelters has grown from two in 2021 to 15 and is forecast to reach 30 by the end of 2023[5].

Downstreaming has been a significant catalyst for Indonesia's economy. Its current account is in surplus, with iron and steel having contributed 70% of the trade surplus over the past 12 months[6]. This has boosted foreign reserves to record levels and supports a more robust economy and currency. More recently we have seen Indonesia become one of the more resilient emerging market economies (Figure 2), maintaining relatively low inflation even as food and energy prices surged elsewhere due to the war in Ukraine, and successfully weathering the impact of higher US interest rates and a strong dollar. The reopening of China's economy has also been a tailwind for Indonesia. China accounts for 26% of Indonesian exports, up from 15% in 2019. Indonesia now runs a trade surplus with China, versus a $17 billion deficit in 2019[7], again mainly because of downstreaming. The resulting macroeconomic stability has had positive knock-on effects for the bond market and supports the financial sector.

Figure 2: G20 countries forecasted growth in 2023



Source: Bloomberg, as at June 2023

[5] Reuters, January 2023

[6] BPS & Verdhana research, 2023

[7] CEIC, Verdhana research, 2023

So we are certainly optimistic on the Indonesian economy. However, we must also evaluate the risks. We will be monitoring the next election, set for February 2024. Presidents can only serve two terms in Indonesia and Jokowi's era will come to an end. While there is an expectation of continuity to the path he has laid, the leading candidates share popularity and are hard to separate.

Geopolitics is another area to monitor and can play a critical role in Indonesia reaching its potential with FDI crucial to it growing its economy faster. US-China tensions have been making all the headlines, and Indonesia has maintained a balance between the two nations. However, given significant investment from China any potential sanctions may risk slowing potential growth. Indonesia has been proactive, though, learning the lessons from the decade of stagnation. As of 2021 exports were only 22% of GDP[8] and government policy to focus on downstreaming and consumption has been pivotal to this. The government has also been savvy on the global stage, demonstrated by Jokowi's recent visits to both Moscow and Kiev, pushing for peace in Europe, and illustrates Indonesia's neutral status. Indonesia also hosted the G20 in Bali, cementing its growing presence in the region.

Looking ahead

The positive news for investors is that Indonesia remains on a solid footing, supported by strong macroeconomic fundamentals and its consumer base. The International Monetary Fund recently forecast that the country is set to be one of the top growing economies over the next five years. Total GDP is expected to be $7.3 trillion by 2045[9], a projection which would rank it in the top five globally. GDP per capita is rising, from $700 in 2000 to $4,700 now[10] – a more than 10% compounded annual growth rate. All of this points to consumption being a major economic driver, and it currently accounts for more than 60% of GDP[11].

As investors this is music to our ears and creates opportunities across sectors: from financials, where their banks' conservative nature and strong economic oversight will benefit from the increased financial penetration; to consumer discretionary, where the likes of auto-manufactures will benefit from the wealth effect as well as the newly developing EV supply chain.

If the government can continue to support the economy with proactive policy the future will continue to be very bright for Indonesia. The country is a prime example of the power of structural reforms on an economy, and all hopes are that the policy momentum continues. If it stays on its current path it could become one of the leading economies in the world. We view Indonesia as an important part of the emerging markets universe and an important source of investment opportunity.

[8] The Global Economy.com, 2023

[9] World Bank, 2023

[10] CEIC data, 2022

[11] CEIC data, 2022

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