ARTICLE FOR THE EDGE

INDONESIA: BUILDING A HEAD OF STEAM

Indonesia has been and remains a good story among large emerging economies. However, the news flow has fallen a tad short of expectations of late. Indonesia's economy grew by about 5% in 2016, rising from 4.8% in 2015 but below the 6%-type rates experienced in 2010-2012 which had raised hopes that Indonesia could enjoy an acceleration in economic growth to above 7%. In addition, foreign investors have been watching the prosecution of Jakarta Governor Basuki Purnama ("Ahok") on charges of blasphemy with some concern, wondering if this heralds a rise in religious intolerance.

Our take is that, occasional setbacks notwithstanding, Indonesia is putting in place the foundations for higher growth. There are disconcerting political developments indeed but we are also confident that Indonesia's leaders will contain these risks.

Cyclical turnaround in the economy in the works

Despite the loss of momentum in the last quarter of 2016, forward looking indicators are now pointing to a turnaround. The OECD's composite lead indicator for Indonesia has been rising strongly. At current levels, it is suggesting that economic growth will be above Indonesia's trend rate of 6% in the 9-12 months. Supporting this, purchasing manager surveys show new orders in the manufacturing sector growing again in January, after four months of decline.

These signs of a pickup in momentum are validated by other data points:

- **Trade is revving up**: Following persistent declines through September, the export sector is now registering expansion again, with exports surging by about 17% in November-December last year. Mining regulations have been tweaked to allow a renewal of exports of copper, nickel and bauxite ore – that should further boost exports while encouraging commodity producers to hire and spend more. Non-oil exports already booming, up about 23% in Nov-Dec 16, should surge even more now. Moreover, there are signs that imports of capital goods have stopped falling, which could mean that businesses are cautiously beginning to consider fixed asset investment again.

- **Commodity prices are recovering**: Crude palm oil prices rose about 37% through 2016 while rubber prices are up 82%. These are the two commodities most important to rural farmers – their rising incomes will help sustain a rebound in rural consumer spending. Prices for oil, coal and base metals have also recovered smartly: these tend to benefit companies more than individuals but with a lag, higher corporate profitability should percolate through to their employees while the higher taxes they pay will help boost government spending in time as well.

- **Consumer confidence holding up**: In the past few months, Bank Indonesia's consumer confidence index has been moving in a range last seen in the more ebullient days in 2014.

Looking forward, we think the turning points are largely positive. All the indicators are showing that the global economy will continue to gain traction, thus lending support to commodity prices as well as demand for Indonesia's exports of all kinds. By April, the current spate of local government elections which has generated some uncertainty and a degree of political shenanigans, should be over and the ensuing political calm should encourage businesses to focus on expansion again. We also expect another cabinet reshuffle soon, which we think will also contribute to greater business confidence.

Structural improvements also more evident

The administration of President Joko Widodo (Jokowi) has introduced 15 reform packages in the past year and a half. These reforms have helped to improve the business environment in many ways, which will eventually raise investment. Indonesia's strategy is not one of big, bold moves which grab headlines but the less exciting but politically more feasible one of continuous, small improvements which cumulatively become very powerful over time.

Already there is some good evidence that this strategy is working. Long notorious for its intimidating business environment, things are beginning to look up. Indonesia's ranking in the World Bank's Ease of Doing Business report has leapt from 106th in the world to 91st in the latest survey. With more reforms in place since that survey, we expect its ranking to continue improving. A big push by government agencies has brought the average time to process a container in Tanjung Priok Port down decisively – from 6.5 days in 2012 to 4.7 days in 2015 and 2.9 days by the end of last year. The government is bringing in more deregulation to achieve its ambitious goal of reducing this to just 2 days by the end of this year.

The low key but persistent efforts to improve the workings of government were also seen in the success of the tax amnesty programme which brought in substantially more asset declarations and repatriations than expected. This happened because people making those declarations had confidence in Jokowi's administration: this growing trust in a competent and clean government is another positive. Foreign investors are taking note. Foreign direct investment in 2016 grew 8.4% to a new record high.

Could political risks cloud the picture?

Ahok's promotion to Jakarta governor and his subsequent dynamic performance and growing popularity had been a great advertisement for Indonesia's richly diverse and highly tolerant society. Both Indonesians and foreigners took heart from how a Christian and Chinese leader could command genuine popularity in an 85% Muslim majority country with a history of resentment against the Chinese minority. So, it came as an unpleasant shock to see Ahok charged with blasphemy over remarks he made to an election rally in September. Religious extremists mobilised massive street protests against Ahok and stoked divisive sentiments in the people as a result.

There is little doubt that these recent events represent a setback. However, it is interesting to see that the secular forces are fighting back. Ahok's accuser, a radical firebrand who commands a controversial force of activists has himself been charged with various offences, taking some of the wind out of his sails. It is also becoming more evident that the actions against Ahok were probably orchestrated by opponents of President Jokowi who wanted to undermine him by attacking his protégé, Ahok. Ahok was Jokowi's deputy governor when Jokowi was Jakarta Governor and the two are political allies.

Jokowi has shown himself over time to be an effective political fighter. If he prefers to fight his opponents quietly and indirectly, that is not a sign of weakness but a deliberate strategy of lulling his opponents into under-estimating him. We believe that he understands that the attack on Ahok is a significant effort to undermine him personally – our bet is that he will fight back quietly but with great effectiveness. This softly, softly approach has allowed him to amass considerable political power, making him effectively the most powerful Indonesian leader since President Suharto.

In short, politics will be turbulent from time to time, but Indonesia's broad direction will remain one of moderation, tolerance and stability.

What else can go wrong?

First, despite the success of the tax amnesty programme which brought in more fiscal revenues, the budget remains under pressure from disappointing revenue growth. But the government remains keen to build in more fiscal buffers by keeping the budget deficit low. So, when revenues disappoint, it has cut investment spending to ensure that the overall deficit is contained. This is one reason why economic growth slowed in the last quarter of 2016 – construction activities weakened as public spending was cut back. Indonesia needs to redouble efforts to expand its tax base – tax revenue as a proportion of GDP remains far lower than many of its peers.

Second, even though the global economy is enjoying its best moments in two and a half years, there are some potential pitfalls in the global environment. Because it still has a current account deficit of around 2% of GDP and does not draw in enough foreign direct investment to finance this deficit, it remains dependent on inflows of portfolio capital, which tends to be more unpredictable. If the US economy continues to surprise on the upside, there is little doubt that the Federal Reserve Bank will have to raise rates more aggressively. That could spark off another round of capital outflows from emerging markets such as Indonesia, which could bring the Rupiah down as well.

This is certainly something to watch closely. However, Indonesia's performance in the past four years of great financial stresses does give some solace. In May 2013 when the so-called "taper tantrums" led to great disorder in global financial markets, Indonesia's currency and asset markets fell sharply. In more recent bouts of global financial turbulence, however, the Rupiah has been more resilient. There is growing confidence in the central bank's ability to manage the currency and inflation while Jokowi's reforming administration has given investors more confidence in the long term.

What about concerns about the implications of the Trump Administration's more aggressive approach in trade and other matters? A more unsettled global environment is surely not helpful to Indonesia. However, Indonesia is not a major exporting nation and so is less susceptible to an anti-trade agenda in the US. It does not run large surpluses with the US and so is less of a target. Moreover, some key political leaders in Indonesia are close to President Trump and can act as bridges to the new administration.

The bottom line: steady improvements will continue

Taking everything into consideration, we expect Indonesia's economy to gain more momentum this year, with its growth rate rising to close to 6% from 5% last year and with inflation, the Rupiah and the current account deficit remaining within a comfortable zone. If, as we believe, Jokowi employs his political skills effectively and neutralises recent challenges to his authority, he will gain in confidence and influence. We would not be surprised if then begins to bring in more controversial reforms such as labour market deregulation which could substantially improve Indonesia's prospects.

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