QNB Economics
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Indonesia's Enormous Potential is Challenged by Short Term Instability and Underinvestment, According to QNB Group

Indonesia has enormous long–term growth potential. The large and rapidly growing population has favorable demographics and is increasingly wealthy. Indonesia has a rich endowment of natural resources and a vibrant and dynamic private sector that underpins the growth outlook. It has already risen to become the 16th largest economy in the world with GDP of USD878bn in 2012 and was the fourth fastest growing economy among the G20 in 2008-12. With these strong fundamentals, emerging Indonesia has the potential to grow at near double digit rates. However, according to QNB Group, there are risks to the economic outlook going forward and growth is likely to be below potential in the 5%-6% range. In the short run, the widening current account deficit and capital flight from emerging markets (EMs) could destabilize the economy. In the medium term, underinvestment in infrastructure threatens to cage Indonesia's tiger economy in crippling supply bottlenecks.

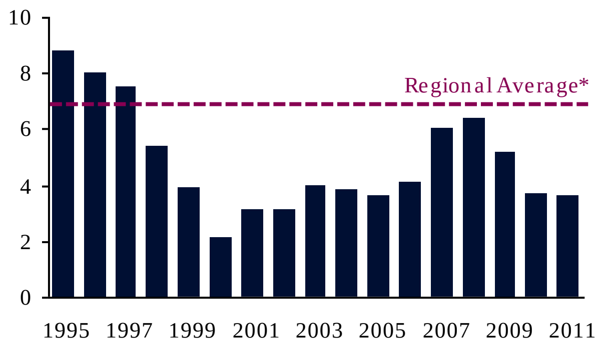
Indonesia's long–term growth potential mainly lies in its favorable demographics. It is the fourth most populous nation in the world (244m people). The population is young and growing quickly, with a rapid expansion of a consuming middle class. GDP per capita has more than doubled in twelve years to USD4,977 in 2012 on a purchasing power parity basis. The scale of opportunity is breathtaking: there were 35m new mobile subscribers in 2012 alone. In addition, there will be 90m new middle class consumers by 2030, according to a recent report from the consulting firm McKinsey. In addition, Indonesia is well endowed with a wealth of natural resources: it is the largest coal exporter in the world; was formerly the largest exporter of LNG (until Qatar took over the top spot); has vast areas of fertile land producing high value crops, such as palm oil and rubber; and has a large mining sector that extracts a broad range of metals from tin to gold as well as various basic materials. With these fundamentals, Indonesia should be able to achieve growth close to the double digit rates reached by China in recent years.

Notwithstanding this strong potential, the Indonesian economy has recently run into a rough patch. The current account deficit has widened, reaching 4.4% of GDP in Q2 2013 as lower commodity prices and a drop in exports of natural resources reduced export receipts. At the same time, strong domestic demand continued to push up the import bill. Investor confidence was further shaken by the announcement on May 18, 2013, of the Federal Reserve's intention to taper its asset-purchasing program (the so-called tapering of Quantitative Easing [QE]). This led to capital outflows from EMs, including Indonesia, as USD liquidity tightened globally. The combination of a widening current account deficit and capital flight led to a sharp depreciation in the value of the Rupiah and a stockmarket correction of 23.9% from its peak in May to end–August 2013. As a result, real growth in investment slowed from 9.8% in 2012 to 4.7% in Q2 2013 (year on year).

According to QNB Group, weaker investment and exports will lead to a slowdown in overall real GDP growth from 6.2% in 2012 to 5.5% in 2013 and 5.1% in 2014. The short term risk remains that growth could be even slower if the global economic recovery fails to materialize or if there is serious fallout from QE tapering. Slow global growth and weaker external demand could lead to lower commodity prices and a wider current account deficit. If QE tapering is actually implemented (now expected in March 2014), it could reignite capital flight from EMs destabilizing the Indonesian economy. These factors would further erode investor confidence, leading to even slower growth in 2013-14.

However, it is the medium term risks to growth that may be of even greater concern. Indonesia suffers from underinvestment in infrastructure (see chart), which plummeted from over 7% of GDP prior to the Asian Financial Crisis (1997-98) to around 2% in 2000 and has mainly been constrained in the 3%-4% range since then. According to the World Bank, this is well below average infrastructure investment levels of above 7% of GDP for neighboring countries: China, Thailand and Vietnam.

Infrastructure Investment in Indonesia
(% GDP)



Source: WB; *Regional average comprises China, Thailand and Vietnam

As a result, Indonesia's infrastructure is in poor condition, which is clogging the economy. Indonesia suffers from heavy road traffic; delays and lack of capacity at ports; overcrowded airports; insufficient railways; power and water shortages; and a sluggish data network. Indonesia performs poorly compared to peers in rankings assessing the quality of infrastructure. Logistics costs are high, averaging 14.1% of sales in 2011, compared with 4.8% in Japan. It is 4-5 times more expensive to ship a container from Jakarta to West Sumatra (within Indonesia) than to Singapore, which is much further. Cement is ten times more expensive in Papua (an Indonesian island) than in Jakarta (the capital). Power infrastructure is inadequate with at least 15m households lacking access to electricity. Energy consumption per capita is the lowest amongst seven major East Asian EM peers. Indonesia has the lowest broadband and internet penetration of its peer group, except for India. This all adds to the cost of doing business, erodes competitiveness, discourages investment and reduces Indonesia's growth potential.

The poor state of infrastructure is probably already having a negative impact on growth. McKinsey estimates that deteriorating infrastructure is restraining GDP growth by 3-4 percentage points every year. Infrastructure dilapidation is the main reason why QNB Group forecasts growth below trend at 5% in 2015-18. There is a downside risk that growth could be even slower over the medium term, should infrastructure crumble under the weight of its growing population, crippling the development of the private sector.

Overall, Indonesia's long-term potential should continue to make it one of the fastest economies in the world. However, short term instability and poor infrastructure mean that Indonesia is failing to realize its full potential. Much will depend on the outcome of parliamentary and presidential elections in 2014. Once the elections are out of the way, a new government committed to infrastructure development could eventually unleash the caged tiger that is Indonesia's private sector.