

# ING Investment Weekly

## Indonesia: Striving to Expand BRIC to BRIC



**Martin Jansen**  
Senior Portfolio  
Manager

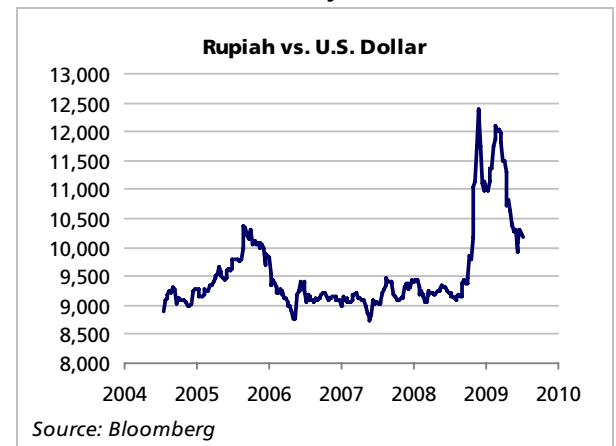
Indonesia, long a codeword for dictatorship, chronic economic mismanagement, and endemic corruption, is finally on the cusp of unleashing its vast potential. Having emerged from under the military dictatorship of Suharto a decade ago, it has just re-elected reformist President Yudhoyono with a convincing majority. Accelerating economic reforms, as well as a continued aggressive anti-corruption drive, should help Indonesia embark on a higher and more stable growth path. Yudhoyono's administration has the ambition to join the BRIC club (Brazil, Russia, India and China) within five years. Is this realistic?

A sprawling archipelago with a population of 230 million, Indonesia is the world's most populous Muslim country. It is also the world's third largest democracy, with a per capita income more than twice that of India (and about 50% of Brazil's), and an impressive 90% adult literacy rate. It is resource rich and energy independent. On paper, the credentials are there; the challenge is to ratchet up annual average economic growth to more than 5% as an admission requirement to the BRIC club. It is weathering the current global slump remarkably well: with GDP growth expected to be around 3% this year and 4% in 2010, a current account in balance, and an expected relatively benign fiscal deficit of 3% of GDP for 2009, it is in far better shape than most of its developing country peers.

Despite these strong positives, the country has a legacy of negatives it will have to work hard to address. Foreign debt remains on the high side and needs to be reduced. This is probably the most important factor behind the excessive volatility of Indonesia's currency, the rupiah. Foreign exchange reserves, covering a relatively meager four months'

worth of imports, should also ideally be higher. As the accompanying chart of the rupiah versus the U.S. dollar reflects, when global currency markets are turbulent, such as in the last quarter of 2008, a dramatic devaluation of 30% or more is consequently almost a foregone conclusion. Relatively high growth of the monetary aggregates and a higher structural inflation rate than most peers also add to the volatility. While the devaluations tend to be followed by sharp recoveries, the volatility of returns for foreign investors is detrimental to attracting dedicated long-term capital.

### Indonesia's Volatile Currency...



It is in this context that the presidential election, and the parliamentary one in April which gave his party a governing majority, could well be a watershed event. A more business-friendly climate for foreign investors combined with attractive returns on capital should go a long way to attract foreign direct investment. This will strengthen the foreign reserves and allow for an accelerated retirement of foreign debt, as well as stepping up much needed infrastructure spending to support sustained levels of higher growth. Additionally, banking system reforms are required to improve the availability of credit at reasonable interest rates. A stronger financial system anchored in relative political stability, combined with attractive opportunities should in time lead to a less volatile currency and a lower risk premium than is currently the case.

In U.S. dollar terms, the Indonesian stock market plummeted more than 70% from its February 2008 peak to its November 2008 low (see Chart 2). It has returned a spectacular 128% since then, but remains 33% below its peak. While the trailing Price/Earnings ratio on the MSCI Indonesia Index at 13 times is average, the companies in this index have been able to hold on to a healthy 24% return on equity through the global malaise. This is a solid base to build on once the global economy manages to trough and accelerate. Cash generation is strong, and the dividend yield is a relatively robust 3.7%. Given the prospect for stronger growth, the market remains attractively valued.

## ...Causes Volatile Returns for U.S. Investors



A well-run, resource-rich country of 230 million certainly deserves to be a member of the BRIC club. It would be the only predominantly Muslim country in the group. Like India, Indonesia has a window of a few years to implement the required changes. The risk is that the opportunity is not grasped, in which event its stated ambition to join the BRICs will be a pipedream. If reforms are pursued, the Indonesian market has the potential for superior returns in the coming years. ■

Copyright © 2009 ING Investment Management. This report does not make any recommendation about your investments, and this information should not be considered investment advice. Any opinions expressed herein reflect our judgment at this date and are subject to change. Certain of the statements contained herein are statements of future expectations and other forward-looking statements that are based on management's current views and assumptions and involve known and unknown risks and uncertainties that could cause actual results, performance or events to differ materially from those expressed or implied in such statements. Actual results, performance or events may differ materially from those in such statements due to, without limitation, (1) general economic conditions, (2) performance of financial markets, (3) interest rate levels and (4) increasing levels of loan defaults (5) general competitive factors (6) changes in laws and regulations (7) changes in the policies of governments and/or regulatory authorities. ING Investment Management assumes no obligation to update any forward-looking information contained in this document. Past performance is not indicative of future results. This material may not be reproduced in whole or in part in any form whatsoever without the prior written permission of ING Investment Management. To obtain permission, contact [stephen.easton@inginvestment.com](mailto:stephen.easton@inginvestment.com) or 860-275-2110. For all other inquiries contact David White, Publishing Manager, [david.white@inginvestment.com](mailto:david.white@inginvestment.com) or 860-275-2056.