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2004: INVESTMENT BOOSTS GROWTH

Confounding concerns over political uncertainty, the Indonesian 2004 general election went very smoothly. The peaceful polling, which saw Susilo Bambang Yudhoyono and Jusuf Kalla elected as President and Vice President respectively, restored confidence to the economy. The new team brought new optimism to the country, reflected by a remarkable strengthening of the Jakarta Stock Exchange Index, strong investment growth, as well as improved forecasts of Indonesian economic growth and higher foreign credit ratings by all major international rating agencies. This induced investors, largely foreign, to buy select Indonesian blue chips in the stock market. Gains in several other Asian markets also buoyed the market.

Following the peaceful presidential election, the economy expanded strongly (by 6.7% yoy) in the last quarter of 2004. The high Q4 growth helped the economy to expand by 5.13% over the full year. In fact, economic growth has remained broadly on track, evolving largely as expected when the previous *Pacific Economic Outlook* was published last year. GDP growth of 5.1% in 2004 (based on 2000 prices) or 4.8% (based on 1993 prices) was slightly higher than our prediction of 4.7% (based on 1993 prices). The tsunami disaster which severely affected Aceh and North Sumatra at the end of December 2004 has had only limited impact on the overall Indonesian economy. The area impacted by the tsunami is estimated to generate less than 3% of the total GDP so the disaster is unlikely to affect overall economic growth in any significant way.

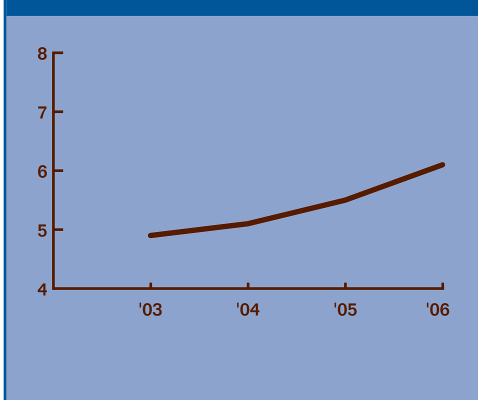
Despite the tsunami and external shocks, including high oil prices, the economy is shifting from consumption-led growth toward more balanced export-, consumption- and investment-led growth. Since the economic crisis in 1998, growth has continued to depend heavily on consumption. However the reverse was true in 2004. Contrary to the speculation of many economic observers, investment grew much faster than expected, by 15.7%. This made investment the largest contributor to growth (60% of total GDP growth of 5.1%). Nevertheless, the investment climate remains a major problem for Indonesia. With the many obstacles that the government faces in implementing good governance, it is difficult to expect that the costs of doing business will drop soon. The implication is that foreign investment will not return unless significant reforms are made in politics as well as to law and order. Although the investment growth in 2004 was remarkable, most of the foreign direct investment is still in the form of machinery and transportation equipment. Thus, despite the strong investment growth last year, the poor investment climate is still a major issue that must be overcome by the government.

As we predicted last year, the general election boosted both private and government consumption, by 4.9% and 1.95% respectively. Both motor vehicle and motor cycle sales rose remarkably. Motor vehicle sales reached more than 480,000 units, the highest sales in history, while motor cycle sales went from 2.7 million in 2003 to 3.8 million in 2004, up 39%.

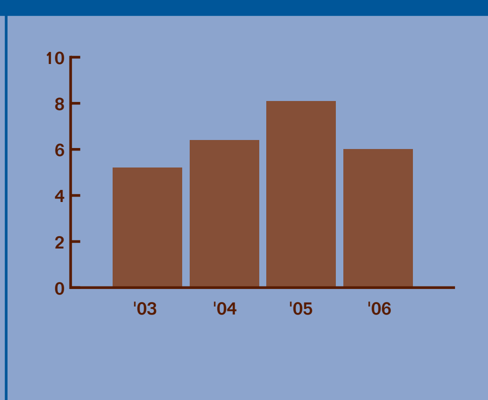
Parallel with the high growth of investment, imports of capital goods and raw materials increased significantly and helped total imports to grow by almost 25%. This is a good news for the economy, because a notable increase of imported capital goods and raw materials indicates an increase in production, both for domestic and export markets, during the year. This trend is confirmed by strong export growth, both for total exports and non-oil exports which grew by 11.5% and 10.7% respectively. Furthermore, the annual growth of electricity consumption, which is an important indicator of economic activity, was 13.8%, almost reaching its pre-crisis level. The high growth of electricity consumption was broad based — in households, industrial and business sectors.

As for fiscal policy, the government has been quite successful in maintaining its fiscal discipline. The budget deficit declined to less than 2% in 2003-04. The government

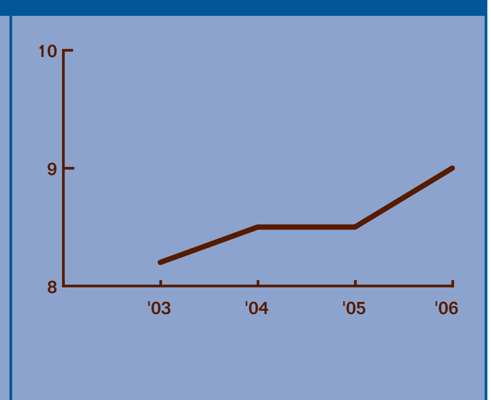
GDP GROWTH (%)



CPI INFLATION (%)



EXPORT GROWTH (%)



debt/GDP ratio also declined further, from 67.7% in 2003 to 53% in 2004. The rupiah depreciated against the US dollar due to both domestic and international factors. The rupiah was at Rps 8,985:US$1 on average, weakening from Rps 8,571:US$1 on average in 2003. The political uncertainty prior to the presidential election and the increase in interest rates in the US led to the depreciation of the local unit. In addition, excess liquidity in the banking system due to weak bank credit allocation for real sectors, provided room for speculative movements, leading to further rupiah depreciation. As for monetary policy, the central bank has succeeded in controlling inflation by absorbing excess liquidity in the banking system, thus maintaining inflation in 2004 lower than expected, at 6.4%.

OUTLOOK FOR 2005-2006 CAUTIOUSLY OPTIMISTIC

Growth is likely to pick up in 2005, rising to 5.5% and 6.1% in 2006 for several reasons. First, durable goods consumption is expected to continue to increase in 2005. Strong demand for cement, motor cycles and motor vehicles was evident in the first quarter of 2005. A higher demand for property is evident in almost all regions of the country. Cement consumption is predicted to continue to grow in the coming year along with the construction sector overall. Regional elections will also boost consumption. The impact of the national general election was evident in boosting demand in 2004. Consumption is projected to grow by 4.9% and 4.5% in 2005 and 2006. Secondly, strong growth of imported capital goods and raw materials, evident in 2004 and the first quarter of 2005, will generate investment and greater exports. Therefore exports and investment are forecast to grow in 2005 and 2006. Nevertheless, investment will not be as strong as it was in 2004 for several reasons. First, the steadily rising trend of US interest rates will force Bank Indonesia to adjust local interest rates, which in turn will dampen down the demand for investment funds. Secondly, looking at the severity of the 1998 economic crisis and the continuing shortcomings in institutional reform, an immediate recovery to considerably higher levels is not expected in the short-term. The investment climate remains bleak due to various labour and institutional problems.

A tight monetary policy is likely to continue in 2005 because of the anticipation of price hikes and depreciation of the rupiah. Inflation is predicted to reach 8.1% in 2005, easing to 6% in 2006. There are several reasons of why inflation in 2005 will be higher than in 2004. First, the depreciation of the rupiah will induce imported inflation, a major contributor to increases in the overall local price level. Secondly, price hikes due to the reduction of the fuel subsidy, although limited, will also tend to push inflation to a higher level. As a result, the interest rate is predicted to be higher than in 2004 in order to maintain a positive real interest rate.

As for trade, total exports are predicted to grow by 8.5% in 2005 and 9% in 2006. On the other hand, total imports, which are dominated by raw materials and capital goods, are predicted to grow by 20% and 18% respectively in 2005 and 2006. Higher world interest rates will increase the interest payment on foreign debt, slightly reducing the current account surplus from 1.1% of GDP in 2004 to 0.9% in 2005.

RISKS AND UNCERTAINTIES

In 2005, the expected economic expansion faces several possible challenges including the continuing rise in global oil prices and the inflationary impact of reconstruction efforts in Aceh province and North Sumatra. Although investment is expected to continue to increase, in line with the government's effort to improve the investment climate and the government's focus on infrastructure development, it has not yet reached the levels seen before the 1998 financial crisis. The problems of corruption, bureaucratic hurdles, weak legal system and problems in the labour market remain, and will take time to solve. This forecast is subject to changes in oil prices and the exchange rate. The government budget will be affected if oil prices turn out to be higher than US$45 per barrel in 2005 and 2006. Higher oil prices will potentially increase the budget deficit, although not very significantly. In addition, if the world economy grows at a slower rate than in 2004, it will impact on Indonesian exports which in turn will affect GDP growth. In addition, further rupiah depreciation will also disturb this forecast due to the impact on inflation. Imported inflation due to rupiah depreciation will push interest rates up further, which in turn will slow investment and GDP growth.