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Economic Analysis

Strategic Review

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Indonesia's economy set to fly like an eagle

Indonesia has become a favorite of international investors in recent years. As evidence of this, portfolio and foreign direct investment flows have been on the rise and the economy continues to receive upgrades by major rating agencies, placing it only one notch away from coveted investment grade status. The favorable attention Indonesia is attracting owes to the economy's strong medium-term growth prospects and its resilience to external shocks.

These positives, in turn, are due to a combination of structural factors that have helped insulate the economy from recent global downturns, implementation of sound macroeconomic policies, and fostering of a stable political environment. Keys to investor optimism include ongoing efforts to upgrade and deepen Indonesia's lagging infrastructure, policies to reduce corruption and promote good governance, and steps to strengthen institutions.

Progress is being made in all of these areas, though much remains to be done to unlock Indonesia's vast growth potential over the medium term. Indonesia's strong prospects are representative of a sea change that has taken place during the past two decades in investor perceptions toward emerging markets more generally. Indeed, negative and static adjectives such as "under-developed" that were once commonly used for these countries have been replaced with "emerging" to describe the dynamic nature of their economies, where higher growth is bringing rapid convergence to the income per capita of rich countries.

Given the large populations of emerging markets including Indonesia—the world's fourth most populous country and largest in Southeast Asia—the emergence of such economies should bring huge business opportunities for investors serving those markets. One of the key factors for this longterm trend in favor of emerging markets is better population dynamics than in the developed world, and higher investment in physical capital driven by urbanization and industrialization. In addition, although investment in human capital is lower than in the developed world on average, the difference is narrowing rapidly; the same is true for expenditure on research and development and the quality of the institutions. These three factors, which had long explained the edge that the developed world maintained against the rest, will also be supporting the convergence of the emerging world. In the remainder of this paper, we present a study undertaken by BBVA Research on a set of EAGLE economies – Emerging and Growth-Leading Economies – to demonstrate the potential of our favorite emerging markets.

This research points to an important structural change in the global economy in which a handful of emerging markets will lead growth in the world economy. Indonesia's "Garuda economy" is one of the EAGLEs and, indeed, it has earned a place high on the list.

Our approach to identifying the world's growth-leading economies is to rely on an objective set of criteria, with regular reviews and updates of the countries that make our list. In contrast to a subjective approach, characteristic of the famous BRICs concept that excludes promising markets such as Indonesia, our concept is transparent and rigorous, yet simple in its methodology.

The growth forecasting methodology for the EAGLEs is based on two steps, one for the short-term and the other for the long-term. For the former, standard econometric techniques are used, including time series models, coincident and leading activity indicators and principal components analysis. These model-based forecasts are adjusted using information of country-specific factors, including the nearterm political and policy outlook. Long-run forecasts are based on estimates of potential growth rates using a production function approach. At the core of our selection criteria is "incremental GDP" during the coming decade or, put another way, the contribution to global growth of a given economy's output over the next 10 years.

In particular, our EAGLEs concept is based on the set of economies that are projected to contribute more to global growth than the average of the "G6" (consisting of the G7 minus the United States) — in other words, each of our EAGLE economies is expected to contribute more to global growth in the next 10 years than the average individual contribution of Japan, Germany, France, the United Kingdom, Canada and Italy. Selecting these economies requires a forecast of each country's economic growth for the next decade.

For the near term, the forecasting methodology is based on standard econometric techniques, including time series models and coincident and leading activity indicators. These modelbased forecasts are then adjusted using country-specific factors, such as the nearterm political and policy outlook. For the long-run, our forecasts are based on estimates of potential growth rates using a production function approach. Based on the selection criteria described above, the advantages of this grouping compared to other prominent lists such as the BRICs, N11 (developed by Goldman Sachs) and CIVETS (developed by the Economist Intelligence Unit and publicized by HSBC) are shown in Table 1.

Table 1
EAGLEs against the other well-known concepts

BRIC (GS)	BBVA EAGLEs definition	N-11 (GS)	CIVETS (EIU, HSBC)
✗ **Based on absolute size**	✓ **Based on absolute growth**	✗ **Based on population/GDP size**	✗ **Based on young population**
• Bigger does not necessarily determine market potential	• Large enough size plus... • Fast enough growth	• Includes high population economies, which do not necessarily determine market potential	• Colombia, Indonesia, Vietnam, Egypt, Turkey and South Africa
✗ **Static concept**	✓ **Dynamic concept**	✗ **Static concept**	✗ **Static concept**
• Allows no anticipation: too much inertia • Too long horizon: at least 20 - 25 years • Why four countries? Subjective	• Anticipation: dynamic concept • Shorter horizon: next 10 years • Flexible number of countries: "Club admission" depends on performance	• Some countries with political instability • Too long horizon between 20-45 years • Based on absolute size	• Missing key economies (Mexico, Korea) • Several large economies are missing • No clear horizon from 2020 onwards • Average growth above 4.5% over 20 years
✗ **No clear cut - off**	✓ **Defined Cut- off: the G6**	✗ **No clear cut - off**	✗ **No clear cut - off**

Source: BBVA Research

First, our classification is purely forward-looking as it is not based on current measures of economic size, but rather on an estimate of new business opportunities derived from the concept of incremental growth. Second, it is a dynamic concept, unlike the others that are static, in that the list of countries can change through an annual revision process based on updated projections of economic growth. New countries can be added to the list and existing ones can be dropped if the outlook deteriorates. Finally, as noted above, the EAGLEs concept is objective, based on a rigorous and transparent set of criteria. So who are the EAGLEs? Following the methodology described above and using our medium-term growth projections based on estimates of potential output, we identify 10 emerging countries that make our EAGLEs list (Table 2).

Table 2

EAGLEs: Gross Domestic Product (USD PPP 2010, in trillions, Constant Prices)

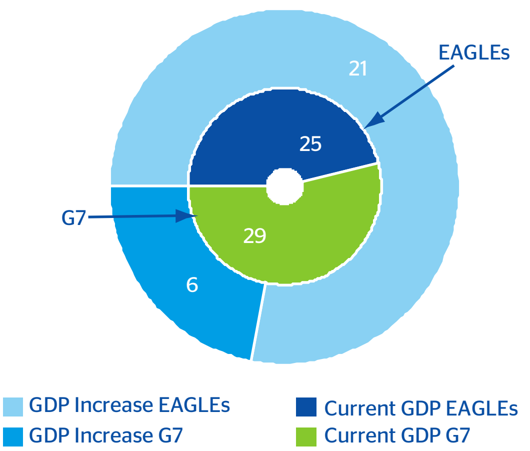
Country	Annual (%)	Incremental GDP Growth 2010-2020	Contribution to Global Growth (%): 2010-2020
China	8.7	12.6	30.2
India	6.9	3.6	8.5
Brazil	4.5	1.1	2.7
Indonesia	6.7	0.9	2.3
Korea	4.4	0.7	1.8
Russia	2.6	0.6	1.4
Mexico	3.1	0.5	1.2
Egypt	6.2	0.4	1.0
Taiwan	4.7	0.4	1.0
Turkey	4.1	0.4	1.0
EAGLEs	6.4	21.3	51.1
Japan	1.7	0.7	1.7
Germany	1.6	0.4	1.1
United Kingdom	1.8	0.4	1.0
Canada	2.4	0.3	0.8
France	1.5	0.3	0.8
Italy	0.9	0.2	0.4
G6	1.5	2.4	5.8
United States	2.3	3.6	8.7
G7	1.9	6.0	14.4
World	4.6	41.7	

Source: BBVA Research (November 2010 Forecast)

Indonesia ranks fourth among them. They are, from the largest to the smallest (in terms of contribution to global growth in the coming decade): China, India, Brazil, Indonesia, Korea, Russia, Mexico, Egypt, Taiwan and Turkey. During the coming decade, we estimate that this group of countries will contribute 51 percent of global growth, compared to just 14 percent for the G7, based on our estimate of GDP growing by more than $41 trillion adjusted for purchasing power parity (PPP) (Chart 1). Indonesia will contribute 2.3 percent of global growth during this period, ahead of the likes of Korea, Russia, and Mexico among others. The three giant economies — China, the United States and India — will lead the world in terms of both levels and incremental GDP in the coming 10 years (Chart 2).

Chart 1

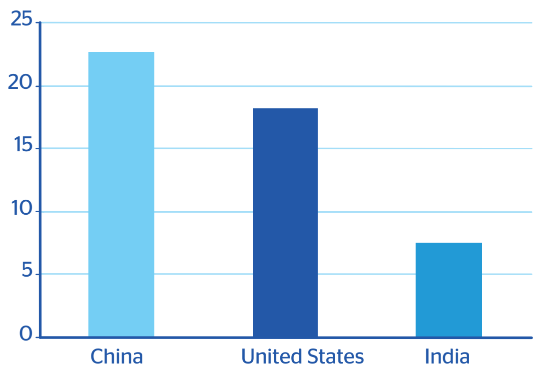
EAGLEs vs. G7: size (US$ trillions) and contribution to global growth (2010-2020)



Source: BBVA Research and IMF

Chart 2

Size of three major economies in 2020 (US$ trillions)



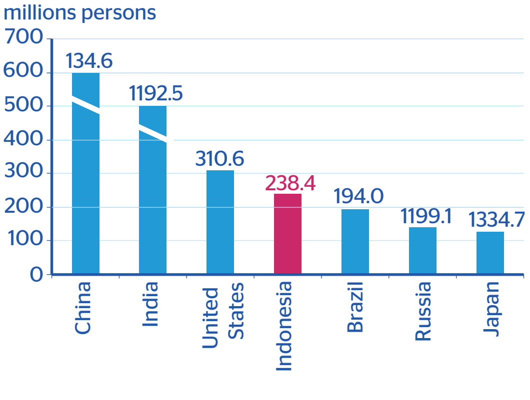
Source: BBVA Research and IMF

With an expected contribution to global growth of 30 percent, China is in a league of its own. Perhaps more surprising is that India's incremental GDP, amounting to $3.6 trillion, is expected to match that of the US. And by 2020, China will have surpassed the US as the world's largest economy. Because India's current economic size is relatively small, it will not approach the magnitude of the US in GDP levels, but will offer at least as much by way of new business opportunities, i.e., incremental growth. Indonesia and Korea are each expected to contribute more to global growth than Russia (the "R" in the BRICS). This illustrates how useful our concept is in going beyond the BRICs to identify where the growth opportunities really are.

As noted previously, EAGLEs is a dynamic concept, in that countries can move on or off the list. Such movements are more likely for smaller or slowergrowing countries (i.e. those closer to the cut-off point) or in cases where downward revisions to growth projections are large relative to revisions of projections for the G6 countries. At the same time, there are a number of countries that are contributing substantially to global growth but not significantly enough to make the EAGLEs list. To capture this, we create a watch list, a so-called "EAGLEs Nest" consisting of countries that are close to being an EAGLE by our objective criteria. In order to determine a cut-off for the EAGLEs Nest, we use the expected contribution to global growth for the next 10 years of the G6 country contributing least to global growth. We identify 12 countries based on this criterion. They are, from the largest to the smallest contributor: Thailand, Nigeria, Poland, Colombia, South Africa, Malaysia, Vietnam, Pakistan, Bangladesh, Argentina, Peru and the Philippines. Indonesia's high ranking within the EAGLEs reflects its strong growth prospects. Keys to such optimism include Indonesia's positive structural factors including favorable demographics (Charts 3 and 4), natural resource endowment and large domestic economy.

Chart 3

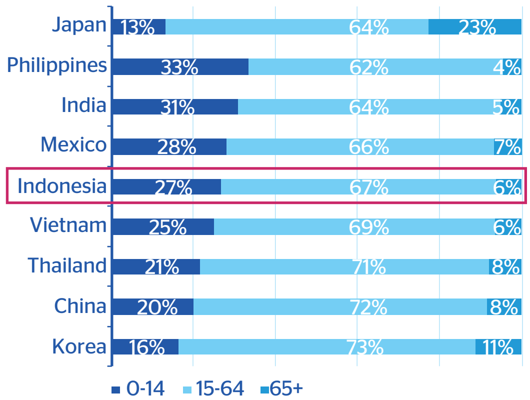
Indonesia is the 4th-most populous country in the world...



Source: BBVA Research and IMF

Chart 4

... with a young population



Source: BBVA Research and IMF

Also important are Indonesia's record of sound economic management, ongoing efforts to upgrade and deepen Indonesia's lagging infrastructure, and policies to reduce corruption, promote good governance, and strengthen institutions. Progress is being made in all of these areas, though much remains to be done to unlock Indonesia's vast growth potential over the medium term. As a result of these ongoing efforts, Indonesia has regained its place as a favored investment destination during the past decade. The country's image took a beating during the 1997-98 Asian Financial Crisis and its subsequent turmoil, which was especially severe in Indonesia given the social and political upheaval it entailed.

As with other countries in the region, the economic components of the crisis revealed underlying financial and corporate sector weaknesses, along with shortcomings in macro policy frameworks — including peggedexchange rates that encouraged excessive unhedged foreign borrowing — and a lack of policy transparency and data availability. In response to the crisis, reforms in Indonesia were undertaken in three important areas. These included: (i) changes to the macroeconomic framework; (ii) strengthening of banking supervision and accounting standards; and (iii) improvements in transparency and governance.

The first set of reforms has led to a more flexible exchange rate regime and an inflation-targeting framework that has delivered macro stability in recent years. The second has led to a stronger banking system marked by improvements in supervisory and regulatory standards, with foreign capital and know-how helping to bring about low and stable levels of non-performing loans, high capital ratios and profitability, and financial innovation more generally. Finally, the third has led to the routine publication of high-frequency information, including of external debt and reserves that analysts now take for granted. Thanks to these efforts, which are still ongoing, Indonesia has weathered recent global turmoil in good shape. During the global economic crisis in 2008-09, for example, Indonesia managed to sustain positive growth, joining China and India as two standouts in the region.

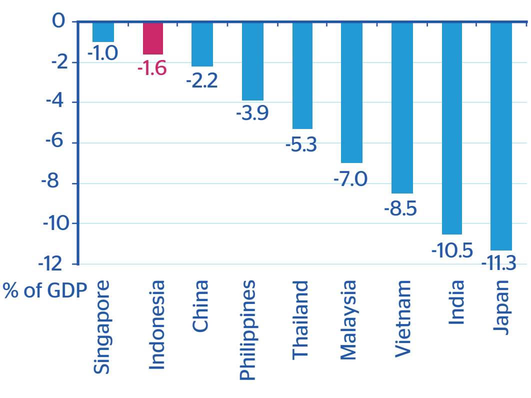
As noted above, Indonesia ranks fourth among our 10 EAGLE economies, and is expected to contribute 2.3 percent to global growth during the coming decade, ahead of the contributions of each of the G6 countries, as well as Korea and Russia. This result, perhaps, should not be surprising. As of 2010, Indonesia's economy was already the 15th-largest in the world on a PPP basis (IMF WEO database), the result of its strong growth performance since the Asian Financial Crisis, during which average annual growth has amounted to 5.2 percent (including a relatively impressive 4.5 percent during the global crisis of 2009). Indeed, Indonesia's membership in the G20 reflects its growing importance in global economic and political affairs. Indonesia's place in the EAGLEs is notable not only for its high ranking, but also for its robustness. According to our sensitivity analysis, it would take a very large negative shock – one that would reduce growth over the next decade by half of our current 6.7 percent projection—for Indonesia to be removed from the list. Thus, even a sharply slower period of growth for one or two years would not be enough for Indonesia to lose its place among the highflying EAGLEs.

Indonesia's strong growth outlook in the coming years derives from expected robust domestic consumption growth – underpinned by favorable demographics (a young population) and an expanding workforce – and rising fixed investment, along with continued strong global commodity demand, including from China. Setting the stage for this growth are sound economic fundamentals, ongoing reforms to improve the investment climate and, as noted above, favorable structural factors.

With respect to sound economic policies, Indonesia's history of prudent fiscal management has led to a low and falling public debt level (Charts 5 and 6), from a peak of over 100 percent of GDP just after the Asian Financial Crisis (due to the costs of the government-led banking bailout), public debt-to-GDP has fallen to around 26 percent. In addition, high foreign exchange reserves (more than $112 billion at present) and diversified export markets – evenly distributed across the US, Europe, Japan, and the rest of Asia – have helped reduce the economy's exposure to external shocks (Chart 7).

Chart 5

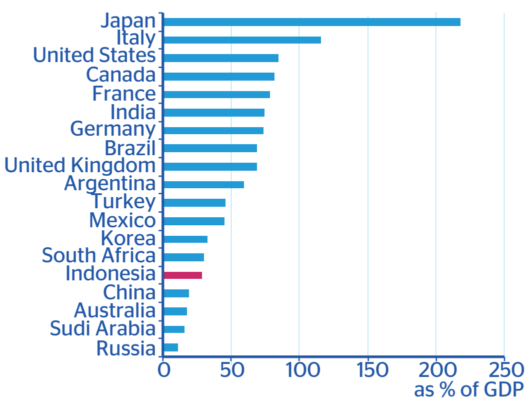
Fiscal policy is prudent, with a low deficit ...



Source: BBVA Research, Bank Indonesia and National Resources

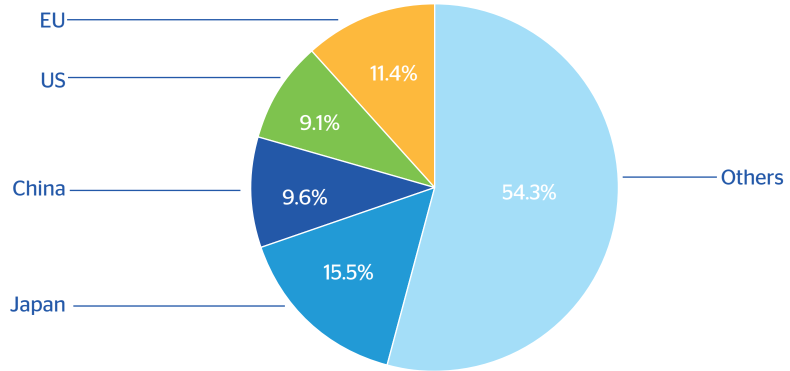
Chart 6

... and a low debt-to-GDP ratio among the G20



Source: BBVA Research and IMF

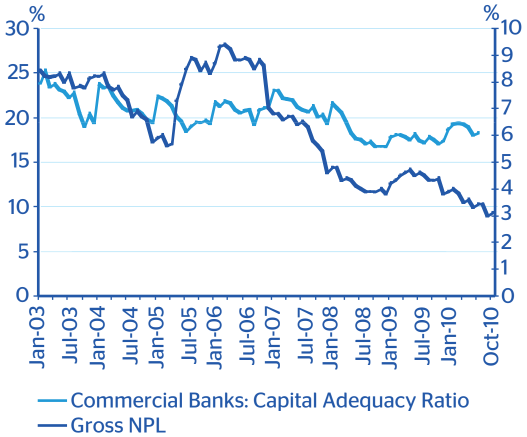
Chart 7
Export markets are diversified



Source: BBVA Research, Bank Indonesia and National Resources

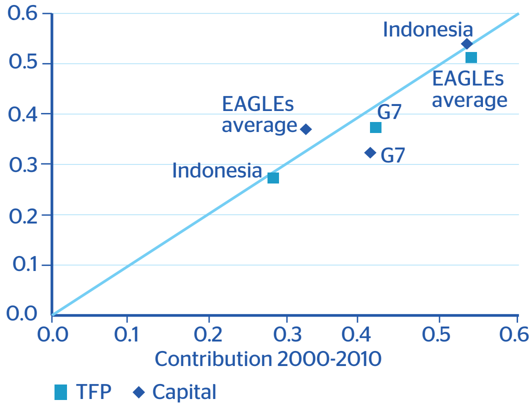
The banking sector, which is critical to channelling savings to productive investment, has also been strengthened in recent years. The sector is well-capitalized with low nonperforming loans (Chart 8), positioning it to weather shocks and deliver high rates of credit growth. Over the longer term, we expect Indonesia's growth potential to rise due to ongoing reforms to boost productivity and investment. Two keys to this positive scenario are: (i) an expected rise in investment levels, which should raise the capital stock; and (ii) further increases in total factor productivity (TFP). Chart 9 shows that the expected contribution of Indonesia's TFP to its potential growth during the coming decade is lower than the average EAGLE, while the contribution of the growth of its capital stock is higher than average.

Chart 8
Banks' capital adequacy and gross NPL ratios are healthy



Source: Bank Indonesia and BBVA Research

Chart 8
Contribution of Capital and TFP to potential growth



Source: BBVA Research

This suggests that efforts to enhance productivity in Indonesia— especially improvements to infrastructure and the legal system — could go far in enhancing potential growth. Importantly, both of these factors — rising investment levels and increases in productivity — hinge on ongoing efforts to improve the investment climate, which continues to lag behind in international surveys, despite all of the positives discussed above. Weak perceptions about government effectiveness, regulatory quality, rule of law, and control of corruption show there is room for improvement. Thus, although its rankings are rising, Indonesia still comes out relatively low in investor surveys of doing business. For example, Indonesia still ranks 121 out of 183 countries in the World Bank's

Ease of Doing Business Survey. Stepping up infrastructure spending (power, ports and roads are priorities), eliminating remaining wasteful and poorly targeted fuel subsidies, and reinforcing efforts to improve the judicial system and fight corruption, all of which appear to be priorities of the government, would go a long way to unleashing Indonesia's vast potential and placing it even higher among the EAGLEs.

Indonesia ranks highly among our list of EAGLE economies due its strong growth prospects. The positive outlook derives from structural characteristics that include a young population and growing middle class, a rich endowment of natural resources and a large domestic market, which have helped shield Indonesia's economy from external shocks. On the policy front, sound economic management and ongoing efforts to improve the investment climate are key. More broadly, the world is changing rapidly, and investors are increasingly focusing on growth opportunities in emerging markets.

The EAGLEs framework outlined above provides a rigorous and transparent framework for helping corporations and individual investors assess these opportunities. In Indonesia, particularly because of its large population and rapidly rising incomes, but in the other EAGLE economies as well, business opportunities arise with the emergence of a new middle class and an associated shift towards consumption expenditure that should favor retail-oriented businesses.

Another business opportunity lies in infrastructure expenditure, which will be key for Indonesia and the rest of the EAGLEs, as it constitutes one of the most important bottlenecks to further increases in productivity and, thereby, potential growth. Investment in infrastructure is needed to close the gap between emerging and developed economies. In Indonesia, for example, the quality of infrastructure lags well below the level in developed economies as well as most of Indonesia's EAGLE peers (Table 3). While this gap, if not addressed, could pose a supplyside bottleneck to growth, it also presents opportunities for companies specialized in infrastructure projects. Indonesia's efforts to enhance the quality of institutions and, in particular, the rule of law and the judiciary system will go far in attracting this muchneeded investment and in enhancing its already strong growth prospects.

Table 3
Quantity and Quality of Infrastructure

Overall Infrastructure		Transport Infrastructure		Electricity and Telephony Infrastructure	
G6 Average	5.83	G6 Average	5.81	Taiwan	6.06
Taiwan	5.63	Korea	5.73	G6 Average	5.85
Korea	5.59	Taiwan	5.19	Korea	5.44
Russia	4.46	China	4.73	Russia	4.82
China	4.44	India	4.50	Brazil	4.28
Turkey	4.21	Turkey	4.40	China	4.14
Brazil	4.02	Russia	4.11	Turkey	4.02
Egypt	3.97	Egypt	3.97	Egypt	3.97
Mexico	3.74	Mexico	3.96	Mexico	3.51
Indonesia	3.56	Indonesia	3.89	Indonesia	3.24
India	3.49	Brazil	3.76	India	2.49

Source: Global Competitiveness Report, 2010-11 and BBVA Research