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Topics Can Indonesia transition to an investment-driven economy?

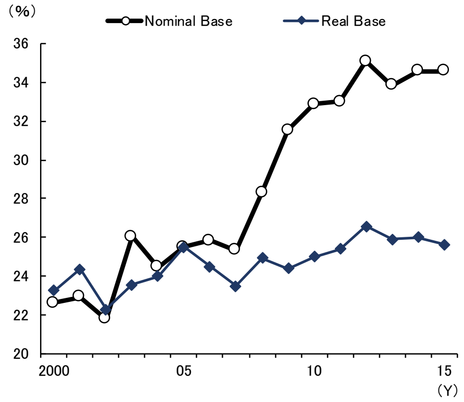
Complacent in its wealth of natural resources, Indonesia has postponed economic structural reform, and has not realized investment-driven high levels of growth. Attention is now being focused on the execution capability and continuity of the Joko administration, which has a positive stance towards reform.

■ Investment-driven growth left out in Indonesia

Despite strong expectations of market expansion due to the growth potential suggested by income levels, the size of the population and the high percentage of young people in the population, Indonesia has not yet been able to achieve high levels of economic growth. In 2005, the income level in China was about the same as that in Indonesia (approx. $1,500). In the subsequent ten years, China's economy continued to post high levels of growth, at an annual rate of about 10%, whereas Indonesia's economy could only manage an average of less than 6%, and in recent times the income gap has widened to more than double.

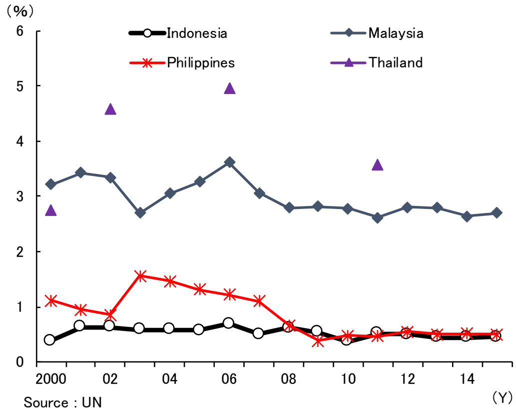
The difference is attributable to whether investment-driven economic growth has been realized or not. The level of economic activity in a country depends upon the degree to which labor and capital are input. In general in developing countries, while they enjoy a cheap and abundant labor force, they often lack sufficient capital stock. Therefore, more aggressive plant and equipment investment and public investment tend to lead to higher growth rates. Examination of the investment ratios (real base) since 2005 shows that, while China was able to achieve between 40 to 48%, Indonesia's investment ratio has remained relatively flat at around 25%. Investment ratios in Malaysia and Thailand in the period of high economic growth of the early 1990s reached the 40% range. That Indonesia has been unable to achieve similar high levels of growth is largely due to the fact that it has not been able to transition to an investment-driven economic growth model.

＜Indonesia's Investment Ratio＞



Source : UN

＜The Output Value of Machinery and Equipment Industry in Major ASEAN Countries (Relative to Nominal GDP)＞



Source : UN

The principal reason that Indonesia's investment ratio has stayed so low is the rise in capital goods prices. The gross capital formation deflator rose 82% in the period from 2008 to 2016. However, the increase rates of the final consumption deflator and the GDP deflator were 54% and 55%, respectively. As a result, while Indonesia's investment ratio increased steadily on a nominal base from 2008, reaching 34.7% in 2015, on a real base it has remained more or less flat, as mentioned above. Which is to say, while there has been sufficient investment volume on a monetary basis, this has not translated into an improvement in substantial growth potential. Also, in line with the increase in the prices of capital goods, investment costs have become comparatively more expensive, making it more difficult to recoup investment costs, which is another factor that has contributed to corporations' hesitancy in making plant and equipment investment.

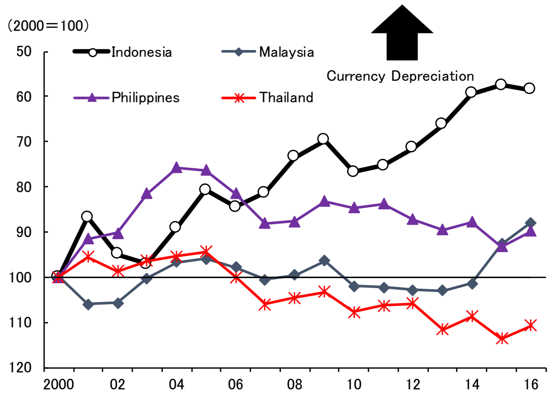
■ Background factors are a sharp currency depreciation and a lack of investment goods supply capability

The following two points may be considered contributory factors in rising capital goods prices.

The first may be said to be an insufficient ability to supply investment goods. In the past, Indonesia's economic development has been dependent on its natural resources, meaning that the industrial base of the capital goods manufacturing industry has remained fragile. Looking at the percentage of nominal GDP of machinery and equipment industries in major ASEAN countries, Indonesia's is around 0.5%, leaving a significant gap between this and the 2 to 3% of Malaysia and Thailand. For this reason, companies have had to procure machinery and equipment and the like by importing it, in order to make plant and equipment investment. Also, it is clear that there is insufficient capacity to supply the iron that is needed for infrastructure development. In the period 2008 to 2015, Indonesia's volume of crude steel consumption increased to 3.07 million tons, whereas the volume of crude steel produced by Indonesia in that period was only 940,000 tons. As a result, more than two thirds of the increased demand for crude steel has had to be supplemented by imports. This lack of ability to supply investment goods, coupled with the currency decline explained next, has boosted the gross capital formation deflators.

Second, there is the steep currency depreciation. Indonesia's nominal effective exchange rate fell by 20% in the period 2008 to 2016. This is in sharp contrast to that of Thailand, which increased over the same period, and that of the Philippines, which stayed more or less unchanged. Though Malaysia's currency also declined significantly through 2015 and 2016, the decline was only -12%. The end result has been the significant boosting of the import prices of capital goods in Indonesia.

＜Nominal Effective Exchange Rate of Major ASEAN Countries＞



Source : BIS

The currency decline was directly triggered by investors' intensified risk aversion stances in the wake of the Lehman shock, causing them to withdraw funds from emerging economies. However, the reason Indonesia's currency decline has been so steep, even for an emerging economy, is that the country's resource-dependent economic structure has reached its limit, intensifying the pressure on the inflation increase rate and the expansion of the current account deficit.

In light of the above, the essence of Indonesia's rising capital goods prices can be found in the fact that Indonesia has been complacent in relying upon its wealth of natural resources, and has long postponed economic structural reform, such as nurturing its manufacturing industries and developing price stabilization policies, etc. Therefore, in order for Indonesia to realize investment-driven economic growth, it will first have to implement structural reform in order to reinforce the country's domestic industrial base. That said, the promotion of structural reform by domestic effort alone involves difficulties in terms of financial and technological capability. Therefore, like other Asian economies, it will be essential for Indonesia to work to actively attract foreign capital.

■ All eyes on Joko administration's execution capability and continuity

Inaugurated in October, 2014, the Joko administration has tackled different types of economic structural reform, such as the development of a business environment that is conducive to the attracting of foreign capital, in order to lead Indonesia towards high economic growth. For example, though the lack of infrastructure in Indonesia is said to pose a challenge to foreign investment, the lack of financial resources has hindered infrastructure development. Shortly after inauguration, the Joko administration made sweeping cuts to fuel subsidies, which had been a significant financial burden, and succeeded in expanding infrastructure related budgets.

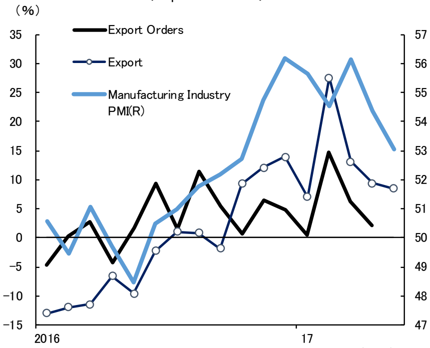
However, few of the policies have linked to concrete achievements, and the Joko administration's reforms may be said to be still a work in progress. It is often pointed out that, while infrastructure development is being implemented in terms of the government's budgetary basis, the progress of actual construction work is falling behind the pace of budgetary implementation. In the first place, it will not be so easy to dispel foreign capital's distrust of Indonesia's investment environment. In Indonesia, past presidents have also pledged the attraction of foreign capital through economic structural reform, and the development of the investment environment, in their election manifestos. However, once in power, their reform proposals have often been watered down in the face of strong resistance from vested interest groups.

This government's support rate has stabilized and, as the global economy enjoys something of a recovery, Indonesia now finds itself presented with a unique opportunity to realize an investment-driven economy. In order to predict whether the introduction of foreign capital will spread, and whether investment ratios will go up, attention is being focused on the execution capability and continuity of the Joko administration.

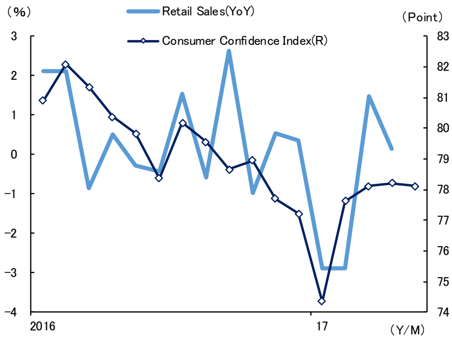
(Yuta Tsukada)

Taiwan *Though the economy is robust, export growth lags*

■ Export growth blunted recently



Source: Ministry of Finance、Markit



Source: Ministry of Economic Affairs, Taiwan National Central University

Taiwan's real GDP growth rate in the January to March quarter of 2017 was 2.6%, compared to the same period in the previous year, decelerating slightly from the October to December quarter of 2016 (2.8%), though steady growth continues, with exports playing a driving role.

However, an examination of recent export trends shows that there has been a sense of a loss of forward momentum since March, with export growth in May, 2017, at 8.4%, compared to the same period in the previous year (and the same hereafter). Despite strong growth in exports of iron and steel and plastic products, major export items such as semiconductors and other electronic products have weakened, and the pace of growth of exports of precision instruments including liquid crystal panels has contracted. In terms of individual countries, while exports to the US and Europe have remained steady, the pace of deceleration of exports to China and ASEAN is intensifying. In response to this blunting of export growth, the manufacturing industry PMI has fallen and production in the manufacturing industry for the month of April lacked conviction at just 0.8%. With regard to orders received, an indication of future performance, the same declining trend can be seen, and the growth rate for the April to June quarter is highly likely to post a slow down.

In terms of domestic demand, April's retail sales growth was up by a wafer thin margin at 0.2%. The backdrop to this is increasingly cautious consumption activity. Examination of the consumer confidence index shows that it had been rising, after bottoming out in January, 2017, but recently has stayed more or less unchanged. Although there has been no conspicuous deterioration in the employment situation, with the unemployment rate trending low, rising consumer prices accompanying last year's bottoming out of crude oil prices and rising food prices may well be supressing consumer sentiment.

On the other hand, the number of foreign visitors in April was a year on year increase for the first time in four months. Though the number of visitors from China has continued to dwindle since the inauguration of the Tsai Ing-wen administration in May of last year, measures designed to spur tourist visits to Taiwan, such as the relaxation of visa restrictions, have been successful, and the number of visitors from Southeast Asia has grown by 45.1%. In the future, it is thought unlikely that there will be any further deterioration of relations between mainland China and Taiwan, and the expectation is that the decline in the number of visitors from China can be halted, and that service exports, mainly in the form of inbound consumption, will be able to rally.

■ Tsai administration looking for concrete results in 2nd year

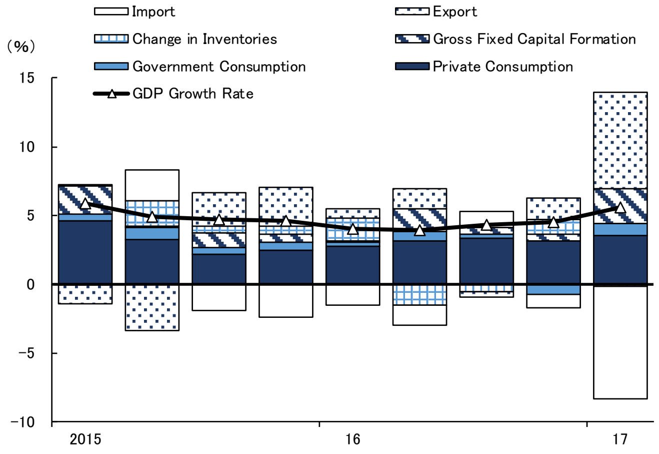
In May, 2017, the Democratic Progressive Party passed its first year with Tsai Ing-wen in office as President. Although progress has been made with some policies, such as the strengthening of relationships in Southeast Asia through the New Southern Policy, unemployment among the young remains high and there has been little progress in redressing income disparity, and the administration is losing its political momentum. Against this backdrop, the "Forward-looking Infrastructure Development Plan" was announced in March. The Plan will invest NT$882.5 billion in railway development, green energy and digital infrastructure in the period 2017 to 2024, and is expected to generate an accompanying investment boosting effect in the private sector and from abroad. As it enters its second year in office, the Tsai administration is challenged with producing concrete results, such as the steady implementation of policies that will translate into the strengthening of mid to long-term growth, and the improvement of stalled relations with China.

(Kentaro Matsuda)

Malaysia　Economy improves

■ 5.6% economic growth in Q1

Malaysia's economy has been trending towards recovery since the start of 2017. The real GDP growth rate in the January to March quarter of 2017 was 5.6%, compared to the same period in the previous year, picking up speed compared to the October to December quarter (4.5%, similarly), and the highest growth rate in two years.



Source : Department of Statistics Malaysia

Domestic demand has also continued to perform strongly. In the private sector, plant and equipment investment by foreign manufacturers has increased. Also, encouraged by an increase in the temporary allowances paid to low income earners, an increase in the minimum wage, and improved employment and income environments as a result of stronger exports, private consumption grew 6.6%, similarly, accelerating from the previous period (6.1%). Additionally, in the public sector, government consumption and public investment both changed to increased growth. Progress in infrastructure development and increased salaries for civil servants and increased purchases of goods and services were contributory factors.

However, it is not expected that a significant increase in export growth will continue. Though the global economy overall is expected to continue to recover, growth in exports of major items such as electrical and electronic goods is expected to contract due to factors such as a cooling of IT related demand towards the end of the year, and the deceleration of the Chinese economy. In fact, the export volume in April, 2017, grew 8.6%, compared to the same period in the previous year, decelerating from the January to March quarter (11.9%, compared to the same period in the previous year). In addition, since private investment growth is largely swayed by export performance, it is thought unlikely that there will be any strong growth there. It is believed that, mainly due to a slowdown in the corporate sector, the Malaysian economy will be slightly weaker over the latter half of the year.

On the other hand, domestic demand is expected to stay strong and to play a major role in supporting the economy. It is anticipated that private consumption will continue strongly due to the effects of an increase in the temporary allowances paid to low income earners, and the expected fall in the inflation rate. Also, with large development projects underway, public investment is thought likely to continue to grow solidly.

■ All eyes on the political situation in the latter half of 2017

It is anticipated that attention will be focused on political trends over the latter half of 2017. In Malaysia, lower house elections are slated for April, 2018, but there is an increasing expectation that Prime Minister Najib will call a general election before the end of the year. This is because the ruling coalition, led by Prime Minister Najib's United Malays National Organization (UMNO) is enjoying popular support due, for example, to the increased allowances being paid to low income earners, while the opposition, on the other hand, lacks cohesion.

However, Prime Minister Najib remains under a cloud of suspicion with regard to his alleged involvement in a financial scandal with 1MDB, a government-run strategic investment company, and the possibility that UMNO will lose the election cannot be ruled out. UMNO has been in power as the leader of the ruling coalition since the founding of Malaysia and, having been able to maintain a stable political base, has attracted a lot of foreign capital. Should the ruling coalition suffer a drastic loss of seats in the election, there are concerns that there could be adverse effects on the economy, such as the suspension of foreign capital investment and ringgit depreciation. To that extent, it will be important to pay close attention to the political situation over the latter half of the year.

(Yuta Tsukada)

China Progress in economic negotiations with US

■ Both sides drawing closer with "100 Day Plan"

The US and China have recently been making progress in the formulation of a "100 Day Plan", designed to try to correct the trade imbalance, based on the agreements made at the summit meeting in April, 2017. As a result of negotiations, the Initial Actions agreed upon as the first stage of the 100 Day Plan were announced in mid-May.

The following two meanings may be read from the content.

First, China has put measures in place to expand US imports, and the two sides have reached agreeement to take steps to alleviate US frustration at the trade imbalance. Although only a limited number of items feature in the agreement, concrete progress has been made with regard to imports of US beef and liquid natural gas. As a result, it may be concluded that the possibility has receded that the Trump administration will trigger hard-line measures, such as raising tariffs on Chinese products.

＜Initial Actions of US-China Economic Cooperation 100 Day Plan＞

Main Agreement	Emphasis Points
Trade	・While China will allow to resumption of imports of US beef, the United States will work urgently on making rules for importing Chinese processed chicken
	・With regard to the export of liquefied natural gas to China, the United States can admit under the same conditions as other non-free trade agreement countries
Market Liberalization	・Liberalization of credit ratings in China by foreign-owned 100% capital enterprises
	・Accept full market entry with electronic settlement service by US company (single capital)
One Belt One Road	・The US side recognized the importance of the one-way road plan by China and dispatched a delegation to a region-one forum held from 14 to 15 May

Source: Department of Commerce, Various News
Note: On agreement matters, it is roughly the 100th day from the US-China summit,
The deadline of July 16, 2017 is clearly stated.

Second, it was not a one-way set of concessions to the US, but also contains actions favorable to the Chinese economy. Looking at the ten agreed actions, while China has agreed to resume the import of US beef on one hand, the US has agreed to the early formulation (by July 16, latest) of a set of rules governing the import of China origin cooked poultry on the other. The opening up of Chinese markets to US firms in the fields of electronic payment services and credit rating services will not only raise the level of these services within China, but may also be said to contribute to the strengthening of China's industrial competitiveness, viewed over the long term. The US has recognized the importance of the One Belt and One Road initiative proposed by the Xi Jinping administration, and its commitment to send delegates to the Belt and Road Forum will doubtless provide a tailwind for the initiative.

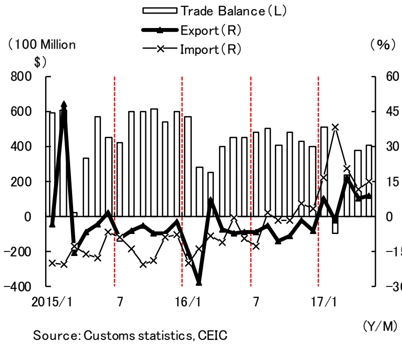
■ Boosting China's political and economic stability

This agreement with the US is expected to boost China's political and economic stability.

Politically, there is consensus among the leadership with regard to the development of an environment in which the National Congress of the Communist Party, scheduled to be held in the autumn, can go ahead smoothly. Against this backdrop, the avoidance of economic friction with the US through this series of negotiations may be highly rated as having helped lessen the risk of political instability.

Economically, in addition to domestic demand, for which the government can work out support measures, there is also now hope that external demand may be able to stage a recovery.

＜Change of Trade＞



Source: Customs statistics, CEIC

Export growth for the month of May was 8.7%, compared to the same period in the previous year, marking three consecutive months of positive growth. Now that steps have been taken to try to resolve the trade friction with China's biggest export destination, the US, the footing of the recovery of exports overall will likely become more certain.

Of course, this recent agreement goes no further than to show that the two sides are on good terms in the initial stages. If future negotiations do not produce further results, such as expanded acceptance of US imports, then the risk that the Trump administration will embark on tougher policies cannot be dispelled.

For the Xi Jinping administration, the resolving of trade issues with the US will continue to be a priority issue, not only for short term stability in the run up to the National Congress, but also looking ahead to the "1 Year Plan" that is to follow the "100 Day Plan", and beyond.

(Junya Sano)