



Asian takeaways

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“Indonesia has always been a market of potential for foreign investors and has been hailed as a potential future powerhouse in the ASEAN region.”

What gives, Indonesia?

Our latest research trip to Indonesia has left us with mixed feelings about the country’s economic landscape. While we see fresh hope with the new president assuming office this past October, we also have concerns about the underlying economy. It faces weak consumption, a shrinking middle class, and slow economic growth in Java, the heart of Indonesia’s economy and politics. So, what gives, Indonesia?

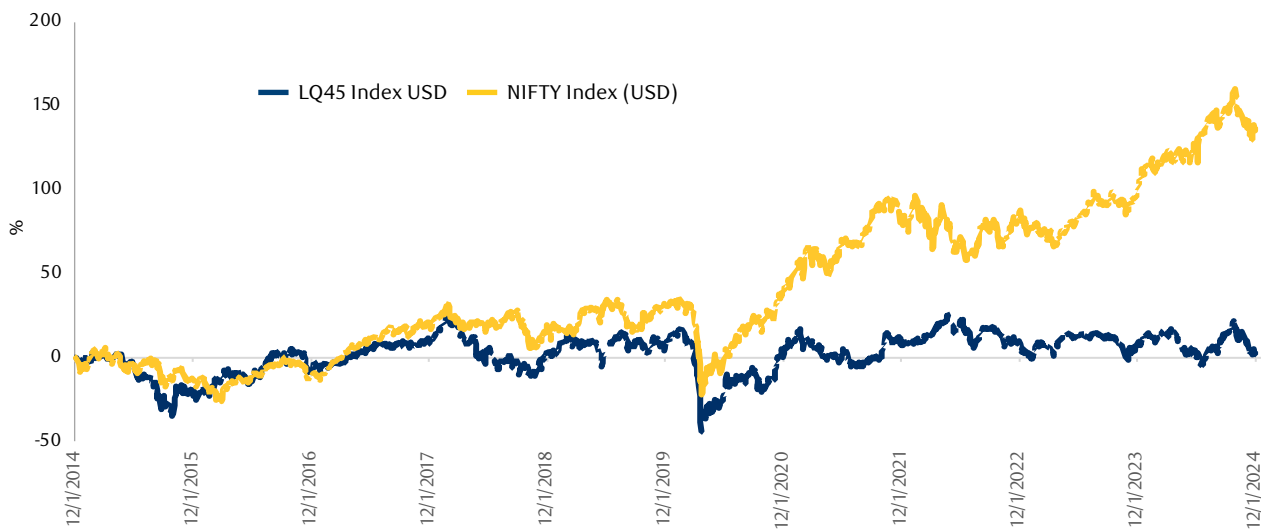
Indonesia has always been a market of potential for foreign investors and has been hailed as a potential future powerhouse in the ASEAN region, driven by its rich natural resources, large labour pool, and an expanding middle class. However, despite these promising factors, the country’s equity market performance has not met expectations. If we compare the index performance with other emerging markets darlings like India over the last 10 years, Indonesia’s LQ45 Index has only delivered 2% of total return, significantly underperforming India’s Nifty 50 Index which saw a modest total return of 137% (Figure 1). This sluggish return, which fell lower than returns from investing in time deposits, has been partly caused by tightened regulatory scrutiny imposed on insurance companies and low pension fund allocations in public equities, estimated to approximately 10% of total assets¹. In the past, several insurance companies, including the state-owned enterprise (SOE) Jiwasurya, failed to meet their financial obligations due to substantial losses in their equities portfolio. This further shifted customer preference towards safer asset classes, such as fixed income. However, this divergence highlights fundamental differences in the economic policies and growth drivers of the two nations despite their shared demographic profiles characterized by large, young populations.

Under President Jokowi, the country has maintained an annual GDP growth rate of around 5%, excluding during the pandemic². This figure falls short of the 7% growth promise made during his 2014 campaign. In contrast, India has consistently achieved average annual GDP growth of around 7% within the same period, also excluding the pandemic³. Although the fact that Indonesia’s current GDP per capita (nearly USD 5,000) is double that of India, means it should experience higher discretionary spending potential, the reality is that the benefits of this wealth gap are not being fully realized⁴.

¹ <https://www.asianinvestor.net/article/indonesia-pension-fund-keen-to-raise-pe-allocations/485316>.

^{2,3,4} Bloomberg.

Figure 1: Indian stocks generate significantly higher total return compared to Indonesian stocks since the post-pandemic rally



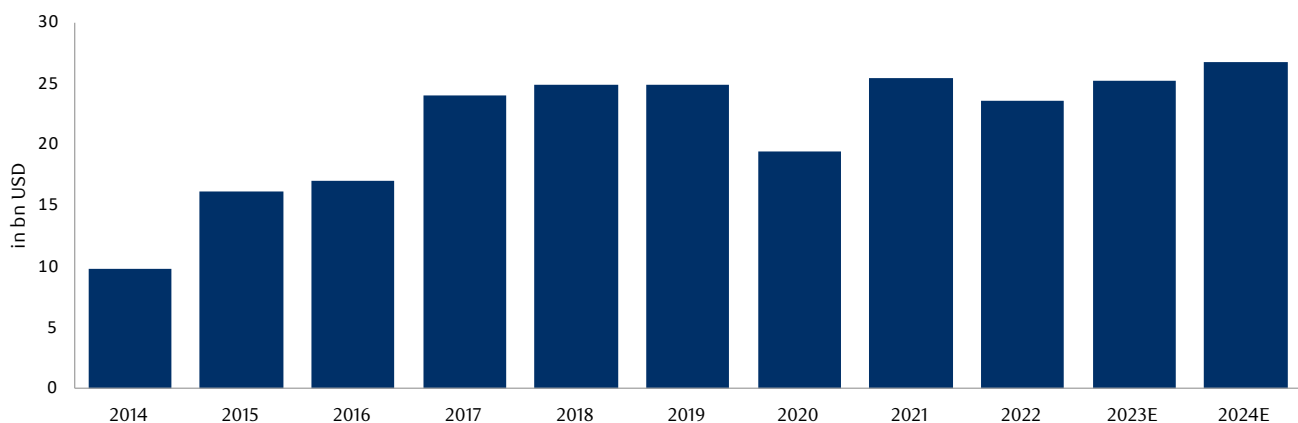
Source: Bloomberg, as at November 2024.

Policy initiatives: A shift towards massive infrastructure development and downstreaming

During Jokowi’s second term, Indonesia implemented significant policies aimed at promoting industrial downstreaming and moving up the value chain for key commodities. A notable example is the 2020 ban on nickel ore exports, which facilitated the establishment of domestic smelters and attracted investments from battery manufacturers and refiners in joint ventures with local firms. This policy has successfully increased nickel export value and contributed to a trade surplus. While commodity prices, including nickel and coal, have normalized from their 2022 peaks, they remain above pre-pandemic levels and are expected to sustain their strength, particularly considering the global rate cut cycle. Additionally, the “China Plus One” strategy has strengthened the development of downstream supply chains.

Infrastructure development has also seen a significant boost, with budget allocations rising from USD 10 billion in 2014 to USD 27 billion in 2024 (Figure 2). This sustained investment has resulted in transformative projects, including Southeast Asia’s first high-speed railway, 366,000 kilometers of village roads, and over 2,000 kilometers of toll roads constructed in the last ten years⁵. This toll road expansion far surpasses the mere 780 kilometers built over four decades by previous administrations. Projects like the trans-Sumatra toll road, which spans over 1,000 kilometers, and developments in Kalimantan and Sulawesi, are parts of Jokowi’s long-standing vision of achieving economic equality outside Java⁶. His ambition to relocate the capital to Nusantara further distinguishes his approach from past Java-centric policies.

Figure 2: Government Infrastructure Budget



Source: Indonesia’s Ministry of Finance, DataIndonesia.id, as at August 2023.

⁵ [Jokowi Sebut Pemerintah Bangun 366.000 Kilometer Jalan Desa 10 Tahun Terakhir](#) (Kompas).

⁶ [Pecah Rekor! 10 Tahun Jokowi Jadi Presiden-Sumatera Punya Tol 1.100 Km](#) (CNBC Indonesia).



Riding Jakarta's Mass Rapid Transit.



The city's Mass Rapid Transit proved to be convenient, safe, and clean.



Electric buses, another aspect of Jakarta's Mass Rapid Transit. Source: <https://vktr.id/products-facilities>

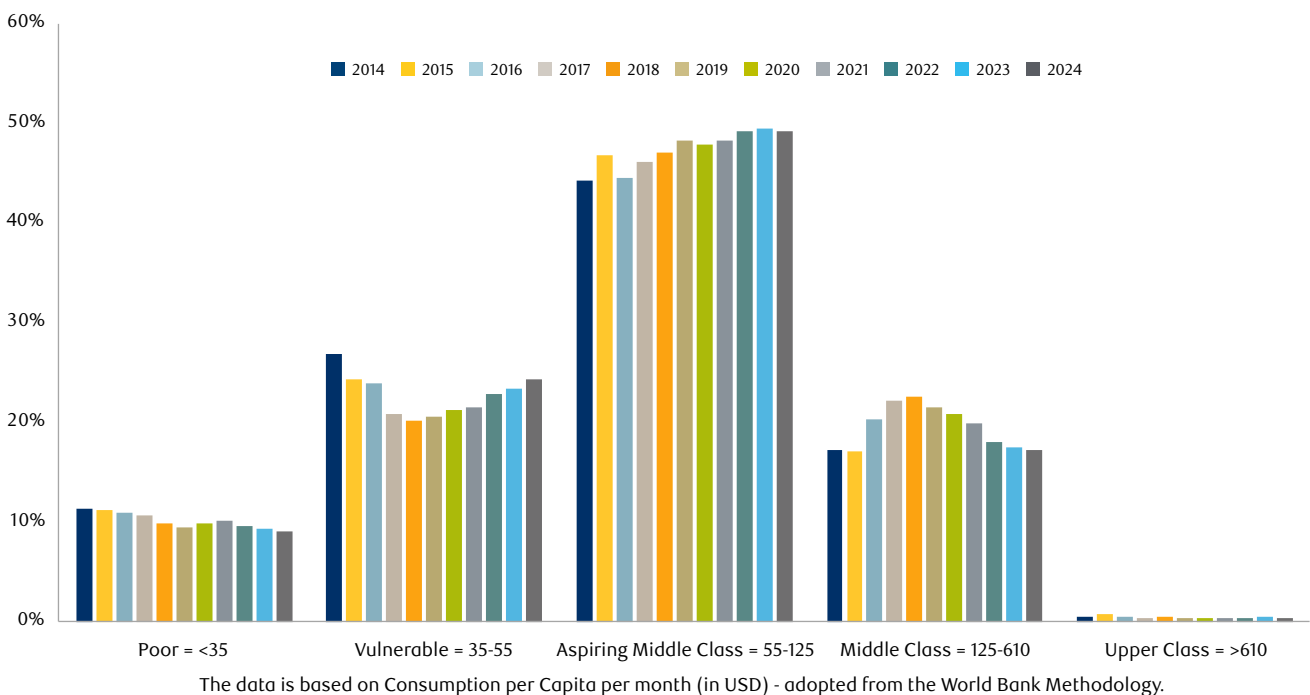
Our visit to Jakarta allowed us to experience the city's Mass Rapid Transit (MRT), which proved to be convenient, safe, and clean, marking a significant uplift in the transportation quality standards in the country. The first phase of this flagship project was completed in 2019 and spans 16 km from Central to Southern Jakarta⁷. However, the full potential of this line will only be realized once phases 2A and 2B become operational in 2028 and 2032 respectively, connecting the northern and southern areas of Jakarta with a single MRT line. Additionally, the integration of the city's bus system (Transjakarta) with the MRT further enhances the efficiency of public transportation. Combined with the visibility of the phase 3 development (East-West Line), this infrastructure will elevate Jakarta's connectivity and potentially offer a solution to the city's notorious traffic congestion.

Challenges ahead: Shrinking middle class and economic disparities amid fiscal challenges

Despite these positive strides, Indonesia faces critical challenges. Particularly, a middle class that has been shrinking since 2019 (Figure 3). The number of individuals classified as vulnerable or aspiring to middle-class status is growing. Economic growth in Java has lagged, even as regions like Kalimantan, Sulawesi, and South Sumatra experience stronger growth. This trend aligns with GDP per capita growth in these regions, which has outpaced the national average between 2014 to 2023, while the three largest provinces in Java have underperformed (Figure 4).

“The number of individuals classified as vulnerable or aspiring to middle-class status is growing.”

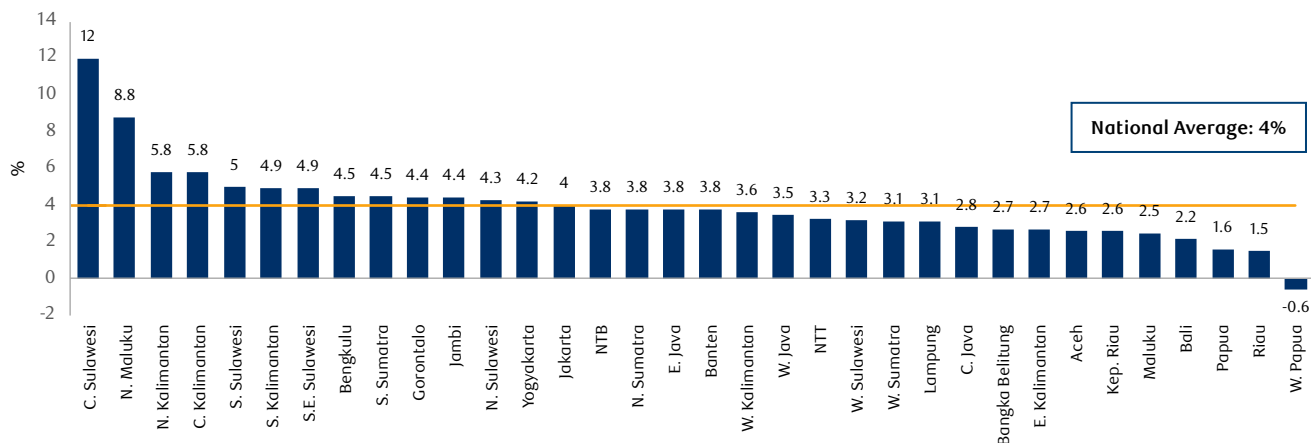
Figure 3: Indonesia Population by Income Level



Source: BPS, BI, Verdhana Research, as at October 2024.

⁷ <https://jakartamrt.co.id/id/proyek-dan-perkembangan>

Figure 4: GDP/Capita CAGR 2014-2023 across different regions of Indonesia



Source: BPS, Nomura Research as at September 2024. Sulawesi, Kalimantan, and South Sumatra exhibit stronger growth trajectory than the national average.

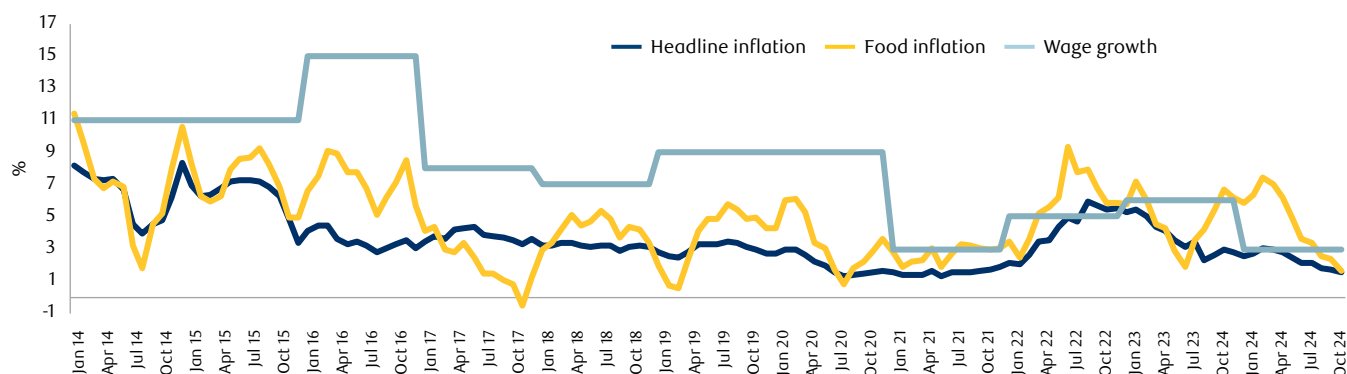
Inflation and wage growth present additional hurdles. Recent data indicates that minimum wage increases have failed to keep pace with food inflation, which is particularly concerning as food accounts for approximately 42% of middle-class spending (Figure 5)⁸. Although inflation is a key driver of wage growth, the government does not adequately factor food inflation into its calculations. The competitive labor costs resulting from the “China Plus One” strategy have made other ASEAN countries attractive manufacturing hubs, complicating Indonesia’s position. While pre-pandemic minimum wage growth was around 10%, there are concerns that returning to this rate could leave Indonesia less appealing to foreign investors.

Indonesia’s public spending remains low relative to its peers, primarily due to a low tax-to-GDP ratio (Figure 6). The government has taken efforts to increase this ratio, including increasing VAT from 10% to 11% in 2022, with plans for a further increase to 12% in 2025^{9,10} but this time only applying for luxury goods.

Although increasing VAT has become an easy way to boost revenue, it also adds to the burden placed on the middle class. The Indonesian government has relied heavily on corporate tax and VAT, which account for 29% and 28% of total tax revenue respectively, while personal income tax (PIT) has contributed only 13% in 2022^{11,12}. Typically, a developed country with high tax-to-GDP ratio has higher contribution from PIT, reflecting a greater contribution from the upper-class segment. While employees pay PIT through monthly wage deductions, effective collection for business owners remains challenging. Planned tax reforms, including the Core Tax Administration System (CTAS), have been developed to enhance efficiency in tax collection and taxpayer identification, which is set to roll out in early 2025. If implemented successfully, these initiatives are expected to generate more tax revenue from the upper-class and thus offer room for government budget expansion.

“Indonesia’s public spending remains low relative to its peers.”

Figure 5: Minimum wage growth has failed to catch up with food inflation after the pandemic



Source: BPS, Ministry of Manpower and Transmigration, Verdhana; as at November 2024.

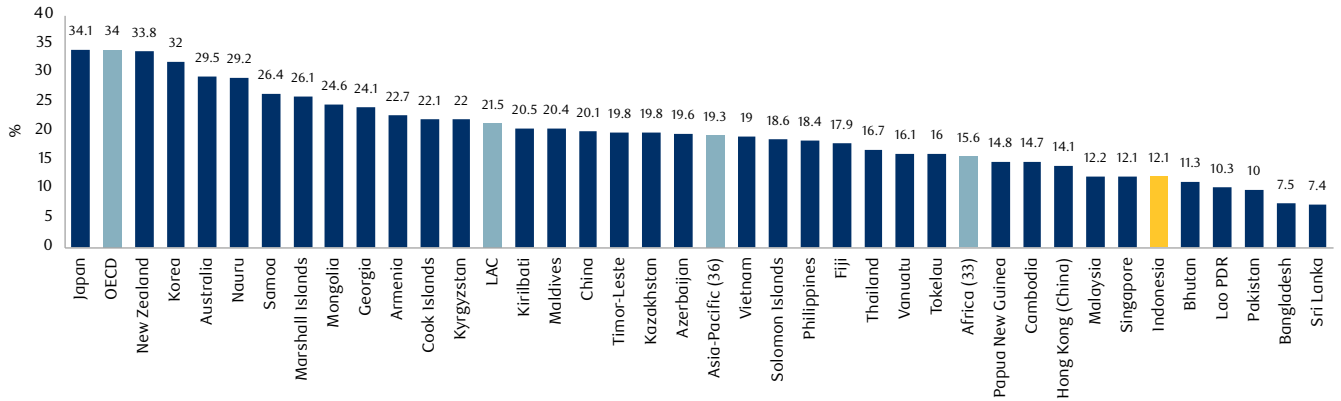
⁸ <https://www.cnbcindonesia.com/research/20240830100306-128-567691/jumlah-kelas-menengah-ri-turun-duit-habis-buat-makan-uang-galon> (BPS, CNBC Indonesia).

⁹ <https://www.bdo.global/en-gb/insights/tax/indirect-tax/indonesia-standard-vat-rate-increase-for-luxury-items#:~:text=An%20increase%20in%20Indonesia%20standard,consumed%20by%20high%20income%20earners.>

^{10,11} [Indonesia's tax reforms risk being undermined by reckless spending | East Asia Forum.](https://www.oecd.org/content/dam/oecd/en/topics/policy-sub-issues/global-tax-revenues/revenue-statistics-asia-and-pacific-indonesia.pdf)

¹² [https://www.oecd.org/content/dam/oecd/en/topics/policy-sub-issues/global-tax-revenues/revenue-statistics-asia-and-pacific-indonesia.pdf.](https://www.oecd.org/content/dam/oecd/en/topics/policy-sub-issues/global-tax-revenues/revenue-statistics-asia-and-pacific-indonesia.pdf)

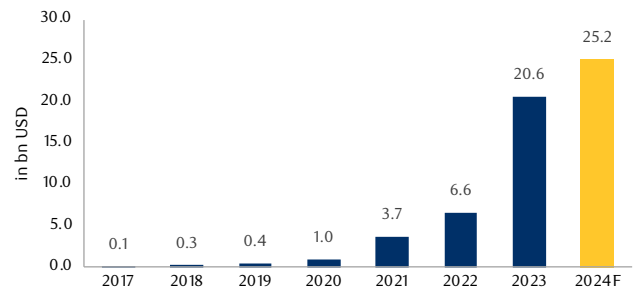
Figure 6: Indonesia’s Tax-to-GDP ratio was only 12.1%, below the APAC average of 19.3%



Source: OECD, data refers to 2022, as at June 2024.

There has been a sharp rise in online gambling in the country, which disproportionately impacts the younger demographics and lower economic classes and has had a knock-on effect on consumption. With transaction values expected to reach around USD 25 billion in 2024, the government faces significant challenges in taking down these offshore platforms which often involve multinational syndicates (Figure 7). As a result, a trend of downgrading has become more prevalent, which negatively impacts mid-range products. Without accelerated mitigation efforts, the economic strain on vulnerable populations could worsen.

Figure 7: Transaction value associated with online gambling



Source: PPAK, Verdhana, as at September 2024.

“Improving educational outcomes is vital to help equip Indonesia with a skilled labor force and attract more foreign direct investment.”

Prabowo’s ambitious growth targets

As Prabowo takes office, he faces the daunting task of achieving an ambitious 8% growth target essential to avoiding the middle-income trap before the demographic bonus diminishes. His initiatives aim to address critical issues, with policies including a free meal program, a housing initiative for 3 million homes, and education reforms. The free meal program is expected to enhance nutritional standards for young students, contributing to a higher quality labor force and increasing disposable income in low-income households. Furthermore, Prabowo has pledged to build high-quality schools in each district, renovate inadequate school infrastructure, and improve teacher quality in rural areas where many educators remain underpaid. With only 6.4% of the population holding a high school qualification or higher as of September 2024, improving educational outcomes is vital to help equip Indonesia with a skilled labor force, attract more foreign direct investment (FDI), and support growth in both the manufacturing and service sectors (Figure 8). Additionally, building new homes can stimulate economic activity by creating jobs and increasing demand for construction materials and services. This initiative will enhance housing affordability, ultimately leading to greater consumer spending power.

Figure 8: Indonesians with tertiary qualifications only account for 6.4% of total population

Education Level	% of population
Doctoral	0.02%
Master’s	0.31%
Bachelor’s	4.39%
Diploma	1.69%
Senior High School	20.89%
Junior High School	14.54%
Elementary School (Graduated)	23.40%
Elementary School (Not Graduated)	11.14%
Not in School yet	23.61%

Source: Databoks-Katadata, Verdhana, data refers to 2022, as at May 2023.

Conclusion

While Prabowo’s flagship programs hold the potential to strengthen Indonesia’s domestic economy, the critical question remains: can the new government effectively execute these initiatives? The involvement of numerous ministers from the previous cabinet helps to foster optimism for Indonesia’s future. However, addressing the challenges of declining domestic consumption power, a shrinking middle class, and lackluster growth in Java is essential for achieving sustainable economic growth. The path ahead is loaded with challenges but, with the right policies and execution, Indonesia can unlock its potential and navigate toward a more prosperous future.

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Cornelius is an Analyst on the RBC Asian Equity team at RBC GAM. He works closely with portfolio managers to support bottom-up research across all sectors in the Asia Pacific region. Prior to joining the organization in 2024, which is when he started his career in the investment industry, Cornelius successfully completed internships both with his current team and also a global investment firm. Cornelius holds a BSc in Quantitative Finance and Risk Management Science from The Chinese University of Hong Kong.

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