FOCUS ON

Indonesia, the time is right

A Produced by the Economic Analysis and Research

Executive summary

- The largest economy in Southeast Asia is leaving the negative commodities cycle behind it. President Widodo's government is implementing free-market measures and reforms, presenting the country as a **symbol of political stability and economic dynamism** and attracting foreign investors. The direction taken leads us believe that this is right time for Italian companies wishing to export products to Indonesia, invest, or participate in the development of the country with on-site operations, taking advantage of the many projects planned by the government.

- There are many opportunities in the **infrastructure sector**, which requires "…US$500 billion in investments over the next five years" according to Jim Yong Kim, President of the World Bank. **Roads, ports and airports as well as energy production and distribution** from both traditional and renewable sources. **Digital infrastructure is also needed**, important for the development of an internal market for placing goods and making production processes more efficient.

- Greater efficiency and increased productivity also involve technology imports from abroad, **industry machinery** in particular. This would play a crucial role in the **mining industry** and related sectors, given the government's wish to develop a local processing industry for extracted minerals as well as the **manufacturing and agricultural sectors**, which still rely on outdated techniques.

- **Close to 60% of Indonesian GDP is made up of domestic consumption** and the **urbanisation** process will result in 70% of the population living in urban centres by 2030, the same year the **consumer class** is expected to reach 140 million people, **the largest in Southeast Asia**. The automotive industry could be strategic both in terms of a target market and direct investment on-site, since most produce is destined for the domestic market.

- Italy is beginning to understand the importance of Indonesia, including it among the target countries identified by the "Control Room". **SACE-SIMEST included the country among the 15 priority geographies for Made in Italy products**, offering direct support through credit risk hedging for deferred payment or protection of on-site investments, and indirect support through guarantees on loans granted to local importers. This "**push strategy**" intends to encourage Indonesian importers to choose Italy as a supply market, offering financial packages that make transactions with Italian exporters competitive.

Economic and political framework

Indonesia is the largest economy in Southeast Asia and the 10th largest in the world in terms of GDP, equal to US$3,032 billion (PPP)[1]; with 260 million inhabitants, it is the fourth most populated country worldwide. The country is one of the fastest growing areas for international trade and among the most promising economies: trade between Indonesia and the rest of the world has quadrupled over the last 10 years[2]. **The fall of the Suharto regime and the Asian Tigers crisis of 1997-8 represented an opportunity for decisive change** and reforms were launched aimed at establishing economic, financial and political stability, focusing on the natural resources the country is rich in and its demographic dividend, with a young and relatively low-cost workforce.

Proximity to China is both an opportunity and a threat: Beijing is an important investor and trade partner and represents the main export market for Indonesian goods. From a political standpoint, however, it is an "overbearing" neighbour for Indonesia and other Asian countries, which seek a balance between the two major powers with influence over the Pacific, the US and China.
The drop in raw material prices in recent years has had a significant impact on the country in terms of reduced exports and tax revenue. Nevertheless, **GDP has continued to grow over time, at an average rate of around 5%**. In 2016 this figure was confirmed and is expected to increase further in 2017 (+5.2%[3]), thanks to the slight recovery in commodity prices.

Since 2014, the government guided by President Joko Widodo has pursued the reforms that began with the previous administration, **focusing on the development of infrastructure and increasing the country's attractiveness towards foreign investors**. This strategy intends to reduce bureaucracy, encourage foreign capital and cut (electricity and fuel) subsidies, reallocating these savings to spending on infrastructure. Another reform aimed primarily at foreign investors raised limits on foreign capital participation (previously 49%) in various sectors, making it possible to hold 100% of share capital in local companies operating in the service sectors (catering, sports centres, toll ways), cold chain companies, the rubber industry, telecommunications equipment and non-toxic waste management. In other sectors, such as logistics, this limit was not increased to 100% but foreign investors will still be able to hold a majority of share capital.
Macroeconomic stability and good prospects have made **Indonesia a privileged destination for foreign investments**, which since 2000 have recorded an average growth of 25%[4] : while 2015 was an exception, with a drop in foreign direct investment (FDI) of almost 30% compared with 2014 (the year in which direct investments in the country reached a record of $22 billion), in 2016 FDI resumed growth (+8.4%[5] over the previous year).

[1] Purchasing Power Parity. Source IMF, WEO April 2017.
[2] Source World Bank, World Integrated Trade Solution.
[3] Source IMF.
[4] Source United Nations, Unctadstat.
[5] Source EIU.

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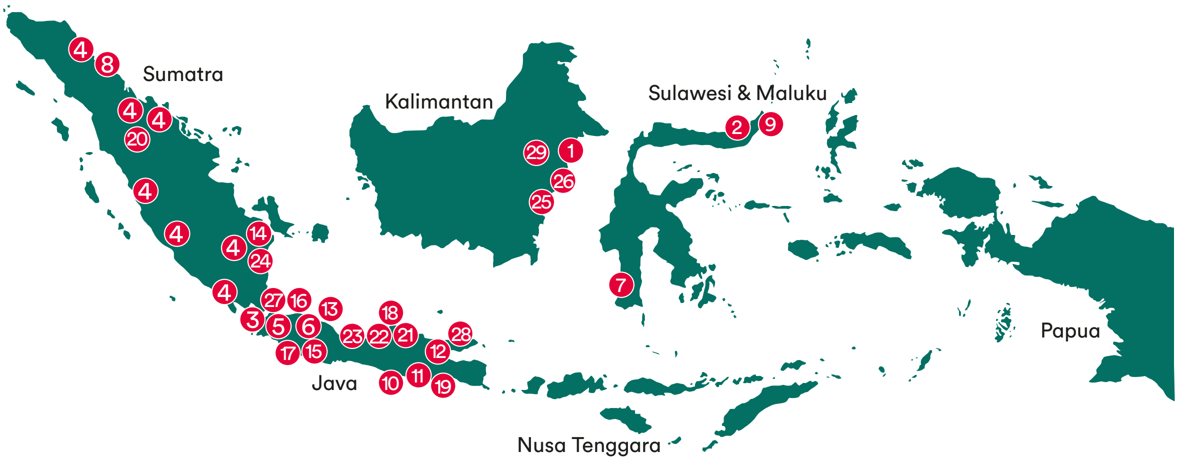
Infrastructure to unlock development potential

"Indonesia needs to invest US$500 billion in infrastructure over the next 5 years", stated World Bank President Jim Yong Kim at the *Indonesia Infrastructure Finance Forum* held in Jakarta on 25 July 2017. This means that by 2020, the share of GDP investment will have to almost double from the current 2.4% to 4.7%. This will not necessarily result in the worsening of public finances; President Widodo has in fact specified that the resources dedicated to this purpose may not exceed 1,500 thousand billion rupiah (approx. US$113 billion). The participation of private investors will thus be essential for the implementation of 225 priority projects the government has identified and undertaken to complete by 2019, with the aim of **improving transport links and connectivity** in a country made up of 19 thousand islands. **This is good news for the construction industry**, which has grown by 6.3% year-on-year in the first quarter of 2017, and is forecast to accelerate to an average annual rate of around 7.5% between 2016 and 2020[6]. Works for new projects - such as the Trans-Sumatra railway, the Soekarno-Hatta international airport, the new Terminal 3 at the Jakarta airport and the new container terminal in Jakarta (New Priok) - have begun over the past two years. This is backed by the 2017 budget, which allocated 387 thousand billion rupiah (approx. US$29 billion) in resources for investment in 836 km of roads, 10 km of bridges, 13 airports, 61 ports and 3 bus terminals.

FIGURE 1. Infrastructure projects (priority projects 2016-2019)



Source: The Jakarta Post, BMI Key Projects Database

1 Balikpapan-Samarinda Toll Road
2 Manando-Bitung Toll Road
3 Serang-Panimban Toll Road
4 Trans Sumatra Toll Road
5 Soekarno-Hatta Railway
6 North-South Line Jakarta MRT
7 Makassar-Parepare Railway
8 Kuala Tanjung Port
9 Bitung Port
10 Karangkates Hydroelectric Power Plant
11 Kesamben Hydroelectric Power Plant
12 Lodoyo Hydroelectric Power Plant
13 Inland Waterways Cikarang-Bekasi-Sea
14 LRT South Sumatra
15 LRT Jakarta
16 National Capital Integrated Coastal Development (Phase A)
17 Waste Processing System Jakarta
18 Development plan Water Supply System Semarang
19 High Voltage Direct Current
20 Electricity Transmission Sumatra
21 Central-West Java Electricity Transmission
22 Batang Power Plant
23 Electric Steam Power Plant Indramayu
24 Electric Steam Power Plant South Sumatra
25 Bontang Oil Refinery
26 Revitalization Refinery Development Masterplan
27 West Java Port (northern coast)
28 Tuban Oil Refinery
29 East Kalimantan Railway

[6] Source BMI.

SACE’s support in air transport

Air transport is a vital industry in the infrastructure sector, with the geography of the country making planes an essential means of transport. In fact, this is the sector in which SACE recorded the largest transactions, which in 2014 secured loans for the purchase of 15 ATR 72-600s, worth a total of US$375 million, by Indonesian airline Lion Air, the leading operator in the Indonesian market. Lion Air has purchased a total of thirty-seven ATR aircraft with the support of SACE.

Infrastructure not only means roads and airports, but also energy. **Energy production and distribution are key components** in enabling the production system to meet domestic demand. Over the next decade, the government’s primary objective is to increase installed capacity using all available resources, although **energy from fossil fuels will continue to drive the market**, given the **abundant reserves of coal** and natural gas. Energy produced from fossil fuels is expected to increase from the current 223.49 TWh to 382.73 TWh by 2026[7].

SACE’s support in the mining industry

In maritime transport, a segment closely linked to the mining industry, SACE’s contribution has allowed the expansion of the Coeclerici Group’s activities in the Indonesian market, which offers integrated services for the supply of raw materials (coal in particular) in the steel and energy industries. The loan granted by European banks and partially guaranteed by SACE enabled Coeclerici to partially fund the purchase of 4 Floating Transfer Stations for the transhipment of coal from the East Kalimantan mines in Borneo to large ocean-going vessels at anchor on behalf of PT Berau Coal, the fifth largest coal producer and exporter in Indonesia.

[7] Source BMI.

There is also good news in the renewable energy sector. Despite representing only 10% of installed capacity, **hydroelectricity is a source backed by the government** with the opening of a number of sites, such as Sarawak Cable, a 10 MW station in northern Sumatra nearing completion, or the 490 MW station which Terregra Hydropower – an Indonesian company founded with the aim of developing renewables - intends to install at 12 stations over the next five years. By 2019, Terregra will complete four stations in northern Sumatra capable of generating 40 MW from hydroelectric sources. The projects planned demonstrate the willingness of the state electricity company PLN to diversify production sources and gain efficiency through the use of large and powerful turbines.

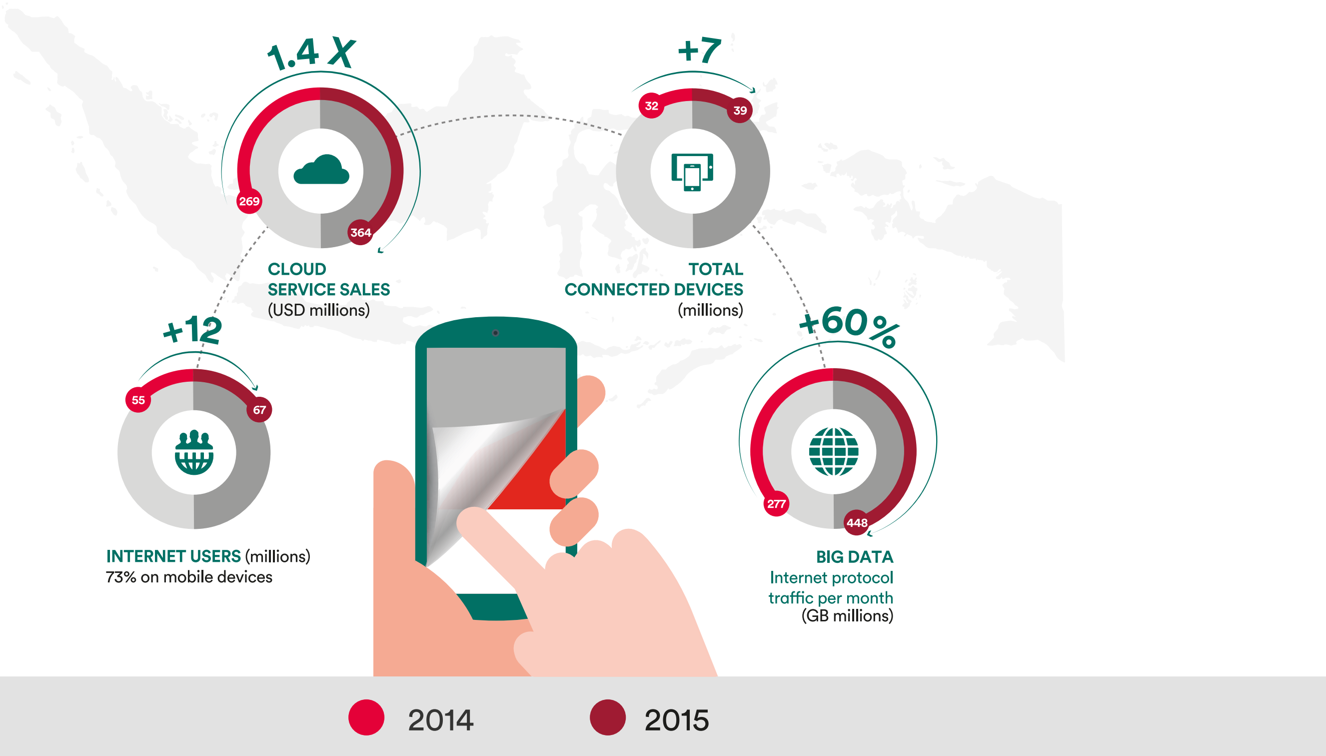
In the area of renewables, **solar power**, which today represents 7% but is expected to grow by almost 6% over the next ten years, **is attracting investment from abroad**, as demonstrated by the joint venture between the French company Engie and Electric Vine Industries (a private Jakarta-based company) for the creation of distribution networks for photovoltaic energy on the island of Papua, with an investment of US$240 million over five years. This network will serve 2.5 million people in three thousand villages for the next 20 years.

Finally, among the renewables geothermal energy is currently driving domestic production with projects underway for 1.7 GW, far above what solar or hydroelectric power can offer today. Geothermal energy has received subsidised grants and funding from multilateral institutions and the Asian Development Bank has already allocated US$350 million for the construction of a 320 MW power plant in northern Sumatra (Sarulla Geothermal Power Development Project). **Italy is present**: in July 2016 **Enel Green Power**, in association with the Indonesian PT Optima Nusantara Energy, was awarded a tender for the development of a 55 MW power plant in the Lampung province (the “Way Ratai” project).

In an increasingly digital world, it is also necessary to pursue investment in technological infrastructure. Technology is not only useful downstream, but also upstream of the value chain: the use of big data, the Internet of things and more generally the d**igitalisation process help increase labour productivity, especially in the manufacturing sector**. Despite persisting infrastructural obstacles **the digital revolution has reached the country**, although it is still lagging behind: Indonesia has the second-least expensive Internet connection, after India, but bandwidth and speed are still below standard[8]. Nevertheless, **Indonesians are frequent and expert Internet users**: they spend an average of 3.5 hours online each day (2 hours in the US), 80% on social media, and 78% of the population purchases online products (75% in the US)[9] and, according to McKinsey’s forecasts, by 2020 there will be 60 million new Internet users in addition to the current 100 million. It is thus easy to understand why Indonesia is an interesting market for consumer goods. Digital innovation is not a coincidence but rather the result of a commitment made by all ASEAN countries[10] as one of the pillars of the new Master Plan for Southeast Asian connectivity, which will take shape by 2025.

[8] The cost is USD 3.4 for 500 megabytes (US$50 in the US and US$38.5 in Italy), while the average connection speed is equal to 3.9 Mbps (14.2 in the US, 7.4 in Italy and close to 27 in South Korea, at the top of the ranking for speed).
[9] Source: McKinsey
[10] Association of South East Asian Nations: Thailand, Malaysia, Indonesia, The Philippines, Vietnam, Laos, Cambodia, Myanmar, Brunei and Singapore.

FIGURE 2. Indonesia is already digital



Source: McKinsey, 2016

Mechanical engineering: necessary to increase added value

The development of the Indonesian economy is strongly connected to its **natural and mineral resources**; during the years of greater foreign capital inflows, the mining industry absorbed almost a quarter of the total. Most of the companies that extract ore directly exported the same abroad, incurring relatively low costs in terms of extraction rights and export taxes. This led to the over-exploitation of reserves in exchange for low returns in terms of public revenue and development of local industry, which carried out low value added activities. This is why **in 2012, the government reformed mining laws** imposing: i) the increase of royalties, ii) the reduction of maximum foreign shareholding in mining companies from 80% to 49%, iii) the levying of a 20% tax on the export of unprocessed minerals and iv) the introduction of more stringent regulations for operations in the sector: bureaucratic requirements and the development of a local processing plan for extracted minerals.

The current government has also moved in this direction, defined by the international community as a form of creeping nationalism. From our perspective, however, the **wish to create a local mineral processing industry is promising** in terms of the positive impact on the Indonesian development model (greater employment and higher tax revenues for investment in infrastructure, healthcare and education), as well as the opportunity for Italian machinery exporters to participate in this new phase of industrialisation. The mining industry is capital intensive and the creation of a segment associated with mineral processing may help shift production to higher segments of the value chain.

SACE's support in the metallurgical industry

The need for technological improvement in Indonesian industry is reflected in SACE's operations, guaranteeing loans for the modernisation of steel plants such as in the case of Tenova Spa, which supplied machinery and engineering services for the upgrade and expansion of certain plants owned by Krakatau Steel, one of the largest steel producers in Southeast Asia.

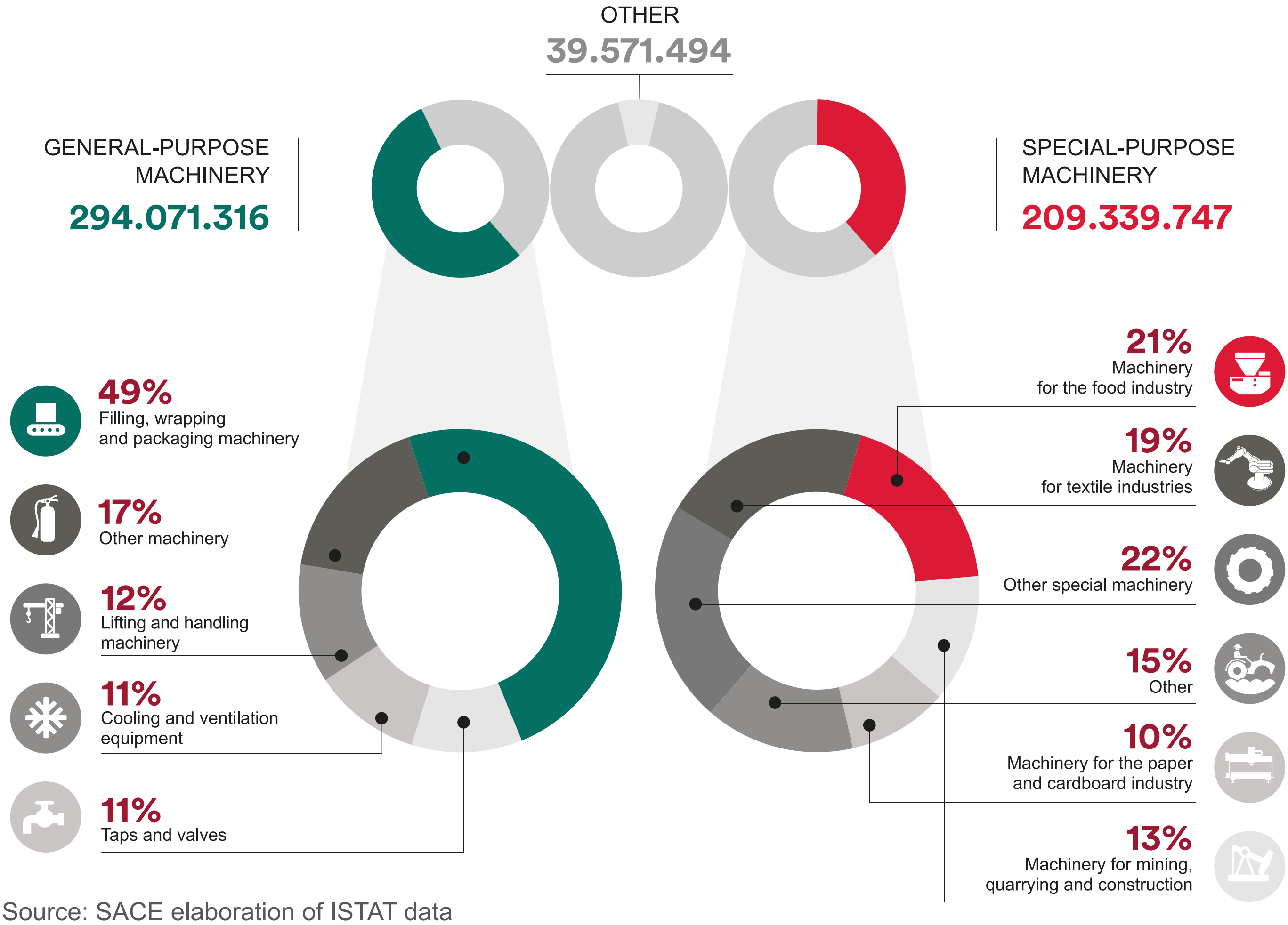
This approach is a consequence of the difficulties faced by certain mining companies: strict regulations that require Clean and Clear certification to retain extraction permits are forcing some companies to cease operations, as in the case of PT Timah Tbk and PT Refined Bangka Tin, two major tin producers. The creation of a local processing industry for extracted minerals is thus a compulsory step for all operators wishing to continue their exploitation of the Indonesian islands' mineral resources and the need to invest in machinery not only applies to the mining industry in the strict sense, but also for allied activities (e.g. the metallurgical industry).

Still in the field of natural resources, with approximately 30 million tonnes per year, **Indonesia is the world's largest player in the production and trade of palm oil**, which is used not only in the international food industry but also in the energy sector (biodiesel). Following the directive adopted for the mining industry, disputes over the environmental unsustainability of intensive palm oil cultivation will force companies to **adopt more efficient production processes**, focusing on oleochemical products with higher added value. The same applies for other raw materials such as cocoa, coffee and sugar cane as well as rubber, coconut and smaller-scale production of rice, soybeans, cereals, fruit and vegetables.

Productivity is an issue for the entire agricultural sector, which in Indonesia employs approximately 40 million people[11], characterized by out-dated techniques, overexploitation of soils (resulting in impoverishment) and waste of water resources. In this context, the urbanisation process underway does not help, reducing the supply of labour and increasing consumer demand. This translates into a **need for quality mechanisation**, also through precision farming for the rationalisation of available resources and optimisation of harvest yields, increasing sustainability in the medium and long term. In addition to mechanisation and quality production, there is also an opportunity for Italian contribution in the packaging phase of the final product, whether raw or processed. In this case, the data confirms Italy's strong position: out of the €524 million in machinery exported to Indonesia in 2016, €115 million was for **packaging machinery** (40% of all general-purpose machinery exported to the country) and €43 million for food processing machinery (21% of special-purpose machinery exported to Indonesia).

[11] Source: Human Capital Outlook, ASEAN 2016.

FIGURE 3. Italian machinery exports to Indonesia (2016, data in € and %)



Source: SACE elaboration of ISTAT data

The largest consumer class in Southeast Asia

Close to 60% of the US$930 billion GDP (at current prices[12]) consists of domestic consumption. Exports amount to almost US$180 billion, but imports are just as important, reaching US$170 billion[13] in 2016, confirming the solid domestic demand. Consumption alone contributed 2.8 percentage points to the GDP growth rate of 5%[14]. This aspect is especially relevant since solid and dynamic domestic consumption not only represents an opportunity for those seeking to enter the Indonesian market with their own products, but also serves as a buffer for the economy, reducing exposure to the performance of the international markets.

[12] 2016 figure; source IMF. In terms of PPP, Indonesian GDP in 2016 amounted to USD 3,032 billion.
[13] Nominal values at current prices.
[14] Source EIU, 2016 figures.

The solidity of domestic consumption is attributable to the large population, but especially the part of the population that falls under the definition of "consumer class": according to McKinsey, by 2030 an additional 90 million Indonesians will join the current 50 million consumers[15]. The urbanisation process will contribute to this growth, with 70% of the population expected to live in urban settings by 2030 (today around half of the population still lives in rural areas); migration will not only be towards the capital Jakarta, already home to more than 10 million inhabitants, but also towards middleweight cities, distributed across the islands of Java and Sumatra, which could each welcome anywhere from two to five million inhabitants (e.g. Bandung, Batam, Pekanbaru and Makassar).

SIMEST's operations in Indonesia

SIMEST has supported the commercial penetration of the Asian market, sustaining Italian companies primarily in the area of subsidised export credit for more than 30 transactions, worth a total of €300 million.

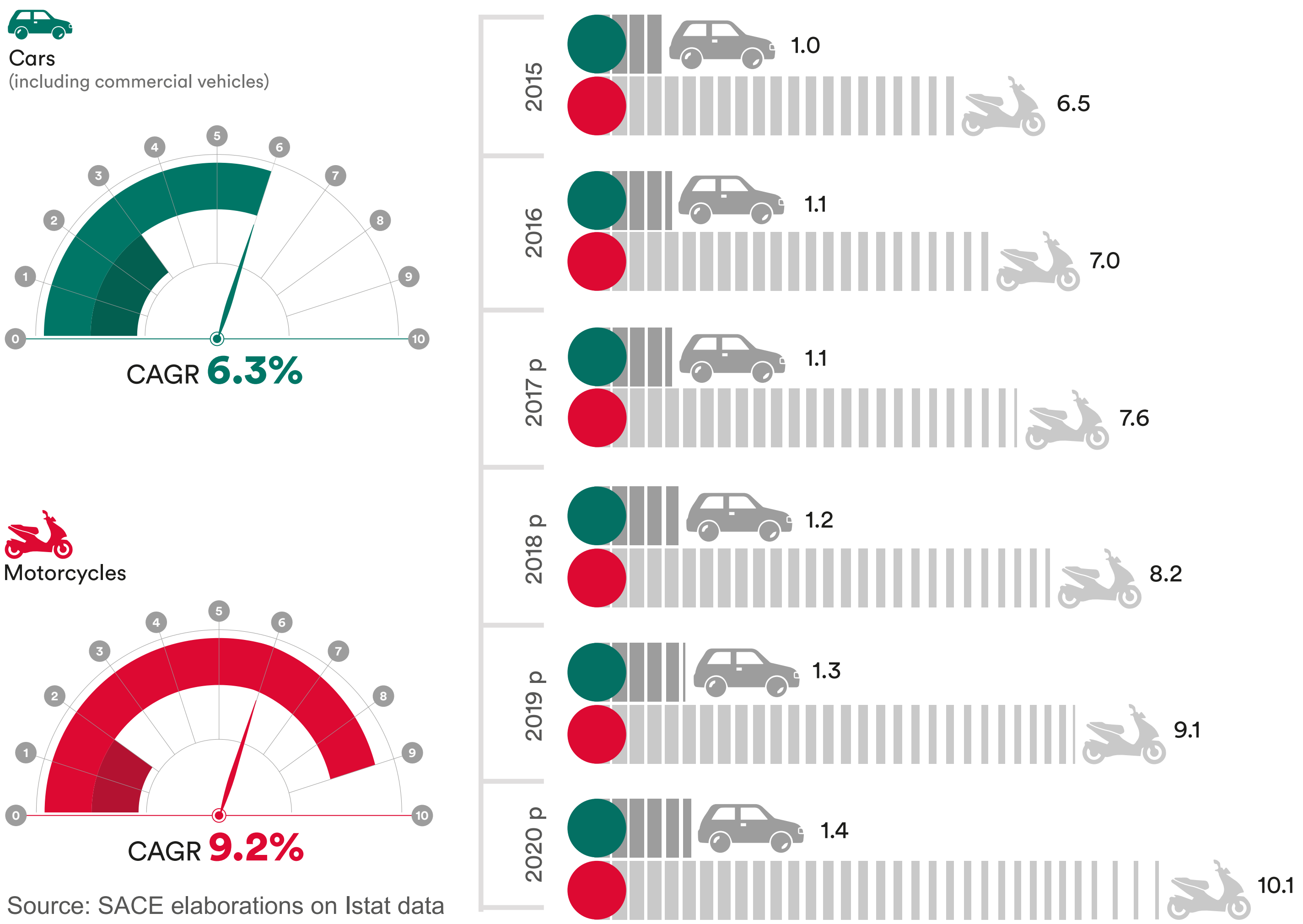
With the increase of disposable income and migration towards urban centres, the food and beverage sector and consumer goods in general, also durable, will experience the most significant growth. From this perspective, the automotive industry should not be overlooked, offering possibilities both in terms of investment (for the establishment of on-site manufacturing facilities) and as a target market for exports. **Excellent performance in the sector has already been recorded in recent years**: in 2015 almost 8 million vehicles were sold (approximately 6.5 million motorcycles and 1 million cars). A 50% increase in car sales is expected by 2020, while motorcycle sales should reach 10 million[16].

The sector is still dominated by Japanese manufacturers (Toyota, Honda, Suzuki) but there are significant opportunities for automotive components. The competitive cost of labour and the domestic growth prospects make Indonesia **an alternative to the Thai automotive hub** despite the "technological disadvantage" of the sector, easily solved through the **import of more advanced machinery and technologies** that would enable the achievement of higher quality standards. Performance in the sector is closely linked to credit dynamics: the average Indonesian consumer, lacking the necessary liquidity, will take out a loan to purchase a vehicle. A more accommodating monetary policy, pursued by the Central Bank since 2016, is sure to benefit the industry.

[15] Consumers are understood as individuals with an annual income of above USD 3,600 (2005 PPP). Currently, the average per capita income of the country is equal to approximately USD 3,604 (PPP).
[16] Source BMI

FIGURE 4. Finished vehicle sales (CBU*) in Indonesia (€ millions)

* Complete Build-up Unit | p: predicted

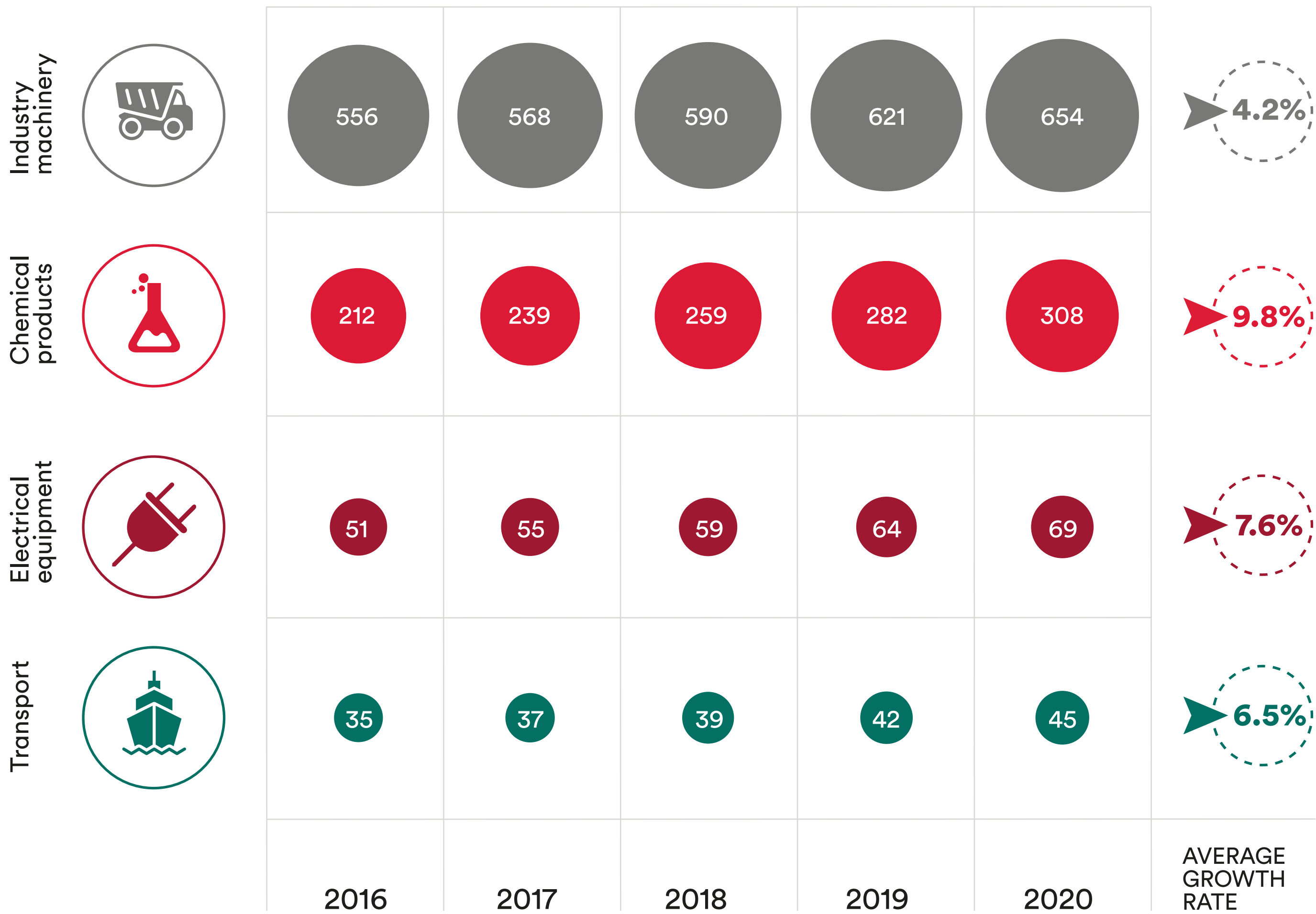


Source: SACE elaborations on Istat data

What Italy has done, what it is doing and what it can do

Italy is still far from being a protagonist in trade relations with Indonesia: the country is the **eighth target market for Italian exports to Asia**, representing 0.3% of our international exports, and our market share is equal to just 1%. **Italian exports have increased significantly**; in 2016 they increased by 5% compared with 2015, amounting to a total of €1.2 billion (equal to just €600 million in 2010). **Dynamics were also positive in the first five months of 2017**, with Italian exports increasing by 9.6% compared with the same period of 2016. The most exported goods remain industrial machinery (almost 50% of total exports to Indonesia), chemicals (18%), building materials and leather (6%). **In the coming years, SACE expects Italian exports to grow at an average annual rate of 5% to 6.7%**: the strongest performance will come from the chemical industry (+9.8%), transport (+6.5%) and electrical equipment (+7.6%).

FIGURE 5. Italian export forecasts for main sectors (€ millions, % change) p: predicted



Source: SACE

Italian companies already present in the market include Eni, Enel, Saipem, Coeclerici, Ariston, SACMI, Piacentini, Perfetti, Iveco and Piaggio. Eni has been active with both onshore and offshore operations since 2001; one of its main projects is Jangkrik, dedicated to the integrated development of two offshore gas fields located 70km from the East Kalimantan coast. The project is already operational and the first shipment of liquefied natural gas (LNG) departed on 22 June 2017 from the Bontang liquefaction plant near Bali[17]. Moreover, Biesse is active in the production of woodworking machinery, Savino del Bene in the logistics sector and other companies such as Lamberti, Unicer and Bozzetto operate in the chemical industry.

Recognising the existing margins for improvement in Indonesia, Italy has begun to grasp the importance of this market, including it among the **"Control Room"** countries; there is an increasing number of events aimed at informing and helping Italian companies approach this market, such as the recent visit by the Minister of Economic Development in May. Information is an essential tool, but sometimes it is not enough for doing business in emerging markets. After identifying the sector of interest and positive growth dynamics, it is necessary to offer the counterparty and clients a **competitive financial package** to support transactions, both in case of exports and more active forms of internationalisation.

[17] Source ENI Press Release.

In this context, **SACE has included Indonesia among the 15 priority areas for Made in Italy products**, formulating a proactive strategy: **not only direct support** for Italian companies requiring credit risk hedging on deffered payments or insurance coverage to protect on-site investments, even against political events, **but also indirect support** through loans for local importers. This **"push strategy"** for Indonesia focuses on specific industries, namely energy, telecommunications, infrastructure, aeronautics and defence, and aims to encourage certain Indonesian companies, selected in advance, to choose Italian suppliers thanks to financial instruments making imports profitable. This competitive advantage offered to Italian companies, together with the current favourable trend, make Indonesia a market worth considering, where Italian companies can "be discovered" also thanks to the **support offered by SIMEST through commercial placement and promotion programs**, such as subsidised loans for trade shows and participation in joint ventures with local partners.
The Italian Trade Agency office in Jakarta assists Italian companies on-site, participating in trade shows such as the Indonesia Maritime Expo 2017 (shipbuilding, Jakarta 10-12 October 2017), Printech INDONESIA in the paper and cardboard sector (Jakarta 15-18 November 2017) and the Indonesian Hospital Expo (medical equipment, Jakarta 18-21 October 2017).

In recent years, Indonesia has become the symbol of a new emerging area, Southeast Asia, and a regional point of reference in terms of economic growth and political stability. On the one hand, the creation of the Asean Economic Community[18] works towards the greater economic and political independence of these countries. On the other hand, **discussions with the European Union for the creation of a free trade agreement**, following the example of Vietnam, show Indonesia's wish to become a gateway for European countries entering Southeast Asia.
In conclusion, although the opportunities offered by the Indonesian market have long been known, little has been done so far, also due to unfavourable economic cycles. Despite this, there have been some positive results, as shown by the growth in Italian exports in recent years and the increasing involvement of Italian companies in major infrastructural projects. Now is the right time, given the direction the country is moving in and the instruments and initiatives Italy has put in place in order to seize the opportunities in Indonesia.

[18] The Asean Economic Community project proposes the creation of a free trade area between Southeast Asian countries. The agreement between the member countries was signed in December 2015.

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