Van Eck Global
SINCE 1955

MARKET VECTORS

The Investment Case for Indonesia

► INVESTMENT OPPORTUNITY
► PORTFOLIO BENEFITS

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Figure 2 Selected Economic Indicators

	2003	2004	2005	2006	2007
Government debt/GDP (%)	61.2	56.7	47.5	39.0	35.3
Debt/asset ratio for nonfinancial companies (%)	41.2	41.0	37.5	35.1	31.5
Inflation rate (%)	6.8	6.1	10.5	13.1	6.4
Private investment/GDP (%)	19.6	21.4	22.5	21.7	22.4
Trade balance ($ bil.)	24.6	20.2	17.5	29.7	33.1
Int'l reserves ($ bil.)	36.3	36.3	34.7	42.6	56.9

Source: Asian Development Bank and Bank of Indonesia

Resurgent Indonesia

The investment case for Indonesia begins with the remarkable recovery it has made from the economic crisis that beset Southeast Asia in the late 1990s, triggered in part by excessive borrowing and asset price bubbles throughout the region. Indonesia was particularly hard hit, enduring a collapse of its currency, a meltdown in its banking and corporate sectors, and a severe economic retrenchment. In the decade since, the country has righted itself by pursuing sound fiscal and monetary policies combined with a broad agenda of reforms aimed at rebuilding, restructuring and revitalizing its economy—the largest in Southeast Asia.

A remarkable political transformation has taken place as well. In 1998, the upheaval associated with the crisis forced the resignation of General Suharto, the country's dictator of 32 years, and democracy has taken a firm hold since then. Susilo Bambang Yudhoyono became Indonesia's first directly elected president in 2004, and has provided effective leadership in furthering the country's progress.

Out of that progress has come a resurgent Indonesia. Real GDP growth has solidly rebounded, averaging 5.5% in the past five years **[FIGURE 1]**.[1] In 2007, real growth topped 6% for the first time since the crisis, and may do the same in 2008.[1] Indonesia's recovery is expected to continue in 2009 and beyond, although the impact of the current global financial crisis has yet to be determined.

Other signs of health abound **[FIGURE 2]**: Government and corporate debt levels have receded[1,2]; the banking system has been restructured and recapitalized[3,4]; investment has revived[3]; inflation has been contained[3,4]; external balances have improved[3,4]; and an ongoing liberalization of the economy has made it increasingly market oriented.[5] Reflecting this progress, Indonesia's stock market rose by more than five-fold over the five years ending in 2007.[6]

Figure 1 Real GDP Growth

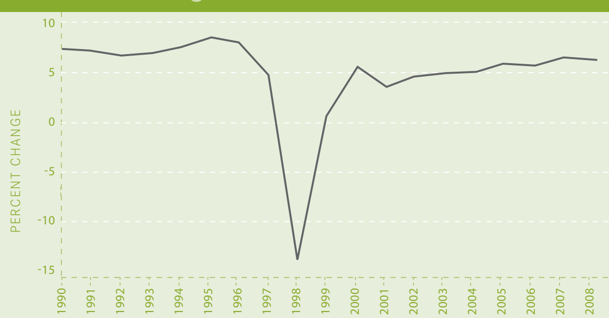


Figure for 2008 is estimated.

Source: International Monetary Fund

Favorable Factors

Indonesia's prospects are further bolstered by a powerful set of positive fundamentals—namely:

OIL AND GAS WEALTH: The hydrocarbon sector accounts for 25% of Indonesia's GDP and 40-50% of its government revenues.[7] It is one of the world's oldest oil producers and was among the first members of OPEC. Oil production has declined in recent years, however, reflecting aging reserves and diminished investment in this sector in the post-crisis era. Due to declining production combined with rising domestic energy needs, Indonesia became a net importer of oil in 2003 and will formally exit OPEC at the end of 2008. But it continues to be a leading exporter of liquefied natural gas, ranking second in the world to Qatar.[5]

MINERAL WEALTH: The country is one of the world's top ten mineral producers, with significant deposits of gold, silver, copper, coal, tin, bauxite and nickel.[3] Its coal reserves are the third largest in the world and it is the leading exporter of tin.[3]

AGRICULTURAL WEALTH: Indonesia is an archipelago made up of more than 17,000 tropical islands that constitute an ideal setting for plantations, fisheries and forestry. It is a top exporter of palm oil, which is gaining ground as an alternative fuel, as well as of rubber, wood, coconuts, tobacco, cocoa, coffee, tea, spices and shrimp.[8]

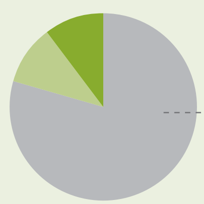
DIVERSIFIED EXPORTS: The country has diversified its export base to include a wide array of manufactured goods in addition to natural resources. Today, oil and gas account for 20% of exports—down from more than 50% in the 1980s—and manufactured goods such as textiles, paper, chemicals, rubber products and electrical appliances comprise almost 80% of non-oil and gas exports **[FIGURE 3]**.[7]

REGIONAL MOMENTUM: Indonesia is situated in a region that has rapidly developed since the 1970s, and has growing ties with China and India, which have ranked among the world's fastest growing nations in recent decades.

"Indonesia has made a remarkable recovery from the Asian economic crisis of the late 1990s."

SHEER SIZE: With a population of 240 million, the fourth largest in the world, the country has a huge domestic market that is becoming increasingly consumer-oriented as incomes rise. Private consumption now powers about half of GDP growth, more than any other single factor.[1]

Figure 3 Non-Oil & Gas Exports in 2007



Source: Bank of Indonesia

Figure 5 Stock Market Profile

	2003	2004	2005	2006	2007
Listed companies	333	331	336	344	383
Listed shares (bil.)	829.3	656.4	713.0	924.5	1,128.2
Volume of net share purchases by foreign investors (mil.)	9,524	23,946	27,938	25,451	38,170
Market capitalization ($ bil.)	54.5	72.7	81.4	138.4	211.1

Source: Indonesia Stock Exchange

Top priority

One of Indonesia's top priorities in recent years has been to increase foreign direct investment as a means of promoting its recovery and development. Many sectors of its economy have been open to foreign investment for decades, and these inflows have played a key role in recapitalizing its banking system—which is now 40% foreign-owned.[3] But in the post-crisis era, Indonesia's investment needs are greater than ever, and the government is actively seeking foreign capital to, in particular: enhance the country's infrastructure, which is vastly inadequate and exerts a drag on economic growth; expand the oil and gas sector's production and refining capacity; sharpen the competitive edge of existing export industries and develop new ones, like pharmaceuticals; and build key domestic industries such as transportation and telecommunications.[5,8]

One big hurdle to progress here has been an invisible but well known one: a legal, regulatory and tax environment that is arbitrary, non-transparent and biased against foreigners. To address this, the government passed a landmark investment law in 2007 that secures the rights of foreigners and streamlines the investment process. It also passed tax reform that strengthens taxpayers' rights and reduces the scope for arbitrary decision making, and has taken steps to better safeguard investors' intellectual property rights. Many more actions of this type have been taken or are planned.

The net effect has been a dramatic increase in FDI inflows, which jumped by 150% in 2007 to $40.1 billion **[FIGURE 4]**.[7] The manufacturing sector captured two-thirds of that inflow—with most of it going into chemicals, pharmaceuticals, paper and metal products—followed by the transportation, construction and agriculture.[7] About one-third of this money came from the U.S., while another third came from Asia—most notably, Singapore and Malaysia.[7] In 2008, inflows into oil and gas and the mineral sector, particularly coal, have accelerated—no doubt partly in response to the rising commodity prices that prevailed until mid-year.[9]

Smaller government

Yet another post-crisis priority has been to reduce the role that the government plays in the economy, both to contain spending and promote efficiency and competitiveness. This is a large, ongoing task

Figure 4 Approved Foreign Direct Investment

Source: Bank of Indonesia

since Indonesia's economy has always operated with a heavy state influence.

To that end, the government has begun to reduce its long-standing subsidies of key basic goods, such as fuel and rice, and is overhauling the vast state-owned enterprise sector—which at its zenith was made up of 200-plus companies. The goal is to reduce that number to 50 by consolidating, selling or privatizing these enterprises. Industry deregulation is also under way.[9] In the oil and gas sector, for example, deregulation has reduced the role of Pertamina, the state-owned oil company, and opened both the upstream and downstream markets to private companies.[10]

Capital market reform has also been an area of focus. In 2007, Indonesia's two stock markets were merged to form the Indonesia Stock Exchange (IDX), with the goal of creating an efficient centralized exchange that is more attractive to domestic and international investors.[6] Trading systems have been updated to better accommodate other types of securities, such as bonds and derivatives, and there has been a drive to persuade companies to list on IDX. Although Indonesian companies have a long-standing preference for operating privately, a variety of special listing incentives, such as tax breaks, have met with some success and the exchange has grown **[FIGURE 5]**.[6,9] The Indonesian market sharply declined in 2008 along with the rest of the global markets, and that may slow its development, but its growth prospects remain good.

In recent years, Indonesia has implemented many other changes that have strengthened its economic foundations—including improved capital standards for and oversight of its banks, reform of its bankruptcy code and corporate governance and accounting standards, and further liberalization of its trade policies. It has also launched an aggressive and high profile campaign against its rampant corruption that independent observers believe is increasingly making an impact.[9]

Long perspective

As solid as Indonesia's recovery has been, it may be slowed if the current crisis produces a prolonged slump in global growth. Moreover, the country continues to face a long list of challenges in restructuring its economy and raising its living standards, and it remains to be seen if Indonesia has the fortitude to sustain the policies that will enable it to achieve greater development.

Given its progress to date, however, Indonesia may warrant consideration by investors who are seeking potentially attractive returns and are willing to accept high levels of volatility and the potential for significant capital loss. Moreover, the Indonesian stock market has historically had one of Southeast Asia's lowest correlations with the developed markets, and as such may potentially offer diversification benefits.

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335 Madison Avenue, New York, NY 10017
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