Indonesia Economic Insight

2014

Contents

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Executive Summary

A. Recent Developments (2013-14)

- The **tightening of global liquidity** emanating from the tapering of Quantitative Easing (QE) in the US has led to periodic bouts of **capital outflows** from Indonesia, **exchange rate weakness and higher inflation** in mid-2013
- In response, the central bank has **hiked interest rates** to combat inflation and used international reserves to support the currency, while the government has introduced export restrictions to reduce domestic price increases
- As a result, **real GDP growth slowed to 5.1% in the year to Q2 2014,** from 5.8% in 2013 reflecting lower exports and weak investment spending
- The export restrictions have widened **the current account deficit (CAD) to 4.3% of GDP in Q2**, from 3.4% in 2013
- **The authorities have not been able to provide a significant stimulus to the economy** as the budget deficit (2.1% of GDP in 2013) is close to the legal statutory limit (3.0%) and inflation (4.0% in the year to August 2014) is in line with Bank Indonesia's inflation target band (3.5%-5.5%)

B. Macroeconomic Outlook (2014-16)

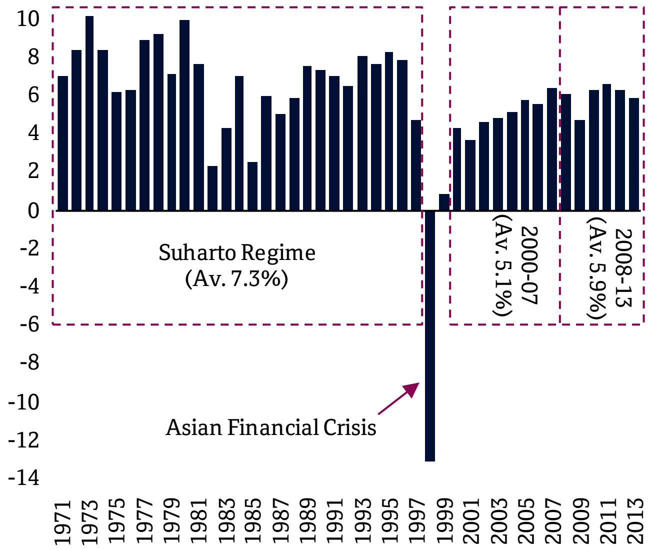
- **The new administration of President Joko Widodo (better known as Jokowi) will face a number of challenges** amidst the slowing economy; structural reforms to boost growth and encourage infrastructure investment will take time to implement
- As a result, **we expect real GDP growth to slow from 5.1% in 2014 to 4.5% in 2015** as the exchange rate could weaken further and policies remain tight; an **export- and investment-led recovery in 2016 could lift growth to 5.2%, provided reforms are implemented**
- Export growth on higher global demand should lead to a **narrower CAD** over the medium term, while a gradual lifting of fuel subsidies should **help reduce the fiscal deficit in 2015-16**
- **Inflation may rise from 5.5% in 2014 to 6.0% in 2015**, owing to fuel subsidy cuts and currency weakness, before easing to 5.0% in 2016 once the currency stabilizes
- **Banking sector growth is expected to continue slowing** in 2014–16 on tighter domestic liquidity and rising interest rates

Background

Since 1971, Indonesia has transformed itself from an agrarian society to a global economic force

Indonesia has maintained consistently high real GDP growth over the last 50 years, only interrupted by the Asian Financial Crisis in 1997–98. In the process, the economy has been transformed from mainly agrarian to one of the fastest growing Emerging Markets (EMs) through industrialization. During the Suharto regime (1967–98), rising oil prices created windfall export revenue, which attracted large foreign direct investment. However, strong growth during that period masked deep–seated structural weaknesses: endemic corruption, rising public debt, a poorly–regulated banking system, protectionism, and a persistent CAD. This left Indonesia fully exposed to the 1997–98 Asian Financial Crisis as large capital outflows led to a drastic depreciation of the Indonesian Rupiah (IDR) and rampant inflation with a severe impact on growth. Real GDP fell 13.1% in 1998. Since then, however, the economy has grown rapidly and was largely unaffected by the global financial crisis of 2008-09.

Real GDP Growth
(%)

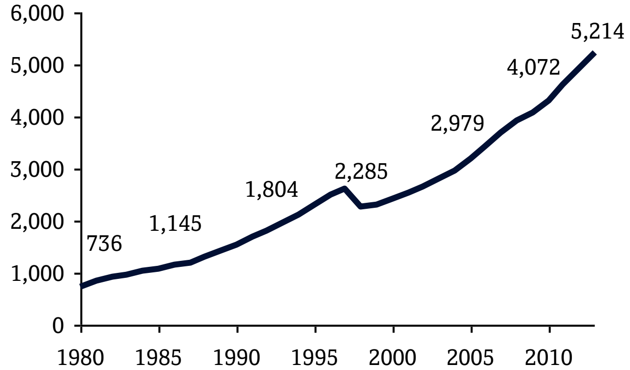


Sources: International Monetary Fund (IMF) and QNB Group analysis

Rising wealth and a young population are driving the rapid emergence of a large middle class

With 248m people, Indonesia is the world's fourth most populous country with the largest Muslim population. Its total population is expanding by 3.5m people every year (1.4% yearly growth). The population is youthful (~38% under 20), which should drive labor force growth and provide a demographic dividend into the 2020s. Economic development has led to steadily–rising affluence. GDP per capita has grown by an average 6.1% since 1980, with a rapidly–growing middle class and reached USD5.2k in 2013 on a purchasing power parity basis (PPP). At the same time, Indonesia was the 16th largest economy globally, with a nominal GDP of USD869bn.

GDP per capita
(USD on a PPP basis)

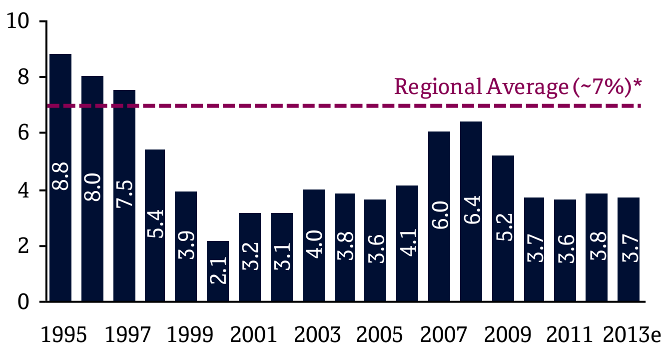


Source: IMF

However, underinvestment since the Asian Financial Crisis has led to a large infrastructure gap

The economy is underpinned by strong fundamentals, but insufficient investment in infrastructure is holding back growth. The economy is clogged by a lack of infrastructure: heavy road traffic, congested transport networks and power and water shortages (see [QNB Indonesia Economic Insight 2013](#)). Infrastructure investment has been well below the average in regional peer countries (around 7% of GDP), falling to below 4% since the global financial crisis. Higher growth is possible, but is dependent on better infrastructure to unleash the private sector.

Infrastructure Investment
(% GDP)



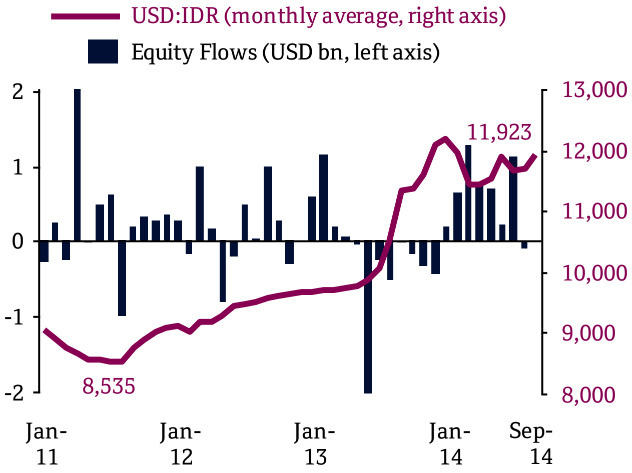
Source: World Bank (WB) and QNB Group estimates for 2013;
*Regional average comprises China, Thailand and Vietnam

Recent Developments

Tightening global liquidity led to capital outflows and a weaker IDR in 2013-14

The tightening of global liquidity emanating from the tapering of QE has led to bouts of capital outflows and exchange rate weakness. In May 2013, the US Federal Reserve (Fed) announced its intention to taper QE, which, against the backdrop of a widening CAD, led to capital outflows from Indonesia. Portfolio tracking data show negative net flows in May-December 2013.[1] The exchange rate weakened 24.8% from IDR9,759 per USD on average in May 2013 to 12,181 in January 2014. After this initial adjustment in early 2014, capital flows recovered and the monthly average exchange rate stabilized in the 11,400-11,900 range. However, in August-September 2014, growing expectations of rising interest rates in the US have reignited capital flight and the exchange rate weakened to 11,923 on average in September 2014.

Capital Flows and the Exchange Rate

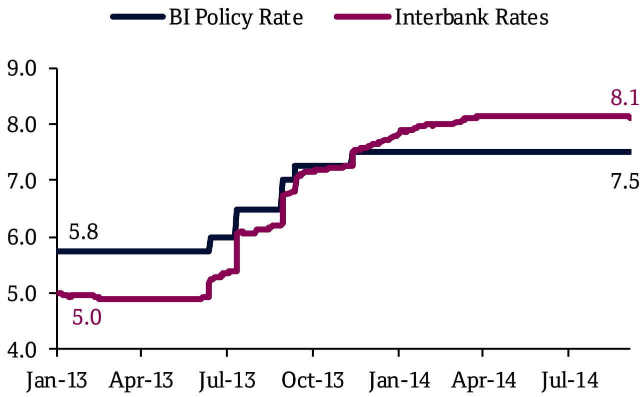


Source: Bank Indonesia (BI) and IIF

In response, the central bank has hiked interest rates to support the exchange rate and contain inflation

In response to the Fed announcement of QE tapering, BI hiked interest rates by 175bps to 7.5% between May and November 2013 to help slow capital outflows, support the exchange rate and contain inflation. The BI has kept the policy rate steady since November 2013 as capital outflows slowed and the exchange rate stabilized. A combination of higher interest rates and other monetary measures (such as reserve and capital requirements as well as loan to deposit caps) have led to tighter liquidity, leading to higher interbank rates. Higher interest are in turn slowing the growth of the banking sector and consumption (see below).

Interest Rates
(%)

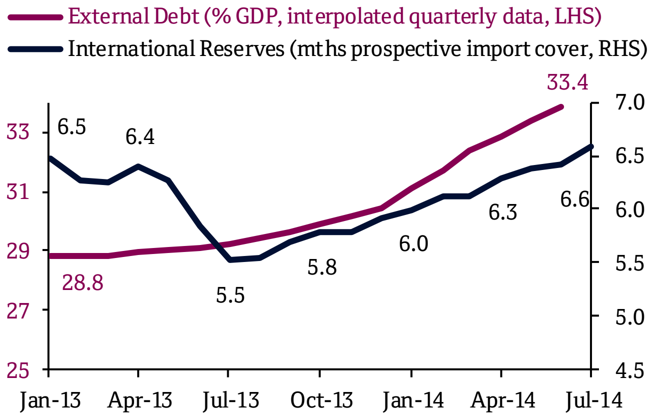


Sources: Bloomberg and QNB Group analysis

International reserves have recovered, but this is partly due to rising external debt

In response to capital outflows, BI intervened in foreign exchange markets in mid-2013 to support the IDR, eroding international reserves to a low of 5.5 months of import cover in July. Since then, international reserves have recovered as the exchange rate has stabilized in the first half of 2014. However, the increase in international reserves has also been supported by higher levels of external debt, which helped to counteract capital outflows. External debt rose to 33.4% of GDP at end–July 2014, compared with 28.8% at end–January 2013. The rising external debt is mainly the result of private financial and non-financial institutions borrowing from abroad to maintain external credit lines amidst tighter domestic liquidity.

International Reserves and External Debt



Source: BI

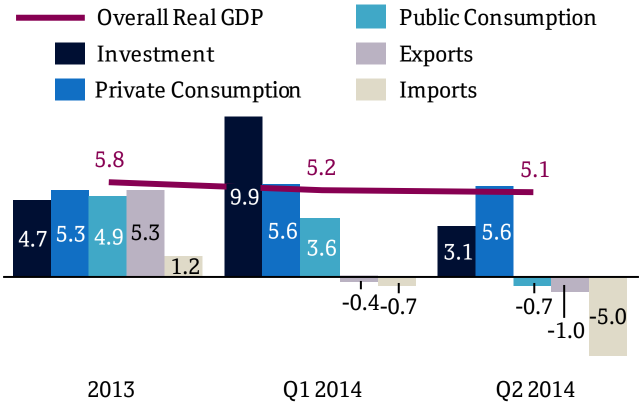
[1] Portfolio Tracker data from the Institute of International Finance (IIF)

Tighter policies have led to a slowing economy, with exports dragging down growth

Real GDP growth slowed from 5.8% in 2013 to an average of 5.2% in the first half of 2014 in line with our earlier forecasts. The slowdown was mainly due to weaker exports. A sharp drop in imports (which are deducted from GDP) offset the export slowdown, but suggests that domestic demand is slowing. Fiscal consolidation led to a contraction in public consumption, while investment growth remained below historical averages owing to a stifling regulatory environment, rising interest rates, concerns about the widening CAD and the depreciating exchange rate. Legislative and presidential elections in April and July 2014 may have added to the uncertainty, contributing to the slowdown.

Real GDP

(% change, year–on–year)



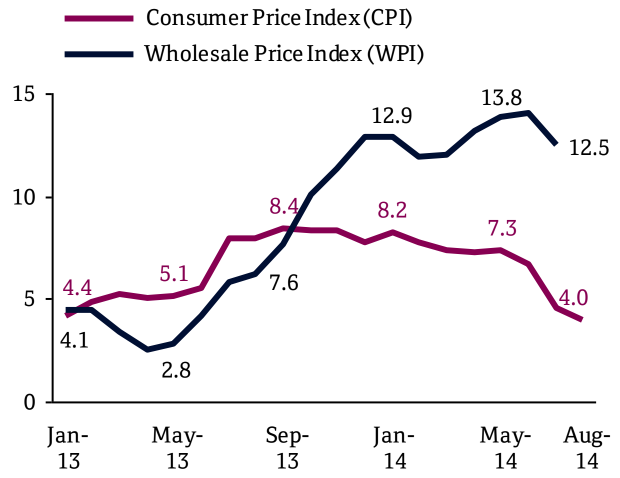
Source: BI

Inflation has slowed so far in 2014 in line with the tighter monetary policy

Inflation was pushed up in 2013 by a nationwide 20% increase in the minimum wage, fuel price hikes and the weakening of the exchange rate. The latter raised import costs, particularly of food, since our last report. In 2014, CPI inflation has slowed and WPI inflation has broadly stabilized as the one-time effects of higher minimum wages and fuel price hikes have cascaded down to other domestic prices, and as the IDR has stabilized. CPI inflation fell to 4.0% in the year to August 2014, in line with the BI inflation target band of 3.5% to 5.5%.

Inflation

(% year on year)



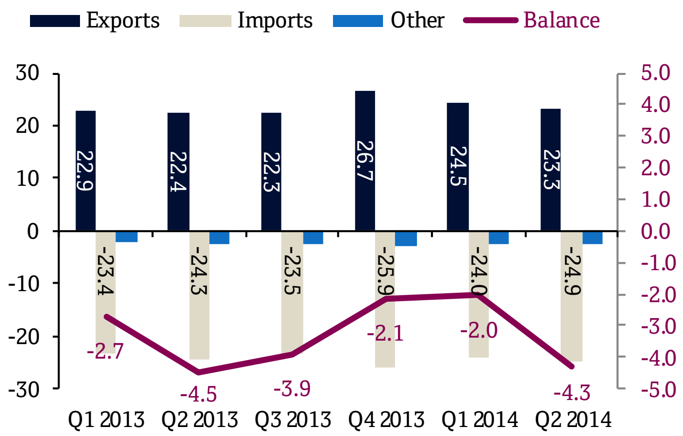
Sources: Statistics Indonesia (SI)

The current account deficit widened in Q2 2014 on weak exports and higher imports

The CAD has remained persistently high (4.3% of GDP in Q2 2014) as exports have been depressed by weak global demand, soft commodity prices, lower crude oil output and restrictions banning exports of raw minerals introduced in January 2014. Indonesian exports are roughly split between hydrocarbons, other primary commodities and manufactured goods. The main Indonesian exports are coal, gas, palm oil and crude oil. Soft global commodity prices have, therefore, negatively impacted exports of hydrocarbons and other primary goods. On the other hand, imports continue to remain high notwithstanding higher import prices due to the weakening IDR.

Current Account

(% of GDP)

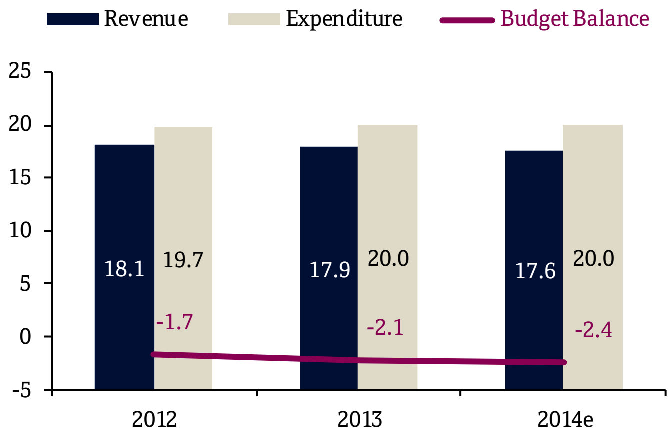


Source: BI

The authorities have provided limited stimulus as the budget deficit is close to the legal limit

The fiscal deficit widened in 2013 as weakening economic activity, low oil production and the ban on raw mineral exports held back revenue. Although the government raised domestic fuel prices in mid-2013, higher international crude oil prices and a weaker exchange rate eroded much of the expected reduction in subsidies, which account for about 20% of public expenditure. The original budget for 2014 planned for a deficit of 1.7% of GDP. It has since been revised upwards to 2.4% of GDP in 2014, close to the legal limit of 3.0%, in order to allow for some additional fiscal stimulus.

Fiscal Deficit
(% of GDP)

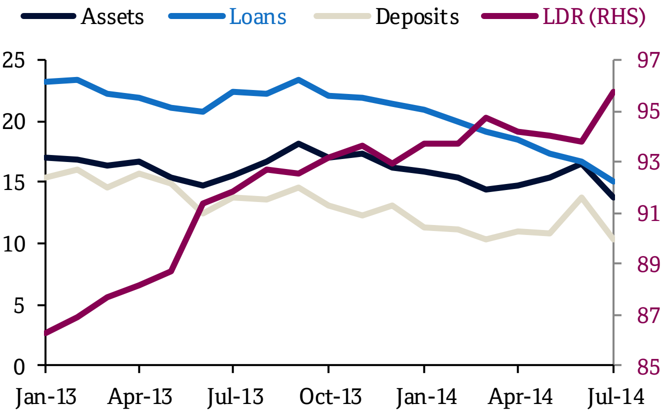


Sources: IMF

Banking sector growth slowed owing to higher interest rates and tighter liquidity

Growth in banking sector assets, loans and deposits slowed in 2013-14 as monetary policy tightened. Deposit growth slowed due to capital flight, despite higher interest rates. This led to a higher loan to deposit ratio (LDR), which rose to 95.7% at end-July 2014 from 86.3% at the beginning of 2013. BI requires a capital adequacy ratio (CAR) of 14% for banks with LDRs over 92%, compared with a CAR of 8% for banks with a lower LDR. Therefore, BI regulations and higher policy rates have created considerably tighter domestic liquidity conditions, slowing down asset and loan growth. Banks are using higher external debt to finance lending, without which the slowdown in loan growth would have been more pronounced.

Banking Sector Assets, Loans and Deposits
(% change in IDR terms, year on year)

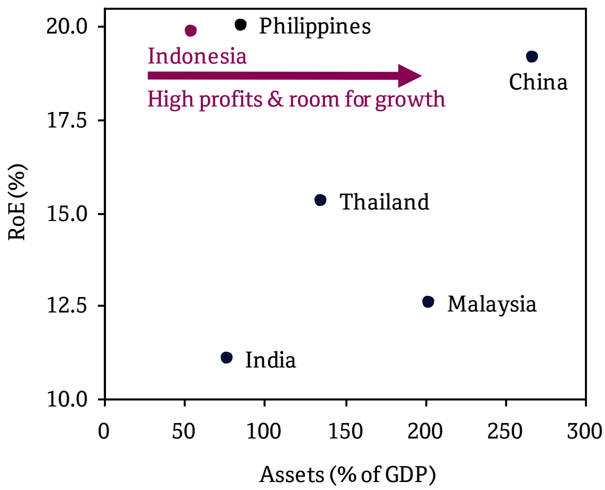


Source: BI

Nonetheless, underlying profitability and financial soundness indicators were strong at end-2013

The banking sector remains well equipped to withstand a crisis with high profit margins, low penetration, strong capitalization and good asset quality. Indonesia had one of the world's most profitable banking sectors in 2013. The average return on equity (RoE) was around 20%, owing to high net interest margins of around 550bps underpinned by strong demand for credit. The banking sector is relatively underpenetrated, with assets accounting for only 54.5% of GDP at end-2013, leaving ample room for growth. Other indicators are positive, CARs were high and rising (19.8% at end-2013) and non–performing loans (NPLs) were low (1.7% of total loans at end-2013). The three largest banks are government-owned, accounting for 29.9% of total assets at end-2013 and enjoying strong sovereign support. However, rising LDRs indicate tighter domestic liquidity, which may lead to deterioration in some financial soundness indicators going forward.

Bank Returns and Penetration (End-2013)

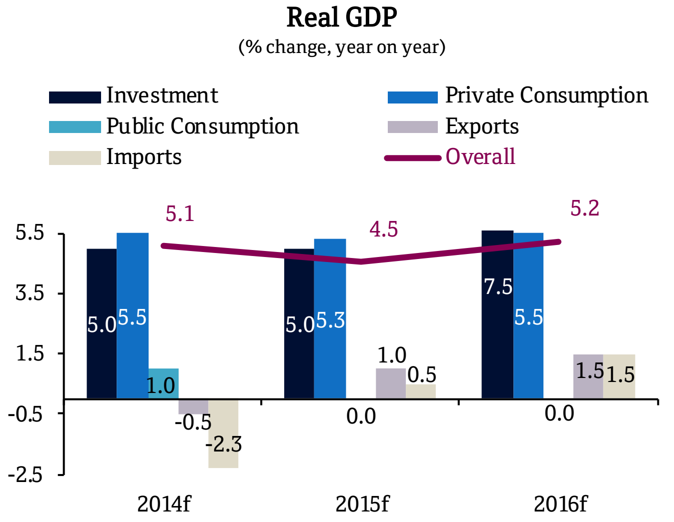


Sources: IMF Financial Soundness Indicators and QNB Group analysis

Macroeconomic Outlook (2014–16)

The new Jokowi administration will face significant challenges amidst slower growth, such as additional capital flight and the large infrastructure gap

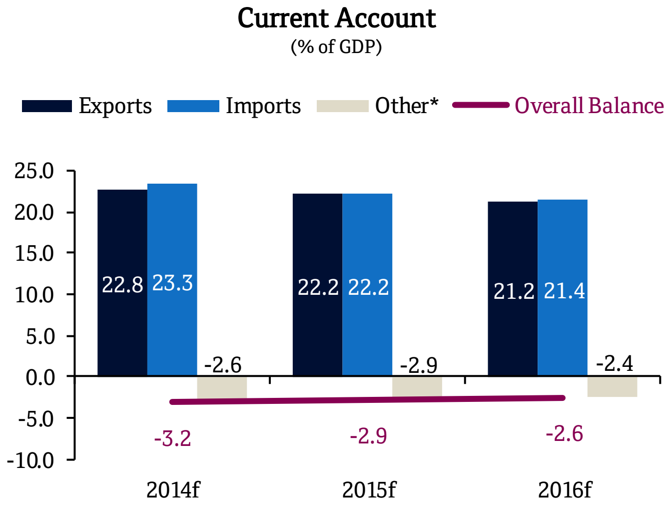
We expect real GDP growth to slow to 4.5% in 2015 as capital outflows and the infrastructure gap hold back growth. The Fed is expected to raise interest rates from 0.25% currently to over 1% by end-2015, which could lead to further capital flight from Indonesia, weaker IDR and tighter monetary policy. The government is likely to have to undertake further fiscal consolidation, given the legal limit on the fiscal deficit. It will therefore take time for the new administration to push through new capital spending to help close the infrastructure gap, which could lead to a pickup in investment. If the new government succeeds in pushing through its investment plans and subsidy cuts while commodity prices and export demand recover, this could lift growth back above 5% in 2016.



Source: QNB Group forecasts

The CAD should narrow as the weaker IDR supports exports and holds down imports

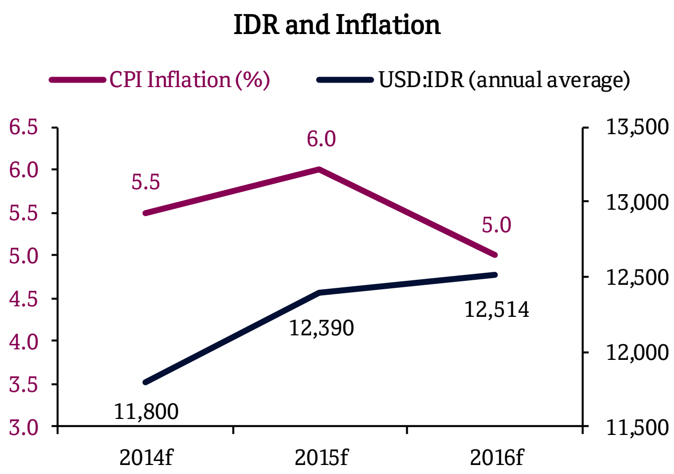
We expect the CAD to narrow to 2.6% of GDP by 2016 (from 3.2% in 2014), predicated on the government lifting export restrictions and removing fuel subsidies. The latter would increase fuel prices, reducing demand for imports of fuel. Restrictions on exports of raw minerals could be eased over time as some large companies have already received exemptions. Government measures, to restrict the import of foreign goods, such as electrical appliances, should also improve the current account balance. The weaker IDR should help reduce the deficit further by making imports more expensive and exports cheaper. However, the gains from greater export competitiveness may be limited by the large share of imported intermediate goods in finished exports, such as clothes, textiles, car parts and other machinery.



Source: QNB Group forecasts; *Flows of Income and Current Transfers

Capital outflows and the persistent CAD are likely to lead to further IDR weakness and higher inflation

Capital outflows are likely to continue as US monetary policy is tightened, leading to a weakening of the IDR. The persistent CAD is likely to add to the weakness of the exchange rate. The combined effect of the depreciation in the exchange rate (pushing up import costs and foreign inflation) and the new administration's plans to gradually remove fuel subsidies over the next five years is likely to lead to higher inflation in 2015 before it eases slightly in 2016. We expect these inflationary pressures to ease as the CAD is reduced and as the exchange rate stabilizes.

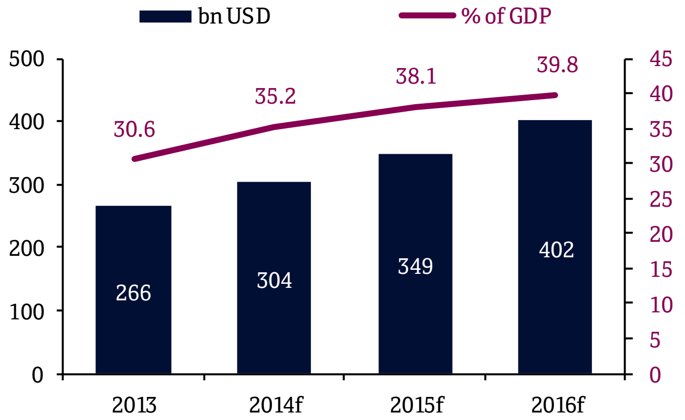


Source: QNB Group forecasts

The CAD is expected to be financed by higher external debt

In line with our earlier forecasts (QNB Indonesia Economic Insight 2013**), higher external debt is likely to finance the CAD going forward.** We expect the CAD to remain well above 2% of GDP during 2014-16. To finance this amidst tight domestic and global liquidity conditions, external debt is likely to continue rising rapidly from 30.6% of GDP at end-2013 to around 39.8% of GDP at end-2016. We expect financial and non-financial institutions to continue borrowing from abroad in order to maintain their credit lines.

External Debt
(end of period)

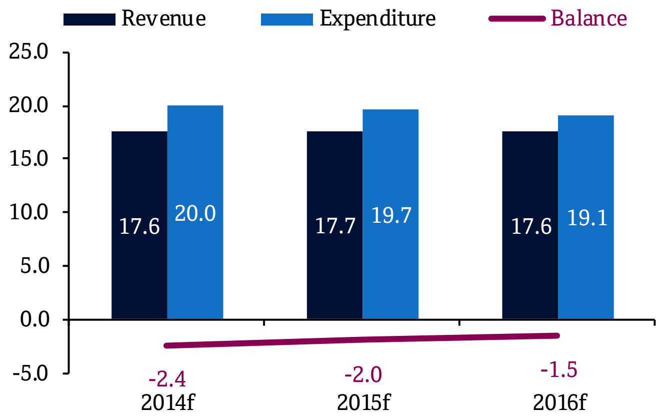


Source: BI and QNB Group forecasts

The lifting of subsidies should lead to a narrower fiscal deficit but spending constraints will remain

The new Jokowi administration plans the gradual removal of all fuel subsidies during its five-year term. It plans to utilize the released resources to finance improved public services and investment in infrastructure. Slowing growth and export restrictions mean that revenue is unlikely to rise significantly as a share of GDP in 2014-16. However, some of the savings from fuel subsidy cuts are also expected to go towards reducing the fiscal deficit. Therefore, on balance, public finances are unlikely to contribute to growth in 2015-16.

Fiscal Balance
(% of GDP)

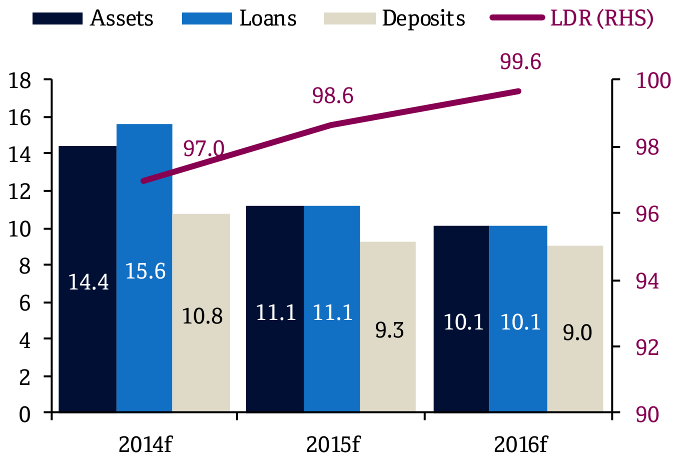


Source: QNB Group forecasts

Tight liquidity and high interest rates may constrain banking sector growth

Capital outflows are likely to further constrain deposit growth, particularly in 2015. BI will probably need to keep interest rates high to support the currency and stave off inflation. This will lead to a continued tight liquidity conditions and a further slowdown in growth of assets and loans during 2014-16. We expect deposit growth to slow from around 10.8% in 2014 to around 9% in 2015-16. The impact of this slowdown on asset and loan growth will depend on BI's prudential regulations, particularly around bank LDRs. Based on our baseline assumptions for loan growth to slow from 15.6% in 2014 to 10.1% in 2016, the LDR would rise to close to 100% by end-2016.

Banking Sector Assets, Loans and Deposits
(% change in IDR terms, year on year)



Sources: BI and QNB Group forecasts

Macroeconomic Indicators

						Forecasts		
	2009	2010	2011	2012	2013	2014f	2015f	2016f
Real Sector (% change, yoy)								
Real GDP Growth	4.6	6.2	6.5	6.3	5.8	5.1	4.5	5.2
Private Consumption	4.9	4.7	4.7	5.3	5.3	5.5	5.3	5.5
Public Consumption	15.7	0.3	3.2	1.3	4.9	1.0	0.0	0.0
Investment	2.4	8.8	10.1	16.3	4.9	5.0	5.0	7.5
Exports	-9.7	15.3	13.6	2.0	5.3	-0.5	1.0	1.5
Imports	-15.0	17.3	13.3	6.7	1.2	-2.3	0.5	1.5
Nominal GDP (bn USD)	540	709	845	877	869	863	917	1,010
CPI Inflation	4.8	5.1	5.4	4.3	6.6	5.5	6.0	5.0
Budget Balance (% GDP)	-1.8	-1.2	-0.6	-1.7	-2.1	-2.4	-2.0	-1.5
Revenue	16.5	17.0	17.8	18.1	17.9	17.6	17.7	17.6
Expenditure	18.3	18.2	18.5	19.7	20.0	20.0	19.7	19.1
Public Debt	28.6	26.1	24.4	24.0	26.1	26.9	27.1	26.6
External Sector (% GDP)								
Current Account Balance (% GDP)	2.0	0.7	0.2	-2.8	-3.4	-3.2	-2.9	-2.6
Exports	24.6	23.5	25.2	24.1	23.6	22.8	22.2	21.2
Imports	20.7	20.5	22.4	24.3	24.3	23.3	22.2	21.4
Invisibles Balance	-2.0	-2.3	-2.6	-2.6	-2.6	-2.6	-2.9	-2.4
Capital & Financial Account Balance	0.9	3.7	1.6	2.8	2.5	4.4	3.3	3.5
FX Reserves (mths prospective imports)	5.5	6.1	6.2	6.4	5.9	6.6	6.4	6.4
External Debt	32.0	28.5	26.7	28.8	30.6	35.2	38.1	39.8
Monetary Indicators (% change)								
Broad Money Growth	13.0	15.4	16.4	15.0	12.7	10.8	9.3	9.0
JIBOR (3 month)	7.1	6.6	5.3	5.0	7.8	7.8	8.6	9.6
Policy Rate (%)	6.5	6.5	6.0	5.8	7.5	n.a.	n.a.	n.a.
Exchange Rate USD:IDR (av)	10,390	9,090	8,776	9,384	10,454	11,800	12,390	12,514
Banking Indicators (%)								
Return on Average Equity	26.8	25.9	20.3	21.0	19.8	n.a.	n.a.	n.a.
NPLs	3.3	2.5	2.1	1.8	1.7	2.5	3.0	3.3
Capital Adequacy Ratio	17.8	16.2	16.1	17.3	19.8	n.a.	n.a.	n.a.
Asset Growth	9.7	18.7	21.4	16.7	16.2	14.4	11.1	10.1
Loan Growth	10.1	23.3	24.7	23.1	21.4	15.6	11.1	10.1
Deposit Growth	13.8	20.4	18.7	15.6	13.0	10.8	9.3	9.0
Loan to Deposit Ratio	75.6	77.4	81.3	86.6	92.9	97.0	98.6	99.6
Memorandum Items								
Population (m)	234.3	237.6	241.0	244.5	248.0	251.5	255.1	258.7
Population Growth (% change)	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4
Unemployment	7.9	7.1	6.6	6.1	6.3	6.4	6.7	6.9

Sources: BI, Bloomberg, SI and QNB Group forecasts

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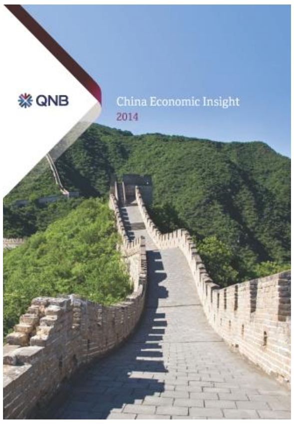
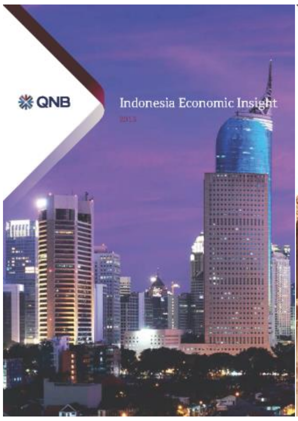
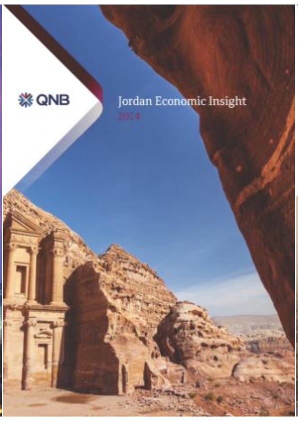


China 2014



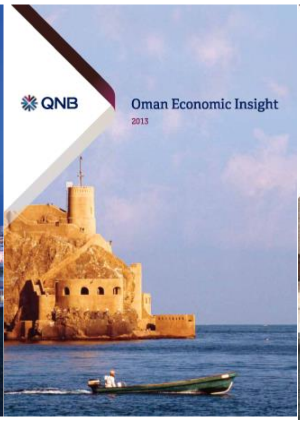
Indonesia 2013



Jordan 2014

KSA 2013

Kuwait 2013



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