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Recent Developments of the Indonesian Economy

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The Indonesian economy has continued to see a stable growth while showing a stronger tolerability for external shocks. This has led for the rating agencies to give its government bonds an investment-grade rating. However, the exchange rate of the Indonesian rupiah (hereinafter referred to as rupiah) against the U.S. dollar has been on a declining trend, and repatriation of capitals by overseas investors is feared. With a presidential election slated for in April 2019, there is a risk of worsening of fiscal balance due to dole-out policies by the current administration and instability of politics and civil order due to recurrent demonstrations.

In this article, the author intends to review the recent developments of the Indonesian economy and point out its future challenges and highlight points. Also the author will touch upon the 2019 presidential election together with its possible impact on the economy.

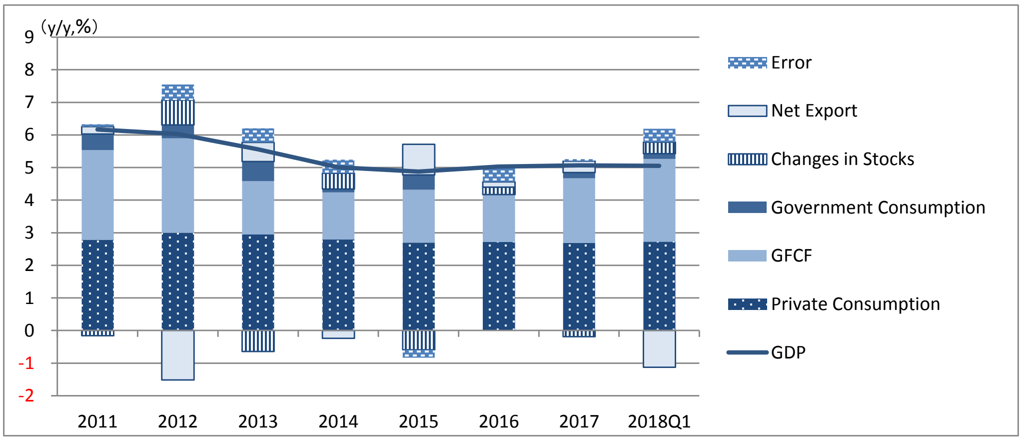
1. The economy is growing soundly at present.

The Indonesian economy has continued to maintain growth rate at around 5% for the last 5 years, and it is projected to continue to grow solidly in 2018 (Figure 1). The steady growth has been led both by an expansion of domestic demand centering on private consumption and by an increase in capital investment (gross fixed capital formation) supported also by an increase in foreign direct investment.

Private consumption is projected to continue to increase in 2018 due to continued rise in minimum wage and growth of population. Hosting the Annual Meetings of the IMF and the World Bank and the Asian Games, the greatest festival of sports in Asia, scheduled toward the end of the year, will help revitalize the regional economy in Indonesia. Also the public expenditures will increase due to the costs of presidential election expected in 2019. Although foreign direct investment (FDI) tended to decline at around the time of the past two presidential elections (2009, 2014), the inflow of FDI is basically expected to continue in 2018 as the government's policies for infrastructure investment promotion have made a good progress and an assignment of credit rating from rating agencies has improved in the past year (see below for details).

Per capita GDP in Indonesia reached almost $4,000 reflecting relatively sound economic growth in the past. In such an environment, the government announced that it would start in full swing its Official Development Assistance (ODA) to other developing countries and established in February 2018 the National Development Planning Agency (BAPPENAS, funded by $70 million). The agency not only has implemented the assistance focusing on the countries in Islamic world, but also nowadays conducts its diplomacy as a member of the G20 nations. It is also noteworthy that Indonesia can reap the benefits of demographical dividend up until 2030, which will serve as a spur to the economic growth (Figure 2). The Indonesia economy ranks 17th in the world today, but President Joko "Jokowi" Widodo aims to make it rank among the world top 10 countries by 2030[1].

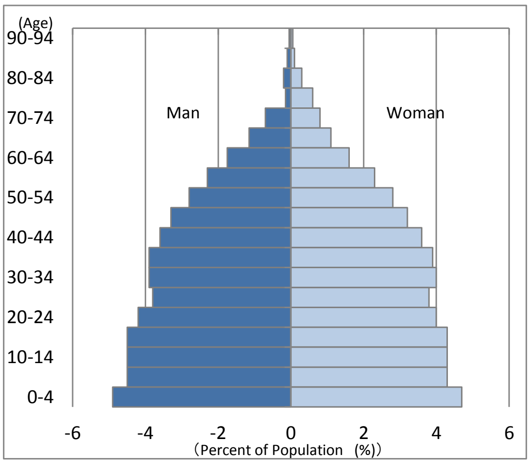
Figure 1: Developments of Real GDP Growth



(Source) Bank Indonesia

[1] President Jokowi has revealed a roadmap toward the realization of the fourth industrial revolution, not to say for a sophistication of its economy to the one based on secondary and tertiary industries, aiming at a transition from a resource-dependent economy of the 1990s to a highly value added economy.

Figure 2: Demographic Composition (by age and sex)



(Source) Indonesian Central Bureau of Statistics (BPS)

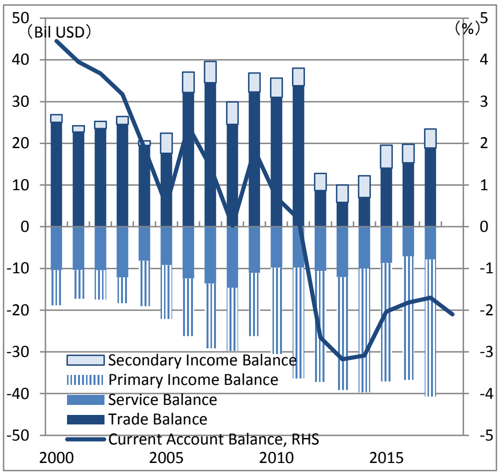
2. Portfolio investment growing at the backdrop of continued current account deficits.

Indonesia's current account has fallen into deficit since 2012 following a decline in trade surplus that reflected an increase of imports due to expanded domestic demand、coupled with a decrease of exports in the primary products including palm oil due to lower resource prices (Figure 3). In addition, following an increased repatriation of the profits to their headquarters by foreign subsidiaries that invested in Indonesia, the deficit in the primary income account increased, contributing to continued deficits in the current account at a 2% level of GDP. The current account deficit is expected to increase in 2018 due to an increase in imports and the primary income deficit in spite of an increase of exports following a recovery in resource prices.

In the midst of continued current account deficits, the deficit (inflow of foreign capital into Indonesia) in the financial account also has tended to expand (Figure 4). Acquisition of Indonesian assets by foreign investors has increased since 2010, exceeding the acquisition of foreign assets by Indonesian investors. Specifically inflow of portfolio investment has been expanding reflecting the development of the Indonesian financial market.

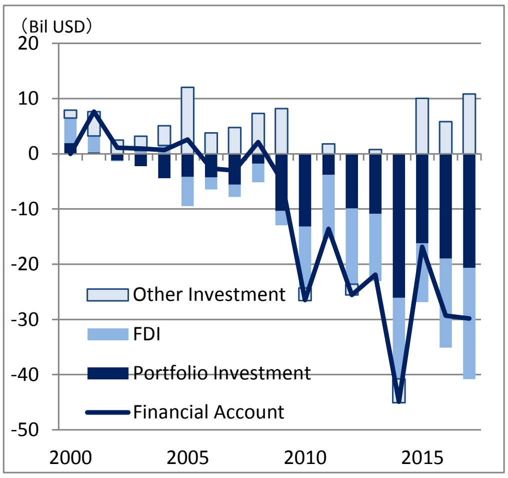
Compared to other emerging economies, Indonesia had a relatively large inflow of portfolio investment in terms of ratio to GDP, especially in 2015 to 2017. Attention should be paid, therefore, to a possibility that a change in financial environment may trigger a withdrawal of foreign capitals invested in Indonesia (Figure 5).

Figure 3: Composition of Current Account



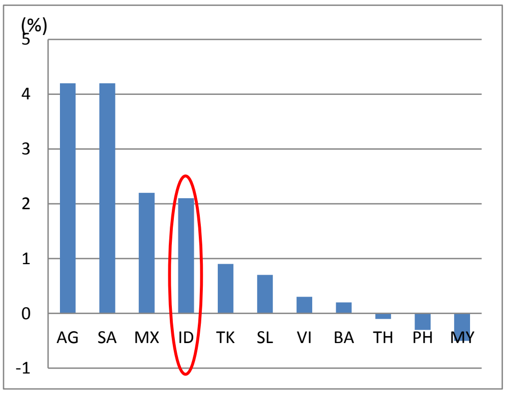
(Note) Figures after 2017 are estimates.
(Source) IMF

Figure 4: Composition of Financial Account



(Note) Figures after 2017 are estimates.
(Source) IMF

Figure 5: Inflows of Portfolio Investment to Emerging Countries (in 2015-2017, in percent of GDP)



AR	Argentina	BA	Bangladesh
SA	South Africa	TH	Thailand
MX	Mexico	PH	Philippines
ID	Indonesia	MY	Malaysia
TK	Turkey	RU	Russia
SL	Sri Lanka	IN	India
VN	Vietnam		

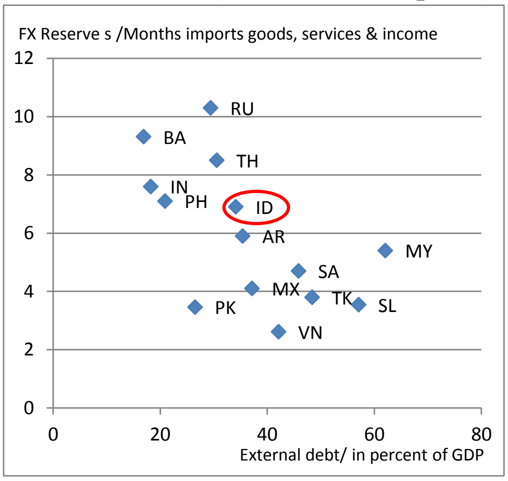
(Note) Country abbreviations should be applied also to Figure 6.
(Source) IMF

3. Attention to be paid on the tolerability of Indonesia to a risk of capital withdrawal of foreign investors

Following a rise in the long-term interest rates that started in April 2018, risks have been pointed out for a withdrawal of capital by overseas investors from emerging economies. However, the ratio of Indonesia's external debts to GDP remains at the level of 30%, much lower than other emerging countries and the foreign exchange reserves has expanded to an equivalent of 6 months of imports (Figure 6). The reserves amounted to almost $120 billion at the end of June 2018, exceeding by far the external debt outstanding (about $69 billion) despite a large decline of the reserves by more than $7 billion in the first half of 2018 due to a heavy intervention by the Bank Indonesia to cope with the selling pressures on the rupiah in the market. This may suggest that a risk will be small at the moment that Indonesia will become unable to repay its external debts like at a time of the Asian currency crisis (Figure 7). Further, the IMF “International Reserves and Foreign Currency Liquidity (IRFCL)” indicates that, unlike Argentina and Sri Lanka, Indonesia is unlikely to face a problem of large debt repayment or rollover in the coming year (Table 1).

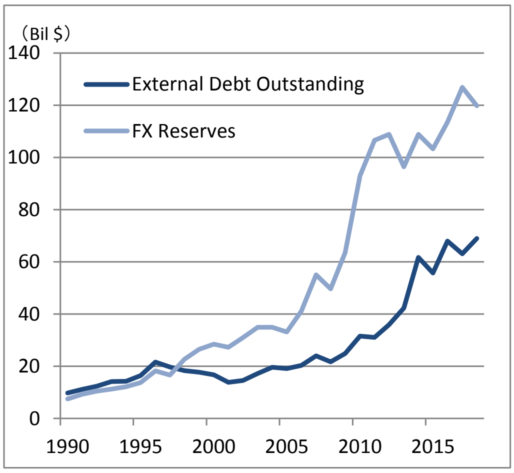
Indonesia’s tolerability to external shocks has been strengthened with its economic fundamentals improving, which helped improve the assessment of major rating agencies to an investment grade since last year (Table 2). It can be said that Indonesia is reaching the same level of investment environment as in other ASEAN countries. As noted below, however, attention will have to be paid to the deprecating trend of the exchange rate of the rupiah that has been in progress since May 2018.

Figure 6: External debts (in % of GDP) and FX Reserves (in months of imports)



(Source) IMF, World Bank. Data are for 2017.

Figure 7: External Debt Outstanding and FX Reserves



(Note) Figure for 2018 FX reserve is as of June 2018.
(Source) IMF

Table 1: Payment Schedule of FX Reserves Due in a year(As of May 2018)

	Total Reserve Asset (Bil $)	Predetermined short-term net drains on foreign currency assets, More than 1 (Bil $)				Contingent Short-term Net Drains on Foreign Currency Assets
		Foreign Currency Loans, Securities, and Deposits	short positions in forwards and futures	long positions in forwards and futures	Other	
Turkey	110.7	-12.0	-1.3			-62.4
Indonesia	**122.9**	**-35.1**	**-3.2**			-5.9
Thailand	215.2	-0.2	0.1	34.2		13.0
Philippine	80.9	-4.8				-1.5
South America	51.0	-2.8		1.9	-0.1	-0.2
Mexico	178.4	-18.3				95.2
Malaysia	109.4	-0.2	-12.8			-0.1
Argentina	**50.1**	**-59.7**			**-12.0**	
Sri Lanka	**8.8**	**-7.8**	**-0.9**		**-0.1**	-0.2
Russia	456.6	-5.6				
India	426.7	-6.0	-2.7	23.4		-1.0

(Source) IMF

Table 2: Rating Assignments for Asian Countries

	S&P	Moody's	Fitch	TE
Indonesia	BBB-	Baa2	BBB	46
	2017/5	2018/4	2017/12	
Malaysia	A-	A3	A-	66
Philippine	BBB	Baa2	BBB	53
Thailand	BBB+	Baa1	BBB+	63
Vietnam	BB-	B1	BB-	29

(Note) Dates for Indonesia refer to the latest reviews.

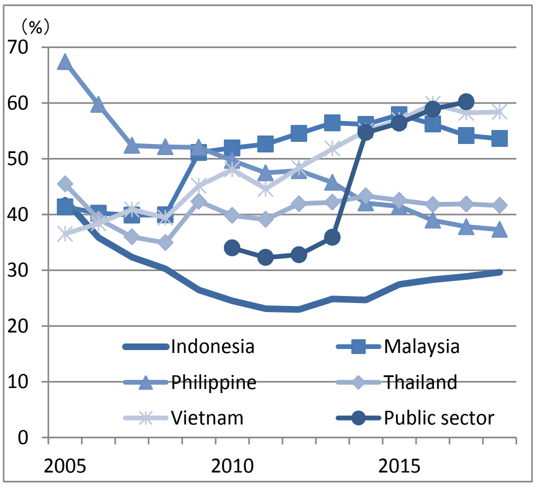
4. Government is promoting reforms for fiscal consolidation.

The ratio of government debt outstanding to GDP remains at the 20% level in Indonesia, lower than in other ASEAN countries, but the fiscal balance has constantly recorded a deficit since 2012, making the fiscal consolidation an important challenge (Figures 8 and 9). The current administration has been promoting reforms for that purpose. Specifically they include an improvement of taxation system through tax amnesty[2] which was introduced in the middle of 2016 given its revenues remaining at a level of 10%, lower than in other ASEAN countries (Figure 10). Although the tax authorities had grasped the situation of unreported assets held by high income earners by 2017, they have not come to collect the targeted amount of revenues set out in the Medium-term Revenue Strategy (MTRS), as tax exemptions and reduced tax rates had been still applied in 2017.

In the meanwhile, expenditures are projected to unavoidably increase due to spending related to the 2019 presidential election and those for improvement in infrastructures to support a sustainable economic growth. In Indonesia it is required by law to keep the fiscal deficit under 3% of GDP and in order to reduce the fiscal deficit it is necessary to largely mobilize revenues. Based on the available data on high income earners, the government intends to promote an improvement of legislations to raise the tax rates and improve the ways of tax collection (Table 3). Looking ahead, how effectively these efforts will work will draw much attention.

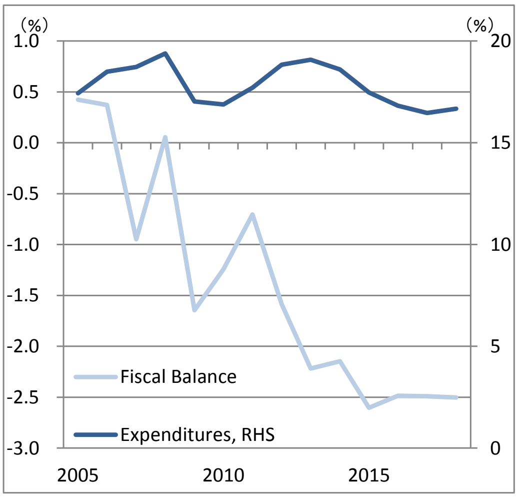
[2] Under the system residents in Indonesia were exempted from tax obligations, surcharges and criminal punishment if they declared their taxable assets to the authority within the period of July 2016 and March 2017.

Figure 8: Public Debt Outstanding In ASEAN Countries (in % of GDP)



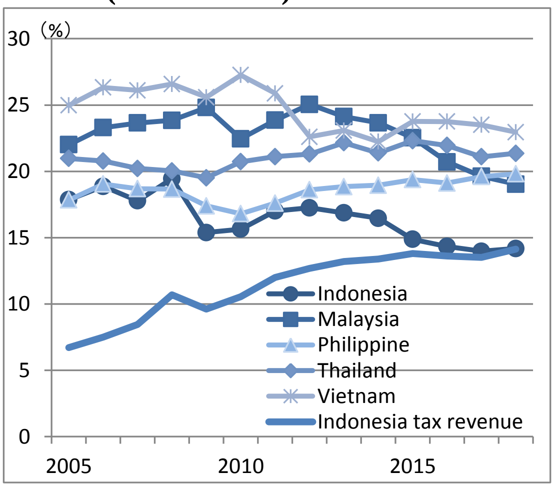
(Note) Figures are estimates for 2018 and after.
(Source) IMF

Figure 9: Indonesia's Fiscal Balance and Expenditures (in % of GDP)



(Note) Figures are estimates for 2018 and after.
(Source) IMF

Figure 10: Revenues of ASEAN countries (In % of GDP)



(Note) Figures after 2018 are forecasts
(Source) IMF

Table 3: Fiscal Policies and their impact by 2022

Policy Options		In percent of GDP
Total Revenue		3%
	Value-added tax	1%
	Excise taxes	1%
	Corporate income tax	0.5%
	Personal income tax	0.3%
	Property tax	0.2%
Total Expenditure		2.7%
	Infrastructure	1.3%
	Education	0.8%
	Health	0.6%
	Social Assistance	0.1%
	Other	−0.1%

(Source) IMF

5. Monetary policy to prevent a plunge in the rupiah exchange rate

The Indonesian rupiah is one of the "fragile 5[3]"currencies in emerging countries that fell drastically in line with the start of tapering of the U.S. monetary policy. In September 2015 the exchange rate of the rupiah against the U.S. dollar renewed its record low since the Asian currency crisis in the order of 14000 rupiah per dollar, coupled with the fears on its expanding

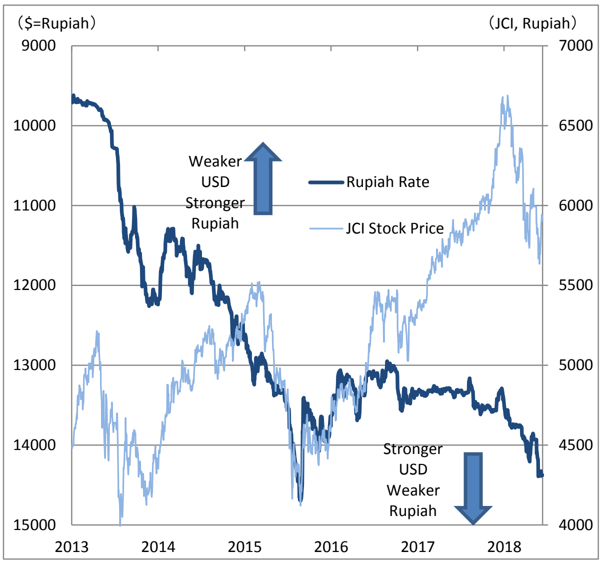
[3] An acronym given by a major U.S. investment bank to the currencies of the emerging economies that have become too dependent on foreign investment to finance its financial needs. Specifically they refer to the five currencies of Brazilian real, Indian rupee, Indonesian rupiah, Turkish lira, and South African rand.

current account deficit and the economic slowdown (Figure 11). Since then, the exchange rates stabilized, supported by the release of economic stimulus measures by the administration and a stable economic development. Although inflation came down to a lower margin of the target range (3 to 5%) set by the central bank, the Bank Indonesia has maintained its policy rate unchanged at 4.25% since August 2017, as the U.S. monetary authority has raised its FF rates step by step (Figure 12).

However, following a rise of U.S. long-term interest rates the exchange rate of the rupiah reached a psychological defense line of 14,000 rupiah per dollar in early May this year. To counter the plunge, the Bank Indonesia began to intervene in the exchange market again, and held three policy meetings including an emergency meeting to raise the policy rate up to 5.25%.

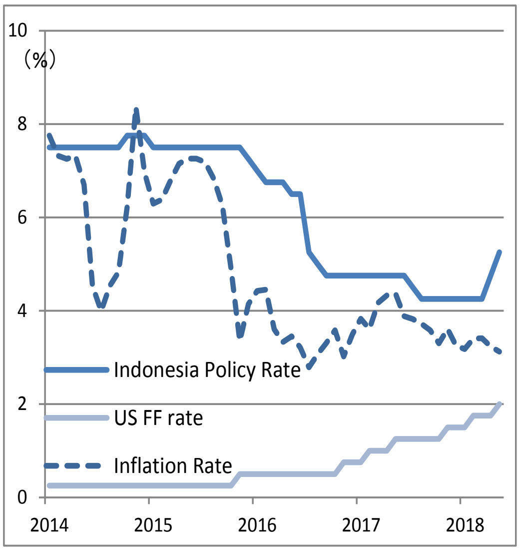
The main stock market index (Jakarta Composite Index) began to fall since the beginning of 2018, suggesting a strengthened investors' sense of caution over a rise in interest rates. The central bank will be required to take policy actions promptly enough to prevent a plunge of the rupiah value against the U.S. dollar, while bearing in mind its impact on the business conditions.

Figure 11: Official Exchange rates and Stock Prices



(Source) Reuters: Indonesia's Main Stock Index

Figure 12: Inflation and Policy rate, US FF rate



(Source) Bank Indonesia, FRB

6. The presidential election in 2019 and its impact on the economy

(1) Overview of the presidential election in 2019

Indonesia faces a series of political events starting from the gubernatorial elections in June 2018 and peaking at the presidential and legislative elections scheduled in April 2019. The gubernatorial elections held last June had been regarded as a touchstone for the presidential election and the current administration gained an edge in the elections as the candidates of the ruling party won the elections in several large provinces including West Java, where Mr. Ridwan Kamil, a mayor of Bandung City and whom President Jokowi supports, won the seat. The term of a President in Indonesia is limited to two terms of maximum 10 years, and President Jokowi has shown his willingness to run for the 2019 election. His rival is considered to be Mr. Prabowo Subianto who fought the 2014 presidential election against Mr. Jokowi, but the future outlook is still unclear with such reports also coming as Mr. Prabowo will form a coalition with President Jokowi.

Further, the Indonesian presidential election rule sets out that only parties or coalitions with at least 20% of seats in the legislature, or 25% of votes in the 2014 election, would be eligible to field a presidential or vice presidential candidate. However, no political party including the current governmental party, Indonesian Democratic Party-Struggle (Partai Demokrasi Indonesia-Perjuangan (PDI-P)) gained the required 20% of seats and therefore they have to form a coalition with another party or parties (Table 4). In that case, they also have to make a coordination between them on which party the presidential and vice-presidential candidates are allocated to, and the backdoor negotiations will be held among the political parties until August 4 when the registration of the candidates starts.

Table 4 Political Parties in Indonesia and their Number of Seats in the Legislature

Political Parties	PDI PER JUANGAN	GOLONGAN KARYA	PARTAI PERSATUAN PEMBANGUN AN	PARTAI NasDem	HANURA PARTAI HATI NURANI RAKYAT	GERINDRA	PKS PARTAI KEADILAN SEJAHTERA	PARTAI DEMOKRAT	PAN PARTAI AMANAT NASIONAL	PKB PARTAI KEBANGKITA N BANGSA
Number of Seates	109	91	39	35	16	73	40	61	49	47
Percentage	19%	16%	7%	6%	3%	13%	7%	11%	9%	8%
Special Mention	President Joko Widodo					Mr. Prawo		Son of a former President Yudhoyono	Islamic Power Base	Islamic Power Base

(Source) Various reports

(2) Its impact on the economy

President Jokowi is believed to expand his dole-out policies from now on to secure the voters' support for his re-election. Specifically, given the recent rise in crude oil, he will revive the subsidy on gasoline which was abolished in 2014 to promote fiscal consolidation. If he does so, there is a risk they will aggravate the economic environment, especially the fiscal foundation of Indonesia.

Also there is a risk that religious or ethical conflicts may arise as the 2019 presidential election approaches. On the occasion of the 2017 election for a governor of Jakarta Province, Mr. Anies who gained much support from Muslim conservatives won the election as the incumbent governor and Chinese Christian Mr. Basuki suffered from demonstrations against him after he insulted the Islam. Although it had been recognized that democracy has been well established and political situation has been stabilized in Indonesia in the 20 years after the collapse of a long dictatorship by President Suharto, a political and social instability did arise in the 2017 gubernatorial election. This instability is considered to have had an impact on the investment decision of overseas investors. Currently President Jokowi has been cautiously promoting his election campaign directed at Muslim conservatives aiming to lock up their votes. If there should arise demonstrations in the 2019 election campaign like in 2017, it is feared that they will have an adverse effect on the economy, including the investment from overseas.

At this point, it is not clear whether President Jokowi will successfully be re-elected or a new president will come into existence. Anyway, economic policies of the current administration that include the one to attract foreign companies through deregulations and expansion of infrastructure spending are essential for the economic growth in Indonesia. Whether or not these policies will be inherited by the next administration will be one of the attention points in the days to come.

References

➢ IMF: "2018 Article IV Consultation-Press Release; Staff Report; and Statement by the Executive Director for Indonesia", February 2018
➢ IMF: "Indonesia : Selected Issues", February 2018

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