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Indonesian Economy: Recent Developments and Its Challenges

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＜Summary＞

1. The Indonesian economy continues to perform well with a stable growth mainly led by domestic demand. Looking ahead, it is expected to continue its strong growth supported by domestic demand as private consumption will keep its robustness and private investment will pick up coupled with accelerated infrastructure investment. Indonesia's low export dependency will limit the direct negative impact through trading channel of the slowdown of the Chinese economy and trade frictions between the US and China.
2. On the external front, its fundamentals have been improved in line with declining dependency on external obligations and accumulated foreign exchange reserves, thus strengthening the resistance to capital outflows. It should be noted, however, that, although the restoration of investment grade rating by all of the three leading rating agencies is a positive factor to capital inflow to Indonesia, it has increased Indonesia's dependence on foreign investment funds, making it more susceptible to the changes in external environment centering on the financial market.
3. Looking ahead, when pressures on currency depreciation increase, there will be a high possibility that Indonesia will respond to them with interest rate hikes by the central bank or restrictions of imports that lie behind the current account deficits. Such policy measures may be effective in stabilizing the currency in the short run, but they can become a factor that hampers the expansion of domestic demand, primarily that of investment. In the medium and longer term, Indonesia needs to foster domestic institutional investors that can make

long-term investment. Furthermore, aiming at reducing the current account deficit, it is indispensable for the country to increase trade surplus through diversification and sophistication of export structure that has much relied on primary products.

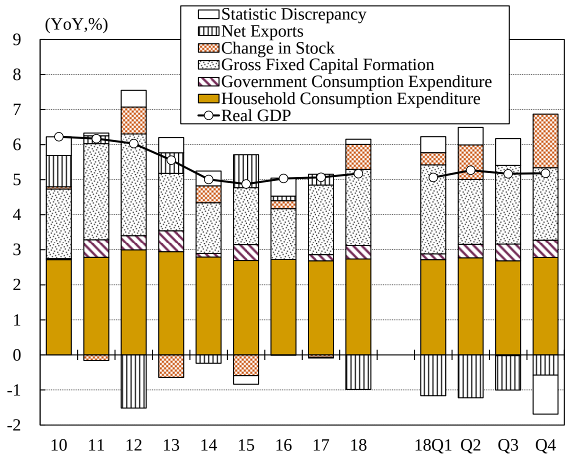
4. Owing to the disciplined fiscal management based on the State Finances Law (2003), the fiscal deficit remained at about 2% of GDP as of 2018 with low level of public debt outstanding at 28% of GDP. In the future, although it is highly likely that the government debts remain on a sustainable level, risks include an increase of debts of state owned enterprises (SOEs) associated with active infrastructure investments and possible rise in the government contingent liabilities through the government guarantees to the Public-Private-Partnership (PPP) projects.
5. In the banking sector, lending activities are picking up reflecting the recovery of the economy, but the rise still remains at a pace consistent with the economic growth. The commercial banks in Indonesia are regarded as very sound with their non-performing loan ratio standing low at 2.7% and high level of capital adequacy ratio at 23.3% (as of November 2018). Looking ahead, the performance of corporate sector which accounts for about 70% of bank lending should be closely monitored.
6. In the presidential election slated for April 2019, it is a majority view that the party of incumbent President Jokowi is leading the race, but it remains unpredictable as there is a possibility that the situation may change depending on the strategies of both parties to be taken in the coming days as well as economic conditions. In particular, it will require more cautious consideration to the risk that if and when the camp of former general Prabowo Subianto should win and slow down the pace of infrastructure improvement and take more protectionist policies they might hamper the sustainable growth to be achieved through diversification of industrial structures and improvement of competitiveness.

1. Recent Economic Developments～Stable growth continues led by domestic demand

(1) Economic growth

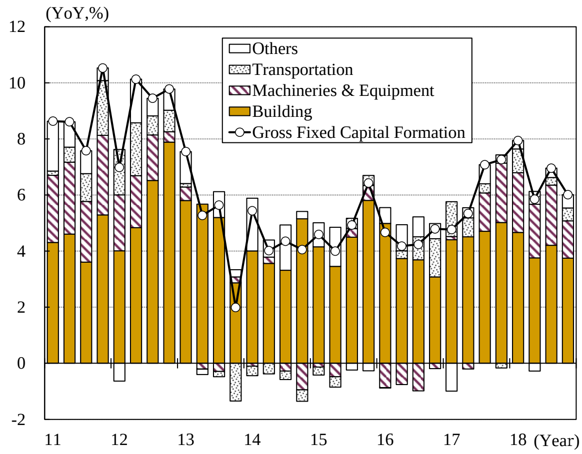
The Indonesian economy continues to grow overall at a stable pace led by domestic demand. In 2015 when the Jokowi administration started, the real GDP growth rate decelerated to 4.9% as compared to the previous year mainly due to a price rise associated with the abolition of fuel subsidies and effect of monetary tightening but since then, it has maintained a growth of over 5%, achieving a 5.2% growth for the third consecutive year in 2018 (Figure 1). Household consumption continues to make a solid growth supported by favorable employment and income environment while the middle class population continues to increase. On the other hand, gross fixed capital formation has been supported by an increase of buildings and structures associated with strong housing demand and active infrastructure investment, with a pickup of corporate machine investment also positively contributing (Figure 2). Toward the end of 2018, however, in addition to interest rate hikes to stabilize the currency and review of big investment projects by the state owned enterprises aimed at restricting the current account deficits, uncertainties over the coming elections scheduled in 2019 also seem to have dampened the expansionary pace of private investment.

Figure 1: Real GDP Growth



Source: Statistics Indonesia

Figure 2: Gross Fixed Capital Formation



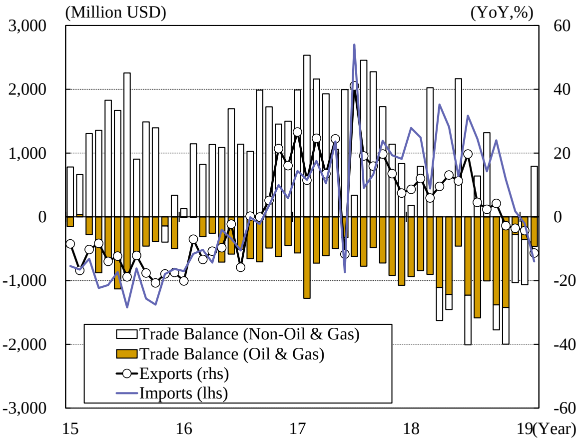
Source: Statistics Indonesia

(2) Trade and current account balance

The trade balance turned into deficit in 2017 as imports rapidly increased due to strong domestic demand while exports stagnated as the demand weakened in major export partners, and the deficit has been increasing thereafter (Figure 3).

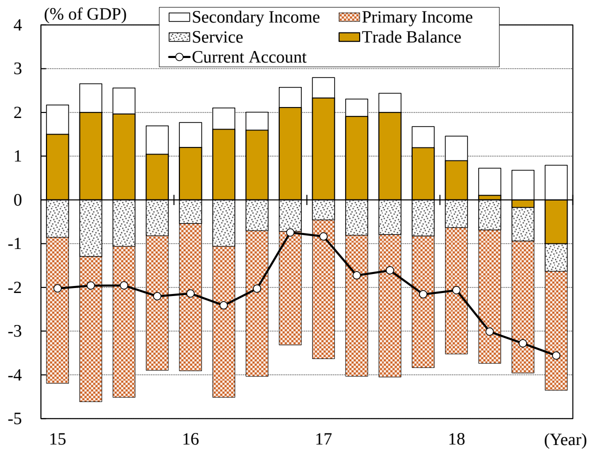
The current account balance continues to be in deficit mainly due to the deficits in the income balance that reflect the foreign repatriation of investment income relating to direct investment and securities investment and services balance, and the deficit is increasing especially since towards the end of 2017 due to worsening trade balance. The current account balance registered a deficit of $9.1 billion (3.6% of GDP) in October-December period of 2018 and a deficit of $31.1 billion (3.0% of GDP) in the full 2018, deteriorating from a deficit of $16.2 billion (1.6% of GDP) in the previous year (Figure 4).

Figure 3: Trade Balance



Source: Statistics Indoenesia

Figure 4:Current Account Balance



Source: Statistics Indonesia

(3) Inflation, exchange rates and monetary policy

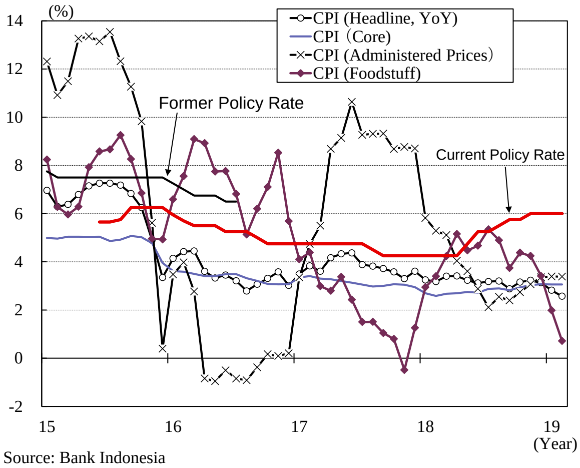
Although food price put an upward pressure on the consumer prices, inflation has remained low at 3.2% over the previous year in full 2018 and 2.8% in January 2019, well within the target range (2.5% - 4.5% over the previous year) set by the Bank Indonesia, the central bank (Figure 5).

The exchange rate of the rupiah continued to fall due to the interest rate hikes in the US and following appreciation of the dollar, which strengthened the pressure for capital outflows especially on the emerging countries with the current account deficits and depreciating currencies. At a time in October 2018, the rupiah temporarily fell below 15,000 rupiah to the dollar, touching the lowest level in the 17 years after the Asian currency crisis (Figure 6).

The BI raised its policy rate six times (from 4.25% to 6.0%) since May 2018 trying to stabilize the currency[1]. Since last December, however, the BI has kept it unchanged as the rupiah started to pick up responding to the fall of interest rates in the US following the pace down of the US rate hike policy. In addition to the hikes of interest rate by the central bank, the government implemented a series of import restrictive measures to reduce the current account deficits, including promotion of conversion of domestically produced palm oil to bio-based fuel, raise of "income tax on the importation of certain goods" which companies pay to the government at a time of import of substitute consumable goods that can be manufactured by local producers in Indonesia, review of investment projects of the SOEs that are accompanied by a large-scale import of capital goods.

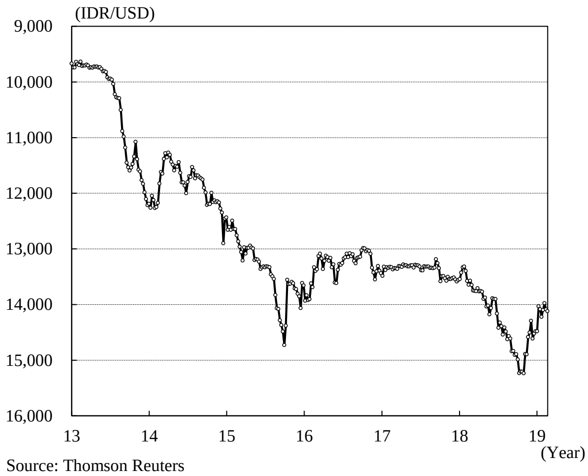
[1] In August 2018, the central bank eased the restriction on housing loans while it raised its interest rate.

Figure 5: Inflation and Policy Rates



Source: Bank Indonesia

Figure 6: Exchange Rate



Source: Thomson Reuters

(4) Near-term Prospects

Going forward, the economy is expected to make a stable growth led by domestic demand. Private consumption will continue to increase strongly supported by enhanced income support by the government expenditures to low income families, in addition to the favorable employment and income situation. Active infrastructure investment will be joined in the latter half of 2019 by private investment following a rollback of uncertainties created around the presidential election.

While the global economy is expected to expand at a modest pace, it is important to prepare for the possibility that the current account deficit will continue to expand with depreciation of the rupiah due to the increase of imports in excess of exports in the backdrop of strong domestic demand. Inflation will be contained within a small rise helped by the stability of international oil prices despite a possible upward pressure on import prices following the depreciation of the rupiah.

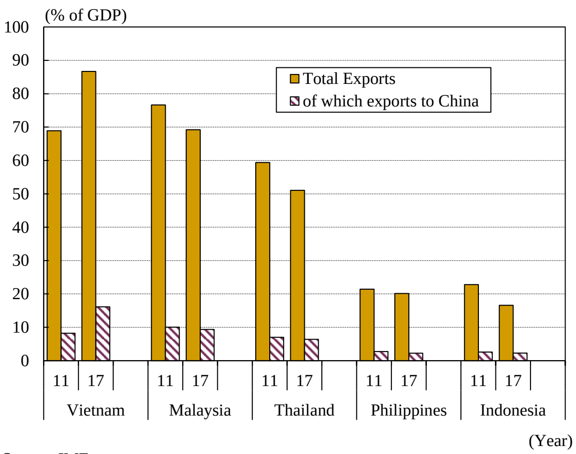
2. While impact on trade of China's slowdown to be limited, spillover effect on finance should be noted

The Indonesia's exports by destination showed in 2017 that, although China accounted for 14% of exports as the largest export partner, the export dependency (ratio of exports to GDP) was low at 17 % and the ratio for China was 2%, which is relatively low as compared to other ASEAN countries (Figure 7). This suggests that the negative impact on Indonesia's trade of a slowdown of the Chinese economy and trade frictions between the US and China will be rather limited.

Meanwhile, it should be noted that there is a possibility that the slowdown of the Chinese economy may have a negative impact on the Indonesian domestic economy through the depreciation of the rupiah associated with the worsening of the current account deficit and the fall of resources prices. Specifically, if an increase of the current account deficit intensifies the downward pressure on the currency and forces the central bank to make a drastic hike of its interest rate, it will become a dampening factor on the expansion of domestic demand, primarily that of investment. There is also a possibility that a fall of resources prices induced by the decelerating Chinese economy may put a downward pressure on the economy through the slowdown of investment in the mining sector. Investment in the mining sector accounts for 10% for the domestic investment by local companies and also for the investment by foreign companies respectively, with combined share of 0.5% of GDP (actual result for 2018) and a tendency can be seen that the investment in the mining sector stagnates when the resources prices fall (Figure 8).

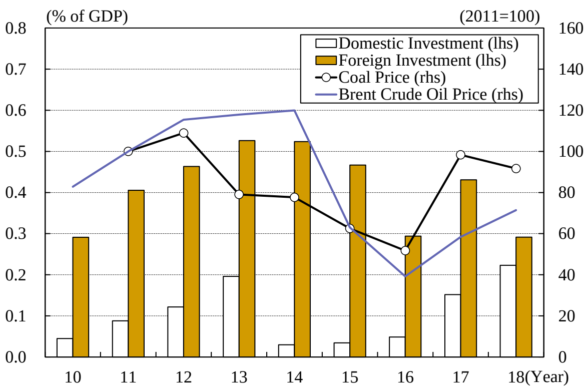
Regarding the impact other Asian countries may receive from the US-China trade frictions, (i) a negative impact will be felt in these countries in that their exports to China of parts and materials which are to be used for the Chinese export products to the US will decrease. On the other hand, (ii) there will be a positive impact in that imports to the US of Chinese products will decrease due to higher import prices of Chinese products induced by higher tariffs while the imports from other Asian countries (i.e., exports from other Asian countries to the US) will increase or there will be shifts of production facilities to these countries from China. However, as Indonesia has lower degree of participation in the supply chains in East Asia, impact will be rather limited in both terms of positive and negative sides.

Figure 7: Export Dependency of major ASEAN Countries



Source: IMF

Figure 8: Investment in Mining Sector in Indonesia



Note: Coal Price refers to the Indonesian reference price, known as Harga Batubara Acuan(HBA).

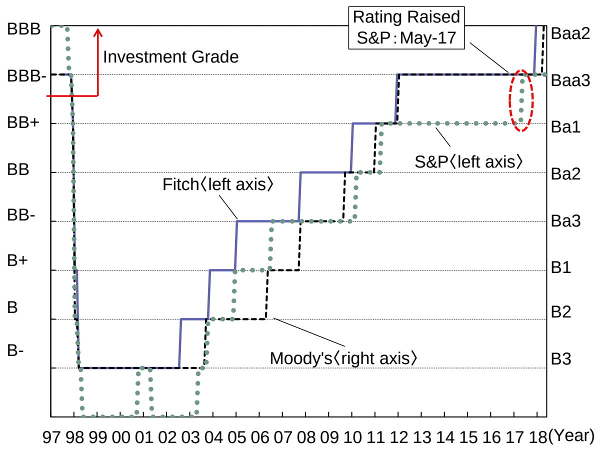
Source: BKPM, Indonesia's Ministry of Energy and Mineral Resources, Thomson Reuters

3. External balance: Despite remaining exchange risks, tolerability to capital outflows strengthened

(1) Fragile 5 with much diversified fundamentals

In Indonesia, much improvement has been achieved since the Asian currency crisis, including decreased dependency on external borrowings and accumulation of foreign exchange reserves. In addition, progress has been seen also on the institutional sides which include the strengthened safety net through shifting to floating exchange rate system and conclusion of currency swap arrangements based on the Chiang Mai Initiative. Therefore it is considered Indonesia’s tolerability to capital outflows has been much increased. The ratings on the Indonesian government bonds were drastically graded down to “speculative grade (non-investment grade)” by the leading rating agencies in the period of the 1997-98 currency crisis. Since then, credit ratings improved gradually in the 2000s as the positive efforts of the Indonesian government toward fiscal consolidation and its stable policy management were highly evaluated together with the improvement of economic fundamentals. In 2012 the Fitch Ratings and Moody’s, and in May 2017 the Standard and Poor’s upgraded Indonesia’s rating to “investment grade” status, respectively (Figure 9).

Figure 9: Indonesia’s Sovereign Bond Rating



Source: S&P, Fitch and Moody's

Following the reference by the US Fed to a tapering of its monetary policy in 2013, downward pressures on emerging currencies intensified and especially those emerging 5 countries (Brazil, India, Indonesia, Turkey, and South Africa) which had been saddled with structural problems like the current account deficits, fiscal deficits and high inflation, coupled with sharp depreciation of their currency, came to be collectively called as Fragile 5. However, it is considered not appropriate to treat Indonesia as one as Fragile 5, since its fiscal deficit remains small with low level of public debt outstanding. In fact, comparing the performance of each currency in 2013 and 2018, all of Indonesia and other countries recorded a drop of the currencies much larger than the rise of the dollar (rise in the nominal effective exchange rate) in 2013, but the drop in 2018 remained within the rise of the dollar in Indonesia and India (Table 1).

Table 1: Fundamentals and Currency Performance in "Fragile 5" Economies

	Current Account (% of GDP)		Fiscal Balance of General Government (% of GDP)		CPI (YoY,%)		Foreign Reserve (% of ARA)		Change in exchange rates (YTD, %)	
	2013	2018	2013	2018	2013	2018	2013	2018	2013	2018
Indonesia	▲ 3.2	▲ 3.0	▲ 2.2	▲ 2.2	6.4	3.4	123.3	115.3	▲ 20.7	▲ 6.4
India	▲ 1.7	▲ 3.0	▲ 7.0	▲ 6.6	9.4	4.7	143.6	142.9	▲ 11.4	▲ 9.0
South Africa	▲ 5.8	▲ 3.2	▲ 4.3	▲ 4.6	5.8	4.8	81.8	62.6	▲ 19.4	▲ 13.9
Brazil	▲ 3.0	▲ 1.3	▲ 3.0	▲ 8.6	6.2	3.7	159.4	164.3	▲ 12.8	▲ 14.6
Turkey	▲ 6.7	▲ 5.7	▲ 1.5	▲ 4.0	7.5	15.0	102.2	76.5	▲ 16.4	▲ 28.6
Argentina	▲ 2.1	▲ 3.7	▲ 3.3	▲ 5.4	10.6	31.8	148.9	67.3	▲ 32.2	▲ 51.8
	【cf.】USD Nominal Effective Exchange Rate Index(YTD, %)								2.6	8.7

Note: 1) Shadowed portion indicates an improvement from 2013.

2)Appropriate level of reserves to hold is culcurated by the Assessment of Reserve Adequacy (ARA) Metric below and figures within the 100-150 % range of the metric is considered to be appropriate.

ARA metric (Float Exchange Rate) = 5% × Exports + 5% × Broad Money + 30% × Short-term Debt + 15% × Other Liabilities

Source: IMF, Thomson Reuters

(2) Dependence on foreign funds entails exchange rate risks

While the re-establishment of "investment grade status" by all the three major rating agencies gave Indonesia a positive sign for attracting capital inflows, it is also to be noted that Indonesia has become more susceptible to a change in external environment as it has increased dependency on foreign investment fund with currency exposure still remaining.

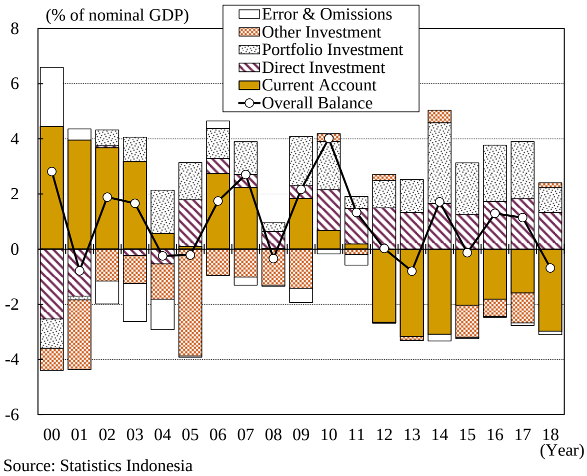
The balance of payments of Indonesia indicates that its current account deficits cannot be financed simply by the stable capital flows of direct investment, and its financing has come to depend much on a fickle portfolio investment (Figure 10). As the domestic institutional investors remain in an immature stage in the Indonesian capital market, Indonesia has a high dependency on foreign investors with the foreign holding in Indonesian government bond market at a high level of a little less than 40% (Figure 11). Also in the stock market, foreign ownership has reached almost 50%. In such an environment, a possibility cannot be ruled out that the downward pressure on the rupiah will be strengthened when international financial market destabilizes in the future, intensifying the risk-averting behavior of investors.

According to market sources, among the 147 trillion rupiah that were repatriated from overseas in the period of tax amnesty[2] that the Indonesian government introduced in 2016, it is

[2] The government of Indonesia introduced the tax amnesty system for the period of June 2016 to March 2017 as an effort to encourage repatriation of assets held in overseas tax haven and increase revenues. Under the system, residents of Indonesia were given tax exemption or reduction (the sooner declared the lower rate applied) or exempted from criminal accusation if they voluntarily declared their undeclared assets and income held at home and

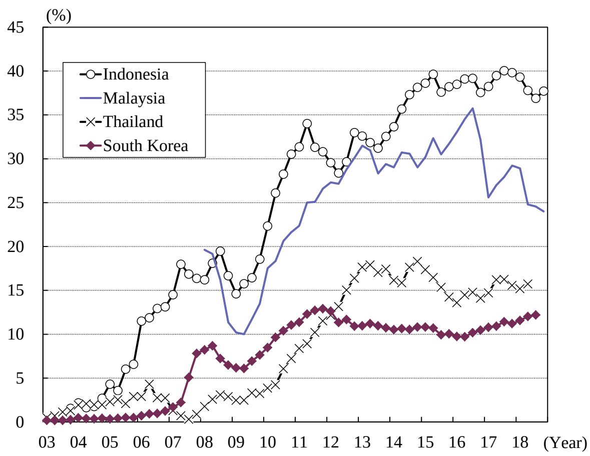
estimated that ninety percent of the funds was invested in the three-year government notes. It is noteworthy where they will go after the latter half of 2019 when these government bonds mature. However, it can be said that Indonesia has strengthened substantially its tolerability to capital outflows as the predetermined payment of foreign currencies that includes these funds remains well within the bounds of foreign exchange reserves excluding gold ($112.1 billion at the end of October 2018) (Table 2).

Figure 10: Balance of Payment



Source: Statistics Indonesia

Figure 11: Foreign Holdings in Local-Currency Government Bonds in Major Asian Economies



Source: ADB

Table 2: Indonesia's Predetermined Foreign Currency Payment within One Year (at the end of 2018)

(Millions of USD)

	Total	Up to 1 Month	More than 1 and up to 3 months	More than 3 months and up to 1 year
Foreign currency loans, securities and deposits	-24,179	-7,467	-6,515	-10,197
Short positions in forwards and futures in foreign currencies	-7,110	-1,492	-2,040	-3,578
Contingent Short-term Net Drains on Foreign Currency Assets	-6,765	-6,765	0	0

Source: IMF

(3) Assessment of currency depreciation～positive effect limited

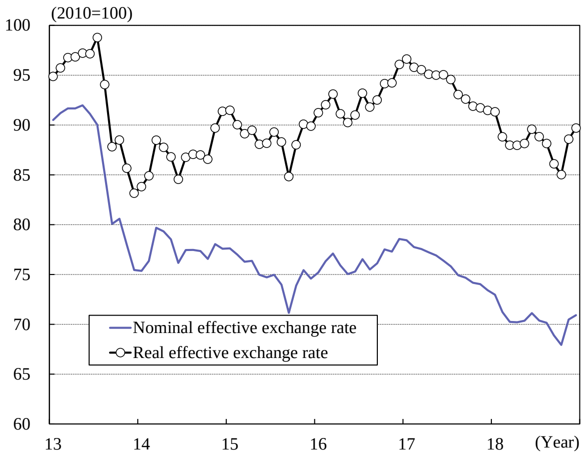
Analysis of the influence of currency depreciation on the Indonesian economy indicates that while the influence on the rise of domestic prices through import inflation has been mitigated by the government price stability policies, the positive influence through the improved export competitiveness is also limited. The rupiah's exchange rate to the dollar fell by about 50% in

abroad during the period set above.

nominal terms from May 2013 to the end of 2018, but in terms of nominal effective exchange rate which incorporates the relationship with major trading partners, it fell by 23%, with a fall remaining only 7% in terms of real effective exchange rate that also takes into account relative price differentials (Figure 12). In addition, effect of cheaper currency on increasing exports is considered to be small in Indonesia given its export structure that relies much on primary goods. Actually, exports of Indonesia are highly dependent on primary products like palm oil in addition to mineral fuels such as coal and natural gas, and those primary products still account for 40% of the total, after peaking out in 2011 (Figure 13). As most of these primary products are usually traded in dollars, higher dollar/lower rupiah does not directly lead to an improvement of export competitiveness.

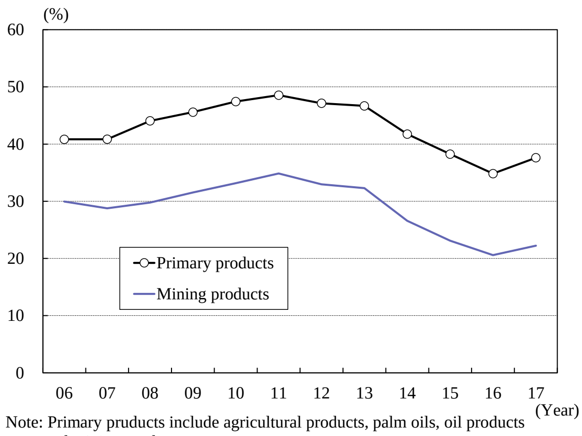
Indonesia has taken a series of measures to respond to the currency depreciation, including interest rate hikes and restriction of imports that lie in the backdrop of the current account deficits. The IMF and other international institutions have given positive assessment to them as effective policy measures available in the short-run. However, in the medium-and long-run, it will need to foster domestic institutional investors that make long-term investment. Furthermore, it is indispensable for Indonesia to increase its trade surplus through diversification and sophistication of its export structure that is highly dependent on primary products.

Figure 12: Indonesia's Effective Exchange Rates



Source: BIS

Figure 13: Share of Indonesia's Exports by Items



Note: Primary pruducts include agricultural products, palm oils, oil products and mining products
Source: Statistics Indonesia

4. Soundness in fiscal policy going to be kept

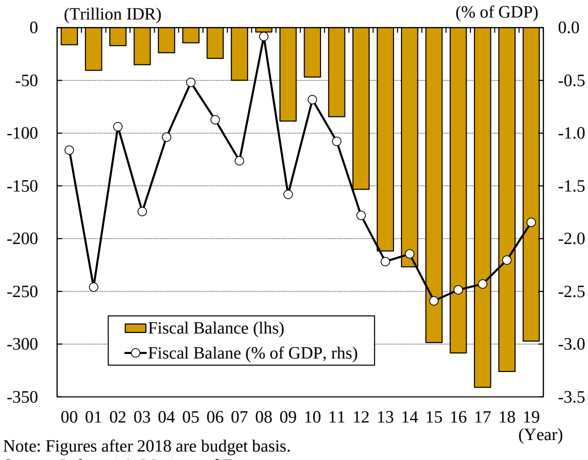
(1) Efforts for fiscal reforms under way

The government has been managing its fiscal and public debt administration based on the State Finances Law (2003) and 2018-2021 Medium-Term Debt Management Strategy[3] which

[3] The strategy sets the upper limit of government guarantee outstanding as of 2021 at Rp 1,178 trillion (6% of GDP) and defines the conditions including currencies, terms, and targets for giving government guarantee.

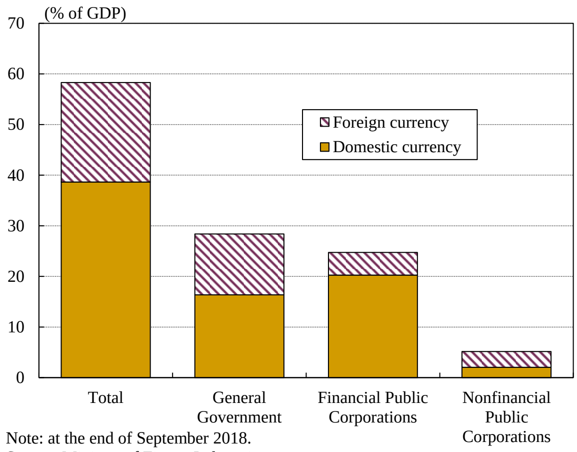
restrict the budget deficit of general government within 3% of GDP and set the upper limit for the central government debt outstanding under 60% of GDP. Currently the budget deficit stays at around 2% of GDP (Figure 14), and the government debt outstanding stands at 28%, and broadly defined public debt that includes those of state banks and non-financial SOEs stands at 58% (Figure 15).

Figure 14: Fiscal Balance



Note: Figures after 2018 are budget basis.
Source: Indonesia's Ministry of Finance

Figure 15: Public Debt Outstanding

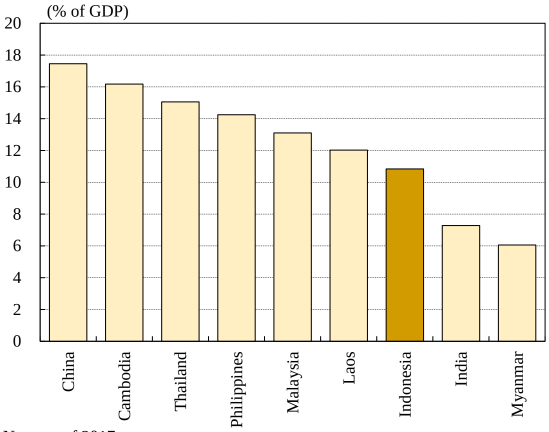


Note: at the end of September 2018.
Source: Ministry of Finane Indonesia

On the revenue side, the size of tax revenues stands at 11%, a lower level as compared to other major Asian countries (Figure 16) and it has been a long-standing issue how to increase the tax revenues through strengthened tax collection and improved environment for investment. On the expenditure side, the government has made efforts to control expenditures through promotion of effective budgetary allocation. The fuel subsidies that had accounted for a bit less than 30% of the total expenditures was reduced to less than 10% as a result of 2015 policy change for fuel subsidy while the ratio of capital expenditures including infrastructure investment was increased modestly (Figure 17). Yet, fuel subsidies were partially reintroduced in 2018 in growing concerns over negative impacts of higher oil prices and depreciation of the rupiah, and in an anticipation of the presidential election slated for in April 2019, the pace of improvement came to a temporary standstill. The 2019 budget draft projects a reduction of the budget deficit to 1.8% of GDP from 2.2% for 2018 budget by restraining capital expenditures while increasing the expenditures for fuel subsidies and social safety-net related provisions.

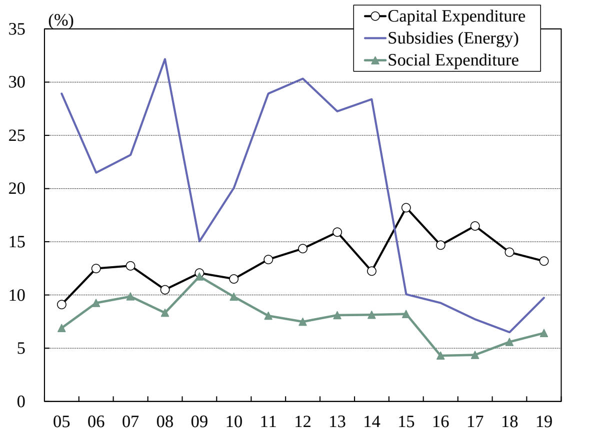
Incidentally, the ratio of fuel subsidies in the expenditures almost corresponds to the ratio of the oil and gas revenues in the total revenues, and the worsening of fiscal balance will be avoided as the revenues from resource-related companies are expected to increase although expenditures for fuel subsidies may increase when oil prices rise.

Figure 16: Tax Revenue in Major Asian Countries



Note: as of 2017.
Source: ADB

Figure 17: Capital Expenditure and Energy Subsidiaries in Government Expenditure



Note: Figures after 2018 are budget basis.
Source: Indonesia's Ministry of Finance

(2) Attention should be given to the increase of liabilities of SOEs and government guarantees associated with accelerated infrastructure investment

Going forward, thanks to the fiscal and public debt management based on the State Finances Law and 2018-2021 Medium-term Debt Management Strategy, the government debt (outstanding) is projected to remain sustainable. The risks for contingent liabilities[4] of the government may include increases in liabilities of SOEs and government guarantees to public-private partnership (PPP) projects associated with the promotion of infrastructure investment.

Currently, economic policy management in Indonesia is made based on the National Long-term Development Plan 2005-2025 (RPJPN) and the Medium-term Development Plan 2015-2019 (RPJM). The RPJPN postulates the funding sources for the cumulative funds needed to improve infrastructures for five years up to 2019 (IDR 5,519 trillion), as the national budget (50%), SOEs (19%) and private funds (31%) [5]. The government actively utilizes PPPs to restrain the increase of government debts, and at the same time, especially for the important PPP projects, it has implemented guarantees that utilize the Indonesia Infrastructure Guarantee Fund (IIGF)[6] and strengthened monitoring of the projects concerned.

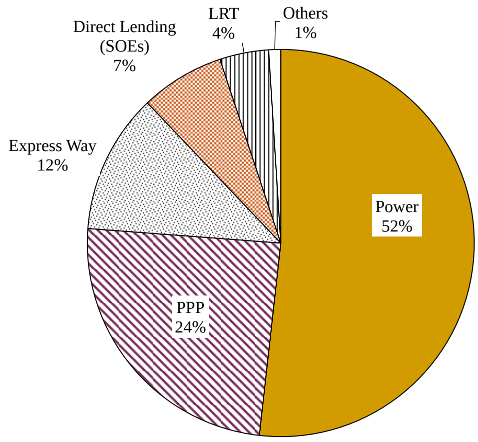
Sectoral breakdown of the government guaranteed debt outstanding (1% of GDP) shows that electricity accounted for more than half at 52% at the end of 2018, followed by 24% for PPPs,

[4] In general, any guaranteed debts that are not identified as debts at that point are recognized as contingency obligations. According to the IMF Manual "Public Sector Debt Statistics－Guide for Compilers and Users", contingent liabilities are treated differently from the debts by themselves on the macro-economic statistics.
[5] The "National Strategic Project" which was released in 2016 by the government to set 247 prioritized projects for 2017 to 2019 plans to finance these projects with IDR 525 trillion from national budget (13%), IDR 1,258 trillion from SOEs (30%), and IDR 2,414 trillion from private funds (58%).
[6] IIGF is a public guarantee agency established in 2009 with a 100% subscription by the Ministry of Finance.

12% for express way and 7% for SOEs (Figure 18). Since the liabilities of non-financial SOEs stood at 12% of GDP at the end of 2017 with their debt-to-equity ratio remaining under 1, risks for debt repayment are considered to be small as a whole. However, the financial situation of major SOEs involved in the infrastructure investment indicates that their debt-to-equity ratio of PT Jasa Marga (state-owned toll roads operator) and major state-owned construction companies like Waskita Karya, Wijaya Karya, Adhi Karya is strikingly rising against the backdrop of increased financing needs although the ratio of PT Perusahaan Listrik Negara (PLN), a state owned electricity company, is improving (Figure 19). Based on the financial statement including interest coverage ratio, concerns over the debt repayment are small at present, but the future changes of their business environment and profit situation should be kept closely monitored.

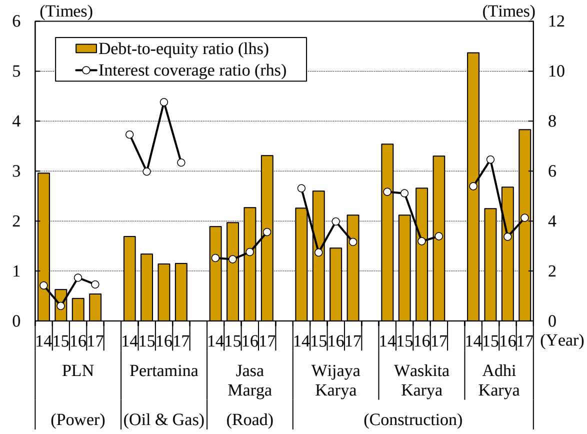
According to the Ministry of Finance, the IIGF provided guarantees amounting to IDR 32.7 trillion (0.2% of GDP) to the PPP projects which total IDR 114.1 trillion at the end of 2018. Calculated simply, this means a provision of guarantees is equivalent to a bit less than 30% of the total investments[7]. Assuming that the IIGF would provide its guarantee to about 30% of private fund procurements expected under the RPJM, the size of the guarantees will represent around 3.5% of GDP, and even if the government happens to bear the loss, its influence on the government debts is considered to be limited.

Figure 18: Government Guarantee Debt by Sector (at the end of 2018)



Source: Indonesia's Ministry of Finance

Figure 19: Financial Positions of Major Infra-rerated State-Owned Enterprises in Indonesia



Source: AMRO

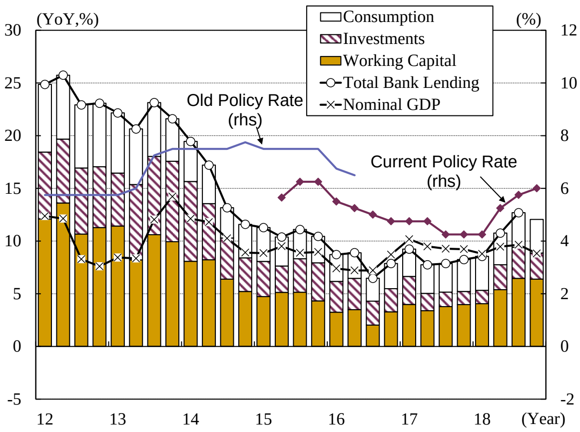
[7] In practice, while a single electricity project is guaranteed for 65%, the ratio for express ways differs depending on the project, such as at 52% and 14%.

5. Soundness of Banking Sector is high on the whole

Bank lending continued to grow at a sluggish pace since the latter half (2H) of 2013 reflecting the monetary tightening and influence of slower economic growth, but following the economic recovery it has picked up with the growth reaching 13% (y/y) in October 2018. Although it decelerated a bit in November mainly that in business investment due to an interest rate hike, it has still maintained a growth of about 12% since then (Figure 20). Consumer loans continued to stagnate since 2012, mainly affected by the strengthened regulations on housing loans and auto loans by the central bank aiming to maintain soundness of banking sector, but since the middle of 2016 it continued to recover against the backdrop of monetary easing and relaxation of regulations on loan. Furthermore, non-performing loan ratio of commercial banks is low at 2.7% while capital adequacy ratio is high at 23.3% (as of November 2018). Thus it can be said soundness of the banking sector is high enough (Figure 21).

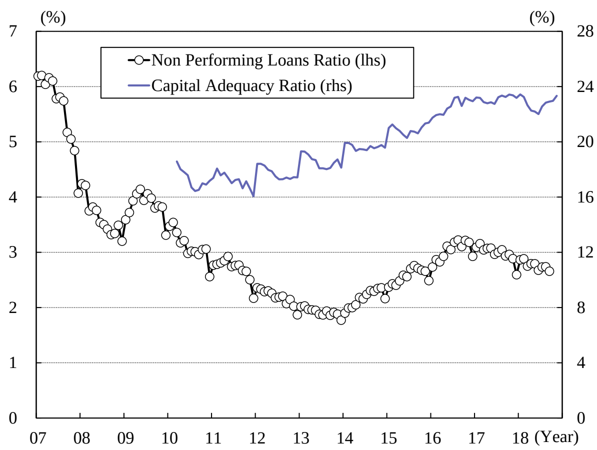
Looking ahead, developments of corporate sector that accounts for about 70% of lending should be continuously monitored as a risk factor that may lead to a worsening of profit situation of the banking sector. Although the debt outstanding of non-financial corporations in Indonesia remains on a lower level of around 20% of GDP as compared to other major Asian countries (Figure 22), sectoral breakdown of private external debts shows that eternal debt ratio remains high for some of the sectors like mining (Figure 23). There is a possibility that if the income situation in such sectors worsens through the change of external environment including currency depreciation, that would exert a negative influence on the profits and balance sheet of the banking sector.

Figure 20: Bank Lending in Indonesia



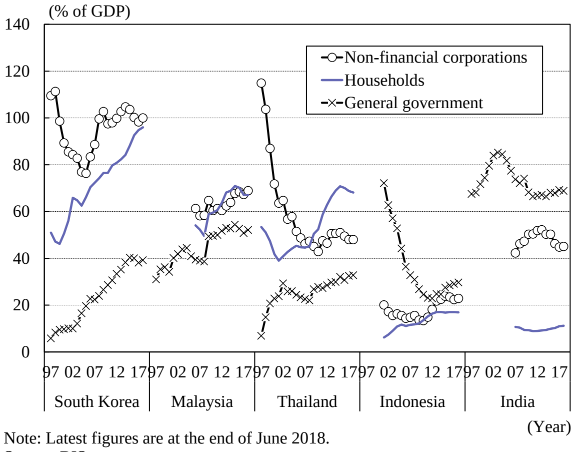
Note: Latest figure for bank lending is as of November 2018.
Source: Financial Services Authority of Indonesia

Figure 21: NPL and CAR of Banking Sector



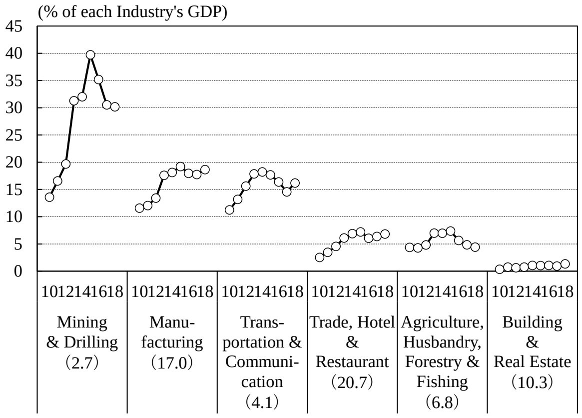
Source: Financial Services Authority of Indonesia

Figure 22: External Debt by Sector



Note: Latest figures are at the end of June 2018.
Source: BIS

Figure 23: Private External Debt by Sector



Note: Latest figures are at the end of September 2018. Figures in brackets under the industry's name are the percentage share in bank loans.
Source: Bank Indonesia

6. Influence of presidential election～Delay in infrastructure improvement and structural reforms of industries should be averted

For the presidential election to be held on April 17, 2019, the incumbent president Jokowi (with his running mate: Ma'ruf Amin, chairman of the MUI) and Prabowo Subianto, party leader of Gerindra (with his running mate: former Jakarta deputy governor Sandiaga Uno) have formally announced their candidacy (Table 3). Both campaign offices have been trying to win a support from a wider group of people by appointing young businessman Mr. Erick Thohir[8] for election campaign chairman on the Jokowi camp and retired general Mr. Djoko Santoso on the Prabowo camp. Thus far it is a majority view that the Jokowi camp is leading the race, but it is difficult to forecast the final result as the situation may change depending on the strategies of both election camps and economic developments in the coming days.

Table 3: Presidential/ Vice-Presidential candidates in Indonesia's 2019 presidential election

		Age	Party affiliations (party head) or organization	Career	Main mission
President	Joko Widodo (incumbent President)	57	PDI-P (former President Megawati Sukarnoputri)	-7th President of Indonesia from 2014 - - Governor of Jakarta from 2012 to 2014 - Mayor of Surakarta (Solo) from 2005 to 2012	1) The increase of Indonesian human quality (education, health care) 2) Competitive, productive and independent economic structure (Infrastructure development, industry 4.0) 3) Just and equal development 4) The enforcement of free from corruption, dignified, and trustworthy legal system
Vice-president	Ma'ruf Amin	75	the leader of the quasi-state Indonesian Muslim Leaders Assembly (Majelis Ulama Indonesia: MUI)	-represented the PKB in the national DPR from 1999 to 2004 -head of the governing board of Nahdlatul Ulama (Indonesia's largest mass Muslim organisation)	
President	Prabowo Subianto	67	the leader of Gerindra	-retired General Commander (Kostrad, Kopassus) -the former husband of Titiek Suharto, the late President Suharto's second daughter	1) Develop a national economy 2) Develop smart, healthy, qualified and productive, competitive Indonesian society 3) Develop justice and transparency in the legal sector 4) Develop a national defense and security system
Vice-president	Sandiaga Uno	49	Independent	-businessman (he co-founded Saratoga Group in 1998) -Deputy Governor of Jakarta from 2017 to September 2018 -Gerindra Party from 2015 to 2018	

Source: various sources

[8] Mr. Erick Thohir (48) is a young businessman who served as executive chairman of the Asian Games held in Indonesia in 2018. He is highly reputed for the success of the Games. On the other hand, Mr. Djoko Santoso (66) experienced the Chief of Staff for regional affairs in his army days, and is said to be an expert on the nationwide political situation.

The impacts of the presidential elections on the politics and economy can be organized from the three perspectives of (i) destabilization of social situation, (ii) destabilization of government base through lowered representation in the parliament of ruling coalition party after the election for Parliament Members, and (iii) new administration's operation policy of economic management.

In the first place, the possibility that the election will trigger destabilization of social situation is considered to be low. Based on the experiences of negative campaign in the 2014 presidential election by the Prabowo camp which focused on religion and ethnic group as a theme, or a plunge of support for the incumbent candidate triggered by his offhand remark and his defeat in the 2017 Jakarta gubernatorial election[9], there is a view that taking up religion as a theme in the election would lead to destabilization of social situation. However, Mr. Prabowo himself is believed not to have a strong intention to excessively strengthen a religious atmosphere although he is "anticommunist" and "anti-Islamic extremist" as a typical member of Indonesian National Armed Forces and has put a great deal of effort in gaining support of "Islamic conservatives". In addition, since both camps swore on the first day the election campaign started in September 2018 that "they would make election campaign peacefully without turning race and religion into a political issue," it is highly likely the stability of the society will be kept unless Islamic radicals approach either of the camps to politicize the religion.

On the other hand, the election for Members of Parliament to be held at the same time of the presidential election needs to be watched closely, since it will become a key to influence the government base of the president. At the time of inauguration of the Jokowi administration in 2014, his government base was vulnerable as the share of the ruling coalition in the Parliament remained at 44%, but afterword the administration gained stronger base by bringing in other parties and making two cabinet reshuffles. Although the National Mandate Party left the ruling coalition to support the opposition candidate Prabowo (also the Democratic Party which had taken a neutral position came to support Mr. Prabowo) in August 2018 when the presidential candidates and their running mates were formally announced, the ruling coalition still maintains a majority share of around 60% in the parliament. Yet, a possibility cannot be ruled out that the speed of policy making will slow down if the ruling coalition fails to gain majority votes in the election.

Also noteworthy is the difference of operation policy of economic management which both camps put focuses on. Although it is hard to assume a big change in economic policies as both camps make commitment on the economy, education and welfare, and anti-corruption, the

[9] In the 2017 Jakarta gubernatorial election, at first incumbent governor Basuki Tjahaja Purnama had been seen as leading but his offhand remarks relating to religion were attacked by the Islamic radicals and he was defeated in a runoff by the former Minister of Education and Culture Anies Baswedan.

Jokowi administration has announced a plan to strengthen development of human resources in his second term, in addition to the strengthening of infrastructure improvement in the first term. This can be said to be an indispensable factor for diversification and sophistication of industrial structure needed for a sustainable growth as well as for strengthening export competitiveness through attracting foreign investment. Meanwhile, the Prabowo camp tends to be more drifted toward populist themes and seems to have an aspect of a resource nationalist. Thus far Mr. Prabowo has advocated, in addition to the correction of income disparity, such policies as the Indonesian ownership of resources (resource nationalism). He has also made in the TV debate a reference to a possibility to review or suspend infrastructure development plan to take into account its influence on the fiscal management. Pace-down in infrastructure improvement or protectionist policies in the resources area could hamper sustainable growth to be achieved through diversification of Indonesian industrial structures and improvement of competitiveness. Measured policy decisions are to be required.

7. Conclusion

The Indonesian economy has generally maintained a stable growth led by domestic demand and going forward it is expected to continue a robust growth centering on domestic demand as private consumption will keep its robustness and private investment will also pick up on top of an accelerated infrastructure investment. As the export dependency of the Indonesian economy is low, it is estimated that the negative impacts directly felt through trade of Chinese economic slowdown or US-China trade frictions will be limited.

Furthermore, while the reestablishment of “investment grade status” by all of the three leading rating agencies against the backdrop of improved fundamentals and appropriate policy management of the government toward structural reforms is a positive factor to capital inflows to Indonesia, it has strengthened the reliance on foreign investment funds, making the financial market susceptible to the impact of external environmental change.

Given the high level of international reserves, it is judged that Indonesia has a considerable tolerability up to a certain level of capital outflows, but if the central bank is forced to make a drastic hike of interest rate as the downward pressure on the currency intensifies due to the increase of the current account deficits caused by sluggish exports, it could dampen the expansion of domestic demand, primarily that of investment.

Going forward, it is highly likely that the authority will respond to an increase of downward pressure on the currency with the rate hikes by the central bank and restraint of imports that are in the background of the current account deficits, but in the medium and long run, it is essential for Indonesia to foster domestic institutional investors that can make long-term investment and to expand trade surpluses through diversification of exports and industrial structures that rely much on primary products, a background of the current account deficits.

On the fiscal front, the fiscal deficit remains at around 2% of GDP as of 2018 with the government debt outstanding remaining low at 28% of GDP. It is likely that both deficit and debts will remain on a sustainable level in the future. The risks include an increase of debts of SOEs through accelerated activities for infrastructure investment, and an increase of government contingent liabilities through government guarantees to PPP projects. Especially the management environment for the infrastructure-related SOEs and their profit developments will hold a key.

In the banking sector, following the economic recovery in recent years, the growth of loans is picking up, but it remains in line with the expansion of the economy, and the soundness has been kept in terms of non-performing loan ratio or capital adequacy ratio. Looking ahead, the development of corporate sector which accounts for about 70% of bank lending needs to be monitored as a risk factor that will lead to a worsening of bank profits.

As for the presidential election to be held in April 2019, many people view that the incumbent president Jokowi is leading, but it will require caution as the situation could change depending on the strategies of both camps and economic developments. Although the possibility that the social situation will be destabilized by the presidential election is low, the possibility cannot be ruled out that the government base will be destabilized depending on the outcome of the election for the share of ruling coalition in the parliament. Furthermore, if and when the Prabowo camp should win the election, pace down of infrastructure investment and inclination toward protectionist policies in the area of resources could impede sustainable growth to be achieved through diversification of Indonesian industrial structures and improved productivity and therefore measured policy judgement would be desired.

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