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Impact of COVID-19 on the Indonesian Economy and its Prospects

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＜Abstract＞

1. In Indonesia, the number of new cases of novel coronavirus (COVID-19) per day has been elevated at around 4,000, and the situation is still far from contained. Although the local governments in major cities and regions including DKI-Jakarta introduced large scale social restrictions (PSBB in Indonesian) in April, the restrictions began to be gradually mitigated since June. However, the restrictions had to be repeatedly extended, calling for the governments to make a tough maneuvering between containing COVID-19 infections and reopening economic activities.
2. To mitigate the damages of the COVID-19 pandemic on the economy, the central government introduced unprecedented measures including the National Economic Recovery (PEN) Program (equivalent of 4.3% of GDP), exempted for the coming three years the cap on the budget deficit set out by the “Law on State Finance of 2003” and enabled the Central Bank to purchase the government bonds in primary market. Looking ahead, although the economy is expected to pick up after the resumption of activities supported by these fiscal and financial supports, its pace will be inevitably slow for the moment amid the continued spread of COVID-19 infection, and the growth rate for 2020 is likely to be in the negative range for the first time since the Asian currency crisis.
3. As compared to the situations during the Asian currency crisis, Indonesia has much stronger resilience to external shocks, with improved fundamentals and systems like lower dependency on external debts and accumulation of foreign exchange reserves. On the other

hand, however, it should be noted that, with an increased dependency on foreign investment funds, Indonesia has become more susceptible to the changes in the external environment, particularly in financial markets.

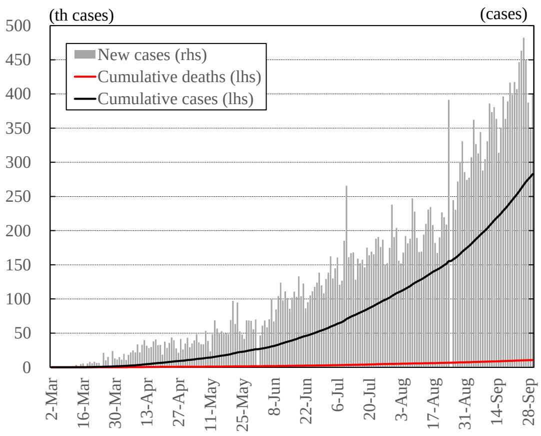
4. In response to the unprecedented crisis of COVID-19 shock, a large scale fiscal and monetary support measures can be considered indispensable in mitigating the impacts of worsening balance sheet of financial institutions affected by the deteriorating economy and increased bankruptcies of corporations. However, it is necessary for the government to shift back its budgetary stance toward restoring its fiscal soundness after the containment of COVID-19 pandemic and it should be evaluated positively that the government has set a goal of reducing the budget deficits under 3 percent of GDP by 2023. A rise in the rate of interest payment to revenue could suppress the expenditures for areas that are essential for sustainable economic growth, and therefore the government is required to promote reforms toward increasing revenues through expansion of tax base.

1. Spread of COVID-19 Infections in Indonesia

(1) Developments so far：Cautious reopening of economic activities after partial lockdowns

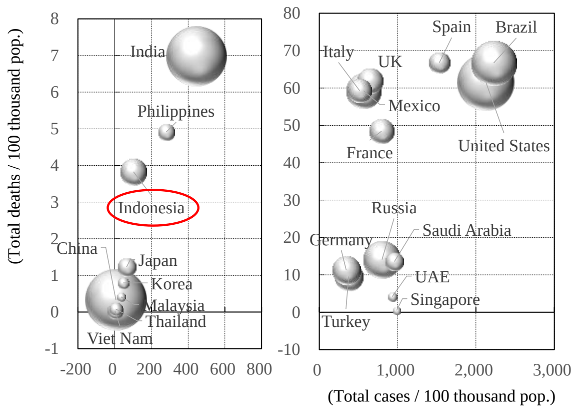
At the end of September, the number of infected cases by the novel coronavirus (COVID-19) and deaths in Indonesia was about 280,000 and 10, 000 respectively, with a daily new cases of infection has been elevated at around 4,000, showing the COVID-19 pandemic is far from contained in Indonesia (Figure 1). However, the situation has been partially on an improvement as the ratio of recovered patients among the total infected cases exceeded 70% while fatality ratio lately declined to 3.7% from the peak ratio of 8.64% recorded in April. Although the numbers of infected cases and deaths in proportion to population exceed those in East Asian nations, they are much lower than the corresponding numbers in Europe and the United States (Figure 2).

Figure 1: COVID-19 epi curve in Indonesia



Source: WHO, Ministry of Health of Republic of Indonesia

Figure 2: Cumulative number of COVID-19 cases and deaths in major Economies



Note: 1) The number of total cases and deaths are as of 29 Sep, 2020.
2) The size of the bubble indicates the population.
Source: WHO, UN

President Joko Widodo (President Jokowi) decided on April 3 to introduce Large Scale Social Restrictions (PSBB), and started in earnest to restrict economic activities from the middle of April formally based on legal grounds set by a decree of the Minister of Health[1]. The local government of DKI-Jakarta imposed the restrictions over the whole district starting April 10 and then the restrictions were extended over other provinces and regencies including the whole West Java Province (Table 1). The contents of restrictions, their terms, penalties, etc. vary by individual communities. In the DKI Jakarta, in addition to prohibition of non-essential outings and outdoor mask mandate, they included work-from-home of corporate employees[2] and temporary closure of schools, temporary closure of entertainment and public facilities, ban on the eat-in sales by restaurants and restriction of the use of or passengers for public transportations (numbers of passengers and operating hours). In addition, on alert against the spread of infection during the Lebaran period[3] that follows the Islamic Ramadan month, the government of Indonesia banned on April 24 the homecoming of people during these periods which had previously been required on a voluntary restraint base[4].

Owing to these measures, the pace of transmission started to decline in the Jakarta capital region, while it accelerated in the regions of East Java, South Sulawesi, and South Kalimantan. Although the returns to hometown during the Lebaran period seemed to have been somewhat curbed, it was likely that the infection seemed to have spread due to increased movements to rural areas of workers who lost their jobs and had a hard going in the metropolitan area. However, as is stated below, in line with the phased easing of restriction measures taken after June, the pace of new infections started to reaccelerate also in the DKI-Jakarta, forcing the local governments a hard steering between controlling the infection and reopening of economic activities.

PSBB in the DKI-Jakarta was initially planned to be implemented for 14 days, but the term has been repeatedly expanded. On June 4, the Jakarta Governor Anies Baswedan announced a policy to gradually ease the restrictions from June 5 after extending the term of PSBB that expired on that day until the end of the month and positioning the month of June as a transitional period. Specifically, restrictions on the use of musalla (places of worship) and transportation facilities were eased on June 5 and offices, factories, stand-alone restaurants/eating places and retail shops were allowed to reopen from June 8 on condition that the occupancy be limited to a half of the capacity. On and after June 15, reopening of operations of shopping malls and the like were allowed. Since then, the transitional period of PSBB which had been planned to expire on

[1] In practice, each community implements the PSBB by issuing its municipal ordinances after applying to and getting authorization by the Ministry of Health for its implementation.

[2] The industries exempted from work-from-home regulations are healthcare, food and beverages and daily needs, energy, communication and information (including media), finance, logistic, and strategic industry.

[3] The Ramadan month for 2020 fell on April 24 to May 23 (until sunset) and Lebaran, a festival of breaking the fast, followed on May 24 and 25. It is said that 20 million people usually move during Lebaran and the consecutive days when people take paid holidays collectively.

[4] Restriction on internal movements related to a ban on returns to hometown remained until June 15.

September 10 was suspended in the DKI-Jakarta reflecting the infection spread and critical conditions in medical institutions with reintroduction of strengthened PSBB on September 14[5].

Table 1: Major Indicator of COVID-19 in Indonesia (by Area and Province)

Province		Total Cases			Total Recovered	Total Death		Population (10 thousand)	Area (km^2)	Population density (Pop./km^2)	Share of GRDP (%)	PSBB
			per 100 th. Pop.	Share (%)			per 100 th. Pop.					
Sumatra	Aceh	1,211	26.9	0.8	191	23	0.5	449	57,956	78	1.0	
	Sumatera Utara	6,129	47.2	3.9	3,140	279	2.1	1,298	72,981	178	5.0	
	Sumatera Barat	1,633	33.7	1.1	1,043	49	1.0	485	42,012	115	1.5	●
	Riau	1,237	22.3	0.8	767	19	0.3	554	87,023	64	5.0	○
	Kepulauan Riau	745	44.4	0.5	465	31	1.8	168	8,201	205	1.7	
	Jambi	274	8.9	0.2	131	5	0.2	309	50,058	62	1.4	
	Bengkulu	288	16.8	0.2	164	24	1.4	172	19,919	86	0.4	
	Sumatera Selatan	4,125	55.4	2.7	2,820	227	3.0	745	91,592	81	2.8	○
	Kepulauan Bangka Belitun	228	18.6	0.1	201	2	0.2	122	16,424	74	0.5	
	Lampung	362	4.8	0.2	283	14	0.2	761	34,623	220	2.2	
Jawa	DKI Jakarta	33,470	348.4	21.5	23,567	1,097	11.4	961	664	14,470	17.3	●
	Banten	2,544	23.9	1.6	1,749	103	1.0	1,063	9,662	1,100	4.1	○
	Jawa Barat	9,283	21.6	6.0	5,668	259	0.6	4,305	35,377	1,217	13.1	●
	Jawa Tengah	12,476	38.5	8.0	7,989	846	2.6	3,238	40,800	794	8.5	○
	DI Yogyakarta	1,193	34.5	0.8	826	33	1.0	346	3,133	1,104	0.9	
	Jawa Timur	30,315	80.9	19.5	23,632	2,172	5.8	3,748	47,799	784	14.6	○
Lesser Sunda Islands	Bali	4,513	116.0	2.9	3,953	52	1.3	389	5,780	673	1.6	
	Nusa Tenggara Barat	2,582	57.4	1.7	1,879	143	3.2	450	18,572	242	0.8	
	Nusa Tenggara Timur	171	3.7	0.1	149	2	0.0	468	48,718	96	0.7	
Kalimantan	Kalimantan Barat	566	12.9	0.4	448	4	0.1	440	147,307	30	1.3	
	Kalimantan Tengah	2,410	108.9	1.6	1,805	104	4.7	221	153,564	14	0.9	○
	Kalimantan Selatan	7,777	214.4	5.0	5,383	333	9.2	363	38,744	94	1.2	○
	Kalimantan Timur	3,101	102.5	2.0	1,910	121	4.0	303	139,462	22	4.3	
	Kalimantan Utara	349	56.1	0.2	311	2	0.3	62	71,176	9	0.6	○
Sulawesi	Sulawesi Utara	3,552	156.4	2.3	2,421	149	6.6	227	13,851	164	0.8	
	Gorontalo	1,959	188.3	1.3	1,515	50	4.8	104	11,257	92	0.3	●
	Sulawesi Tengah	238	9.0	0.2	206	8	0.3	264	61,841	43	1.0	○
	Sulawesi Tenggara	1,323	59.3	0.9	900	22	1.0	223	38,067	59	0.8	
	Sulawesi Selatan	11,470	142.8	7.4	8,461	349	4.3	803	46,717	172	3.1	○
	Sulawesi Barat	352	30.4	0.2	237	7	0.6	116	16,787	69	0.3	
Maluku	Maluku	1,669	108.8	1.1	997	31	2.0	153	46,914	33	0.3	
	Maluku Utara	1,774	170.9	1.1	1,494	61	5.9	104	31,982	32	0.2	
Papua	Papua	3,567	125.9	2.3	2,277	42	1.5	283	319,036	9	0.5	
	Papua Barat	566	74.4	0.4	448	4	0.5	76	97,024	8	1.4	
Total		155,412	65.4	100.0	111,060	6,759	2.8	23,764	1,919,400	124	100.0	

Note: 1) The number of "Cases", "Recovered" and "Deaths" are as of 23 August, 2020. ●/○ shows implementation of PSBB as state-wise / in some local governments or regions.

2) "Population" is as of 2010, "Share of GRDP" is as of 2018.

Source: Ministry of Health of Republic of Indonesia, Statistics Indonesia and various sources

[5] The new restriction measures are milder than those imposed in April to June with no restriction imposed, for instance, on the movement into and out of the Jakarta Capital Region. PSBB has been also extended in the parts of neighboring West Java Province and Banten Province.

(2) Not easy policy management due to people's dissatisfaction with COVID-19 handling and battle over the next election

There is a criticism persist that the government of Indonesia had been one step behind in containing COVID-19 infections. Although the government strengthened in early February the immigration control from China[6], there were successive optimistic statements in the early stage of infection by high-level government officials which were not based on medical and scientific reasons[7]. This may have reflected the fact that China accounted for about 90% of the world infection cases as of the end-February and it was on March 2, a later date than in the neighboring Asian countries, that the first confirmed infection case was announced in Indonesia. Further, there were smoldering dissatisfactions with the slow response of the central government as measures like closure of schools, work-from-home system to companies, temporary closure of entertainment facilities were introduced only on a request basis from some of the local governments including the DKI-Jakarta and West Java province despite a rapid increase of transmission since the middle of March.

In such circumstances, handling the COVID-19 by the central government has a low standing from the nation, as is seen in an opinion poll conducted in the middle of May in which 53.8% responded "unsatisfactory" to the response of the central government to the public health crisis caused by COVID-19 pandemic, whereas 57.3% responded "satisfactory" to the response by the 7 reginal administrations[8]. However, the approval rating of policy management of President Jokowi stood at 66.5%, declining only slightly from 69.5% recorded in February, on the 100th day after the inauguration of his government, showing his enduring popularity against a backdrop of his common-man style and clean political stance[9].

The government has been enjoying a stable political foundation as the ruling coalition accounts for about 70% of the seats in the People's Representative Council (lower house of the Parliament) (575 seats) (Figure 3). However, it is a fact that the government has been under difficult circumstances to promote economic reforms and deregulations that would affect employment and income of the middle class who get relatively less benefit from the measures, since the government is obliged to take actions to deal with COVID-19 focusing on the social stability and vulnerable classes such as low-income earners and poverty sector as well as state-owned enterprises that were hit hard by the COVID-19 pandemic (see 2. (2) below for more details).

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[6] Issuing of visa and visa exemption measures were suspended to Chinese nationality and all foreigners who stayed in or visited China (excluding Hong Kong, Macau and Taiwan) within 14 days before entering Indonesia.

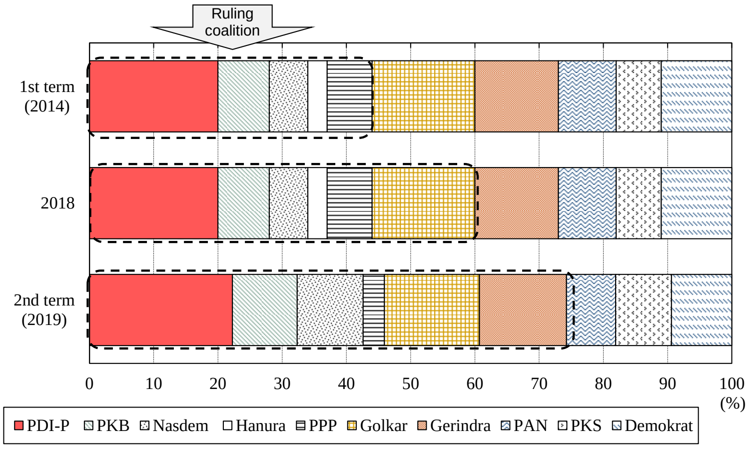
[7] The Minister of Health suggested that prayers ("doa" in Indonesian) were among reasons why Indonesia had been able to confirm zero coronavirus cases to date amid the global outbreak. (https://www.thejakartapost.com/news/2020/02/17/its-our-nations-right-to-rely-on-the-almighty-minister-justifies-calling-for-prayers-in-coronavirus-battle.html).

[8] https://www.thejakartapost.com/news/2020/05/27/most-indonesians-dissatisfied-with-administrations-covid-19-response-survey-finds.html

[9] Another poll found the support rate of the president stood at 70.1% as of February 2020, surpassing the rate (57.5%) shown on a similar date in his first administration (https://www.bloomberg.com/news/articles/2020-02-17/jokowi-s-approval-rating-surges-as-economy-remains-top-concern).

President Jokowi presented in February an “Omnibus Bill for Job Creation” as a policy highlight in his second term administration, where he aimed at inviting foreign investment to strengthen competitiveness of Indonesia through reforms of labor law and legislation on investment procedures. However, the reconciliation process has run into tough waters due to backlashes from labor organizations[10]. Additionally, with the next presidential and general elections slated for 2024 in mind, each political force has been launching a political offensive and the deliberation of the “Pancasila Bill” submitted in June to the Parliament by the Indonesian Democratic Party of Struggle (PDI-P), the largest of ruling parties, had to be postponed owing to the protests by major Islamic groups. The bill aims at reinforcing the Pancasila ideology[11].

Figure 3: Composition of the Political Forces in Indonesia DPR



Source: Indonesia DPR

2. Impact of COVID-19 catastrophe on the economy and future prospect

(1) Current Performance

The real GDP contracted in the April-June quarter of 2020 by 5.3% (increase of 3.0% in the previous quarter) from a year earlier, marking the first negative growth in about 21 years (Figure 4). Personal consumption declined especially in the sub-categories of transportation and communication and restaurant and hotel affected by voluntary restraint of going-out and business operation associated with the implementation of PSBB while investment recorded a large decline

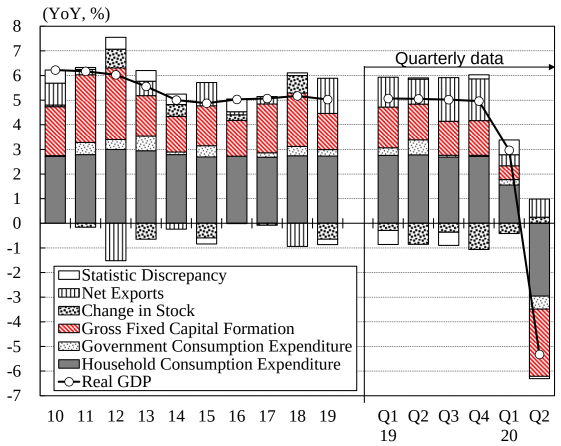
[10] The bill passed into law on October 5, but protests have been spreading against the bill among workers and students.

[11] The five principles (Pancasila) founding the nation stipulated in the preamble of the 1945 constitution comprise of (1) belief in The One and Only God, (2) a just and civilized humanity, (3) unity of Indonesia, (4) democracy led by Inner Wisdom in consultation/representation (5) social justice for the entire people of Indonesia. The objects of worship referred to in (1) above include Islamic, Catholic, Protestant, Hindu, Buddhism and Confucianism. This symbolizes the unity in diversity, and is positioned as the first pillar of national ideology. Islamic groups criticize the Pancasila Bill arguing that the bill failed to include a ban on the Indonesian Communist Party (PKI) that had been clearly defined by the Temporary House of Representatives (MPR) in 1966 in the list of references that show the factual reasons of the Pancasila Bill.

in both building and machineries due to suspensions of construction affected by stagnation of supply chains and fall of resources prices (Figure 5). Government consumption could not make up for the contraction of domestic demand due to decrease in payments for travel expenses and other costs reflecting the implementation of PSBB while a series of economic measures remained on their initial phase. By region, the Gross Regional Domestic Product (GRDP) contracted by 6.7% (with the contribution ratio of 4.0% in the total of 34 provinces) in Java Island whose economy accounts for about 60% of the nation and had many provinces including DKI-Jakarta and West Java that implemented PSBB either in the entire area or partially (Figure 6).

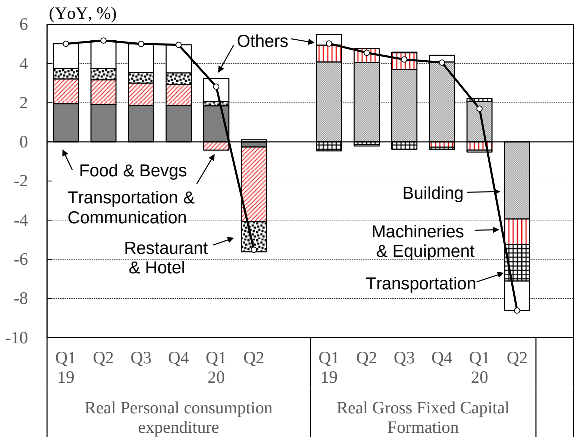
Monthly economic indicators have begun to show a sign of recovery reflecting the resumption of economic activities since June, suggesting the worst of the downturn has been over. However, its pace of recovery has been moderate. Retail sales continue to grow sluggishly mostly in the categories of automobiles and related parts, paying for culture and articles used for recreation, and clothing, while consumer confidence index remained at 86.9, well below the benchmark of 100 above which it indicates an optimism and below which a pessimism (Figure 7). Exports in August dropped by 8.4% from a year ago, with the growth rate continuing to remain in the negative range, while imports fell sharply by 24.2% mainly reflecting contraction of domestic demand and drop of oil and gas prices (Figure 8). The number of foreign tourists visiting Indonesia stood at about 160,000 (drop of 89.2%)[12] in August and occupancy rate of hotels continued to be low at 32.9% (Figure 9).

Figure 4: Real GDP Growth



Source: Statistic Indoensia, IIMA

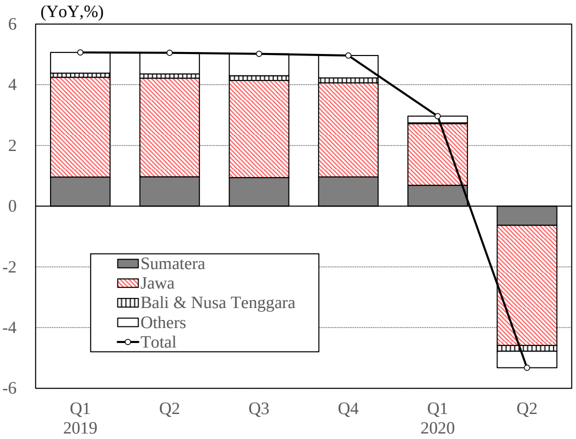
Figure 5: Real Personal Consumption and Real Gross Fixed Capital Formation



Source: Statistic Indoensia, IIMA

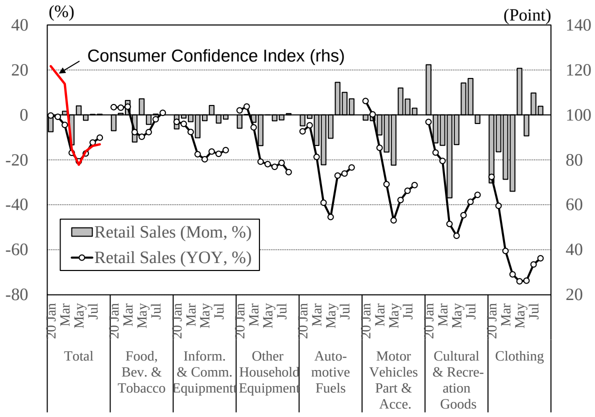
12 Visitors from East Timor (89,000) and Malaysia (58,000) accounted for about 90% of the total foreign tourists visiting Indonesia in August.

Figure 6: Real GRDP Growth



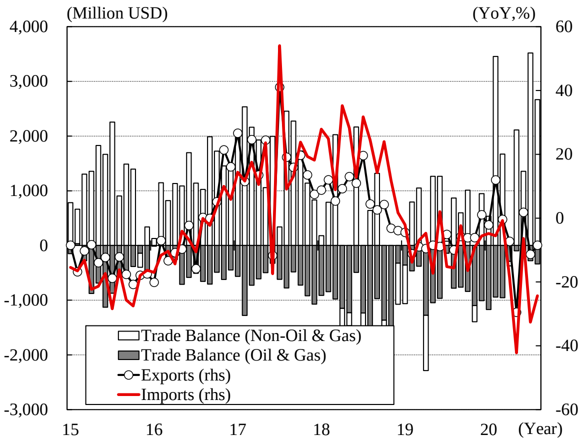
Source: Statistic Indonesia, IIMA

Figure 7: Retail Sales and Consumer Confidence



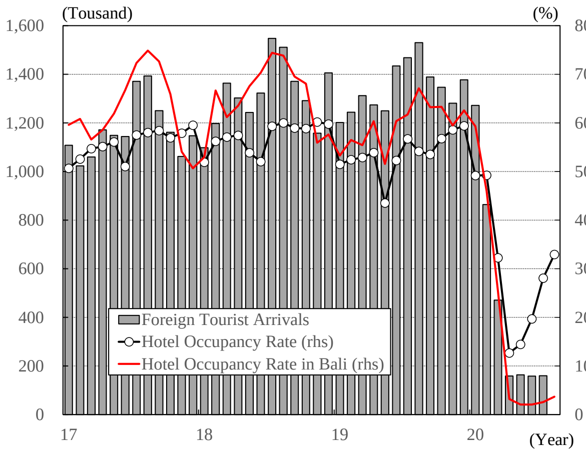
Note: "Consumer confidence" above / below a level of 100 indicates optimistic /pessimistic zones.
Source: Bank Indonesia, IIMA

Figure 8: Export and Import



Source: Statistics Indoenesia, IIMA

Figure 9: Indicators of Tourism Sector



Source: Statistics Indonesia, IIMA

(2) Government's response : Support the economy and finance from both fiscal and monetary sides

The government and monetary authority have been working together to alleviate the adverse effects of COVID-19 pandemic[13]. The government has proposed the National Economic Recovery (PEN in its Indonesia initial) Program that amounts to 695.2 trillion rupiah, or 4.3% of GDP and in August it expressed its intention to continue the program in 2021 on a scale of 356.4 trillion rupiah, or 2.2% of GDP (Figure 10). Specifically, in addition to support measures to low income households and health sector, corporate tax relief (cut of the rate from the former 25% to 22% in 2020 and to 20% in 2022) and exemption of import tariffs, the program has included capital injection to state-owned enterprises[14] that have been seriously hit by the COVID-19

[13] The policies are decided in the framework of the Financial System Stability Committee (KSSK) consisting of the Ministry of Finance, Bank Indonesia (central bank), Financial Services Authority and the Deposit Insurance Agency.
[14] The State-owned enterprises (SOEs) that receive government support under the PEN program comprise of 12 SOEs in the fields including electricity, construction, train, investment, airline, oil and gas, etc.(https://setkab.go.id/en/12-soes-to-receive-stimulus-as-part-of-economic-recovery-programs/).

pandemic, interest payment subsidy to micro/small and medium sized enterprises which have been facing difficulty in debt repayment, liquidity support to banks on the occasion of debt restructuring and guarantees to bank loans. Among these, 313.2 trillion rupiah, or 2.2% of GDP is planned to be disbursed in 2020 as real expenditures backed with budget appropriation, while the rest being expensed mainly through tax incentives. These measures will be financed mainly by borrowing from home and abroad and bond issuance[15]. The decree[16] issued at the end of March by President Jokowi enabled the expenditures to increase for three years before 2022 exceeding the limit (3% of GDP) of budget deficit defined by the Law on State Finance of 2003[17] and Bank Indonesia (central bank) to purchase long-term government securities (SBN) and government Islamic securities (SBSN) in the primary market. Also, the government agreed in July with the central bank to take measures to alleviate budget burdens related to COVID-19 handling. Under the agreement, the central bank directly undertakes the government bonds (397.56 trillion rupiah) that are issued for public interests/services (such as medical care, social security, and fiscal assistance to the local governments) and bears a portion of interest payments (177 trillion rupiah) on the government bonds the government issues to support micro, small and medium sized enterprises[18]. With these dealings, the balance sheet of the central bank is expected to expand by about 20%, which it is feared to lower the profitability and capital adequacy ratio (11.1% at the end of 2019) [19]. In this regard, the central bank governor stresses that the latest measures are one-off and given the sufficient capital stock, the situation will be handled without problem[20].

In the meantime, the central bank cut its policy rate by a cumulative 100 bps (from 5.0% to 4.0% on the 7 days reverse repo rate) since February to August (Figure 11) and strengthened interventions in the spot market, domestic non-deliverable forward (DNDF) market, and secondary government bond market. It also reduced the reserve deposit rate from 8.0% to 4.0%. In April, the bank cut its reserve ratio on the rupiah-denominated deposit of commercial banks by 2% points/200bps from 5.5% to 3.5%, while to promote smooth absorption of government bonds

[15] 89% of procurements in FY2020 (1531 trillion rupiah) come from domestic sources and 11% from overseas.

[16] Government Regulation in lieu of law (Perppu) No. 1 of 2020 concerning State Financial and Financial System Stability Policies to Handle the Coronavirus Disease 2019 (COVID-19) Pandemic and/or Confront the Threat to the National Economy and/or Financial System Stability (https://www.kemenkeu.go.id/media/14788/perpu-nomor-1-tahun-2020.pdf)

[17] The Law on State Finances of 2003 stipulates that the budget deficit of the general government should be under 3% of GDP and the debts outstanding of the central government should not exceed 60% of GDP.

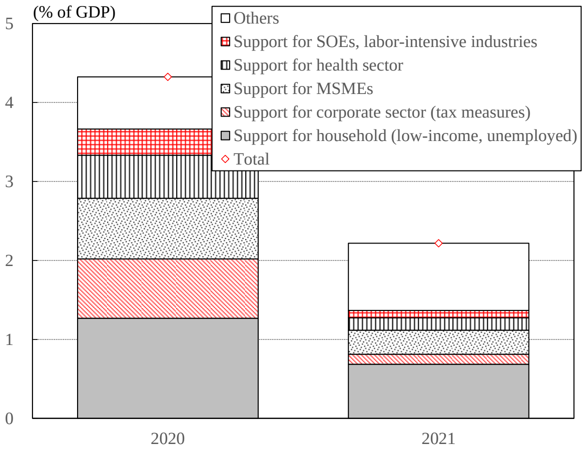
[18] The yield of the government bonds that the central bank directly undertakes is set at zero while publicly placed bonds are issued at the rate 1% lower than the policy rate (i.e., reverse repo rate), and the central bank bears the difference of these rates (https://setkab.go.id/en/govt-bank-indonesia-agree-on-burden-sharing-scheme/).

[19] It is pointed out that the capital adequacy ratio of the central bank could decline to around 8%. (https://www.uobgroup.com/web-resources/uobgroup/pdf/research/MN_200715C.pdf)

[20] As a possibility was shown that the direct underwriting by the central bank of the government bonds could be maintained in 2021 and there was a move to seek for an amendment of the central bank law, there once emerged a fear surrounding the independence of the central bank, but the government officials including the President have emphasized the intention to maintain/guarantee the independence of the central bank.

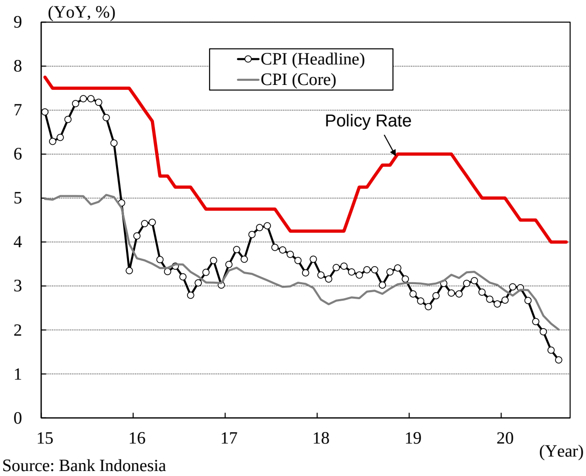
it introduced such unconventional measures as a hike of its macroprudential liquidity buffer (MLB) rate by 2% points /200bps from 4.0% to 6.0% starting from May and introduction of obligation to meet the MLB by government bond purchase in the primary government bond market[21]. To stimulate consumption, it is planned that the down payment ratio on loans for environment friendly cars (eco-cars) be lowered (from former 5-10% to 0%) starting from October.

Figure 10: Summary of PEN program



Souece: Ministry of Finance of Republic of Indonesia

Figure 11: Inflation and Policy Rate



Source: Bank Indonesia

(3) Short-term outlook: Economy will dip into negative growth for the first time since the Asian currency crisis

Looking forward, the Indonesian economy, especially domestic demand, is expected to pick up supported by the restart of domestic economic activities coupled with the effect of the PEN program[22]. However, amid the continued spread of infection, recovery of private consumption is forecast to be slow until vaccination can be implemented. While investment is expected to be driven upward by infrastructure construction of high priority, capital/equipment investment is projected to grow at a sluggish pace against the backdrop of deteriorating profit performance and future uncertainties. It is hardly expected for the economy to recover the pre COVID-19 level of activities before the end of the year, and it is highly likely that the economy will dip into negative growth for the first time since the Asian currency crisis (a negative growth of 13.2% was recorded in 1998). In August, the government revised downward expectation of the real GDP growth rate for 2020 to negative 1.1% to positive 0.2% range from negative 0.4% to positive 2.3% range forecast as of May (Table 2). These forecasts assume a rapid and steady implementation of the

[21] It is said that the central bank provided liquidity equivalent of 651.54 trillion rupiah in the period from the start of the year to August 14 through these measures (https://www.bi.go.id/en/ruang-media/siaran-pers/Pages/sp_226420.aspx).

[22] Implementation ratio of the PEN program stood at 21.8% as of the first week of August (http://www.anggaran.kemenkeu.go.id/in/post/perkembangan-realisasi-program-pemulihan-ekonomi-nasional-%28pen%29). The government intends to accelerate its implementation in the time to come.

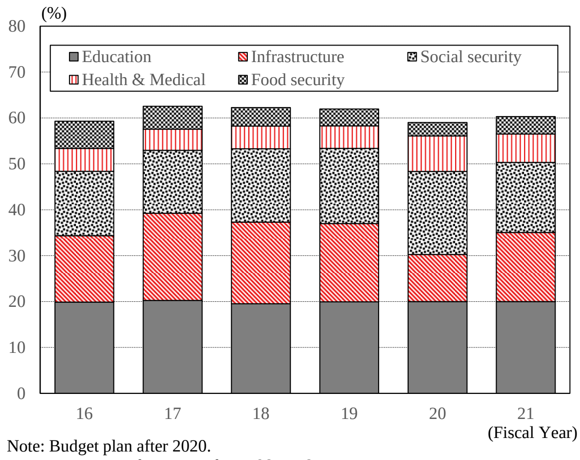
planned economic measures, and therefore it should be noted that there is a downward risk depending on the deterioration of the infection and a delay in implementation of the planned economic measures.

Table 2: Economic Outlook by Indonesian Government and major International Organizations

	2019 (Actual)	2020(Est.)		2021 (Est.)
		(Initial)	(adjusted)	
Real GDP (YoY,%)	5.0	5.3	-1.1-0.2 (-0.4-2.3)	4.5-5.5
Fiscal Balance (% of GDP)	1.8	1.76	6.34 (6.27)	5.5 (3.21-4.17)
IMF (as of Oct 2020)	5.0	5.1	-1.5 (-0.3)	6.1
World Bank (as of Oct 2020)		5.1	-1.6 (0.0)	4.4
ADB (as of Sep 2020)		5.2	-1.0 (2.5)	5.3

Note: Adjusted figures for 2020 in lower parentheses by Indonesian government indicate as of May 2020 (ADB as of April, IMF and World Bank as of June).
Source: Indonesian government, IMF, World Bank and ADB

Figure 12: State Expenditure by major Sectors



Note: Budget plan after 2020.
Source: Ministry of Finance of Republic Indonesia

In a longer view, however, the growth potential of Indonesia is considered well maintained. President Jokowi set forth in his annual state of the nation address the following four goals as the policy pillars for 2021, namely (i) acceleration of economic recovery, (ii) promotion of structural reform to improve productivity, innovation and competitiveness, (iii) adaptation to the digital age, and (iv) exploitation of the demographic change. He secured a certain level of budget allocation to the education sector to which he attaches a high importance as his main policy agenda in the second term administration and budget for infrastructures which has been largely reduced in 2020 to deal with COVID-19 pandemic is expected to see a great increase in 2021 (Figure 21). The Ministerial Meeting on National Strategic Projects held in May reviewed the projects to prioritize in the coming 5 years, and announced a plan to invest a total amount of 1,422 trillion rupiah (8% of GDP) mainly in roads and bridges, industrial zones, and dams projects and irrigation facilities. The government promotes the utilization of funds from international financial institutions such as ADB and private funds as a source of funds for infrastructure investment. The reforms contemplated by the Omnibus Law for Job Creation and the like, if implemented, should contribute to boost the growth rate through strengthened productivity and improved competitiveness.

3. Impact of COVID-19 pandemic on external position, financial sector and fiscal balance

At the time of the Asian currency crisis of 1997-98, a substantial decline in the value of the currency led to an increase in the external debt repayment burdens of domestic companies with high dependency on foreign borrowings, leading to worsening cash flows and financial system instability for firms and domestic banks. Subsequently, sluggish growth rates and deteriorating fiscal balance continued for several years against a backdrop of prolonged balance sheet adjustment in the corporate and banking sectors. Building on these experiences, I would like to examine in the following section the impact of COVID-19 crisis on the external position and fiscal and monetary fronts in Indonesia.

(1) External position: Despite a generally favorable position, destabilization risk of financial market remains

Compared to the time of the Asian currency crisis, Indonesia has much improved fundamentals including a lower dependency on external debts and higher accumulation of foreign exchange reserves (Figure 13). In addition, institutional improvements, such as the shift to floating exchange rate system and a strengthened safety network through currency swaps agreement based on the Chiang Mai Initiative, suggest that Indonesia's resistance to external shocks has been much increased.

Credit ratings on the Indonesian government bonds by major rating agencies were significantly downgraded to a "speculative level" at the time of the Asian currency crisis of 1997-98. Later, in the 2000s, credit ratings began to be gradually revised upward due to improved fundamentals coupled with better evaluation on government's efforts for fiscal consolidation and its stable policy management. This resulted in the reassignment of "investment grade" by Fitch and Moody's in 2012 and by S&P in May 2017.

However, citing the deteriorating external position and fiscal outlook due to impacts of the current COVID-19 pandemic, S&P downgraded in April its outlook of Indonesia's credit rating to "negative". It says it would revise the outlook back to "stable" if the budget deficits would be cut to below 3% of GDP within a few years and external position would improve. So, the economic recovery and fiscal consolidation after the containment of COVID-19 pandemic will hold the key to the revision of Indonesia's credit rating.

Meanwhile, Moody's rating agency has kept its rating outlook for Indonesia as "stable", in consideration of efforts of the Indonesian government aiming at maintaining a fiscal discipline and Indonesia's stable external position. However, Moody's expressed in July its concern over the direct purchase of government bonds by the central bank[23], so it will be important for

[23] https://www.thejakartapost.com/news/2020/07/08/indonesias-burden-sharing-scheme-may-affect-bis-credibility-moodys.html

Indonesia to show exit strategy for fiscal consolidation and budget financing once the COVID-19 pandemic comes to converge.

On the other hand, R&I rating agency upgraded in March 2020 its credit rating of Indonesia by one notch from BBB to BBB+.[24] It evaluated favorably especially the medium-and long-term stability of the macro economy, the government's policy management focusing on fiscal discipline and resiliency to external shocks, and considers that the temporary worsening of the economy and budget will not affect its rating for Indonesia.

It should be noted, however, that, while regaining "investment grade" on its credit rating will give a boost to the investment inflow Indonesia, the country has been more susceptible to the changes of external environment, especially in financial markets due to increased dependency on foreign investment funds. The capital market of Indonesia has a high dependency on foreign investors as domestic institutional investors are still underdeveloped. Although the non-residents' holding ratio of government bonds declined from a peak level of 40%, they still account for 30% and the situation remains one win which the investment trend of nonresidents determine the stability of markets (Figure 14).

There were concerns of destabilization of Indonesian financial markets in February to March 2020 when the behavior to avoid risk assets intensified triggered by the global spread of the COVID-19 pandemic and a fall of oil price. The capital outflow from Indonesia amounted to 150 trillion rupiah (appr. $10.5 billion) in the two months, and at the end of March the rupiah plunged to a record low of 16,000+ rupiah per dollar (Figure 15). Since then, the financial market recovered its stability helped by the aggressive monetary easing by the monetary authorities in the US and Europe, as well as positive policy response by the central bank of Indonesia (Bank Indonesia) and a maintained international confidence in Indonesia. The exchange rate of the rupiah recovered the pre-plunge level and Indonesia successfully issued in early April global bonds ($4.3 billion) the first in Asia since the outbreak of COVID-19 and in July yen-denominated foreign bonds (Samurai bonds) (in the amount of ¥100 billion)[25].

Balance of payments shows that the current account deficits cannot be covered by direct investment alone, which is a more stable flow of fund, resulting in an increased reliance on the inflow of portfolio investment of more short-term character (Figure 16). Immediately after the currency crisis of 1997-98, the overall balance registered a big deficit as not only portfolio investment but also "other investment" category (mainly comprising of foreign borrowing) turned to a net outflow. In the following several years, portfolio investment and other investment continued to show net outflows although the current account and the overall account registered a surplus mainly due to a decrease in imports associated with a stagnant domestic demand. In the

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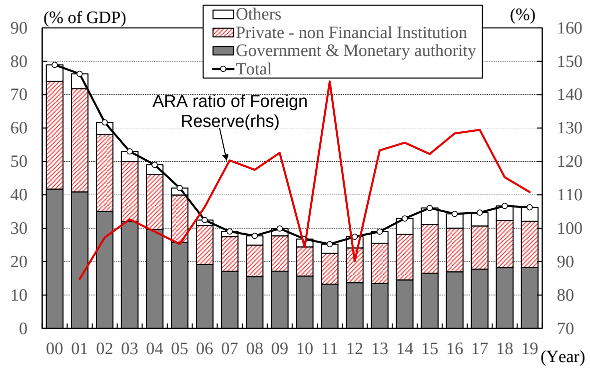
[24] https://www.r-i.co.jp/news_release_cfp/2020/03/news_release_cfp_20200317_2002260101_jpn.pdf

[25] https://www.djppr.kemenkeu.go.id/page/load/2838

January-March quarter 2020, although both portfolio investment and other investment registered a net outflow, causing a small deficit in the overall account, the overall account turned into surplus in the April-June quarter, showing a big difference from the situation seen at the time of the Asian currency crisis.

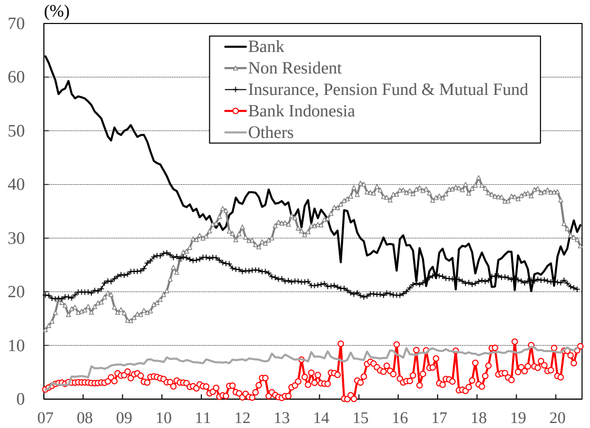
Figure 13: External Debt in Indonesia



Note: 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

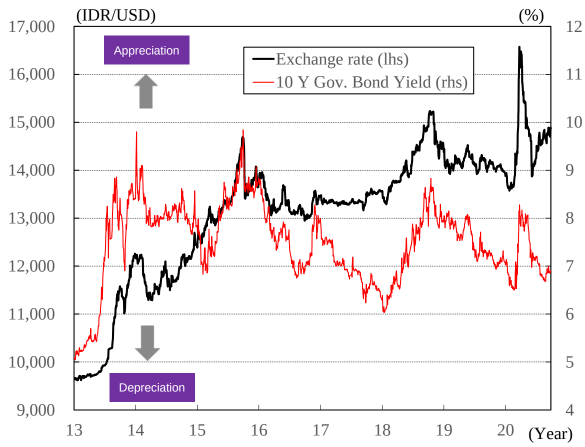
Source: IMF, IIMA

Figure 14: Ownership of Indonesian Government Securities



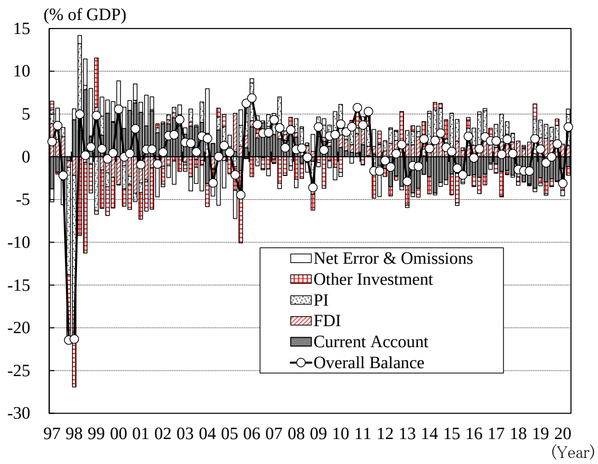
Note: Latest figures are as of August 18, 2020. (Year)
Source: Ministry of Finance of Republic Indonesia

Figure 15: Exchange Rate and 10Y-Gov.Bond Yield



Source: Bank Indonesia, Ministry of Finance of Republic Indonesia

Figure 16: Balance of Payment in Indonesia

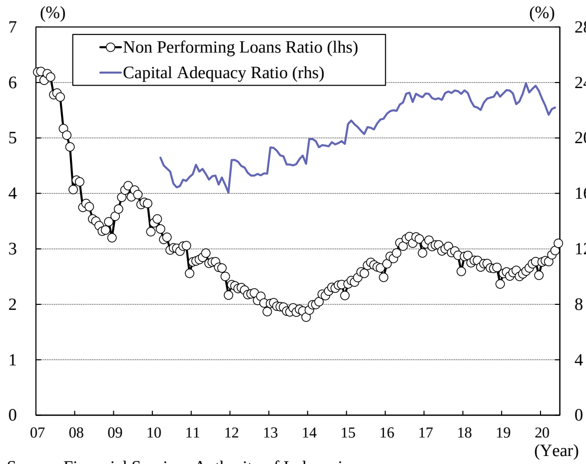


Source: Statistics Indonesia, IMF

(2) Financial Sector：Likely to maintain stability as a whole

The non-performing loans (NPLs) ratio of commercial banks as of June 2020 rose to 3.1%, the highest level in the last three years (Figure 17). On the other hand, capital adequacy ratio, liquidity coverage ratio (LCR) and net stable funding ratio (NSFR) stood at high levels of 22.2% (as of May 2020), 209.2% and 128.7% respectively, showing a high level of soundness in the banking sector. In the near term, there is a concern about rise in the ratio of NPLs due to a sluggish growth of bank lending and deterioration of loan assets reflecting a slow-down of the economy. However, the stability of the financial system will be maintained helped by the supporting measures for micro/small and medium-sized enterprises (MSMEs) facing difficulty in debt repayment that the government introduced in March as part of packages to handle COVID-19 pandemic, as well as the ample liquidity provision by the central bank.

Figure 17: NPLs ratio and CAR of commercial banks in Indonesia



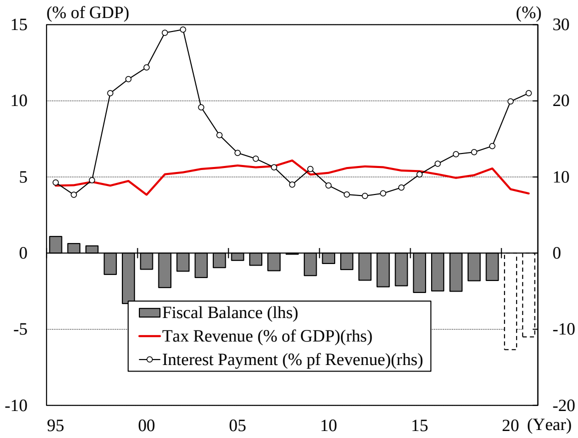
Source: Financial Services Authority of Indonesia

(3) Fiscal balance: Unavoidable deterioration in the near term and urgent need of accelerated fiscal reforms in the post COVID-19 time

A large scale of fiscal and monetary support measures are considered essential for tackling the unprecedented crisis of the COVID-19 shock in that they will mitigate the degree of deterioration in the balance sheet of financial institutions associated with the worsening economic situation and increase of corporate bankruptcies and thus accelerate the economic recovery that follows. Due to these government responses, the fiscal deficit for FY2020 is forecast to expand to 6.34% of GDP from 1.76% expected in the initial budget bill (Figure 18). The government debt outstanding, though it is expected to rise to 38% in 2020 from 30.5% in 2019, still falls far below the upper limit (60% of GDP) stipulated in the Law on State Finance of 2003. The deterioration of government debts is relatively limited also in the international comparison (Figure 19). The government plans to limit the government debt outstanding under 41% through 2024 and gives high priority to issue fixed coupon bonds or rupiah denominated bonds to avoid risks of interest rate rise and exchange rate risk and a swell of debt service burden while extending the average term to maturity for a longer period. These may suggest the financing risk of the budget deficits is generally small.

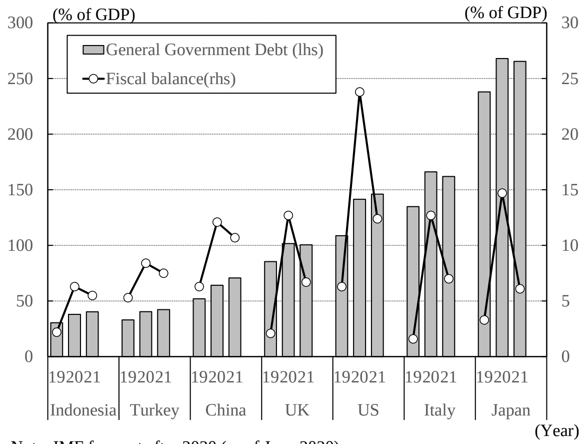
However, the government needs to shift its focus to fiscal consolidation as soon as the COVID-19 pandemic converges. Although the central bank has cooperated in reducing the debt service burden, the ratio of interest payments to revenues is expected to rise from 14% in 2019 to over 20% or the level reached in the early 2000s (Figure 18). A rise in the ratio of interest payments to revenues could become a factor to put strain on the expenditures in such areas as infrastructure and education which are essential for achieving a sustainable growth. The World Bank[26] recommends the following measures as the tax system reforms to be implemented after the containment of COVID-19 pandemic : (i) expansion of taxation base by an increase of personal income tax (from the current 30% to 35% that prevails in the neighboring Asian countries), (ii) securement of fiscal resource for infrastructure through introduction of green tax on fuels and plastics, (iii) securement of fiscal resource for healthcare through health taxes (simplification of tobacco exercise taxes and introduction of tax on sugar sweetened beverages), (iv) reform of corporate tax (reduction of taxable income of MSMEs (micro/small-and medium-sized enterprises), and (v) imposition of digital tax. In fact, the government introduced digital services tax in August 2020 to cover the decline of tax revenues due to COVID-19 pandemic[27]. Finance Minister Sri Mulyani, who chairs the Financial System Stability Committee (KSSK) and has won a strong trust internationally, announced a goal to reduce the fiscal deficit under 3 % of GDP in 2023 by making efforts to restore fiscal health after the convergence of COVID-19 crisis.

Figure 18: Fiscal Balance in Indonesia



Note: Budget plan after 2020.
Source: Ministry of Finance of Republic Indonesia

Figure 19: Government Debt and Fiscal Balance in major Economies



Note: IMF forecast after 2020 (as of June 2020).
Source: Ministry of Finance of Republic Indonesia, IMF

4. Conclusion

Indonesia has faced a hard policy steering between containment of COVID-19 infection and reopening of economic activities. To mitigate the impact of COVID-19 shock on the economy, the government implemented National Economic Recovery (PEN) program (4.3% of GDP), in which it took unconventional measures like abolition of the cap on the budget deficit stipulated

[26] World Bank(2020)

[27] When a foreign company with no permanent establishment in Indonesia sells digital products and services in Indonesia through online and meets a certain criterion (annual sales of more than 600 million rupiah or annual users of more than 12,000), it becomes subject to VAT taxation. 10% VAT is imposed on the users of the products and services. It is estimated that the taxation increases the revenues by 10 trillion rupiah annually (0.5% of revenues in 2019).

by the Law on State Finances of 2003 and purchase of governments bonds by the central bank in primary market. The economy is expected to pick up in the time to come helped by the resumption of economic activities and fiscal and monetary supporting measures, but it is likely that it will register in 2020 the first negative growth since the Asian currency crisis as the pace of recovery has to be slow amid the continued spread of infection.

As a response to an unprecedented crisis of the COVID-19 pandemic, massive supporting measures from both fiscal and monetary sides are essential in terms of alleviating the degree of worsening in the balance sheet of financial institutions affected by the economic downturn and increase of corporate bankruptcies. However, the government needs to promptly shift the focus back to fiscal consolidation after the convergence of the COVID-19 pandemic. A rise of ratio of interest payments to revenues could put strain on the expenditures directed to the areas like infrastructure and education that are essential for achieving a sustainable economic growth, and therefore the government is required to make fiscal reforms targeted to increase tax revenues through increased taxation base and higher tax.

It is true that the government has to take care of social stability as the near-term priorities, focusing on the vulnerable class such as low-income households and poor groups as well as ailing state-owned enterprises, and it is facing a difficult environment in promoting infrastructure constructions and making bold economic reforms and deregulations such as offered in the Omnibus Law for Job Creation of which President Joko Widodo aims at enactment as a key policy in his second term of administration. It is hoped, however, that efforts be made to promote a steady progress in these challenges aiming at boosting the medium-and long-term growth rate through increase of productivity and improved competitiveness.

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