

12 February 2020
Article

Indonesia country brief

Can investments lift growth past 5%?

With growth hovering around 5% since 2012 and household spending showing signs of moderating, can President Jokowi’s investment push get the Indonesian economy to achieve lift off? Jokowi has pledged reforms to attract foreign investors while also unveiling a US\$178bn budget for 2020, focusing on infrastructure and human capital development, but until the investment drive comes online Indonesia may remain mired in its current 5% growth trajectory.



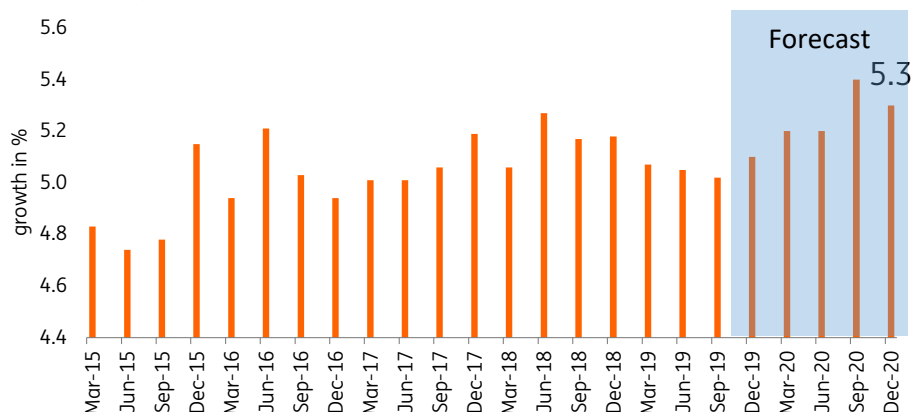
Indonesia's president Joko 'Jokowi' Widodo

Source: shutterstock

Growth and outlook: Investment push will be key in 2020

The protracted trade war between the US and China weighed on the overall global exchange of goods with Indonesia feeling the heat as exports contracted for almost all of 2019. Indonesia managed to post sporadic months of trade surpluses albeit on the back of import compression as the government postponed capital-intensive construction projects. Full year 2019 growth likely settled at 5.1%, missing the downwardly revised government growth target (5.3%) with Jokowi calling for a fresh round of investments in 2020 to bolster the country’s growth trajectory.

Indonesia GDP growth and forecast



Source: Bloomberg and ING estimates

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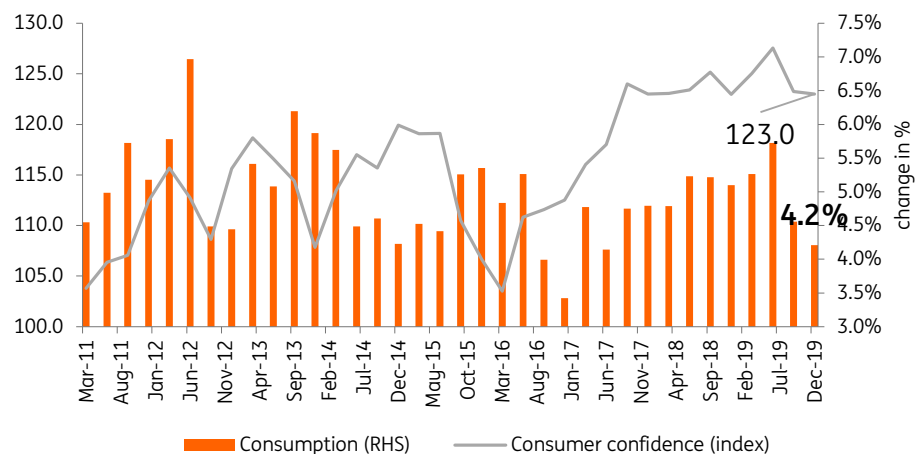
With challenges mounting at the onset of the COVID-19 virus, Indonesia's growth momentum in 2020 hinges largely on a rebound on investment activity as exports and related manufacturing activity remain vulnerable given the projected economic slowdown induced by the coronavirus outbreak. China remains Indonesia's main export destination and import source, making the 2020 landscape all the more challenged.

The anticipated fiscal boost in the form of Jokowi's IDR2,528.8tr budget, up 3% from the 2019 version, could provide a decent buffer while waiting for the investment boom to kick in but we do not expect a substantial improvement from the current 5% growth norm. We expect growth momentum to be driven by consumption and government outlays but forecast GDP to slip below target to 5.1% as investment is only expected to pick up in the latter half of 2020.

Consumer sentiment points to lacklustre household consumption

GDP growth appears to be stuck in the 5.0% gear with slowing momentum evident across all sectors. Somewhat concerning was the pullback in household consumption to 4.2%, which was the slowest pace of growth since 2017, and the fate of this sector could be telling for overall GDP momentum given its 62% share to total GDP.

Fig 1 Indonesia consumption growth and consumer confidence



Source: CEIC

The outlook for consumption, however, may not be particularly optimistic with consumer confidence showing mixed trends in the second half of 2019. Average consumer confidence in 4Q was at 123.0 with surveys pointing to consumer concern about the increase in healthcare costs after healthcare premiums doubled in 2020.

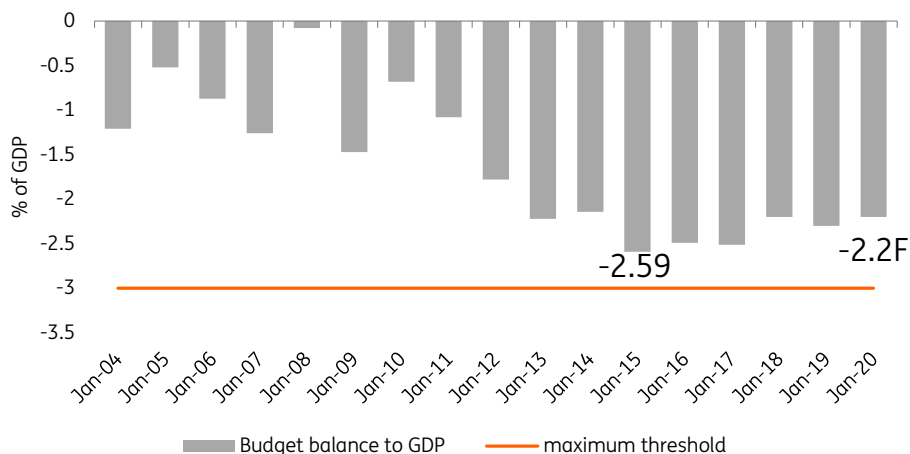
As consumer confidence continues to show mixed trends and consumption growth decelerating, Indonesia may have to brace for another quarter of lacklustre consumption spending with Indonesia needing to get a lift from other sectors of the economy.

Fiscal space limited as budget deficit to GDP ratio widens

Indonesia had attempted to get its fiscal house in order in 2019, targeting a deficit to GDP ratio of 1.84%. The 2019 budget deficit to GDP ratio widened to 2.2%, missing the government's forecast substantially on disappointing revenue collection amid weaker economic growth. Revenue collection lagged its official target of 11.4% growth as tax collection from corporations dipped below expectations with the government tagging poor earnings of exporting companies. Poor collections from exporters amid poor sales was tagged by authorities for the revenue collection shortfall and we can expect revenue collections to remain challenged again in 2020 given COVID-19's likely impact on China and global trade.

Indonesia is targeting a deficit to GDP ratio of 1.76% in 2020, which is likely to be challenging should revenue collection continue to miss targets. If revenue collection lags projections again in 2020, Indonesia will have limited scope to implement fiscal stimulus with the deficit ratio approaching the 3% threshold stipulated by the state finances law of 2003.

Fig 2 Indonesia budget balance as a % of GDP

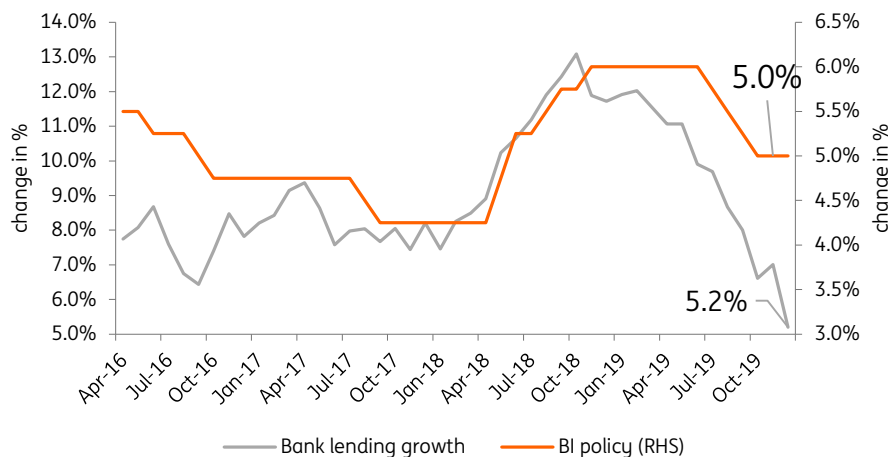


Source: Bloomberg and ING estimate

Investment momentum key to growth but likely to kick in by late 2020

In order to lift growth to achieve Jokowi’s growth target of 5.3%, Indonesia will need to get a substantial boost from capital formation as consumption appears to have hit a ceiling and with fiscal spending likely constrained. Thus, additional easing from the central bank will be key in helping further the investment push to help bolster overall growth momentum. Commercial bank lending remains lacklustre with December 2019 showing a 5.2% gain down from the previous month (7.0%) with central bank easing carried out last year still not feeding into loan demand. We can expect a faster recovery in lending activity and overall investment activity especially if Bank Indonesia (BI) cuts policy rates further.

Fig 3 Indonesia bank lending growth and BI policy rate



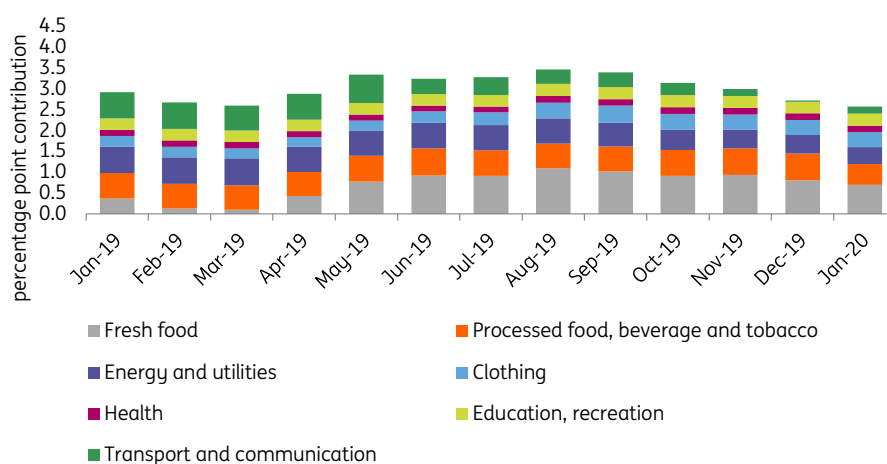
Source: Bloomberg

Meanwhile, Jokowi has pressured his administration to hammer out the omnibus law reform package that is designed to help attract foreign investment to Indonesia by revamping the labour and corporate tax code. The projected influx of foreign capital can help augment overall investment momentum and provide the proper catalyst to boost GDP growth momentum.

Inflation: expected to tiptoe higher but no concern ...for now

Indonesia recently updated the base year for the CPI basket to 2018 and inflation is driven in large part by the movement in food beverage and tobacco (25% of CPI basket), with inflation for this component affected in large part by weather and non-fixed holidays. The other major contributors to past inflation breaches were utility/energy prices (20.5% of CPI basket) and transport (12.4% of CPI basket), both of which currently have inflation below 2% with expectations for subdued global crude oil prices given likely depressed demand from China is likely to keep price movements in check. Taken together, these three subsectors account for 58% of the CPI basket and price developments for fresh food, transport and energy are likely to determine the inflation path in 2020.

Fig 4 Indonesia inflation (percentage point contribution to total)



Source: CEIC

The El Niño weather phenomenon in 2019 has faded which should improve crop yield and ensure ample supply of fresh food in 2020. Recent flash floods may, however, cause a temporary spike in prices to open the year as several low lying areas, including Jakarta, remained underwater for an extended period of time. Meanwhile, both transport and utility prices are expected to rebound in 2020 on base effects but gains are likely to be capped given projections for depressed oil demand related to COVID-19.

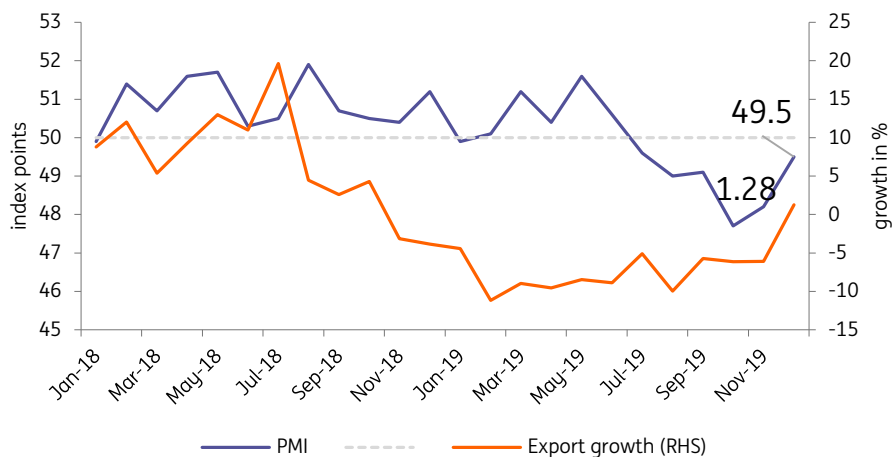
In the coming quarters, we expect inflation to remain within the 2.5-4.5% inflation target and average 3.5% for 2020 given our expectations for stable food prices coupled with well-behaved transport and utility prices given subdued global crude.

However, should oil prices eventually trend higher (resumption of US-Iran tension or substantial OPEC+ supply cut), we expect the Indonesian government to push for a higher domestic fuel blend component (currently at 30%) to limit the demand for imported oil. Meanwhile, recent significant flooding is likely to cause upward pressure on commodity prices in 1Q although we do not expect inflation to breach the inflation target in 2020.

Trade deficit to widen on import demand

Despite efforts by the government to curb the current account deficit, the gap remains sizeable at 2.7% of GDP for 2019. Indonesia rolled out several reforms to help boost exports (incentives and tax perks for exporters) and postponing infrastructure projects to achieve import compression but the external position, measured by the current account deficit, remained relatively vulnerable.

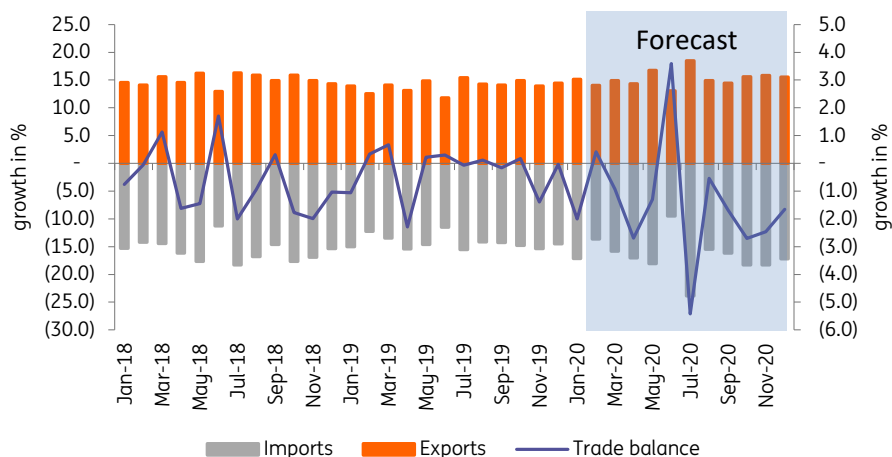
Fig 5 Indonesia PMI manufacturing and export growth



Source: Bloomberg

Going into 2020, we expect a widening of the trade gap on a resurgence of merchandise imports tied to Jokowi’s investment directive. The largest component of the Indonesian import bill, transport equipment and machinery (32.2%), grew a mere 3.4% in 2019, weighed down by a contraction in imports for road vehicles, specialised machinery and electrical apparatus. Meanwhile, prospects for a strong export recovery appear unlikely with recent PMI manufacturing numbers still in contraction (49.5) as factory activity related to export orders pullback, translating to a sizeable trade gap. With the onset of COVID-19 and its impending impact on China’s economy, we expect Indonesian exports to suffer at a time when import demand will accelerate with the Jokowi investment boom set to kick in. This double development is likely to push the trade deficit to swell, dragging the current account deeper into deficit.

Fig 6 Indonesia trade balance and forecast

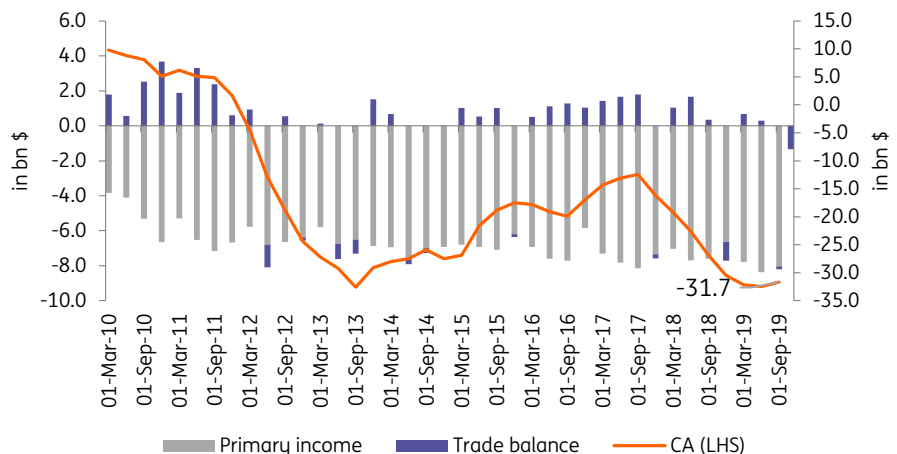


Source: Bloomberg and ING estimate

The other reason for current account woes to continue

Meanwhile, sustained weakness in primary income will be an additional reason for Indonesia’s current account woes in 2020. Primary income, which represents interest payments on foreign denominated borrowings, is expected to remain in deficit given the size of foreign bond holders and this, together with a wider trade gap, is likely to keep the current account deep in the negative for 2020.

Fig 7 Indonesia current account per component



Source: Bloomberg

In the coming quarters, we expect the current account to remain in deficit, especially with the trade deficit expected to swell while primary income continues to post an outflow on interest payments. Indonesia is targeting a current account deficit to GDP of 2.5-3.0% and we predict that the deficit to GDP ratio will test the upper end of this target. Depreciation pressure on IDR due to import demand could be one reason for BI to refrain from further rate cuts. Given that the current account is expected to remain in deficit, we expect Indonesia to rely heavily on the financial account to finance its expansion with Jokowi readying important legislative reforms to entice foreign investors to Indonesia.

With the current account in deficit, IDR fate tied to financial account

The Indonesian rupiah (IDR) appreciated sharply for the most part in 2019 bolstered by financial flows enticed by favourable interest rate differentials despite several rate cuts by the central bank. The narrative in 2020 may be slightly different especially with the current account widening on import demand and interest payments. Given projections for the current account to remain in deficit, the fate of the IDR is tied directly to financial account flows.

Should foreign capital inflows continue in 2020, IDR may enjoy appreciation pressure in the short term while also providing a boost to capital formation and overall growth momentum. However, should financial flows dry up at a time Indonesia's current account deficit widens, we can expect IDR to face a depreciation bias and reverse last year's gains.

Thus, Jokowi's promised reform agenda will be extremely key in attracting foreign capital to offset the projected current account deficit. Early on, we have noted Jokowi's investment directive making early returns with the President's recent official trip to Dubai netting an investment pledge of US\$23bn from the United Arab Emirates for infrastructure and energy development.

Monetary policy and interest rates: Scope for BI rate cuts remain

At his first policy meeting in 2020, Governor Warjiyo reiterated that BI retained its accommodative stance, indicating he would carry out additional easing in 2020 to help bolster economic growth with the central bank gauging the precise timing for the rate cut. Key considerations for additional rate cuts will be the stability of IDR and the inflation path and we currently pencil in a 50bp-worth of easing from BI in 2020. With inflation expected to remain subdued in the coming quarters, BI's decision to provide additional accommodation hinges largely on IDR stability.

Episodes of risk off, driven by event risk (resumption of Middle East tension, the US-China trade spat or the ill effects related to COVID-19), may force financial account outflows and thus Jokowi's reform agenda will be key in ensuring that the financial account remains in surplus to offset the current account deficit. With inflation forecast to be subdued, we expect BI Governor Warjiyo to pull the trigger on additional rate cuts during episodes of IDR strength to help bolster growth momentum via investment.

Summary

Growth has been trapped at the lower end of the 5% region with Indonesia needing other sectors of the economy to provide the added push to achieve Jokowi's 5.3% growth aspiration. Entering his second act as President, Jokowi has emphasised investment-driven growth, revamping his cabinet by reaching across the political divide to hire election rival Prabowo. Jokowi has vowed sweeping reforms in corporate tax and labour laws in a bid to attract foreign investment flows to the country, embodied in his so-called "omnibus bill", which he targets to pass by the first quarter. The investment push is likely to determine whether Indonesia can finally break away from the current norm of 5% growth with consumption likely to be challenged and fiscal space appearing tight. The COVID-19 episode adds yet another challenge for the Indonesian economy given its close trade ties to China with the pressure on Jokowi's investment reform agenda heightened further.

For the next few quarters, we expect growth to settle close to the current heading of 5% with consumption and limited fiscal spending to offset weak export demand until Jokowi's investment boom kicks in by 2H 2020. Should the promised reforms on both corporate tax and labour markets be delayed, fiscal spending and household spending may not be enough to lift growth out of the 5% trend. Meanwhile, Bank Indonesia will be looking to ease monetary policy further to aid in Jokowi's investment push with the economy in need of stimulus from all fronts.

We expect the rebound in investment momentum to be delayed until the latter half of 2020, which may bode well for growth in 2021 but it may also mean that Indonesia will miss its growth target with only consumption and limited government spending doing the heavy lifting amid a global COVID-19 economic slowdown. However, if investment activity accelerates more quickly than anticipated, Indonesia may have a chance at hitting Jokowi's 5.3% target within the year.

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