SHORT FEATURE

Economic Outlook 2014: Prospects and Challenges

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Looking ahead, the outlook in 2014 is expected to see sizeable downside risks, coming from both domestic and external sides. It is estimated that the economic growth in 2014 would remain under 6.0 percent as the country's economy is much more impacted by tighter economic condition, lower commodity prices, as well as uncertainty in financial market and regulatory regime in the run-up to the 2014 election, offsetting the positive effects of global economic recovery and rising spending related national election. Inflation rate, meanwhile, is projected to ease and return to the Bank Indonesia's target band of 4.5±1 percent in 2014, as the effect of the effect of the fuel price increases may have subsided and the aggregate demand growth slows. However, the recent depreciation in rupiah, the minimum wage hikes for next year, and the second and third-round effects from the increase in fuel prices and electricity billing rates may give further inflationary pressures to the outlook. As for external side, a modest narrowing in current account deficits is expected to be help by slowing imports, as investment growth continues moderate in 2014.

Domestic Factors

Sizeable downside risks are expected to remain daunting for the outlook in 2014. On the domestic front, higher expected inflation,

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higher interest rates, and a more lingering reduction in investment could be catalyst for further weakening in domestic demand. Meanwhile, external risks to the outlook center on the prolonged weakening in non-oil commodity prices, international oil fuel cost, and the uncertainty over the trajectory of the global recovery and China's economy performance. Although the growth in advanced economies is expected to continue improving that may lift up Indonesia's growth prospects and partly help its external position, the risks remains high amidst the possible continued global financial market volatility and the increase in external financing costs.

Against the backdrops above, it is estimated that the economic growth in 2014 would still be below 6.0 percent. While the renewed improvement in global economic recovery and spending related national election is expected to have positive impact on the country's economic growth, tighter economic condition, lower commodity prices, as well as uncertainty in financial market and regulatory regime in the run-up to the 2014 election is expected to give higher impact on the final output. Table 1 below shows the projection of some Indonesia's major economic indicators published by Government of Indonesia, Bank Indonesia, and major international institutions.

Table 1: Macroeconomic Outlook for 2013 and 2014

	Government		Bank Indonesia		World Bank		IMF		ADB	
	2013	2014	2013	2014	2013	2014	2013	2014	2013	2014
GDP Growth (%)	6.3	6.4	5.5-5.9	5.8-6.2	5.6	5.3	5.4	5.3	5.7	6.0
Inflation (%)	7.2	4.5	9.0-9.8	4.5 ± 1	7.3	6.7	9.5	6	7.2	5.5
Budget balance (% GDP)	-2.38	-1.49	-2.38	-1.49	-2.5	-2.3	-2.5	-2.5	-2.4	-1.5
Current account deficit (% GDP	-	-	-	-	-3.4	-2.6	-3.5	-	-3.4	-2.7
Exchange rate (Rp/US)	9,600	9,750	-	-	-	-	-	-	-	-
Interest rate (3 month)	5	5.55	-	-	-	-	-	-	-	-

Source: Collected from various sources

On the demand side, higher inflation and interest rate, coupled with lower consumer confidence and wealth effects of recent financial market turbulence, is expected to dampen private consumption, although the election-related spending should provide positive contribution for consumption growth in the first half of next year. Similarly, investment is likely to weaken further next year, weight down by the increase in interest rates, depreciation in rupiah, sluggish outlook for domestic and external demand, as well as regulatory changes or uncertainties that particularly intensify ahead of national election. At the same time, public investment will be more subdued as indicated in the 2014 budget. As for export, although the commodity export prices are expected to remain weak, export volume is likely to be lifted up next year as growth in advanced countries recovers and rupiah depreciates. Meanwhile, import growth is likely to remain low, in line with the rupiah depreciation, the moderation outlook for domestic demand, and government policies to curb imports.

On the supply side, the moderation growth outlook in 2014 is likely occurred across most sectors, as credit conditions tighten and international commodities prices remain subdued. Manufacturing sectors is expected to see mix performances. While export-oriented sub-sectors is likely to gain by possible improving in global growth and the depreciation in rupiah, other more domestic-oriented manufacturing is predicted to chart slow growth in line with the faltering domestic demand. In addition, as many Indonesia's manufacturing industry remains heavily dependent import inputs, weaker exchange rate is likely to raise some input cost and thus hampering some manufacturing activities. Meanwhile, construction activity is likely to prolong its deterioration, largely driven by the continuing decline in investment as credit is tightening. As trade, hotel and restaurants, lower purchasing power, caused by higher prices and interest rate, is estimated to contribute to the sector's slowdown, offsetting positive effects from election-related spending.

The outlook for inflation in 2014 is expected to ease as the effect of the effect of the fuel price increases may have subsided and the aggregate demand growth slows. Inflation rate is projected to return to the Bank Indonesia's target band of 4.5±1 percent. However, a number of challenges remain in the next year's inflation outlook. The recent depreciation in rupiah is expected to give further inflationary pressures, as it would not only fuel pressures to core inflation, but also influence the volatile foods inflation through the increases in prices of imported food commodities, such as wheat, soybeans, and corns. Additionalinflationary pressures could also come from the supply-side risks, notably from the minimum wage hikes for 2014 and the second-and third- round effects from the increases in fuel prices and electricity billing rates.

External Factors

On the external side, meanwhile, a modest narrowing in current account deficits is expected to be help by slowing imports, as investment growth continues moderate in 2014. The recent sharp depreciation in rupiah is expected to help the trade balance by increasing Indonesia's export competitiveness. Moreover, better growth prospect of Indonesia's major trading partners, together with a stabilization of commodity export prices, is also projected to provide some additional support to exports. In contrast, the projected slowdown in domestic demands in 2014 and the recent increase in subsidized fuel prices is expected to contribute to reduce import demand, hence narrowing the current account deficit. Meanwhile, downside risks in the outlook for FDI inflows are expected to come from policy and political uncertainty ahead to the 2014 national election, aggravating the effect of the continued weaker global commodity prices.

While domestic risks stem from further weakening in domestic demand is impacted by higher expected inflation, higher interest rates and a more prolonged reduction investment, external risks to the outlook the current account deficit attributed to the prolonged weakening in non-oil commodity prices, international oil fuel cost, and the uncertainty over the trajectory of the global recovery and China's economy performance. Although the growth in advanced economies is expected to continue improving that may raise Indonesia's growth prospects and partly help its external position, the risks remains high amidst the possible continued global financial market volatility and the increase in external financing costs.