REVIEW OF ECONOMIC DEVELOPMENTS

Rounding up 2013: The Vulnerable Indonesia

Deni Friawan

Overview

In general, 2013 has highlighted the vulnerability of Indonesian economy. Economic growth is slower than anticipated, while inflation has elevated, on the back of a sharp increase in fuel prices. Moreover, as prices of export commodities remained drops and the non-resident investors reduced their holdings in emerging markets, including Indonesia, in the expectation that the US would reduce its monetary stimulus, the external accounts deteriorated in the first three quarters, partly contributing to a fall in the rupiah and local stocks. Meanwhile, steps to tighten monetary policy taken to address inflation and the current account deficits are expected to restrain growth in the near term.

Economic Growth

Expenditure Side

Indonesia economy's has slowed throughout the first nine-months of 2013, drove down by a sluggish domestic demands and weak exports. The quarterly GDP growth increased from 1.44 percent in Q1-2013 to 2.61 in Q2-2013 and 2.96 percent in Q3-2013. On a yearly basis, however, the real GDP grew by only 5.62 percent, down from 6.05 percent in

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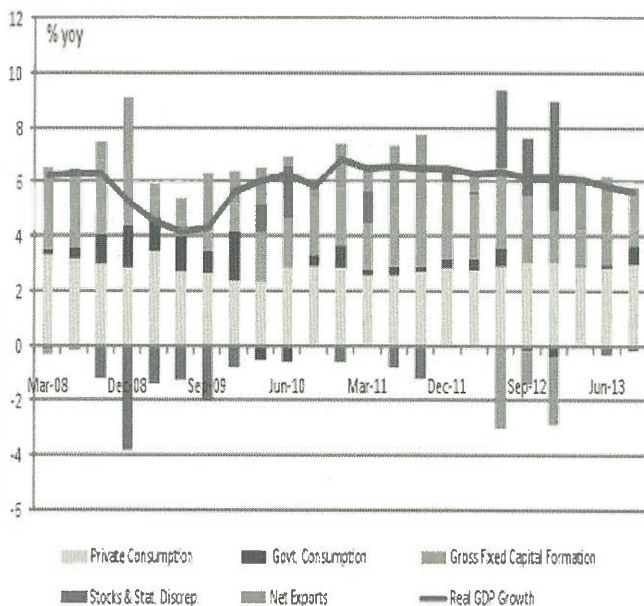
Q1-2013 and 5.83 percent in Q2-2013. As exports remained weak due the global slowdown, and consumer spending and investment may still hurt by soaring inflation and a high interest rate environment, it is estimated that the full-year economic growth in 2013 will be5.7 percent, lessen than 6.2 percent predicted earlier and below 6.0 percent for the first time since 2010.

On demand side, a continued easing in investment growthwere the main contributors for the year-on-year slowdown in 2013. After expanding at, on average, more than 9 percent over the past 3 years, the fixed investment slowed down to 4.82 percent and contributed only slightly above 20.5 percent of total GDP growth in the first three quarter of 2013. The moderation in investment attributed largely with the reduction in non-construction investment, especially machinery, equipment, and transportation. This reduction was in-line with a significant drop in capital good imports, which were partly due to a considerable fall in commodity-related activities. In contrast, the growth of investment in construction has remained robust, though it was predicted to ease in the future.

Figure 1: Expenditure contribution to growth



Source: CEIC Database

Private consumption, contributing nearly half of total GDP growth, grew by an average of 5.9 percent. The robust household consumption was underpinned by an increase in employment, wages, as well as tax reduction for lower-incomer earners since January 2013, offsetting the effect of rising inflation and tighter consumer credit. Due to delays in budget projects and the reduction in nonessential expenditure, meanwhile, government consumption increased by only 3.79 percent and accounted less than 5 percent of total GDP growth in the first nine months of 2013.

Following a negative growth over much of 2012, net export recorded positive growth in the first three quarter of 2013, as export growth exceeded that of import. The real net export, on average, grew by 18.12 percent and added nearly 28 percent to total GDP growth. The slower import growth was primarily due to a decline in imports of raw material and consumer products, as domestic demand eased and rupiah depreciated. Meanwhile,as demand from advance economies recovered, export volumes recovered mildly, underpinned by an increase in mining exports that outpaced slowing exports in agricultural and manufacturing products.

Side

On the supply side, the moderation in economic growth over 2013 was mainly pulled down by industrial sectors, especially mining and quarrying. In the first three quarter of 2013, the growth in manufacturing sector was only 5.57 percent, down from the last two years' average of 5.92 percent. This slowdown reflected weaker export demands. At the same time, mining and quarrying also remained stagnant, growing by an average of 0.32 percent and contributing 0.38 percent to total GDP growth. The slow growth in mining and quarrying sector largely attributed to a decrease in crude oil production as a result of aging oil fields and low investment in oil extraction sector. In contrast, construction sector recorded a robust expansion of 6.54 percent in the first nine months of 2013.

Much of service sectors continued performed well, while agriculture sector growth remained stagnant. Trade, hotel, hotel, and restaurant that contributed to almost 20 percent of total GDP growth increased by an average of 6.35 percent from January to September

2013, though down from more an average of 8.7 percent in the last three years. At the same time, due to strong demand for mobile telephone and internet services transportation and telecommunication services continued to expand at double digit, growing by 10.6 percent and contributing to more than 18 percent to total GDP growth. On average, meanwhile, the agriculture sector grew by only 3.27 percent as a result of bad weather.

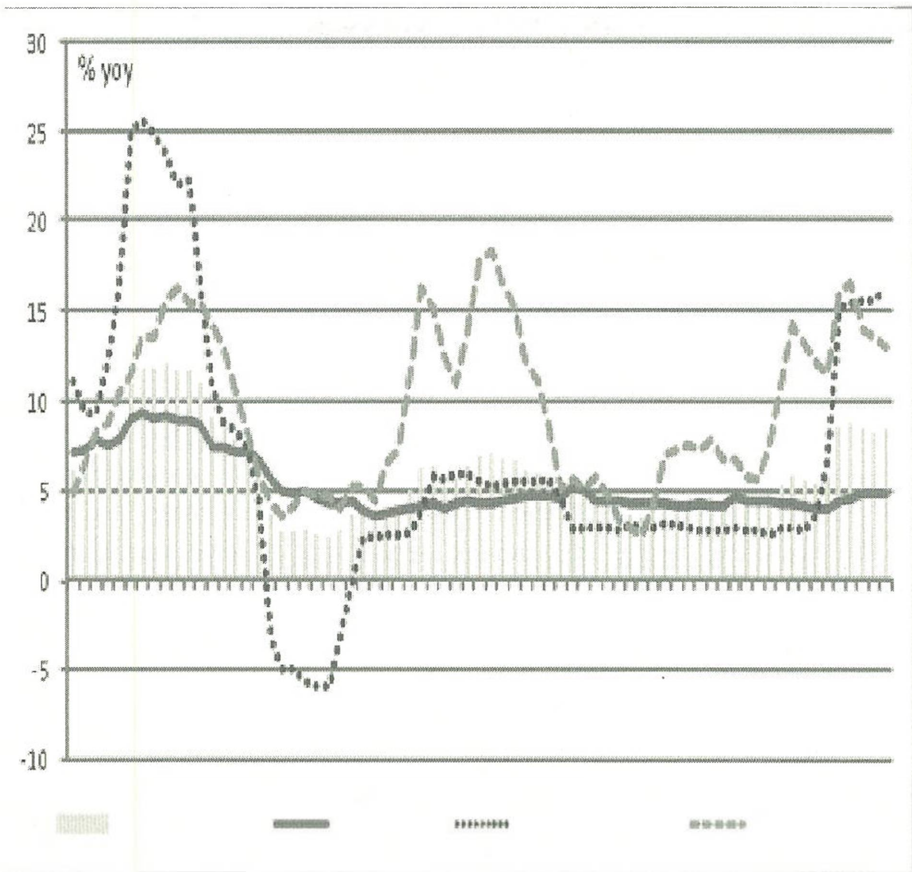
Monetary

Inflation

Inflation dynamics over the first nine months of 2013 was much influenced by the effect of fuel subsidy reform and the seasonal impact of Ramadhan and Idul Fitri fetivities. After remained contain at around 5 percent in the first half of 2013, Indonesia's annual headline inflation accelerated afterward and peaked at 8.8 percent in August, the quickest pace in four years. It was boosted by a sharp rise fuel prices in June, when the government cut fuel subsidies by increasing the prices of gasoline and diesel by 44 percent and 22 percent, respectively. In addition, the increasing demand during the Ramadhan period, combining with the residual effects of trade restrictions issued in October 2012, has also lifted up the food price inflation, which in turn pushing up the year-on-year headline inflation. The volatile food price inflation rose from an average of 11.5 percent in the first semester to 16.5 percent in August, with chili, onion and garlic being particularly impacted.

Subsequently, Bank Indonesia's recent rate increases and the ongoing tightening of credit conditions has helped to dampen the second-round effect inflation of fuel price hikes and inflationary expectations. As food and clothing prices edged down, the yearly inflation eased to 8.32 percent in October, before went up somewhat to 8.37 percent in November. This slight rise in November's inflation was partly due to the electricity rate hike and the pass-through cost from rupiah depreciation. The government has lifted up electricity prices by a total of 15 percent in 2013 through quarterly hikes since January. By the end of 2013, meanwhile, it is estimated that the full-year headline inflation would stand at below 9 percent, which would still be in-line with the central bank's target of 9-9.8 percent.

Figure 2: Inflation



Source: CEIC Database

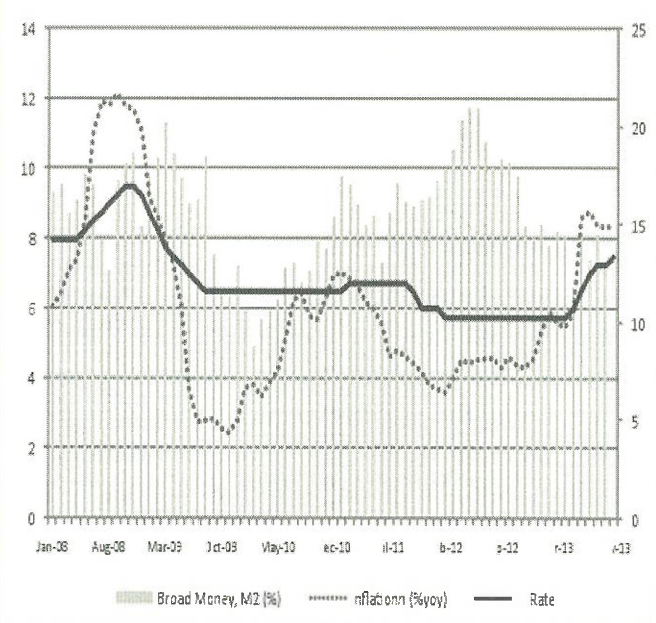
Monetary Policy and Banking

Indonesia's central bank has embarked on a series of stringent monetary tightening measures in the efforts to tame the rising inflation and narrow the current account deficit, preventing further decline in rupiah. Since June, the central bank's monetary policy stances continued to be directed to the limitation of inflationary pressures and the adjustment process of the external balance, pushing down demand for imported goods and preventing a heavy outflow of funds on the concerns over the prospect of the unwinding of quantitative easing in the US. After keeping BI rate at 5.75 percent from February 2012 to May 2013, Bank Indonesia lifted up its key interest rate five

times by 175 basis points to reached 7.5 percent in November 2013. Ahead, it is expected that the benchmark rate would stay at 7.5 percent until the year-end 2013, as inflation has been tamed relatively in the past several months and is likely to trend downward in early 2014. However, further tightening by the central bank may happen in the first quarter next year, if pressure on the current account deficit and rupiah intensifies due to the Fed's expected quantitative eased.

In addition to the recent increases in the cost of borrowing, a number of macro-prudential policies with a tightening bias have also been applied. Bank Indonesia lowered the upper band of the loan-to-deposit ratio target from 100 to 92 percent, combining with more rigid loan-to-valuation ratios for residential mortgages. Moreover, the secondary reserve requirement ratio was also raised from 2.5 percent to 4 percent by December. Furthermore, a number of measures, such as: permitting both government bonds and BI certificates of deposit to be counted up against bank's secondary reserve requirement, and introducing shorter tenor BI deposit securities, have also been undertaken to facilitate liquidity management.

Figure 3: Inflation, base money growth, and Bank Indonesia rate



Source: CEIC Database

Meanwhile, Indonesia's banks have been sound enough to withstand the pressures of a falling currency, rising inflation and slowing growth, sufficiently insulated from another 1997-style crisis. Up to September 2013, the capital ratios (CAR) stood at 18.11 percent, higher than the minimum level of 8 percent. At the same time, non-performing loans (NPL) remained at 1.86 percent, well under the 5 percent ceiling. Meanwhile, Indonesian bank profitability has also remained high, with aggregate return on assets (ROA) have been above 3 percent.

Balance of Payment

Export and Import

Despite the recent improvement, Indonesia's trade account deteriorated sharply throughout much of the first three quarters of 2013. In nominal term, exports fell by an average of 4.57 percent, year on year, to reach cumulative exports of US$ 134.9 billion during January-September period. This drop was largely due to decrease in prices of export commodities, such as coal, copper, and palm oil, offsetting a recovery in many of their volumes. Meanwhile, the country's cumulative imports posted US$ 134.01 billion, slightly increased by an average of 0.38 percent in the same period under consideration. As result, the trade balance swung from a surplus of 1.63 billion in Q3-2013 to a deficit of US$ 0.7 billion in Q2-2013 and US$ 0.006 billion in Q3-2013, though the overall cumulative trade balance still recorded a surplus of US$ 0.91 billion. The recent narrowed trade deficitwas helped by a weaker import offsetting the continued slowdown in exports. The country's imports slowed due to a weakening rupiah and a weaker domestic demand caused by the aggressive rate rises.

Current, Capital, and Financial Account

A dwindling surplus in merchandise trade, together with deficits in income and services, has widened the current account deficit in the January-September period. The deficit increased from US$ 5.9 billion in Q1-2013 to a record of US$ 9.8 billion in Q2-2013, before slightly slowed to US$ 8.4 billion in the following quarter. As a result, the deficit hit US$ 24.3 billion in the first nine month of this year. Looking a head, it is estimated that the deficit would be US$ 7-8 billion in Q4-2013, bringing the full-year current account deficit to US$32 billion.

The sizeable current account deficit outweighed a surplus in the capital and financial account, pushing the overall balance of payment into negative territory in the first nine months of 2013. The foreign direct investment remained robust, rising to 12.8 billion in the third quarter, while the portfolio investment recorded a net inflow of US$ 8.03 billion, declining form a year earlier as global funds reduced their holdings in emerging markets in expectation that the US would reduce its monetary stimulus. Overall, the capital and financial account booked overall inflows of US$ 0.12 billion and US$ 12.95 billion, respectively. These inflows, however, were not sufficient to offset the outflow on the current account, and thus caused the overall balance of payment of US$ 11.73 billion over the first three quarter of 2013.

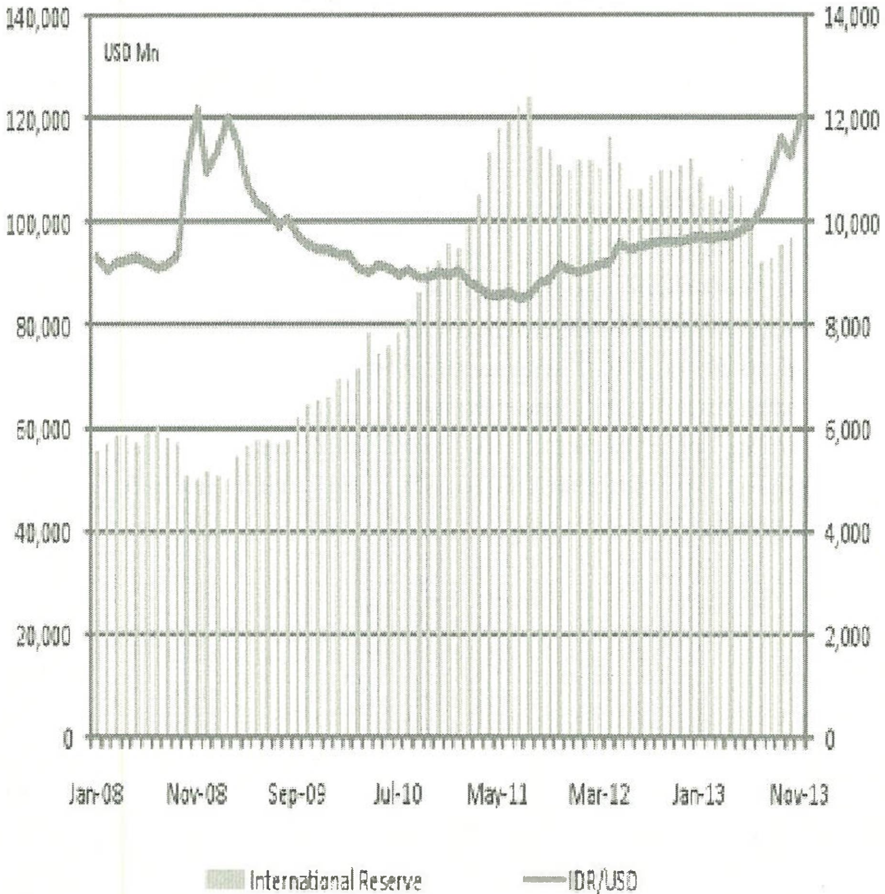
Money and Capital Market

Foreign Exchange

Domestic factors—rising inflation, the current account deficit, and a drop in foreign reserves, coupled with changes in global risk appetite contributed to the weakness in Indonesian financial markets. Up to the end of November, Indonesian rupiah was under downward pressures and have slid by more than 23.7 percent to its lowest level since March 2009 at Rp 11,977/US$, the worst performing currencies in Asia.Ahead, the rupiah is expected to be weakening in the foreseeable future, driven by the strong year-end demand for dollar purchases as companies look to pay off dollar-dominated debts, and the possible reduction of the Fed's bond purchasing program.

Despite the recent advancement, international reserves fell significantly in the first ten months of 2013. Due to the current account deficit, capital flows and central banks intervention to defend rupiah, the reserves decreased by 17.4 percent to its lowest level since early 2011 at US$ 92.7 billion in July. Since then the reserves increased gradually in the three consecutives months to US$ 97 billion in October as Bank Indonesia has allowed greater flexibility and cope for the rupiah to depreciate and exports started to recover.

Figure 4: Rupiah exchange rate and official reserves



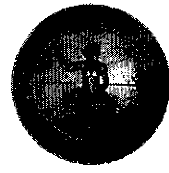
Source: CEIC Database

Stock Exchange

In line with other emerging markets, the volatility in Indonesia's equity markets increasedover 2013, driven by domestic economic and policy developments and the prospect of the Fed's QE tapering that triggered a major sell-off in emerging market assets, including Indonesia. In the first five months of 2013, Indonesia's benchmark stock index (IDX) went up significantly by almost 20 percent to its new all-time record of 5,214 in May 20th, underpinned by continued robust corporate profit growth across most sectors and strong net foreign

purchases of the country's equities. Subsequently, however, the IDX dropped back by nearly 24 percent to its lowest level in a year at 3,967 in August 27th, triggered by fears over mounting inflation, weakening rupiah and prevailing current account deficit, coupled with the jitters over the Fed's tapering risk.

Due to the postponement in tapering and a significant number of company share buybacks, the index subsequently held back from further losses, before entering its renewed weakness at the end of November. The IDX bounced back to 4,670 in September 9th, and it was under downward pressures and tumbled to 4,233 November 28th. Uncertainty over US budget deliberation and government shut down, combined with negative sentiments from domestic issues related to the depreciating rupiah, the persistent current account deficit, and the declining performance of much of domestic companies prompted heavy selling by foreign investors, creating downward pressures on the local stocks.



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Yose Rizal Damuri

Editor

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