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Country Risk Monitor

INDONESIA

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In a nutshell

- Thanks to fundamentals, the Indonesian economy remains resilient. Economic performance continued to improve in 2016 against a backdrop of weak global growth, heightened global policy uncertainty, as well as international financial market volatility. Real gross domestic product (GDP) expanded 5.0% in 2016, and the government expects growth to improve slightly to 5.1% in 2017. Domestic demand, which also expanded 5.0% in 2016, continues to be an important growth driver. Importantly, this continues to contribute toward Indonesia's low GDP growth volatility (2011-2016: 0.6%). Meanwhile, prices remained stable in 2016. Inflation averaged 3.5%, compared to an average of 5.8% over the 2011-2015 period. With the central bank intent on maintaining macroeconomic stability, inflation should remain within the official target band of 3.0%-5.0%. Downside risks to economic outlook, mainly external in nature, include policy uncertainties in the US, tighter global financial conditions, and lower commodity prices.

- Strict rules capping fiscal deficit at 3% of GDP and debt at 60% of GDP have kept government debt low (2016: 27.9% of GDP). Meanwhile, foreign currency-denominated debt as a percentage of public sector gross debt is on a downtrend. In 2016, it settled at 40.3%, more than six percentage points lower than at end-2013. While the proportion of foreign currency-denominated debt may have fallen, the proportion of foreign currency-denominated government securities has risen. In 2016, its share of central government debt stood at 20.8%, compared to 2.6% in 2005. The share of IDR-denominated government securities in central government debt has also risen. In 2016, their total combined share reached 78.9% (2005: 52.8%), an indication of rising issuances and foreign interest. Foreign investors currently hold about 37% of IDR-denominated government securities. Meanwhile, standard shock and stress test results indicate that Indonesia's public debt dynamics remain robust, with government debt stabilising at 35% of GDP even under a severe combined macro-fiscal shock.

- The banking sector remains stable with high capitalisation and profitability, though non-performing loans (NPL) are a risk concern. After bottoming out at 1.7% in 2013, the sector's NPL ratio rose to 2.9% in 2016, mainly because of manufacturing, trade and mining sector loans. In January 2017, it reached 3.1%. Due to rising NPL and low credit demand, credit growth slowed in 2016. Tighter lending standards due to higher NPL at especially medium-sized banks also contributed to the slowdown. In 2016, the monthly average growth pace of loans extended by commercial and rural banks slowed to 7.9% from 10.5% in 2015. If the credit growth slowdown continues, bank profitability will likely be pressured. While corporate debt in Indonesia is relatively low at around 32% of GDP, risks remain elevated due to, among other things, the fact that around two-thirds of corporate debt exposures are denominated in foreign currency.

- Even though Indonesia's economic fundamentals remain sound, its external vulnerability is a risk concern. It has persistently run a current account (CA) deficit (2016: -1.8% of GDP), on top of a fiscal deficit (2016: -2.5% of GDP). At end-2016, its net international investment position (NIIP) reached a significant -34.4% of GDP, though it should be noted that that was a significant improvement from -43.8% a year earlier. Due to its reliance on external financing, the economy is vulnerable to, for example, monetary policy normalisation in the US and other economic and geopolitical events that impact global capital flows. That said, Indonesia's sound monetary policies and macro-prudential policy mix should help somewhat mitigate its vulnerability to shifts in investor sentiment. In addition, its stock of foreign exchange reserves (March 2017: USD121.8 billion) is seen as sufficient to buffer the economy against most external shocks.

- Weak institutions are also a risk concern. Indonesia scores poorly in all the components of the World Bank's World Governance Indicators project – namely political stability and absence of violence/terrorism, voice and accountability, government effectiveness, regulatory quality, rule of law, and control of corruption. Weak government monitoring, law enforcement and bureaucratic hurdles, for example, have encouraged low tax compliance, and the resulting fiscal implications have been serious. Due to low tax compliance, Indonesia's actual tax-GDP ratio is about four to five percentage points lower than its 'potential'. Weak institutions also affect the other side of the fiscal coin – public spending. Slow fiscal disbursements, for example, have time and time again held back economic growth in Indonesia. The effectiveness of the government's fiscal policy has thus been affected.

Table 1: Selected economic indicators

	2011	2012	2013	2014	2015	2016
Real GDP growth (% y-o-y)	6.2	6.0	5.6	5.0	4.9	5.0
Inflation rate (%, annual average)	5.4	4.3	6.4	6.4	6.4	3.5
Fiscal balance (% GDP)	-1.1	-1.8	-2.2	-2.1	-2.6	-2.5
Public sector gross debt (PSGD) (% GDP)	23.1	23.0	24.9	24.7	27.4	27.9
Total external debt position (% GDP)	29.6	27.4	29.1	32.9	36.1	34.0
- of which government and central bank (% GDP)	15.6	13.7	13.5	14.6	16.6	17.0
- of which private sector (% GDP)	14.0	13.7	15.6	18.4	19.5	17.0
Current account (% GDP)	0.2	-2.7	-3.2	-3.1	-2.0	-1.8
Net international investment position (% GDP)	-35.6	-39.3	-40.6	-43.1	-43.8	-34.4
International reserves (USD bn)	110.1	112.8	99.4	111.9	105.9	116.4
Unemployment, total (% of labour force)	7.4	6.1	6.2	5.9	6.2	5.6

Source: World Bank, IMF, Bank Indonesia, CEIC, MARC Economic Research

Key Strengths

Resilient growth

Indonesia's economic performance, thanks to fundamentals, continued to improve in 2016 against a backdrop of weak global growth and lower export prices. Real GDP expanded 5.0% in 2016, an improvement from the previous year's 4.9%, which also happened to be the economy's slowest growth pace in the post-Global Financial Crisis period.

Domestic demand, particularly household expenditure (2016: 5.0%) continues to be an important growth driver. GDP growth volatility remains low (2011-2016: 0.6%). In fact, the resilience of Indonesia's domestic demand to external influences has set it apart from its peers in the Association of Southeast Asian Nations (ASEAN) region. Research has shown that the correlation between domestic final demand and exports was considerably lower in Indonesia than in Malaysia, Thailand and the Philippines.

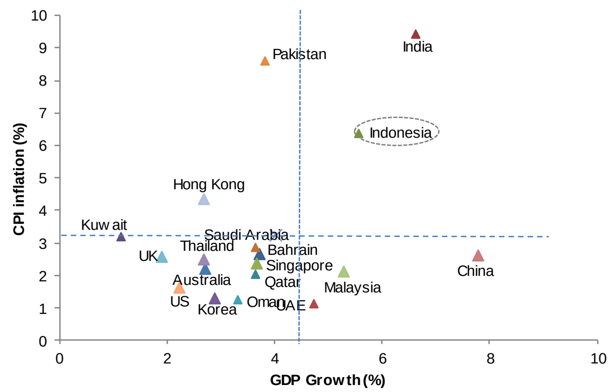
Meanwhile, prices have stabilised. In 2016, inflation averaged 3.5%, compared to an average of 5.8% over the 2011-2015 period. This has had a positive effect on private consumption spending growth, as well as allowing a spell of accommodative monetary policy.

The government has set a GDP growth target of 5.1% in 2017, while the central bank expects the economy to grow between 5.0%-5.4%. With the central bank intent on maintaining macroeconomic stability, inflation should remain broadly stable and within the official target band of 3.0%-5.0%.

Indonesia has managed to preserve economic stability and at the same time make progress on structural reforms amidst challenging shifts in the external environment. Thanks to ongoing reforms, Indonesia is better placed today than it was in previous years to weather an uncertain external environment. However, a lot of work remains and it is important that the government continues strengthening its medium-term policy framework through fiscal and structural reforms.

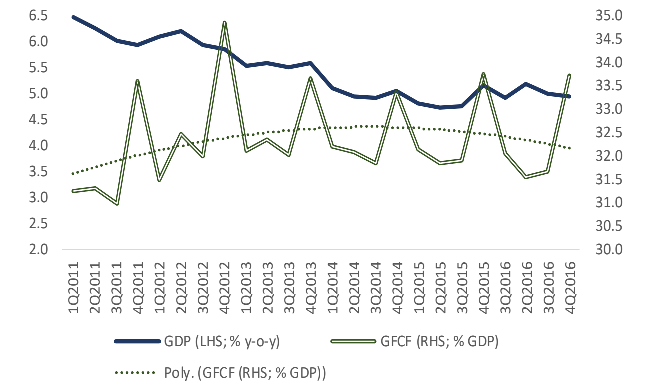
Downside risks to Indonesia's economic outlook are mainly external in nature. The risks include policy uncertainties in the US, a substantial China slowdown if the economic rebalancing efforts do not pan out, tighter global financial conditions, and lower commodity prices. On the domestic side, there is risk of narrower fiscal elbow space if tax revenue shortfalls worsen or domestic interest rates rise due to tighter global financial conditions.

Chart 1: Inflation and GDP growth (5-year median)



Source: IMF WEO Database, MARC Economic Research

Chart 2: GDP & gross fixed capital formation



Source: CEIC, MARC Economic Research

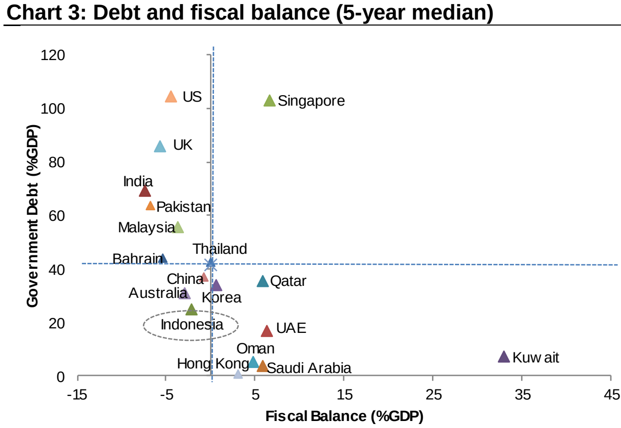
Low government debt

Indonesia's strict rules that cap the fiscal deficit at 3% of GDP a year and debt at 60% of GDP continue to keep public sector debt relatively low (2016: 27.9% of GDP). In the aftermath of the Asian Financial Crisis, government debt had ballooned to almost 100% of GDP. While public debt has been kept relatively low, contingent liabilities related to borrowings by state-owned enterprises (SOEs) and public-private partnerships (PPPs) to fund the government's infrastructure development plans have risen.

Meanwhile, the level of foreign currency-denominated debt as a percentage of public sector gross debt continues to trend downward. In 2016, it settled lower at 40.3% of public sector gross debt, more than six percentage points lower than at the end of 2013. This trend is also reflected at the central government level. While the combined total share of external loans and foreign currency-denominated government securities as a percentage of central government debt has fallen, the latter's share has risen. In 2016, its share of central government debt stood at 20.8%, compared to 2.6% in 2005. The share of IDR-denominated government securities in central government debt has also risen. In 2016, the combined share of foreign currency- and IDR-denominated government securities reached 78.9% (2005: 52.8%).

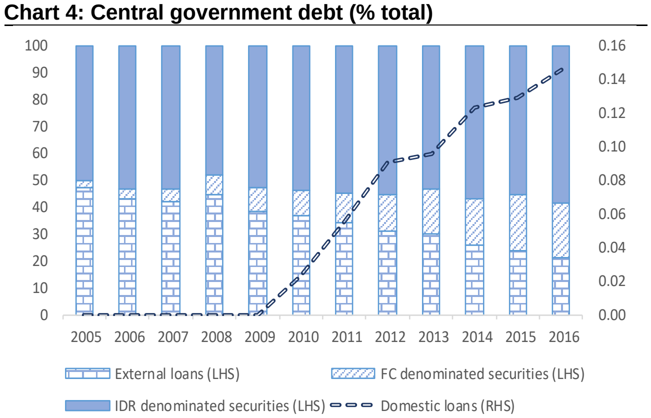
The results of standard shocks and stress tests indicate that Indonesia's public debt dynamics remain robust. According to the IMF, total government debt will stabilise at 35% of GDP even under a severe combined macro-fiscal shock. While that may be so, it should be noted that the government's reliance on external financing makes Indonesia vulnerable to funding reversals. As such, a severe combined macro-fiscal shock could prove to be the tipping point that triggers a massive capital outflow.

Chart 3: Debt and fiscal balance (5-year median)



Source: IMF WEO Database, MARC Economic Research

Chart 4: Central government debt (% total)



Source: CEIC, MARC Economic Research

Major Risks

Rising non-performing loans

The banking system remains broadly healthy with high capitalisation and profitability. End-2016 data show a commendable average capital adequacy ratio of 20.6%. Bank profitability improved in 2016, with return on assets (ROA) and return on equity (ROE) rising to 3.0% and 20.7%, respectively. While the financial system remains liquid overall, some smaller banks remain susceptible to liquidity shocks because of limited money market access and higher dependence on short-term time deposits.

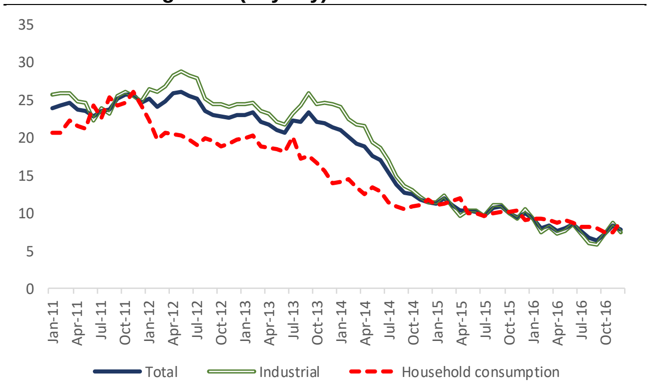
In line with slower economic growth, the banking sector's NPL ratio has continued to rise after having bottomed out at 1.7% in 2013. In 2016, the NPL ratio rose to 2.9% (2015: 2.4%), mainly due to manufacturing, trade and mining sector loans. With regard to the mining sector, the latest available data show deteriorating profitability. In 3Q2016, the sector's ROA and ROE fell to -5.0% and -11.1%, respectively, from 0.2% and 0.6%, respectively, at end-2015.

The pace of bank credit growth varies by sector. In the case of the construction sector, credit growth pace has remained robust, thanks particularly to the government's infrastructure development efforts. Credit growth for manufacturing and mining was, on the other hand, weak. While overall weak corporate credit growth can be traced to lower investment spending, tighter lending standards given the higher NPL especially at medium-sized banks also contributed.

We expect bank asset-quality problems to continue creeping up in 2017, especially if GDP growth does not pick up. The latest available data show the banking sector's NPL ratio reaching 3.1% in January 2017. While declining commodities prices had sparked NPL issues in commodity exporters over the 2014-15 period, a commodities resurgence going forward should help limit the rise in NPL.

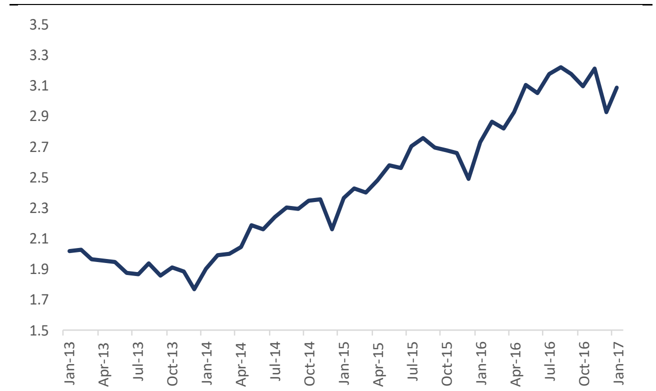
On top of having to contend with the expected rise in NPL in 2017, banks have had to work hard to maintain profitability after six policy rate cuts in 2016. Credit disbursements in 2016 grew only 7.9% (2015: 10.1%), which was within the lower half of the Financial Services Authority's targeted 7.0%-9.0% range.

Chart 5: Loans growth (% y-o-y) *



Source: Bank Indonesia, MARC Economic Research
** Note: Commercial and rural banks*

Chart 6: Commercial bank NPL ratio



Source: Bank Indonesia, MARC Economic Research

Vulnerability to external shocks

Even though Indonesia's economic fundamentals remain sound, its external vulnerability continues to generate risk concerns. It has persistently run a CA deficit (2016: -1.8% of GDP), on top of a fiscal deficit (2016: -2.5% of GDP). Indonesia has thus been highly reliant on foreign capital inflows to finance its deficits.

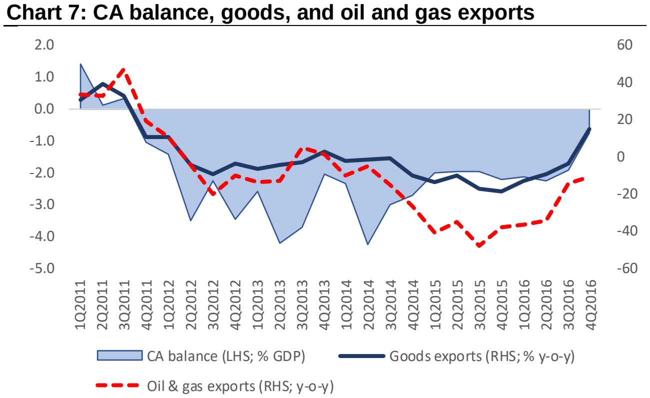
Indonesia's NIIP as at end-2016 reached a significant -34.4% of GDP, though it should be noted that that was a significant improvement from a deficit of 43.8% of GDP at end-2015. In fact, its NIIP had climbed to about -46% of GDP at end-June 2016 on account of strong net portfolio inflows into mainly government debt.

The economy is thus vulnerable to the ongoing monetary policy normalisation in the US, as well as other economic and geopolitical events that impact global capital flows. That said, Indonesia's stock of foreign exchange reserves (March 2017: USD121.8 billion) is deemed sufficient to cushion the economy against most external shocks as it is higher than its reserves adequacy threshold of about USD89 billion. In addition, its reserves-to-short-term external debt ratio has been trending upwards, which is a positive development.

Indonesia's sound monetary policies and macro-prudential policy mix should somewhat mitigate its vulnerability to shifts in investor sentiment. The central bank has put in place measures to improve monetary transmission effectiveness. According to Bank Indonesia, its new key policy rate, the seven-day (reverse) repo rate has a stronger correlation with money market rates. On top of that, it also increases financial market deepening, which is important because of Indonesia's dependence on external financing.

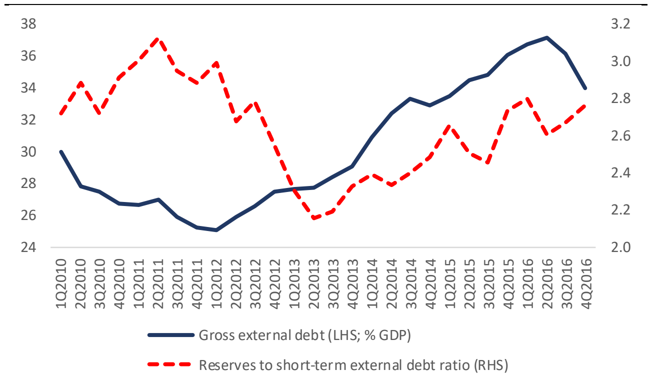
The level and composition of Indonesia's NIIP and gross external debt (2016: 34.0% of GDP) indicate a still sustainable external position. However, an abrupt pull-out by foreign portfolio investors who currently hold about 37% of IDR-denominated Indonesian government bonds can have serious consequences in terms of liquidity and exchange rate stability in Indonesia.

Chart 7: CA balance, goods, and oil and gas exports



Source: IMF, CEIC, MARC Economic Research

Chart 8: External debt



Source: CEIC, MARC Economic Research

Institutional issues

President Joko Widodo (Jokowi) has had a challenging two-and-a-half years since taking office. In May 2015, the Jakarta-based Institute for the Policy Analysis of Conflict released a report concluding that the military seems “to be testing the political waters to see how far they can push their authority in the face of a weak president with little experience in security affairs.”

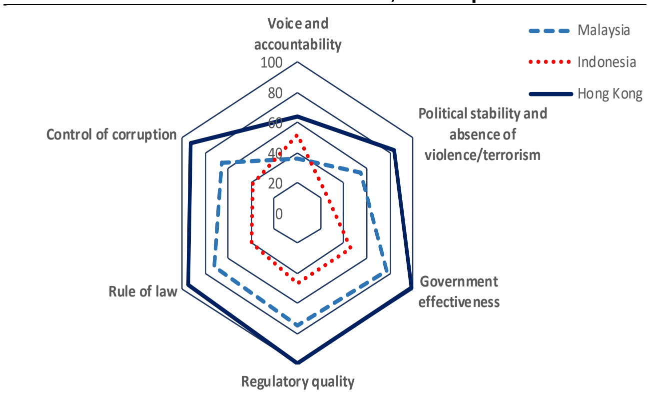
Fast forward to today, and things do not seem to be getting easier. The blasphemy charges against Basuki Tjahaja Purnama (Ahok) who recently lost an election for the governorship of Jakarta is a major new challenge that will test Indonesia's democracy and national identity.

Indonesia continues to score poor percentile rankings in the World Bank’s World Governance Indicators project – namely political stability and absence of violence/terrorism, voice and accountability, government effectiveness, regulatory quality, rule of law, and control of corruption. Faced with challenging governance issues, it is not surprising that Indonesia also does poorly in the World Bank’s Ease of Doing Business report. In the 2017 edition of the report, Indonesia is ranked at number 91 out of 190 countries. For context, Malaysia is ranked at number 23.

Governance issues have also affected the effectiveness of Indonesia’s fiscal policy, which according to the World Bank, has contributed less than it could have done to growth and poverty reduction. In its 2016 publication entitled "Indonesia's Rising Divide", the World Bank reported that inequality in Indonesia is climbing faster than in most of its regional peers. It also said that rising inequality may lead to slower growth and poverty reduction, and therefore increased risk of conflict.

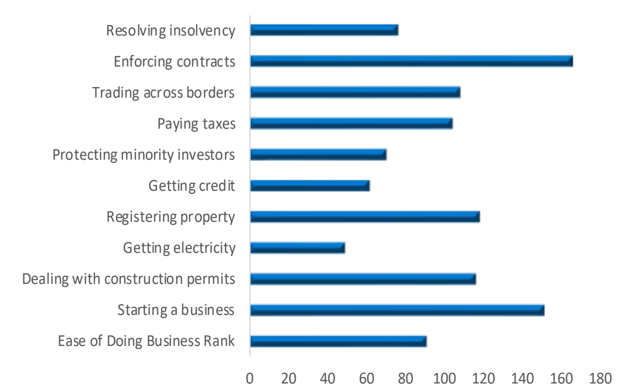
Terrorism, simmering just below the surface, continues to be a threat in Indonesia. Given the history and presence of militancy in the region, there are concerns that a formal Islamic State (ISIS) affiliate will be formed eventually. As ISIS loses territory, foreign fighters will return and it is only a matter of time before they set up a formal ISIS presence in the region. Based on this scenario, the number of terrorism incidents in Indonesia can only rise.

Chart 9: World Governance Indicators, 2016 Update



Source: World Bank
Note: percentile ranking

Chart 10: Indonesia: Ease of Doing Business 2017



Source: World Bank
Note: ranking

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