NEW PRESIDENT PRABOWO INHERITS A STRONG ECONOMY

Subianto Prabowo will become the new President of Indonesia on 20 October. He will inherit a strong economy with robust and stable growth (5.1% on average over the last ten years, excluding the COVID-19 period), a low fiscal deficit, moderate public debt and sound external accounts. However, there are major challenges ahead for the new President. In the next decade, the country's demographic dividend will begin to fade. He will need to adopt reforms more quickly in order to get significantly more young people and women into employment and attract more foreign direct investment. Without this, Indonesia will become an "old" country before it becomes a "high income" country.

A NEW PRESIDENT THAT FOLLOWS THE SAME PATH AS THE PREVIOUS ONE

Subianto Prabowo, who had already been a presidential candidate in 2014 and 2019, won the presidential elections in February in the first round.

The future government is expected to follow a similar foreign policy to Joko Widodo's government. However, future President Prabowo is seemingly more ambitious for his country, both economically and politically on the international stage. The former general, who made a point of putting "national security" at the forefront of his campaign, is expected to continue his defence spending commitments from his time as Minister of Defence. He is also possibly expected to be more receptive to the United States' security interests in the region, as the United States and Europe are its main arms suppliers.

At the same time, the future President is aspiring to make his country a key economic player in Asia. In order do this, he will look to attract investments from China (its biggest investor behind Singapore) and penetrate this market. However, this "multi-alignment" could be difficult to sustain should there be stand-offs in the South China Sea, as Indonesia's economic and nationalist objectives would then run counter to each other.

A STRONG ECONOMY

The government, which will officially take office next autumn, will inherit a strong economy.

Since 2014, apart from the years of the COVID-19 pandemic, economic growth has remained robust and stable. It has reached 5.1% per year on average over the last ten years (excluding the pandemic period). In 2024, it is expected to remain dynamic, despite slowing down slightly to 4.9%, before rebounding to 5.1% in 2025, once the uncertainties surrounding the change of government have passed. In the short term, the main risks to the economy are linked to the international environment.

Inflationary pressures have accelerated slightly since the beginning of 2024. They stood at 3% year-on-year (y/y) in March 2024 compared to 2.6% in January, a rate which is still short of the new target set by the monetary authorities (2.5% +/- 1pp since 1 January 2024). This slight acceleration is mainly due to rising food prices, as well as a slight upturn in prices excluding energy and food (+1.8% y/y).

Even though the rising inflationary pressures are under control, they could restrict Bank Indonesia's monetary easing plans. Its monetary policy is already being constrained by the United States' monetary policy. The prospect of the Fed postponing its decision to cut its key rates (initially expected in June 2024) has led to capital outflows and a 4.6% depreciation of the rupiah against the dollar since the start of the year. The yield spread between Indonesian and US government bonds narrowed over the first three months of the year.

FORECASTS

	2021	2022	2023e	2024e	2025e
Real GDP growth (%)	3.7	5.3	5.0	4.9	5.1
Inflation (CPI, year average, %)	1.6	4.2	3.7	3.0	2.4
Gen. Gov. balance / GDP (%)	-4.6	-2.4	-1.7	-2.3	-2.9
Gen. Gov. debt / GDP (%)	40.7	39.7	39.2	38.8	39.0
Current account balance / GDP (%)	0.3	1.1	-0.1	-0.5	-0.5
External debt / GDP (%)	34.9	30.1	29.7	29.7	29.4
Forex reserves (USD bn)	131	124	133	128	130
Forex reserves, in months of imports	7.4	5.6	5.9	5.7	5.8

TABLE 1 e: ESTIMATES & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

INDONESIA: REAL GDP GROWTH IS ROBUST EXCLUDING DURING THE COVID

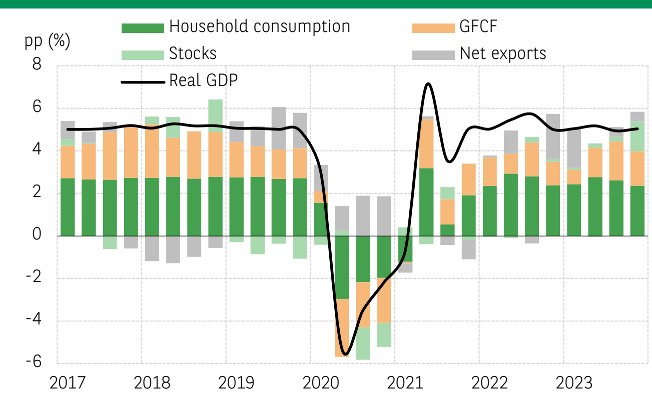

CHART 1 SOURCE: CEIC, BI, BNP PARIBAS

Despite the recent downward pressures on the rupiah, Indonesia's external accounts are sound. In 2023, after two years of surplus, the current account balance fell back into negative territory as a result of a drop in the value of goods exports caused by falling exported commodity prices (-25.3% for palm oil and -56.4% for coal). However, the current account deficit is still very small, standing at 0.1% of GDP, partly thanks to rising tourism revenue. In addition, foreign direct investment (FDI) flows were sufficient to cover the entire current account deficit. The deficit is expected to increase slightly over the next three years, unless the prices of commodities exported by Indonesia rise sharply

thanks to the geopolitical climate. However, there should still be enough FDI flows to cover the current deficit.

The recent downward pressures on the rupiah are not a cause for concern. Despite contracting slightly since the start of the year, foreign exchange reserves reached USD 130.4 billion in February 2024 (i.e. 5.9 months of imports) and overwhelmingly covered the external debt repayments that would be falling due over the next 12 months (USD 69.8 billion). External debt is still low (29.7% of GDP). Even though the country is still exposed to volatile capital outflows, the central bank has enough foreign exchange reserves to contain the depreciation of the rupiah. In addition, the stock of portfolio investments held by foreign investors is lower than five years ago (20.1% of GDP in Q4 2023, compared to 26.7% in 2019).

One of the main risks identified since Subianto Prabowo's election is a slip in the fiscal deficit. His campaign rhetoric suggested that his fiscal policy could be much less conservative than his predecessor's. In particular, he promised substantial measures for students, which will cost an estimated 2% of GDP, even though the country's fiscal leeway is limited. Government receipts are still low (13.3% of GDP) and interest payments on government debt are consuming 16.6% of revenue. The government fiscal deficit and debt are moderate (standing at 1.7% and 39.2% of GDP, respectively, in 2023), but their financing could pose a potential risk. The domestic capital markets are still underdeveloped and the country is still structurally dependent on external financing. Even though the share of public debt held by foreign investors had plummeted due to the central bank's policy of purchasing bonds on the primary market over the 2020-2022 period, it still stood at 37.4% of total debt at the end of 2023.

MAJOR CHALLENGES FOR INCREASING GROWTH

In order to achieve the 7% growth target that Prabawo championed during his election campaign, the new government will have to continue, and even accelerate, the reforms undertaken during the Widodo era. In particular, it must successfully manage to quickly and fully capitalise on the "demographic dividend[1]", which will begin to evaporate in the coming decade. According to projections by the United Nations (UN), the share of the working age population will start to decline from 2030, with the working population growth rate falling below the dependent population growth rate. From 2044, the dependency ratio will fall below 50% and economic growth could then slow down before the country successfully manages to significantly increase the population's income levels.

Since 2014, Indonesia's real GDP per capita (at purchasing power parity) has increased by 2.9% per year on average. For comparison purposes, in South Korea, during its own demographic dividend period (1987-1997), GDP per capita increased by 7.5% per year on average. Therefore, even though Indonesia managed to reach the upper middle-income group of countries in 2019, and then came back into it in 2023 (having fallen out of it during the COVID-19 crisis), its economic growth is now relatively modest compared to previous growth rates recorded in the past in other Asian countries. This reflects the fact that the country is not fully benefiting from its demographic dividend.

INDONESIA: LOW CURRENT ACCOUNT DEFICIT

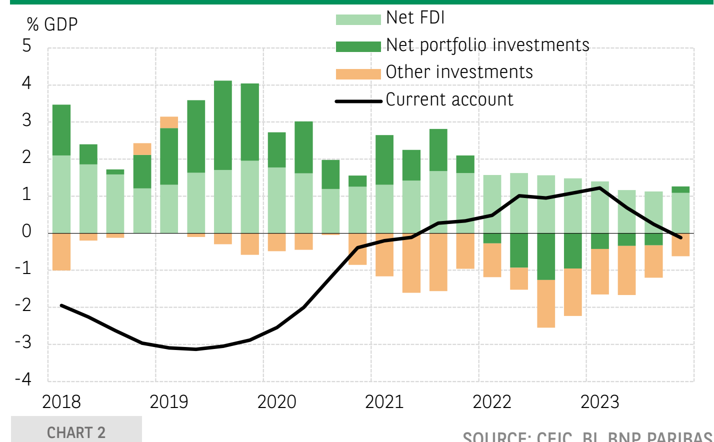

CHART 2 SOURCE: CEIC, BI, BNP PARIBAS

In order to capitalise on its demographic dividend, a country must invest in human capital (education and training) and adopt economic policies that i) promote the extensive use of its labour force (in order to respond to the sharp increase in the labour supply) and ii) aim to attract FDIs.

However, the level of job creation among women and young people remains highly insufficient. According to Statistics Indonesia, the unemployment rates for 15-19 year-olds and 20-24 year-olds were 29.1% and 17%, respectively, in 2022. According to the International Labour Organization, the employment rate for women was 51.7% in 2023, compared to 79.1% among men. In addition, agriculture is still the sector with the largest share of the country's employees (28.2% in 2023), while the share of employment in the industrial sector has been stable over the last decade, standing at 13.8%. It's a similar case for the industrial sector's value added share, which is still small (19.7% in 2023) and has not increased in ten years. To accelerate the pace of job creation, the government must successfully manage to develop the labour-intensive industrial sectors, which involves attracting more FDIs. However, FDI inflows in Indonesia, which are already structurally weak, fell by 0.4 pp in 2023 to 1.6% of GDP, the lowest level recorded in the last five years. This low level is due to cyclical factors (the drop in global liquidity and uncertainty stemming from the February 2024 elections), but also due to Indonesia's low level of integration into global trade. The country's market shares are low (1.1% of global exports) and have barely increased over the past twenty years (+0.2 pp). Its governance is still weak (it was ranked 107th out of 213 countries in 2023) and its working population are inadequately trained. According to the OECD, 42% of 25-34 year-olds have not attained an upper secondary educational qualification. Spending on education is still too low (3% of GDP, compared to 4.8% in South Korea). From a fiscal perspective, the government must optimise its tax structure and increase its revenue in order to meet the needs of young people and achieve its goal of becoming a high-income country by 2045.

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1 Its dependency ratio is less than 50% (the share of the working age population is larger than the share of the dependent population) and working population growth is higher than dependent population growth.