# INDONESIA



## INDONESIA'S ECONOMY IS HOLDING UP WELL

**Despite the global economic slowdown, Indonesia's economic growth has remained robust. Inflationary pressures remain contained despite rising rice prices. Public finances have strengthened and the fiscal deficit has fallen below the regulatory threshold of 3% of GDP a year earlier than expected. Although government debt is higher than before the crisis, it remains modest and its refinancing is less reliant on portfolio investments. The increase in the payment of interests on debt should be monitored as it reduces the government's fiscal leeway to support the economy. Despite increased pressures on external accounts, due to the downward reversal in prices of exported raw materials and capital outflows, foreign exchange reserves remain sufficient to cover the country's short-term external financing needs. Looking ahead to the next two years, the current account deficit is expected to remain modest and covered by FDI.**

## GROWTH DRIVEN BY DOMESTIC DEMAND

In Q2 2023, economic growth remained robust: it reached 5.2% y/y and 5.1% over the first half-year as a whole. Economic activity was supported by domestic demand (+5.9% y/y) while exports contracted by 2.7% y/y. Household consumption returned to its long-term growth rate (5-5.2%), supported by the upturn in tourism and the decline in unemployment. Although still slightly higher than before the Covid-19 crisis, the unemployment rate stood at 5.5% in February 2023. Investments remained strong, especially public investment in infrastructure. Activity was particularly buoyant in the construction, transport, trade and services sectors.

Growth prospects for the second half of the year are favourable, although downside risks remain high, particularly due to the global economic environment. The contribution of net exports to growth is expected to fall into negative territory in Q3. A significant rebound in exports is very unlikely due to the economic slowdown in China, Indonesia's largest trading partner (22.6% of exports in 2022), and the United States (9.7% of its exports).

Household consumption is expected to remain dynamic, although slightly slowing. Retail sales already started to slow down in July and August. Although consumer confidence indices remain positive, they seem to have slightly lagged behind. Similarly, the pace of expansion in credit growth to households has stabilised. For their part, companies seem to remain confident, according to the latest survey results. On the other hand, growth in imports of capital goods slowed significantly in August, pointing to a slowdown in private sector investment.

In addition, the sharp rise in international oil prices since July 2023 should weigh on corporate profits and household purchasing power. In August, consumer price index remained moderate (+3.3% y/y) and below the target of 3% +/- 1 pp set by the monetary authorities for 2023 (2.5% +/- 1 pp for 2024). However, it has rebounded slightly from the low reached in July, mainly due to the rise in food prices caused by the increase in rice prices. Inflation is set to pick up again in the second half of the year, but should be contained by domestic price controls; excluding food and energy prices, the rise in prices recorded in August was just 2.2% y/y. The Indonesian central bank (Bank Indonesia, BI) remains confident that inflation will be well under control. It thus kept its key rate unchanged at 5.75% in September.

## CONSOLIDATION OF PUBLIC FINANCES

Public finances have strengthened over the past two years. The fiscal deficit, although still slightly above the 2019 level, has fallen significantly. Furthermore, government debt remains modest, although it is above its pre-crisis level (37.8% of GDP at the end of August 2023 vs. 29.7% of GDP at the end of 2019).

FORECASTS

| | 2020 | 2021 | 2022 | 2023e | 2024e |
|---|---|---|---|---|---|
| Real GDP growth (%) | -2.1 | 3.7 | 5.3 | 5.0 | 5.0 |
| Inflation (CPI, year average, %) | 2.0 | 1.6 | 4.2 | 3.4 | 2.7 |
| Gen. Gov. balance / GDP (%) | -6.1 | -4.6 | -2.4 | -2.7 | -2.5 |
| Gen. Gov. debt / GDP (%) | 39.4 | 40.7 | 39.7 | 39.3 | 38.9 |
| Current account balance / GDP (%) | -0.4 | 0.3 | 1.1 | -0.1 | -0.5 |
| External debt / GDP (%) | 34.1 | 34.9 | 30.1 | 29.3 | 29.0 |
| Forex reserves (USD bn) | 129 | 131 | 124 | 120 | 123 |
| Forex reserves, in months of imports | 7.3 | 7.4 | 5.6 | 5.5 | 6.1 |

TABLE 1

(1) FISCAL YEAR FROM APRIL 1ST OF YEAR N TO MARCH 31ST OF YEAR N+1
e: ESTIMATES & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

INDONESIA: INFLATIONARY PRESSURES REMAIN MODERATE

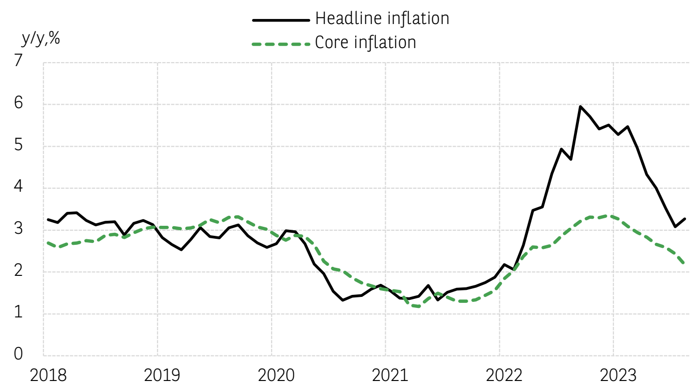


CHART 1

SOURCE: CEIC, BI, BNP PARIBAS

Its structure remains fragile but is less vulnerable to an external shock than in 2019. The share of debt denominated in foreign currencies (exposed to an exchange rate shock) is high (37.3% of total debt in Q2 2023), but the proportion of debt held by foreign investors, although slightly up since the end of the central bank's asset purchasing programme at the end of 2022, remains much lower than the 2019 level.

It was only 27.9% of total debt in August 2023 compared to 58.2% at the end of 2019. Domestic banks currently hold 30.6% of government debt, compared to just 23.9% in 2019.

In 2022, the government managed to reduce its fiscal deficit to 2.4% of GDP (compared to 4.6% of GDP in 2021), which is below the 3% of GDP threshold that it had committed to achieving by the end of 2023. This good performance can be explained by the increase in fiscal revenues (+2.7pp to 13.5% of GDP) against a backdrop of rising export commodity prices.

For 2023, the government forecasts an increase in the fiscal deficit to 2.8% of GDP. It anticipates a decline in revenues linked to the fall in exported commodity prices, including crude oil price (on an annual average basis). However, over the first eight months of 2023, public finances were stronger than the government expected. Revenues accelerated slightly compared with the same period last year, reaching 74% of the annual target. In addition, government expenditures were more modest than initially anticipated (53% of the annual target compared with 60% over the 2015-2019 period), despite the increase in investment and transfers to the provinces. Although the recent rise in food and oil prices could weigh on the cost of subsidies, the fiscal deficit should be below the target set by the government. In addition, the government has proven its ability to control its spending on subsidies. In 2022, despite the rise in commodity prices, subsidies remained contained at 1.3% of GDP (the level recorded in 2019) and, compared to GDP, they should continue to fall in 2023 and 2024 (-8% over the first eight months of 2023).

The biggest increase in expenditures is the payment of interest on debt (+17.1% over the first eight months of the year), which reached 15.1% of revenue (compared to 14.3% in 2022) and could reach over 17% according to government forecasts. This increase reduces the government's budgetary leeway to support the economy.

In the short and medium term, the risks of public finances slipping out of control are contained, even if the structurally low fiscal base remains a major source of weakness. The government should continue to consolidate its public finances. It plans to reduce the deficit to 2.3% of GDP in 2024. The next government to emerge from the general elections (presidential, legislative and regional) in February 2024 should continue along this path. The main risk, although contained, relates to sources of financing due to the end of the central bank's asset purchasing programme on the primary market.

## SLIGHT DETERIORATION IN EXTERNAL ACCOUNTS IN Q2 2023

In 2022, for the second year running, the current account recorded a surplus equivalent to 1% of GDP, boosted by a trade surplus of 5.1% of GDP, a level not seen since 2010. In contrast, net foreign direct investment (FDI) have slowed. Incoming investments, already structurally modest, only reached 1.8% of GDP over the whole of 2022, compared to 2% of GDP the previous year (which also corresponds to the average recorded over the 2017-2021 period). Nevertheless, even though the FDI-to-GDP ratio fell, the share of flows received by Indonesia worldwide increased in 2022 to 1.7% (compared to an average of 1.3% over the last decade). Investment from China has accelerated significantly since 2021 (+16.2% in 2022, compared with an average of 8.1% over the 2015-2019 period). In particular, China has increased its investment in manufacturing by a factor of 7.5 compared with the average recorded between 2015 and 2019.

INDONESIA: CURRENT ACCOUNT STILL IN SURPLUS IN H1 2023

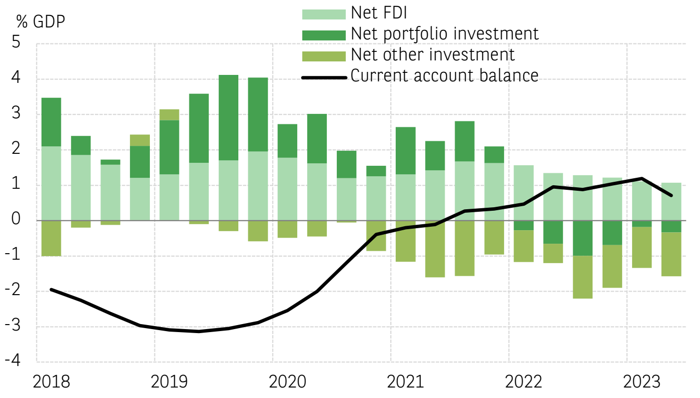


CHART 2 SOURCE: CEIC, BI, BNP PARIBAS

Indonesia is seeking to attract FDI to become a major electric battery manufacturing centre and expand its metal processing activities.

Since the beginning of 2023, the balance of payments has deteriorated due to the negative impact of the fall in commodity prices on the current account and the indirect impact of the tightening of US monetary policy on the financial account.

In Q2 2023, the current account balance returned to negative territory (-0.5% of GDP) after seven quarters of surplus. The decline in the trade surplus (as of Q1 2023) was significantly accentuated in Q2 due to the global economic slowdown and the fall in the prices of the main commodities exported by the country (-57.9% on the price of coal, -32.2% on the price of palm oil over the first eight months of 2023). This was not offset by the increase in the surplus of the balance of services brought about by the upturn in tourism.

At the same time, the financial account recorded a deficit of 1.4% of GDP, whereas it was in surplus in Q4 2022 and Q1 2023. Net capital inflows slowed significantly due to the sharp narrowing of yield spreads between domestic government bonds and those in advanced countries (particularly US government bonds). Thus, the balance of payments (excluding changes in foreign exchange reserves) recorded a significant deficit in Q2 2023 (2.1% of GDP). According to data from the Institute of International Finance (IIF), capital outflows increased in August, as in many other Asian countries.

Downward pressures on external accounts and the rupiah are expected to remain strong until the end of the year, as well as in 2024, due to risks on Chinese growth and food and energy prices. However, despite the expected increase in external financing needs, refinancing risks are limited. Foreign exchange reserves, although slightly down in Q2 (-5.7% since March 2023), remain comfortable. Estimated at USD 124 bn in July 2023, they still covered 2.3 times the country's short-term financing needs.

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