INDONESIA

A DIFFICULT RECOVERY

For the first time since the 1998 crisis, Indonesia is expected to enter recession in 2020. In Q2 2020, the economy contracted by more than 5%, and the recovery should be slow. Domestic demand is struggling to pick up, and Jakarta has just been put under a partial lockdown again. Fiscal support has been slow in coming: planned fiscal spending still hasn't materialised in the first seven months of the year. Even so, the deficit is under control and the central bank is acting as the lender of last resort. In H2 2020, the government hopes to consolidate the recovery via a massive support package for low-income households. Even though inflation is under tight control, the poverty rate could reach 11.6% according to the World Bank (vs 9.2% in 2019).

GDP GROWTH: A DIFFICULT RECOVERY

In the first half of 2020, GDP contracted 1.3% compared to the year-earlier period. For the first time since the 1998 crisis, Indonesia will be in recession this year.

In Q2 2020, the economy contracted 5.3% year-on-year (y/y) due to declining domestic and external demand. All of the components of demand contracted. Household consumption, which contributes more than 54% of growth, declined 5.5% y/y following partial lockdowns in numerous regions, including Jakarta, starting in March. Investment contracted even more sharply (-8.6% y/y), especially for machinery and capital goods purchases. Government spending was down by nearly 12% y/y despite the announcement of massive plans to stimulate growth, which have not been implemented yet. Net exports made a positive contribution to growth because the contraction in imports (-17%) more than offset the decline in exports (-11.7% y/y).

By sector, the contraction was especially sharp in the transport sector (-30.8%) and to a lesser extent in construction and industry. In contrast, agriculture and information & communications services continued to report positive growth.

Activity indicators for Q3 2020 suggest a recovery, albeit a slow one differentiated by sector. In July and August, domestic demand rebounded slightly but still 13% below pre-Covid levels. Vehicle and motorcycle sales continued to decline in July, down 59% and 44.5% y/y, respectively, while retail sales fell 10.7% y/y in August. Household confidence has improved since June, but is still depressed. Tourism has collapsed, down 89% in July 2020. Capital goods imports contracted by more than 29.2% y/y in July, reflecting the persistently sharp contraction in corporate investment. The only positive point is business sentiment, which returned to expansion territory in August (PMI of 50.8). Yet the slight recovery in domestic demand could be throttled by the reintroduction of partial lockdown measures in the Jakarta region as of 14 September, after a very strong surge in the number of new Covid-19 cases.

According to the World Bank, in a worst-case scenario the poverty rate could rise to 11.6% by the end of the year (from 9.2% in September 2019) if the government fails to distribute funds to support the most vulnerable households in an optimal manner. Fortunately, price increases have been extremely mild so far, but by late July, the government still had not paid out the social welfare benefits provided in the budget.

A RESILIENT BANKING SECTOR

Like in all the Asian countries with the exception of India, inflationary pressures are extremely mild in Indonesia, providing the central bank with substantial leeway to ease monetary policy and stimulate growth (although this is not one of their official targets, contrary to the wishes of certain members of parliament). In August, inflation was limited to only 1.3% y/y, compared to the central bank's target of 3% give or take 1%. Under this environment, the central bank lowered its key rates by 100 basis points to 4%. This reduced corporate and consumer lending rates by only 67 bp and 27 bp, respectively, and these rates remain high even in real terms (at an average of 8% and 9.7%, respectively). The growth of bank lending continued to slow to only 1% y/y in July

FORECASTS

	2018	2019	2020e	2021e
Real GDP growth (%)	5.2	5.0	-3.0	5.4
Inflation (CPI, year average, %)	3.2	2.6	1.9	1.7
Gen. Gov. balance / GDP (%)	-1.8	-2.2	-6.1	-3.4
Gen. Gov. debt / GDP (%)	30.1	30.4	36.4	37.1
Current account balance / GDP (%)	-2.9	-2.7	-1.6	-2.5
External debt / GDP (%)	36.0	36.0	37.3	37.4
Forex reserves (USD bn)	115	122	130	137
Forex reserves, in months of imports	6.3	7.1	7.3	7.6
Exchange rate USDIDR (year end)	14 496	14 017	14 500	14 100

TABLE 1
e: ESTIMATES AND FORECAST
SOURCE: BNP PARIBAS GROUP ECONOMIC RESEARCH

PRIVATE CONSUMPTION

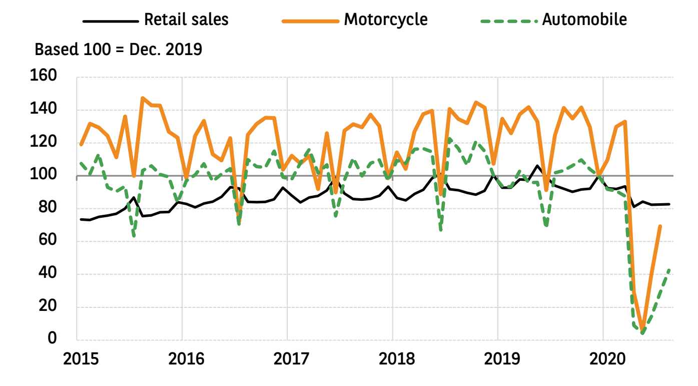

CHART 1
SOURCE: BI

2020, vs 9.7% a year earlier.

Yet monetary easing is still restrained by one of the central bank's other targets: stabilisation of the rupiah. With the number of Covid-19 cases surging again in August, the currency came under such fierce downward pressure that the monetary authorities did not change their key rates at the most recent monetary policy committee meeting.

Despite a tough macroeconomic environment, Indonesia's banking sector seems to be holding up well in the current crisis. Credit risk was on the rise at the end of June, but still under control. The doubtful loan ratio was only 3.1% (up from 2.5% at the end of last year), while special-mention loans, i.e., those with late payments of less than 90 days and/or susceptible of becoming doubtful loans, had declined to 5.2% after peaking at 6.9% in April. These strong figures are partially due to the fact that banks have the possibility of waiting until Q1 2021 before classifying loans in the "doubtful loan" category. The banks still have very satisfactory capital adequacy ratios (22.5% in June) and abundant liquidity, with a loan-to-deposit ratio of 89% in June. In contrast, profitability indicators have deteriorated sharply in line with higher provisions and falling interest rates: the return per asset and per security was only 1.9% and 12.7%, respectively, at the end of June (vs. 2.5% and 16.2% a year earlier).

PUBLIC FINANCES: A LIMITED DEFICIT IN THE FIRST 7 MONTHS

In the first 7 months of the year, the government's fiscal deficit remained under control. It amounted to only 31.8% of the full-year target, which the government revised to 6.34% of GDP in June 2020. The public accounts have held up relatively well despite a 13.2% decline in revenue compared to the same period last year, which is essentially due to a very tight grip on public spending. Spending increased only 1.3% and amounted to only 45.7% of the full-year target. Yet the government claims that it will resort to public spending in the second half.

Government debt issues were 62.4% underwritten by private banks and 25.4% by public banks. Although central bank purchases were on the rise, they have been relatively limited so far (10.4%). Yet the expected increase in spending in the second half of the year will be mainly financed by zero interest rate bond issues purchased by the central bank on the primary market for a total of IDR 575 trillion (i.e. 47.1% of the provisional full-year deficit). Officially, the government has announced that only social and healthcare spending will be covered by the central bank. Yet the central bank will remain the government's lender of last resort for all of 2020.

At the end of June 2020, government debt was still low at 35.5% of GDP, even though it had increased by 5 percentage points since the beginning of the year. The debt structure is more risky, however, compared to other countries such as India. Indeed, 37.9% of Indonesia's debt is denominated in foreign currencies, and 58.2% is still held by non-resident investors. For the moment, the Indonesian government has been highly dependent on foreign investors to ensure its debt financing, because the domestic bond market has not been sufficiently developed (17.4% of GDP).

THE RUPIAH IS UNDER PRESSURE DESPITE THE CONSOLIDATION OF EXTERNAL ACCOUNTS

Indonesia's external accounts are still solid. In Q2 2020, the balance of payments (excluding the change in foreign reserves) showed a surplus

IMPORTS

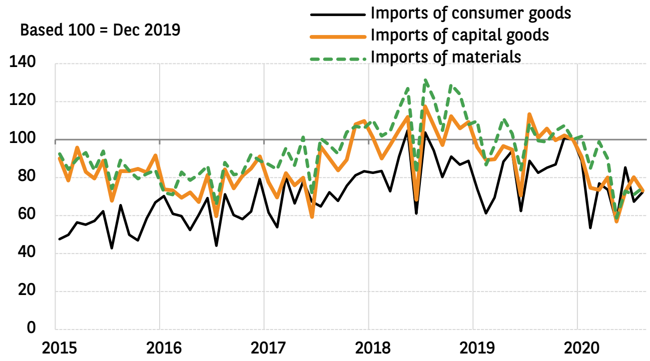

CHART 2

SOURCE: BI

of USD 9.2 bn, the equivalent of 3.8% of annualised GDP.

The current account deficit continued to contract in Q2 2020, despite a sharp decline in exports[1], to an annualised rate of only 1.2% of GDP (vs 3% of GDP in Q2 2019). The decline in the current account deficit is mainly due to the sharp contraction in imports of oil-based products, but also of capital and consumer goods, in keeping with the contraction in domestic demand. The first statistics available for the third quarter confirm the strength of the trade surplus. In full-year 2020, the current account deficit should be limited to 1.2% of GDP according to the Indonesian central bank.

In Q2 2020, the financial account surplus increased, buoyed by an increase in portfolio investment after the massive capital outflows reported in Q1 2020. Already moderate, foreign direct investment declined further to reach only 1.7% of GDP in Q2 2020, although this was still enough to cover the current account deficit. In the first two quarters of 2020, the base balance showed a surplus for the first time after nine quarters of deficits.

Although external debt rose 5% y/y in Q2 2020, it was still under control at 36.5% of GDP (2019). The country had a net external debit position of 22.5% of GDP, but this mainly reflects the stock of foreign direct investment (18.2% of GDP). At the end of July, foreign reserves amounted to USD 127 bn, USD 5 bn more than at year-end 2019. This is equivalent to 7 months of imports and 1.5 times the country's short-term financing needs. Even so, Indonesia is still vulnerable to capital flight: in 2019, portfolio investment flows amounted to 2% of GDP, which is higher than the amount of foreign direct investment (1.5% of GDP). During periods of high financial market volatility like we have seen in recent months, Indonesia reports massive capital outflows that make the rupiah extremely volatile. At the end of September, the rupiah was still down 6.7% against the dollar compared to its value at the beginning of the year.

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1 In the first 8 months of 2020, export commodity prices fell by 4.7% on average (-17.3% for coal, -11.4% for rubber, -8.7% for aluminium, and -5% for copper).