INDONESIA

A LESS FAVOURABLE OUTLOOK

During the first six months of 2022, the economy proved to be quite resilient to the consequences of the conflict in Ukraine and China's zero-Covid policy. In particular, it benefited from the higher prices of exported commodities (mainly coal and palm oil). Its public finances and external accounts consolidated despite rising subsidies and net capital outflows. However, the situation could deteriorate in the fourth quarter and the medium-term outlook is less favourable. Although the fiscal deficit and government debt remain modest, refinancing risks will increase in 2023 in conjunction with the end of purchases by the central bank of government's bonds, which have been in place since 2020. Moreover, pressures on the rupiah will intensify with the fall in commodity prices.

EXPECTED SLOWDOWN

In the first half of 2022 economic growth was +5.2% compared to the same period last year. Household consumption and net exports picked up pace significantly. The return of tourists supported the demand for services. The increase in the consumer price index (CPI) remained relatively modest over the first six months of the year (+3% year-on-year), thanks in particular to the maintenance of regulated petrol prices and the ban in May on exporting palm oil in order to limit the rise in domestic vegetable oil prices.

However, activity will slow down over the second half of the year and inflationary pressures will intensify. The increase in the consumer price index reached 5% year-on-year between June and September 2022, and so exceeded the 4% target set by the monetary authorities. Domestic demand is expected to slow down (particularly in the last quarter), mainly due to the rise in food prices (already +9.2% on average over the past three months), the increase in regulated petrol prices and the tightening of monetary policy.

Indeed, in order to limit the rise in public spending, at the beginning of September the government announced a rise in the controlled petrol and diesel prices, for the first time since 2016. They have been raised by an average of over 30%. In anticipation of the impact of this increase on transport prices and, more generally, in response to the rise in inflationary pressures, the central bank (Bank Indonesia, BI) tightened its monetary policy by 50 basis points (bps) at the monetary policy committee in September, having previously raised its rates by 25 bps in August. Further rate hikes can be expected.

Furthermore, the economic slowdown in China and the United States, Indonesia's two main trading partners, will weigh on its exports.

Against this backdrop consumer confidence indices fell slightly over the summer and the pace of growth in retail sales began to slow. While entrepreneurs remained confident in August, there is every indication that this optimism won't last.

The government has less room for manoeuvre for supporting its economy than in 2019. Moreover, the prospect of having to finance its entire deficit without direct support from the central bank means it has to be cautious. This explains the recent increase in regulated petrol prices following several months of support for the population.

PUBLIC FINANCES REMAIN STRONG

However, the public finances consolidated over the first eight months of 2022. The government's fiscal balance recorded a surplus equivalent to 0.6% of GDP, compared to a deficit of 2.3% of GDP in the same period last year.

FORECASTS

	2019	2020	2021	2022e	2023e
Real GDP growth (%)	5.0	-2.1	3.7	5.5	4.9
Inflation (CPI, year average, %)	2.6	2.0	1.6	4.3	4.7
Gen. Gov. balance / GDP (%)	-2.2	-6.1	-4.6	-3.9	-2.9
Gen. Gov. debt / GDP (%)	30.7	39.8	41.1	41.3	40.9
Current account balance / GDP (%)	-2.7	-0.4	0.3	0.3	-0.2
External debt / GDP (%)	36.0	39.4	35.1	31.8	30.9
Forex reserves (USD bn)	122	129	131	115	110
Forex reserves, in months of imports	7.1	7.3	7.4	6.0	6.9

e: ESTIMATE & FORECASTS

TABLE 1 SOURCE: BNP PARIBAS ECONOMIC RESEARCH

INDONESIA: INFLATIONARY PRESSURES HAVE ACCELERATED SINCE JUNE

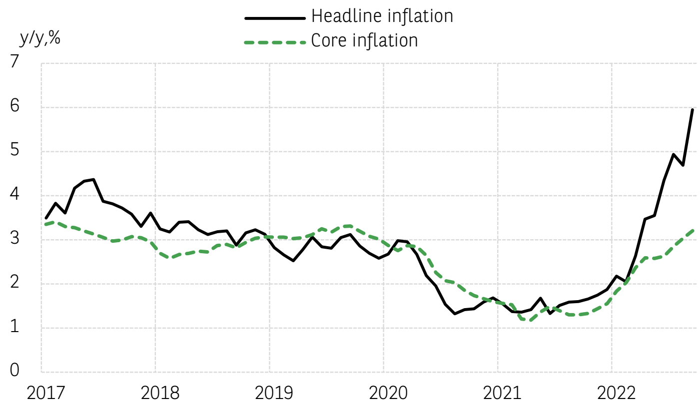

CHART 1 SOURCE: CEIC, BI, BNP PARIBAS

This strong performance was made possible by the very significant increase in budget revenues. These increased by almost 50% year-on-year over the first eight months of 2022 to reach the equivalent of 14% of GDP, fostered by the dynamism in domestic demand, the rise in VAT in April, and the sharp increase in company profits excluding oil and gas.

The increase in expenditure was relatively modest (+8.3%) despite the increase in interest payments and subsidies (+10.1% and +16.8% respectively over the first eight months of the year). Nevertheless, the government expects a sharp rise in costs in the fourth quarter of 2022 because of the conflict in Ukraine, despite the increase in regulated oil prices in September. Subsidies are therefore expected to amount to 1.8% of GDP over the full year 2022 (compared to 1.4% of GDP in 2021), plus income transfers (for the lowest income households) which will amount to 1.6% of GDP in 2022 (they were almost zero in 2021).

Over 2022 as a whole, the deficit should reduce to 3.9% of GDP (compared to 4.6% of GDP in 2021). In its budget projection for 2023 the government envisages reducing the deficit to 2.9% of GDP, below the «legal» threshold of 3% of GDP (temporarily suspended between 2020 and 2022 and restored for 2023). This consolidation will in particular be supported by the reduction in expenses (-4%), including subsidies and transfers to households. The growth in revenues is likely to be marginal. The one-point rise in VAT (set at 12%) should help to compensate for the expected drop in corporate income taxes resulting from the expected normalisation in commodity prices.

On the other hand, debt interest payments are expected to increase (in conjunction with the rise in debt and the yields on government bonds) and account for more than 18% of government revenues in 2023 (compared to 14.1% in 2019), further restricting the government's budgetary room for manoeuvre.

In 2023 the deficit will be wholly financed by the issuing of bonds on the domestic market. However, unlike the last three years, the central bank will not purchase government's bonds on the primary market (439 trillion rupiah in bonds were purchased by the BI in 2021 and 2022, equivalent to 2.6% of the 2021 GDP).

In 2022, government debt is expected to continue increasing, to 41.3% of GDP, before falling slightly from 2023. However, refinancing risks will increase with the end of the central bank's debt purchasing programme and the rise in US interest rates.

While government debt remains modest, the refinancing risks are greater than in other countries (such as Malaysia and India where the debt-to-GDP ratio is, however, much higher) as Indonesia remains structurally dependent on foreign investors to meet its financing needs. Prior to the BI's debt purchasing programmes in 2020, the proportion of tradable domestic debt (91% of the total debt) held by foreign investors stood at 38.6% in 2019. It was only 15.2% in June 2022.

EXTERNAL ACCOUNTS SHOW RESILIENCE

Indonesia's external accounts have proved far more resilient to the external environment than might have been feared in view of previous episodes of rising oil prices and US monetary policy tightening. Furthermore, although foreign exchange reserves fell over the first eight months of the year they are still sufficient to cover the country's overall short-term external financing needs by a factor of 1.9. The rupiah depreciated by only 6.3% against the dollar in the first nine months of 2022. Nonetheless, external account pressures are expected to grow in the coming quarters and volatility in the rupiah is expected to increase.

The country's external debt fell below pre-Covid-19 levels to stand at just 31.8% of GDP in June 2022 compared to 36% of GDP in 2019. This reduction mainly reflects the decrease in government debt purchases by foreign investors and, to a lesser extent, the slight fall in Indonesian corporate debt, while banks' external debt increased slightly. In addition, while external debt still accounts for almost 1.8 times the country's export revenues, the refinancing risks are modest. External debt repayments in the next twelve months remain low, especially in relation to foreign exchange reserves. At the end of June they stood at only 66 billion US dollars, equivalent to 0.5 times the country's foreign exchange reserves.

INDONESIA: CURRENT ACCOUNT SURPLUS IN H1 2022

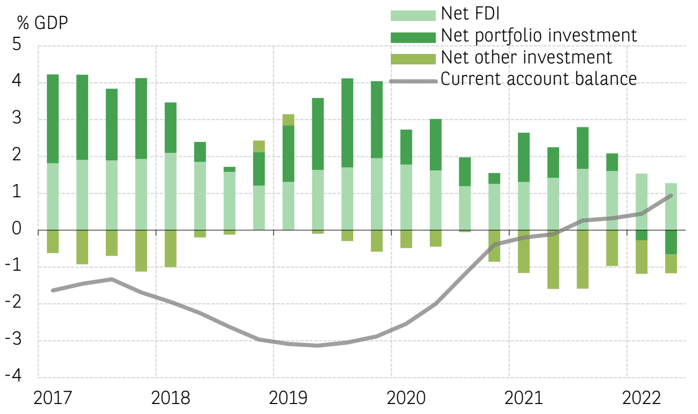

CHART 2

SOURCE: CEIC, BI, BNP PARIBAS

As a net exporter of commodities, particularly coal and palm oil (each of which accounted for 11.6% of the country's total exports in 2021), Indonesia has benefited from the sharp rise in commodity prices in the first half of 2022. Although oil and gas imports increased by 83% compared to the same period last year, the effect on the trade balance was largely offset by the rise in exports. The current account therefore recorded a surplus of around 0.7% of GDP over the first six months of 2022 while it showed a deficit of 1.4% of GDP a year ago.

Furthermore, although the country has continued to post net portfolio investment outflows, these have fallen significantly in comparison to Q4 2021. They were only 0.5% of GDP in the first half of 2022.

However, foreign direct investment (FDI), which was already structurally modest (1.6% on average over the past five years), declined in the first half-year compared to the same period in 2021, at just 1.1% of GDP. Investments remained concentrated in the metallurgy industry, the transport sector and telecommunications, the food industry and the mining sector. This drop in FDI flows could be explained by the uncertainty surrounding President Joko Widodo's succession. If foreign investment remains as modest in 2023 this could become a concern as the current account could show a (slight) deficit again, and the government's external financing needs would be expected to increase to compensate for the lack of bond repurchasing by the central bank. The downward pressures on the rupiah could intensify next year.

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