INDONESIA

A MODEST RECOVERY

Having contracted by 2.1% in 2020, the Indonesian economy is likely to see only a modest recovery in 2021. Domestic demand is struggling to recover. Consumer sentiment remains weak and any resurgence in the pandemic could undermine the recovery, at a time when a very low percentage of the population has been vaccinated. Moreover, despite the highly expansionary monetary policy, bank lending has continued on its downward trend. The financial position of Indonesian companies prior to the Covid-19 crisis was more fragile than those of ASEAN peers, and they are likely to seek to consolidate their positions rather than invest in an uncertain future. The banking sector remains solid and well-placed to deal with an expected increase in credit risk.

A MODEST RECOVERY IN 2021

Real GDP contracted in 2020 (by 2.1%) for the first time since 1998. Besides, the recovery in 2021 is likely to be modest and below potential.

In the fourth quarter of 2020, economic activity still contracted by 2.2% compared to the same quarter in 2019 and, in the first two months of 2021, it was still smaller than it was at the end of 2019. Domestic demand, which is the main engine of growth, remains fragile. Retail sales were still 24% below their pre-crisis level and the increase in oil prices could hold back the recovery, even though in February, consumer price inflation, at 1.4% year-on-year, was well below the monetary authorities' target of 3% +/-1 pp.

Consumer confidence remains depressed. Consumers have been hit hard by the crisis due to health measures and the loss of income resulting from the fall in employment, with a substantial share of the population having no social protection. The Indonesian central statistical agency estimates informal employment at more than 60% of the total. In addition, the latest surveys of both consumers and corporates showed that the situation in the labour market has remained fragile through the early months of 2021.

Business leaders seem to be more confident than consumers. The manufacturing sector PMI index was above 50 in March, for the fifth month in a row. The increase in imports (excluding oil and gas) in February, and particularly that in capital goods, confirmed the recovery in industry. That said, investment is unlikely to recover to any significant degree until the second half of this year. Although business leaders view financial conditions as better than before the Covid-19 crisis, the terms of lending appear less flexible. In addition, capacity utilisation rates, whilst rising, remain below their long-term average.

The recovery could, however, be undermined by another epidemic wave, although since the beginning of February it seems to have lost intensity. Vaccination levels remain far too low to protect the population from a possible new wave. By the end of March, only 2.4% of the population had received a first dose of the vaccination.

Against this background, the Indonesian central bank cut its policy rate by 25 basis points (bp) to 3.5% in February, in order to bolster the economy, at a time when other central banks were raising their rates. This took the total cut in rates since February 2020 to 150bp. The relaxation of monetary policy could, however, be disrupted by an increase in oil prices and the rise in US long-term rates. This has resulted in capital outflows and downward pressure on the rupiah, which has lost 4.3% against the dollar over the first three months of 2021.

1 Over the first two months of 2021, spending increased by 1.2%.

FORECASTS

	2019	2020e	2021e	2022e
Real GDP growth (%)	5.0	-2.1	4.2	4.6
Inflation (CPI, year average, %)	2.6	2.0	1.6	2.1
Gen. Gov. balance / GDP (%)	-2.2	-6.2	-5.8	-4.5
Gen. Gov. debt / GDP (%)	30.7	40.7	43.5	45.8
Current account balance / GDP (%)	-2.7	-0.4	-1.0	-2.1
External debt / GDP (%)	36.0	39.4	40.0	40.2
Forex reserves (USD bn)	122	129	134	142
Forex reserves, in months of imports	7.1	7.3	7.4	7.6

e: ESTIMATES & FORECASTS

TABLE 1 SOURCE: BNP PARIBAS GROUP ECONOMIC RESEARCH

DOMESTIC DEMAND IS STRUGGLING TO RECOVER

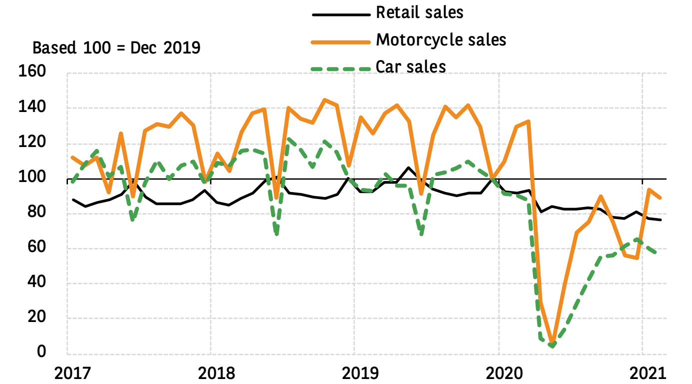

CHART 1 SOURCE: BI

A BUDGET TO SUPPORT RECOVERY

In 2021, the Indonesian economy will benefit from a 7% increase in public spending relative to 2020[1]. In particular, the finance ministry plans to increase infrastructure investment by 47.3%, alongside increases in spending on social security and health, education, and new generation IT and communication equipment. To help finance infrastructure spending, a sovereign wealth fund has been created with an initial contribution of USD5 billion from the government, which hopes that this will be topped up to USD20 billion by a mix of private and public investment.

Despite economic growth recovering to between 4.5% and 5%, the finance ministry estimates that the increase in government revenues will be a modest 6.7%.

Thus, the government expects only a limited reduction in its fiscal deficit, taking it from 6.2% of GDP in 2020 to 5.5% in 2021. Moreover, the government's target of cutting its deficit to 3% of GDP by 2023 looks difficult to achieve, unless with a drastic cut in spending, as reductions in company tax rates and various other tax cuts included in the 'Omnibus Law' will affect government receipts.

Against this background, the government's debt will rise by around three points of GDP in 2021, taking it to 43.5%. This will nevertheless be lower than in other ASEAN countries, such as Malaysia. There are, however, two remaining areas of concern: interest payments will account for more than 21.4% of receipts, whilst the domestic bond market will be unable to cover the government's entire financing needs. Moreover, since March 2020, foreign investors have limited purchases of rupiah-denominated Indonesian debt. By January 2021, they held 24.9% of the total stock, down from 38.6% at the end of 2019. To address this issue and control borrowing costs, the central bank will continue to purchase government bonds on the primary market, as it did in 2020.

VERY EXPANSIONARY MONETARY POLICY

The central bank helped support the economy through 2020 by adopting a very expansionary monetary policy. In addition to policy rate cuts, it injected the equivalent of IDR 750.4 trillion (4.9% of GDP), not only through purchases of government bonds for a total of IDR 473.5 trillion (3% of GDP), but also through substantial cuts in statutory reserve requirements for banks, which increased liquidity across the sector by IDR 155 trillion. As a result, the liquidity coverage ratio hit 226.2% in Q2 2020.

In February 2021, to help support a recovery in lending, the central bank also removed the deposit requirement on mortgages and car loans (for banks with a non-performing loan ratio of less than 3.5%). However, the fall in the average lending rate has been limited. Rates on lending for investment have come down by only 90bp on average, and those for consumer lending by just 50bp.

The economic policies adopted jointly by the government and central bank have helped support the actors most affected by the crisis, in particular small and medium-sized enterprises, which have benefited from debt restructuring and government-guaranteed loans. Despite this, overall bank lending has contracted. In January 2021, lending to business was still 4% lower than in January 2020, whilst lending to households had risen by only 0.6%. Banks remain extremely cautious in their lending policies.

CREDIT RISK REMAINS UNDER CONTROL

The banking sector has remained solid so far, despite a fall in profitability. Returns on assets and returns on equity fell to 1.5% and 10.2%, respectively, by the end of 2020 (from 2.5% and 16% at end-2019).

BANK LENDING CONTINUES TO CONTRACT

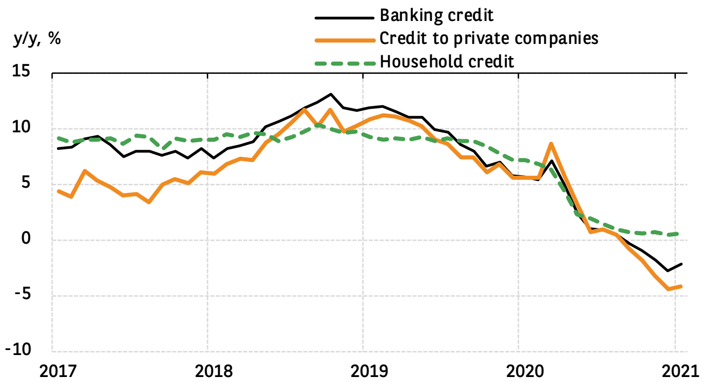

CHART 2 SOURCE: BI

At the end of 2020, asset quality remained more than satisfactory: the non-performing loan ratio was just 3.2% in February 2021 (from 2.8% a year earlier). However, this ratio varies from one segment to the next (it is nearly 4.9% in retail) and in all likelihood is understated; banks can wait until 31 March 2022 before categorising loans as non-performing. Meanwhile, according to S&P, loan restructuring increased by 18% in 2020.

At the same time, the position of companies, which was already fragile before the Covid-19 crisis[2], has further deteriorated following a contraction in revenue. According to the central bank, the interest coverage ratio (a measure of the number of times a company could make the interest payments on its debt with its EBIT) was only 0.5 on average in Q2 2020. The ratio was below 1 in all economic sectors apart from mining. This is a trend that threatens a sharp rise in credit risk.

Overall, however, banks still have the capacity to deal with the expected deterioration in the quality of their assets. They have increased provisions (the provisioning rate jumped to 66.3% in Q3 2020, from 53.3% at the end of 2019) and their capital adequacy ratio remained very comfortable in December 2020, at 23.8%.

Completed on 9 April 2021

Johanna MELKA
johanna.melka@bnpparibas.com

2 According to the IMF's Article IV report in March 2021, the financial position of Indonesian companies was more fragile than in other ASEAN countries at the end of 2019. The IMF estimates that at end-2019, debt stood at 27% of assets, against 22% in the rest of the ASEAN zone. Moreover, for 56% of companies (compared to less than 40% in Malaysia), profits were less than twice their interest costs.