Indonesia

A violent shock hits a solid economy

The Covid-19 crisis will have a huge impact on an economy that was already weakened slightly by the slowdown in global trade in 2019. Yet Indonesia's macroeconomic fundamentals are strong: its public finances are solid, the banking sector is robust and both companies and households have very little debt. The country has sufficient foreign reserves to cover its short-term financing needs. Yet the rupiah is bound to remain under fierce downward pressure: the current account deficit is only partially financed by foreign direct investment, and capital outflows have reached unprecedented levels since 31 January.

Growth

GDP growth slowed to 5% in 2019 from 5.2% in 2018. This is mainly due to the downturn in corporate productive investment in the midst of a sharp slowdown in global trade and falling commodity prices (attributable to US-China trade tensions). In Q1 2020, economic indicators suggest that growth will continue to slow. Industrial output contracted in January, and the ongoing decline in capital goods imports (for the 14th consecutive month) does not augur well for a rebound in investment. Retail sales also contracted in February for the third consecutive month, while automobile and motorcycle sales plunged.

Indonesia will not be spared from the economic fallout of the COVID-19 pandemic. At least it is less exposed to the slowdown in global trade than the other ASEAN countries like Malaysia, because it is not very integrated in global supply chains. The COVID-19 crisis will affect the economy via several channels: 1) the contraction in tourism, 2) the drop-off in commodity prices, and 3) the decline in domestic demand (especially as confinement measures are enforced).

The pandemic's impact on tourism revenues will not be as strong as for the other ASEAN countries like Thailand, since tourism accounts for only 1.4% of GDP. Even so, a 50% decline in tourism revenues would generate a 0.7 percentage point (pp) decline in GDP growth.

A 2 pp slowdown in world trade would trigger an 11% decline in Indonesian exports (which account for 20.7% of GDP), resulting in a 2.3 pp decline in GDP growth. Commodity prices fell sharply in Q1, with oil prices down 60%; palm oil, -22%; rubber, -6%; coal, -21%; and copper, -22%. This trend is expected to continue in Q2, placing a tight squeeze on corporate earnings and investment.

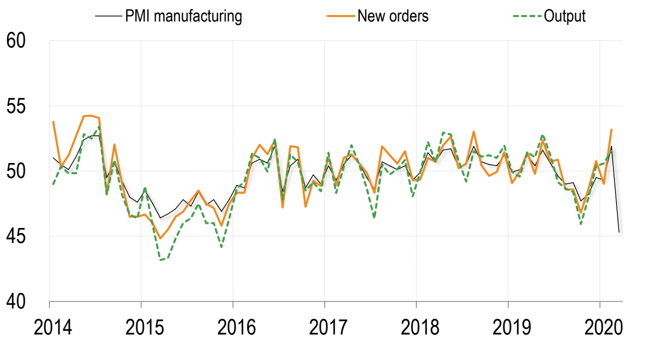
So far, the population has not been in lockdown, but if the coronavirus were to spread, stricter confinement measures would have to be introduced. A lockdown would have severe economic and social consequences that would be hard to alleviate given the importance of informal employment (55% of the labour market). In 2019, household consumption contributed more than 54% to growth. Assuming household consumption contracts in Q2 before rebounding thereafter in Q3, and assuming investment projects (29% of GDP) are postponed by companies until Q4 and by the government until 2021, then growth could slow by 4 pp to 1% before rebounding in 2021. If the coronavirus were to spread far and wide, however, growth could contract at -0.4% according to the ministry of finance.

1- Forecasts

	2018	2019	2020e	2021e
Real GDP growth (%)	5.2	5.0	1.0	5.4
Inflation (CPI, year average, %)	3.3	2.8	2.3	2.7
Fiscal balance / GDP (%)	-1.8	-2.2	-5.1	-3.0
Current account balance / GDP (%)	-2.9	-2.7	-2.2	-2.0

e: BNP Paribas Group Economic Research estimates and forecasts

2- PMI manufacturing index: strong decline in March



Source: Markit

Support measures

Since the beginning of the crisis, the monetary authorities have lowered the policy rate by 50 bp to 4.5%. However, the central bank kept its key interest rates steady in April in order to sustain the rupiah.

Monetary authorities also lowered the required reserve ratios for commercial banks from 8% to 2%. Swap operations will be carried out every day to meet USD liquidity needs. As to fiscal policy, the government announced three economic stimulus packages for a total of nearly IDR 436 trillion (2.7% of GDP). Moreover, the government temporarily scrapped the fiscal deficit ceiling of 3% of GDP.

Key measures include the exemption of manufacturing sector employees from income taxes and a 30% corporate tax rebate for six months starting in April. Food subsidies for low income households will be expanded to cover 15.2 million individuals on 1 April.

Public finances remain solid

Indonesia's public finances are very solid. In 2019, the fiscal deficit and government debt were limited to 2.2% and 30.1% of GDP, respectively. Yet the slowdown in domestic activity and the contraction in foreign trade will strain government revenues. In the first two months of 2020, the fiscal deficit has already widened by 15% compared to the same period last year. The fiscal deficit is projected to reach 5.1% of GDP in 2020 but it could exceed this new target if the pandemic lasts for more than six months. The public debt ratio is also mild at 30.1% of GDP, but more than 60% is held by non-resident investors, and nearly 38% is denominated in foreign currencies, the vast majority in USD. Even so, from a 2020 horizon the refinancing risk is small because debt servicing amounts to only USD 10.2 bn, equivalent to 8.1% of foreign reserves.

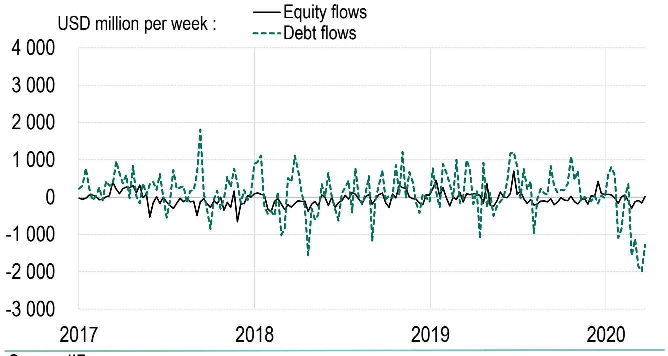
Refinancing risks are small

In Q3 2019, the debt ratio of households and non-financial companies was moderate at 17.8% and 22.7% of GDP, respectively, according to BIS data. According to the central bank, the situation of non-financial companies was satisfactory in 2019, even though it was weakened by the slowdown in global trade and declining commodity prices. In June 2019, the debt-to-equity ratio was still moderate at 0.58. Corporate assets covered commitments 1.86 times and the liquidity ratio was 1.21. Companies had satisfactory coverage of their debt servicing charges, with a debt coverage ratio of 70.5%, while earnings were 2.9 times interest payments alone. Yet the situation varies widely depending on the sector. Companies in the agricultural sector, and to a lesser extent the water, gas and electrical power utilities, were considered to be more fragile at year-end 2019.

Depreciation of the rupiah will automatically revalue the country's foreign currency debt. Since the beginning of the coronavirus outbreak, the rupiah has depreciated by more than 18% against the US dollar. Yet only 51% of corporate debt is denominated in foreign currencies. According to the IIF, international corporate bonds reaching maturity amount to only USD 5.3 bn in 2020 and USD 6.4 bn in 2021. International loan payments are much higher, estimated at an average of USD 17 bn in 2020 and 2021. On the whole, however, Indonesian companies can meet their payments on international debt denominated in foreign currency. The monetary authorities adopted strict regulations requiring companies to cover their foreign exchange risk as of 2015 (which were strengthened in 2016). In Q3 2019, the central bank estimated that 88% of companies had covered 90% of their positions. The most fragile companies are in construction, real estate, media and retailing, sectors that do not generate foreign currency revenues.

Lastly, the banking sector is also solid and has the capacity to handle an increase in credit risk. The doubtful loan ratio was only 2.5% of total loans outstanding at year-end 2019. Solvency ratios were very satisfactory, with a capital adequacy ratio (CAR) of 23.3%.

3- Significant capital outflows since January 31



Source: IIF

The rupiah is under fierce pressure

Indonesia is vulnerable to an external shock because commodities (excluding food) account for 51% of exports. It also depends on non-resident portfolio investments to finance the current account deficit (2.7% of GDP in 2019), because foreign direct investment (FDI) is insufficient (1.8% of GDP in 2019). Since 31 January, however, portfolio investment outflows have swelled to USD more than 11 bn according to IIF, compared to net inflows of USD 12 bn in 2019. In the short term, the rupiah is likely to remain under strong downward pressure, even though the current account deficit is contracting due to the decline in oil imports and the slowdown in domestic demand. Indonesia had foreign reserves of USD 113 bn at the end of March, which will largely suffice to cover the country's short-term financing needs.

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