ECONOMIC ANALYSIS

Taking stock of the challenges ahead for Indonesia's new President

Sumedh Deorukhkar / Carlos Casanova / Alicia García-Herrero

- **Indonesia's new president Joko Widodo (Jokowi) will assume office on October 20:** His election caused a wave of positive sentiment among investors. Initial enthusiasm has given way to skepticism, as a number of political bottlenecks threaten to hamper Jokowi's ability to push for reform. These include a fragmented and unsupportive People's Representative Council, as well as losing the support from outgoing President Susilo Bambang Yudhoyono.
- **The growing current account deficit threatens to hinder Indonesia's growth potential:** Despite a number of aggressive measures to stem external imbalances were implemented last year, the CAD only corrected marginally from -3.8% of GDP in 3Q13 to -3.2% of GDP in 1Q14. A number of factors have contributed to aggravating this further, including a contraction of exports and falling global commodity prices. Looking ahead, we expect a gradual correction in Indonesia's CAD, in line with BI's estimate of -3.2% of GDP for 2014 and -2.8% in 2015, provided reforms go ahead.
- **Indonesia's fuel subsidy is a major source of instability:** Indonesia's burgeoning fuel subsidy may be costing the economy approximately USD 21 bn per year. Higher fuel subsidy outlays have also contributed to the widening of Indonesia's CAD, eroded its fiscal position and crammed out much needed investments in infrastructure.
- **Capital outflows to pose downside threats to the economy and raise inflation:** An un-orderly quantitative easing exit by the US Federal reserve may cause capital outflows which would affect Indonesia's liquidity. The South Asian economy has a high foreign ownership of domestic assets compared to its Asian peers with more than 37% of domestic bonds and 66% of free floating equities owned by foreigners. We expect Bank Indonesia to infuse greater amounts of liquidity into the banking system in its bid to avert a hard landing in the case of large scale capital outflows.
- **Jokowi will need to push through some tough reforms:** To pursue strong, structural and balanced growth, Indonesia must implement structural reforms that: 1) spur investment in infrastructure; 2) promote banking sector liberalization; 3) expand its manufacturing base, especially in the value added segment, attracting greater foreign investments in the sector; and 4) enhance secondary and higher education enrolments.

Healthy growth prospects in spite of macroeconomic headwinds

Indonesia, South East Asia's largest economy, is striving to regain its status as the darling of global investors. The potential is huge: Indonesia has abundant natural resource endowments, is home to a dynamic population of approximately 250 million people and offers relatively untapped investment opportunities. Furthermore, the country cruised through the Asian Financial Crisis, enjoying robust average annual growth rates of 6% between 2008 and 2012, on the back of improving terms of trade amid rising commodity prices. This commodity trade surplus triggered a virtuous cycle of higher foreign exchange reserves, lower funding costs, stable currency and low inflation; all of which helped to ensure a current

account surplus. However, the economy has lost its mojo over the past years, revealing underlying fragilities. Indonesia has gone from enjoying a current account surplus to having a current account deficit which lingers around -3.0% of GDP, while its real GDP growth fell from 6.0% in 2012 to 5.8% in 2013 and is expected to continue to slow down to around 5.0% in 2014 (1H14 GDP at 5.2% y/y). We believe that this will pick up in 2H15 provided ongoing reforms to ensure sustainable growth continue down the right path.

The onus of advancing structural reforms and spurring growth falls on the new President elect Joko Widodo (Jokowi), who assumes office on October 20. Jokowi has pledged to boost growth to 7.0% within 3 years from the current 5.0%. Of priority would be steps to reduce Indonesia's fuel subsidy bill, measures to boost infrastructure development and prop up alternative growth engines by enhancing the competitiveness of the manufacturing sector to compensate for lower commodity prices. Nonetheless, Jokowi faces serious political as well as macroeconomic challenges. A highly divided and hostile legislature in parliament may hamper any efforts to push forward necessary reform. Downside risks to the economy emanate from sooner than expected US interest rate hikes and falling Chinese demand for Indonesian natural resources.

Notwithstanding ongoing macro challenges, we believe that Indonesia's long term growth prospects remain healthy given its favorable economic outlook and demographic dividend. In this Economic Watch, we will examine the challenges ahead for Jokowi as well as what measures are needed in order to boost Indonesia's alternative growth engines.

What are the major challenges ahead for Indonesia's economy?

A hostile and divided legislature could pose challenges for Jokowi in fulfilling his electoral promise

Despite winning the elections, Jokowi's lack of experience at national-level politics has started to show. The opposition leader, Gerindra's Prabowo Subianto, has been swift to erode Jokowi's political leverage by mobilizing allegiances in the People's Representative Council (Indonesia's House of Representatives) and enlisting support from the outgoing government led by Democratic Party leader Susilo Bambang Yudhoyono.

In a taste of potential gridlock, Jokowi's opponents won a Parliamentary vote to scrap direct elections for local and regional leaders across Indonesia last month. Jokowi had opposed this measure as it constitutes a set-back in Indonesia's democratic reform, potentially stifling investor sentiment. In yet another sign of weakened presidency, the powerful opposition bloc also won control of important positions in national legislature, including that of the speaker. Political pressure on Jokowi is too high to discount pragmatic compromises. Jokowi's cabinet remains unnamed, but he noted that it would comprise 34 ministers, larger and with fewer technocrats than his supporters had previously hoped for. On a positive note, Jokowi intends to keep politicians from all top economic ministries, including energy, state owned enterprises and agriculture.

A current account deficit (CAD) that remains obstinately high in spite of recent efforts

A number of aggressive measures to stem external imbalances were implemented last year. These included a 175 bps interest rate hike by Bank Indonesia (BI), the country's central bank, between June and November 2013, as well as a 44% hike in subsidized petrol prices and a 22% hike in subsidized diesel prices. However, Indonesia's CAD corrected only marginally as a result of these measures; from -3.8% of GDP in 3Q13 to -3.2% of GDP in 1Q14. The statutory budget-deficit ceiling for Indonesia is 3.0% of GDP.

Nonetheless, a number of factors continue to impede Indonesia's external rebalancing efforts:

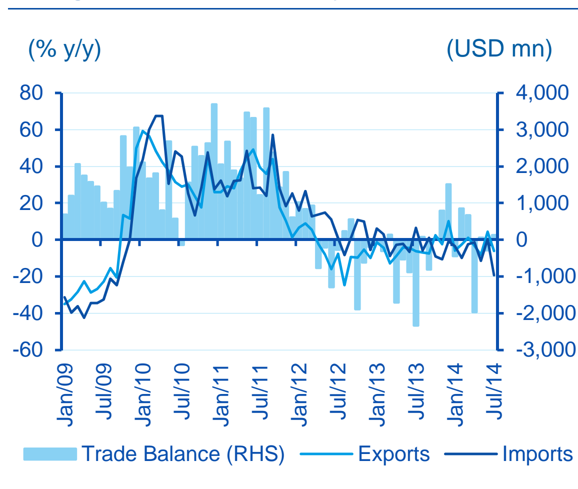
1) Indonesia has experienced a contraction in exports, which has been partially attributed to the mineral export ban imposed since January 12, 2014 (Figure 1). The ban follows Indonesia's Mining Law of 2009,

which prohibits exports of unprocessed minerals in order to retain more value added. These include nickel ore, copper ore, bauxite, zinc ore, and iron ore. According to estimates, the ban may have already cost the economy approximately USD 5.5 bn in lost export realizations.

2) A slowdown in global commodity prices led by coal, palm oil, gas and mineral ores (which constitute 59% of Indonesia's total exports) have shaved off some of Indonesia's growth momentum (Figure 2). Combined with a decline in total exports, lower commodity prices may be helping to keep Indonesia's CAD sticky by worsening the terms of its balance of payments.

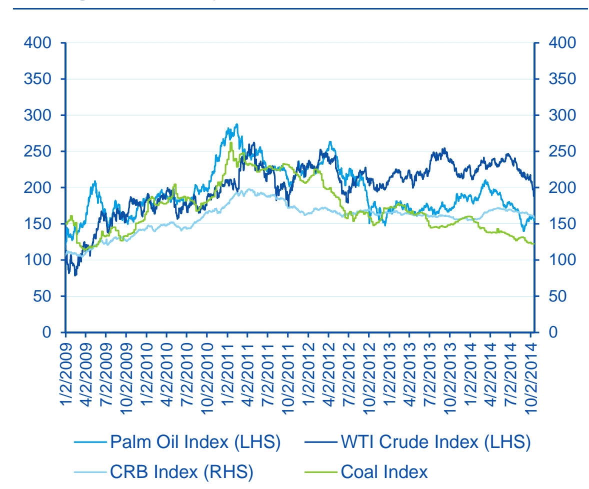
Looking ahead, we expect a gradual correction in Indonesia's CAD, in line with BI's estimate of -3.2% of GDP for 2014 and -2.8% in 2015. Positive progress on renegotiations between the Indonesian government and ore miners bodes well for Indonesia's near to medium term export outlook. BI noted in its policy statement last month that the upward momentum in non-oil and gas trade balance is expected to remain positive as "mineral exports recommence and the global economic recovery persists". However, a number of structural fragilities continue to weigh down on Indonesia's CAD, as we shall see next.

Figure 1
Falling exports since January 2014



Source: CEIC and BBVA Research

Figure 2
Falling commodity prices (Index: Jan 2005 = 100)



Source: Bloomberg and BBVA Research

An unsustainable fuel subsidy overhang that threatens to overshoot budget allocation

The bulk of Indonesia's energy subsidies are fuel related (Figure 5). They constitute a sizable 4% of GDP and about one sixth of the fiscal budget, which is roughly equivalent to USD 21 bn. The subsidy mechanism involves a fix on the price of fuel per liter[1]. This means that any depreciation of the rupiah vis-à-vis the US dollar or an increase in oil prices will take a toll on Indonesia's budgetary outlays. In fact, despite steep cuts in fuel subsidies last year (44% increase in gasoline price and 22% increase in diesel price), Indonesia's energy subsidy budget saw a 17% increase in 2014, owing to a weaker rupiah and higher oil costs. Higher fuel subsidy outlays have therefore contributed to a widening budget deficit, eroding Indonesia's fiscal position. Furthermore, the growing energy subsidy budget has crammed out other sectors, forcing cut-backs in infrastructure spending in excess of 25%.

[1] The current market price of gasoline in Indonesia is IDR 11500/ltr while subsidized gasoline is sold at a fixed price of IDR 6500/ltr, implying IDR 5000/ltr in subsidies.

BOX: Increased dependency on China may pose risks to Indonesia's growth in the near term

Indonesia's total exports were equivalent to 21% of its GDP in 2013. Exports during the same period were very concentrated both by country and commodity. Japan was the largest buyer of exports from Indonesia, followed by China, Singapore, the USA and India. Together, these 4 countries accounted for over one half of Indonesia's total exports to the world in 2013. Correspondingly, exports were also highly concentrated by commodity, with raw materials featuring prominently (Figure 3).

The concentrations by trading partner are even more striking. Indonesia's exports to Japan consisted of 53% mineral fuels (this category includes coal but also oil and its derivatives), while 70.5% of total exports to China consisted of mineral fuels, mineral ores, vegetable oils and rubber.

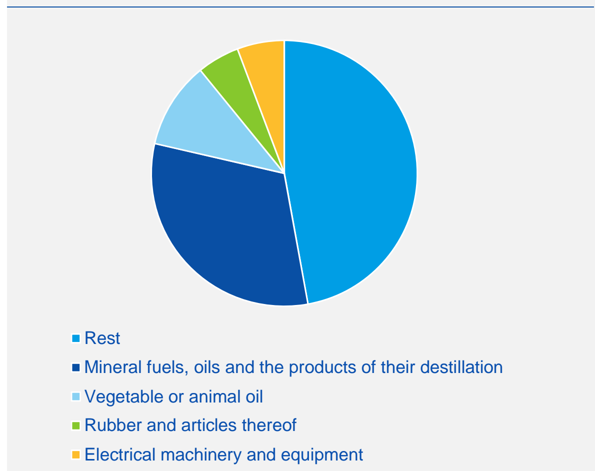
Japan is still the largest destination for Indonesia's exports; however China's share has increased very quickly in the last years. Exports to Japan grew by 50% y/y between 2005 and 2013, whereas those to China more than doubled, growing by 239% y/y during the same period. According to our calculations, this has led to an alarming commodity dependence increase on China (Figure 4), especially for raw materials such as fossil fuels and mineral ores.

In this context, a number of aspects threaten to increase uncertainty surrounding Indonesia's exports. First, a deceleration of China's economy will adversely affect Indonesia's mineral exports, putting further pressure on the country's burgeoning current account deficit. The decision to implement an export ban to boost downstream refining is most certainly not timely, especially given the absence of sufficient bilateral investment agreements. To further complicate things China has announced a set of measures to curb coal imports, including a 3-6% coal import tax (starting 15 October 2015) and a ban on low-quality imports (starting 1 January 2015). The ban targets certain types of highly polluting coal (>40% of ash and >3% of sulfur content) and will affect mainly Indonesia and Australia, China's main sources of coal overseas.

India's growing demand for coal (approximately 62% of India's coal imports are sourced from Indonesia) may help to absorb a fall in Chinese demand, but only if Indonesia's exports are cost effective vis-à-vis those of competitors. In this respect, a recent decree by India's Supreme Court which cancelled arbitrarily allocated domestic coal mining licenses issued since 1994 would help spur Indonesia's coal exports to India. However, it is unlikely that demand growth in India will be fast enough to offset the fall in Chinese demand.

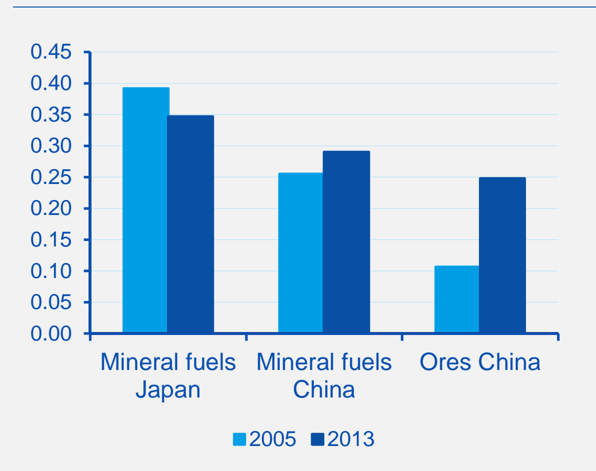
The bottom line is that Indonesia needs to do more to make sure that it revamps one of its traditional growth powerhouses, while simultaneously developing more downstream capacity to facilitate higher rates of value retention. An export ban may not be the most effective policy in this regard. Jokowi will have to devote more efforts to promoting bilateral trade and investment links with a number of partners that go beyond what is being done right now.

Figure 3
Indonesia's exports are very concentrated by commodity (% total)



Source: UN Comtrade and BBVA Research

Figure 4
Increasingly dependence on Chinese demand (0 = no dependence; 1 = complete dependence)



Source: UN Comtrade, CEIC and BBVA Research

Budgetary adjustments are also needed in the wake of slower than budgeted GDP growth, which expected to slow down to around 5.0% in 2014 from 5.5% in 2013. Furthermore, the outgoing government recently launched a costly new social security system – the Sistern Jaminan Sosial Nasional (SJSN) – starting January 2014 adding to the existing budgetary pressures. In this context, another round of large fuel subsidy cuts or a relook at the subsidized price fixing mechanism seems inevitable.

Amid legislative as well as public opposition to aggressive fuel subsidy cuts, we expect Jokowi to adopt a gradual rationalization of subsidized fuel prices, akin to the one implemented by the Indian Government, which has been raising diesel prices by Rs. 0.5 per liter every month. If Jokowi does decide on steeper fuel price hikes before this year end, we expect a modest sub-10% price hike in the first round.

Another alternative would be to a move towards a fixed subsidy regime, away from the current fixed price regime. Under this system, the new government could fix a fuel subsidy level (as opposed to a price) and reduce the quantum going forward. A fixed subsidy regime would lessen Indonesia's budget exposure to any volatility in international oil prices and provide room for Jokowi to achieve target to remove fuel subsidies over the next three years.

Aggressive efforts towards fuel subsidy rationalization will be credit positive for Indonesia, enhance currency stability and cement Jokowi's image as a leader willing to undertake tough reforms. Delays on this front are likely if the new legislature fails to finalize a plan to compensate lower income households for the increase in fuel prices. Two plans are currently under consideration, 1) direct cash transfers, or 2) the top up of national health and education cards. However, mobilizing support for any one scheme may prove difficult for Jokowi, given a divided legislature.

Upside risks to inflation led by a possible fuel subsidy rationalization and capital outflows

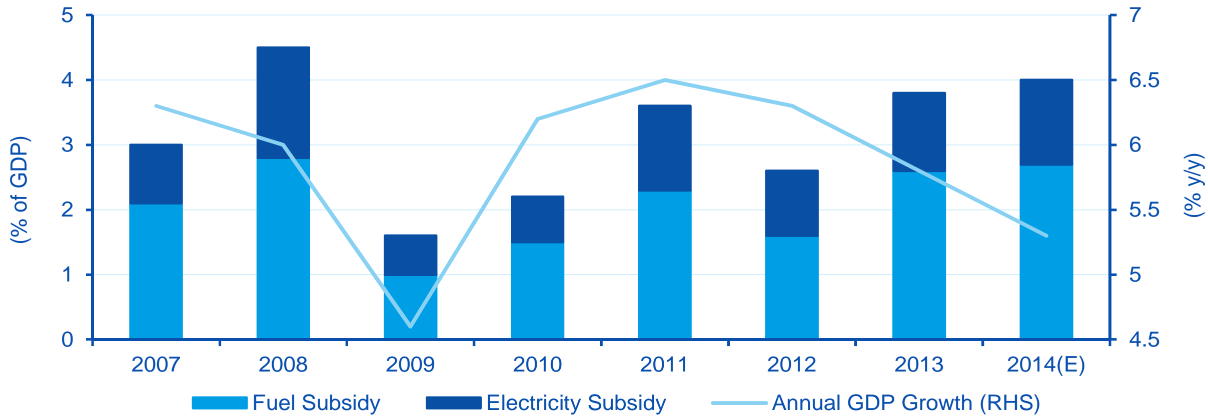
CPI inflation remains subdued at around 4.5%, well within BI's target range of 3.5% and 5.5%, driven by higher base effects from last year, benign food inflation and easing demand pressures (Figure6). Nonetheless, risks to inflation are skewed to the upside due to possible hikes in subsidized fuel prices later this year or early 2015. In fact, BI has noted that fuel price rationalization "could undermine the achievement of the inflation target", making it likely for BI to hike interest rates further in mid-2015.

BI has kept policy interest rates on hold at 7.5% since November 2013. The central bank maintains a tight policy bias in line with its objective of reducing external imbalances to a more sustainable level through demand compression and economic rebalancing. We expect Indonesia to pause interest rates until 2Q15

In addition, Indonesia is facing external vulnerability risks emanating from a sooner than expected interest rate hike by the US Fed. A narrowing of interest rate differentials with the US would expose Indonesia to foreign capital outflows. The South Asian economy has a high foreign ownership of domestic assets compared to its Asian peers with more than 37% of domestic bonds and 66% of free floating equities owned by foreigners. A sudden flight of foreign capital would weigh heavily on the rupiah, a situation as seen in 2013, when a 4% fall in foreign ownership levels pushed USD/IDR Spot from 9800 to 11500 (Figure 7).

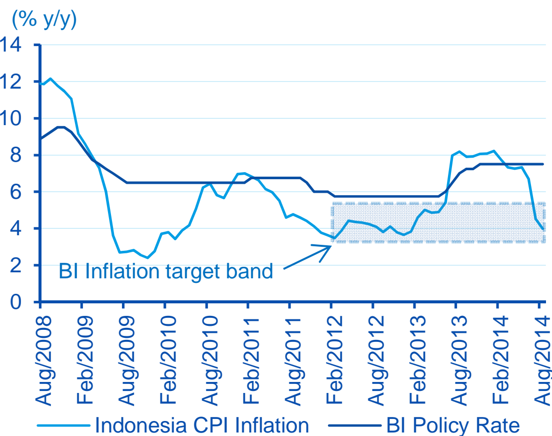
Capital outflows would aggravate liquidity concerns in Indonesia, which is already quite tight. Indonesia's bank regulator, the Financial Services Authority (OJK), set ceilings for fixed deposit interest rates starting October 2014, in a move to prevent an interest rate war that has been draining liquidity out of the system. According to the new rules, interest rates for banks with core capital of more than 30 trillion IDR (USD 2.47 billion) will be capped 9.50% (225 bps above BI rate), while those for smaller banks (between 5 trillion and 30 trillion IDR) will be capped at 9.75%. We expect Bank Indonesia to infuse greater amounts of liquidity into the banking system in its bid to avert a hard landing in the case of large scale capital outflows.

Figure 5
Indonesia's fuel and electricity subsidies have been dragging on the economy



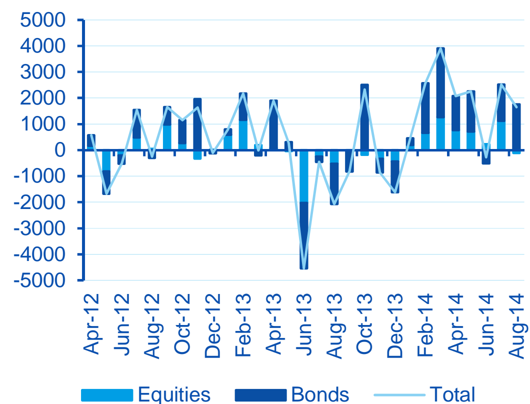
Source: International Institute for Sustainable Development, Haver and BBVA Research

Figure 6
The central bank maintains a tight policy bias amid subdued inflation



Source: Haver and BBVA Research

Figure 7
Capital flows have remained positive but could reverse in case of higher US interest rates



Source: Bloomberg and BBVA Research

Propping up Indonesia's primary growth engines

Global commodity prices are cooling amid a supply glut and slower economic growth in key markets such as China. Meanwhile domestic demand is weakening and wage growth has slowed as a consequence of Bank Indonesia's 'ongoing economic rebalancing process' to stem inflation and reduce its CAD to more sustainable levels. Reducing the fuel subsidy will be of help in this regard; however it has become clear that Indonesia can no longer rely on its traditional drivers to sustain growth in the near-term. To pursue strong, structural and balanced growth, Indonesia must implement structural reforms that: 1) spur investment in infrastructure; 2) promote banking sector liberalization; 3) expand its manufacturing base, especially in the value added segment, attracting greater foreign investments in the sector; and 4) enhance secondary and higher education enrolments.

Boost infrastructure investments – in particular energy and transport

Stunted infrastructure development has dragged on Indonesia's economic growth since the Asian Financial Crisis. A study by the IMF reveals that infrastructure in Indonesia is amongst the worst in ASEAN (Seneviratne, Dulani and Sun, Yan, 2013). Public spending on infrastructure investment has consistently undershot the budgeted target, substituted by higher subsidy outlays and other social spending. Inadequate transportation infrastructure is a pressing problem for Indonesia, as the archipelago with 922 permanently inhabited islands needs to enhance connectivity to the outlying islands. Jokowi has promised to renovate old ports and build 10 new ones; and wants to construct 2000 km of new roads to connect outlying islands and repair existing ones.

Revving up investments in energy infrastructure is equally important as the country is over dependent on costly diesel fired power plants to generate electricity, while distribution is inefficient and expensive. Jokowi plans to amend the oil and gas law to enhance the use of natural gas, coal and geothermal energy. He has also mentioned that he wants to remove 90% of Indonesia's diesel fired power plants over the next three years, resulting in annual savings of USD 7bn in energy costs.

However, energy reforms in Indonesia still have a long way to go. Liberalizing foreign investment limits in the oil and gas sector, offshore and onshore drilling and pipeline construction will be crucial in order to boost capacity in Indonesia's energy sector. Last April the outgoing Government eased foreign investment restrictions on public private partnership projects in sea ports and large power plants and electricity transmission projects, a precedent which should be followed by Jokowi. In addition, Indonesia could leverage its membership of the Asia Economic Community (AEC), a forum of ASEAN economies aimed at fostering closer trade and investment ties within the region, to attract foreign investments in the infrastructure and energy sectors.

Speed up banking sector liberalization

Indonesia should takes cues from the Philippines, who aggressively liberalized foreign investment limits in its domestic banking sector this year, an important stepping stone towards the implementation of the ASEAN Banking Integration Framework (ABIF). As a part of the ASEAN Economic Community (AEC) integration, the ABIF aims to achieve parity of banking regulations across ASEAN, and in turn strengthen local banks through greater competition and wider market access.

Currently, the level of integration in ASEAN's banking sector is relatively limited. Indonesia has the highest share of banking assets held by other ASEAN banks at approximately 15% according to experts. However, recent efforts by Malaysia and Singapore to enter ASEAN markets may undermine Indonesia's position once the ASEAN market becomes open to more regional competition. Indonesia needs to step it up quickly or risk losing market share to stronger regional partners once the AEC kicks in on December 31 2015.

Policy incentives to boost manufacturing and foreign investment in Indonesia

Investors fret that Indonesia has stuck to its 'dig-and-ship' model for too long, neglecting its manufacturing sector which now accounts for less than 25% of GDP (Thailand's share is 35%). Against the backdrop of an unwinding global commodity super-cycle, Indonesia should look towards its manufacturing sector to provide some much needed growth impetus. In this respect, the slowing down of China's economy coupled with rising labor costs could provide Indonesia with a unique chance to attract investors looking for alternative manufacturing centers.

Indonesia may still enjoy lower labor costs than some of its regional competitors (Figure 8), but this has not been sufficient to enable the country to develop a broad manufacturing base. In order to move up the pecking order, Indonesia should implement policies that boost investment (domestic and foreign) in higher

value added segments. In our opinion, more reforms to improve institutional capacity and reduce corruption are needed in order to boost investor sentiment.

Improve education attainment levels to unlock the potential of Indonesia's human resources

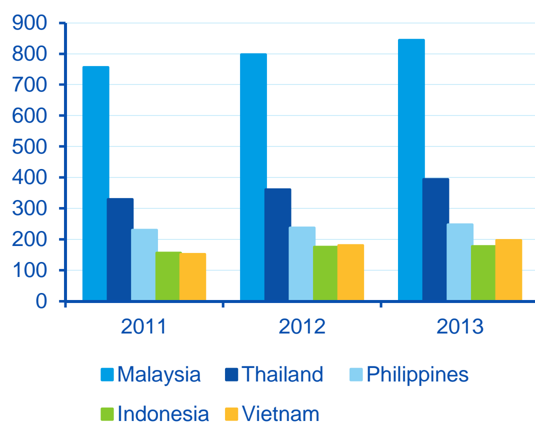
According to World Bank data, nearly 33% of Indonesia's youth is not engrossed in employment, education or training (Figure 9) While Indonesia scores high on primary education enrolment; it has not done enough to boost secondary and higher education in the country. As per Barro Lee data, secondary and tertiary education enrolment in Indonesia is the lower than India, Thailand, Malaysia and Philippines. Lack of higher education has inhibited skill development amongst Indonesia's large set of working age population.

Hopes run high on Jokowi

Jokowi needs to move swiftly in the next few weeks to lure opposition parties to back him in the People's Representative Council. Given the fluid nature of Indonesian politics, where political affiliations are thin, there is still some hope for Jokowi to win over opponents. However, while deal-making efforts continue, the chances of Jokowi governing with majority support look bleak with outgoing President Yudhoyono's party choosing to side with the opposition. For these reasons, we do not expect Jokowi to implement radical reforms which are not approved by the Council. More clues into how the political prospects will impact Indonesia's reforms will be available once Jokowi nominates his cabinet, after he assumes office on October 20.

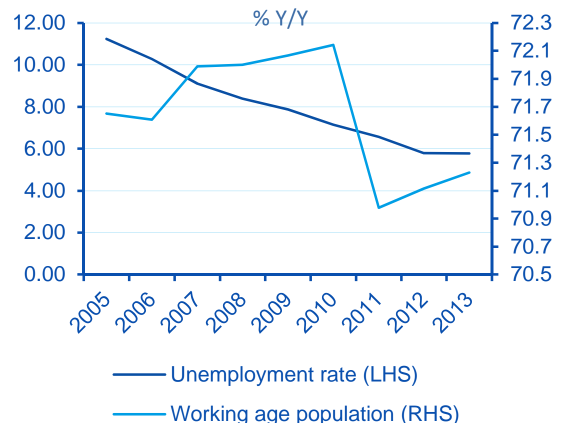
Notwithstanding his predicament, Mr. Widodo has assured investors of progress on reforms, albeit at a slower pace. His image as a clean administrator, impressive performance at the city and state level and past record in removing bureaucratic delays will most definitely benefit Indonesia, which suffers from a high incidence of corruption in government circles and inefficient bureaucracy.

Figure 8
Average monthly wages in Indonesia remain low compared to its neighbors (USD)



Source: Haver and BBVA Research

Figure 9
Rising working age population may put upward pressure on unemployment rates



Source: Haver and BBVA Research

DISCLAIMER
This document has been prepared by BBVA Research Department, it is provided for information purposes only and expresses data, opinions or estimations regarding the date of issue of the report, prepared by BBVA or obtained from or based on sources we consider to be reliable, and have not been independently verified by BBVA. Therefore, BBVA offers no warranty, either express or implicit, regarding its accuracy, integrity or correctness.
Estimations this document may contain have been undertaken according to generally accepted methodologies and should be considered as forecasts or projections. Results obtained in the past, either positive or negative, are no guarantee of future performance.
This document and its contents are subject to changes without prior notice depending on variables such as the economic context or market fluctuations. BBVA is not responsible for updating these contents or for giving notice of such changes.
BBVA accepts no liability for any loss, direct or indirect, that may result from the use of this document or its contents.
This document and its contents do not constitute an offer, invitation or solicitation to purchase, divest or enter into any interest in financial assets or instruments. Neither shall this document nor its contents form the basis of any contract, commitment or decision of any kind.
In regard to investment in financial assets related to economic variables this document may cover, readers should be aware that under no circumstances should they base their investment decisions in the information contained in this document. Those persons or entities offering investment products to these potential investors are legally required to provide the information needed for them to take an appropriate investment decision.
The content of this document is protected by intellectual property laws. It is forbidden its reproduction, transformation, distribution, public communication, making available, extraction, reuse, forwarding or use of any nature by any means or process, except in cases where it is legally permitted or expressly authorized by BBVA.