

Indonesia Economic Outlook: Traversing turbulent times in the digital era

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A challenging global backdrop for emerging Asia

Exports

- Uneven global growth has led to an uncertain trade environment – Asian exports remain fragile
- US on-shoring a lot of its manufacturing and China's economic slowdown have weighed
- Yet, net terms of trade gains and import contraction has led to narrower trade deficits

Fed Hike

- Markets to discriminate against those with relatively weaker fundamentals and/or oil exporters
- Higher USD debt will take a hit through higher interest rates and weaker local currencies
- Fed's move will be calibrated, giving time for Asian central banks to take prudent policy steps.

China

- China decided to adopt a more market determined fx rate, daily fix raised by 2% on Aug 11.
- Move also helps support export growth but has heightened currency depreciation in the region
- Yuan's unexpected adjustment underscores China's slowing growth concerns
- Hit hard on corporate balance sheets with high Yuan deposits and unhedged fx exposures

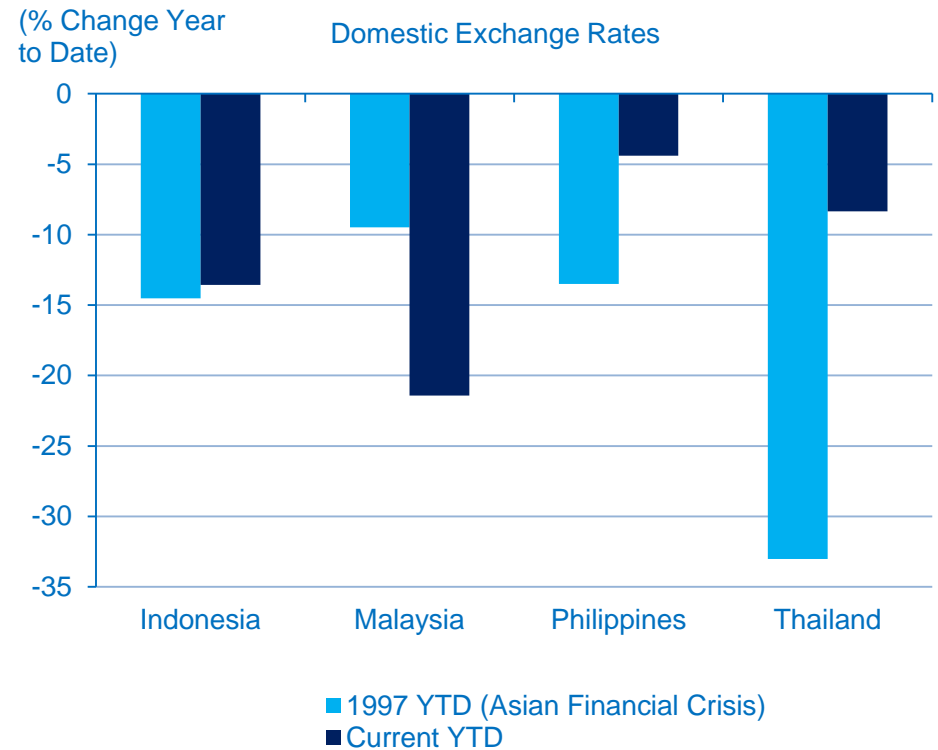
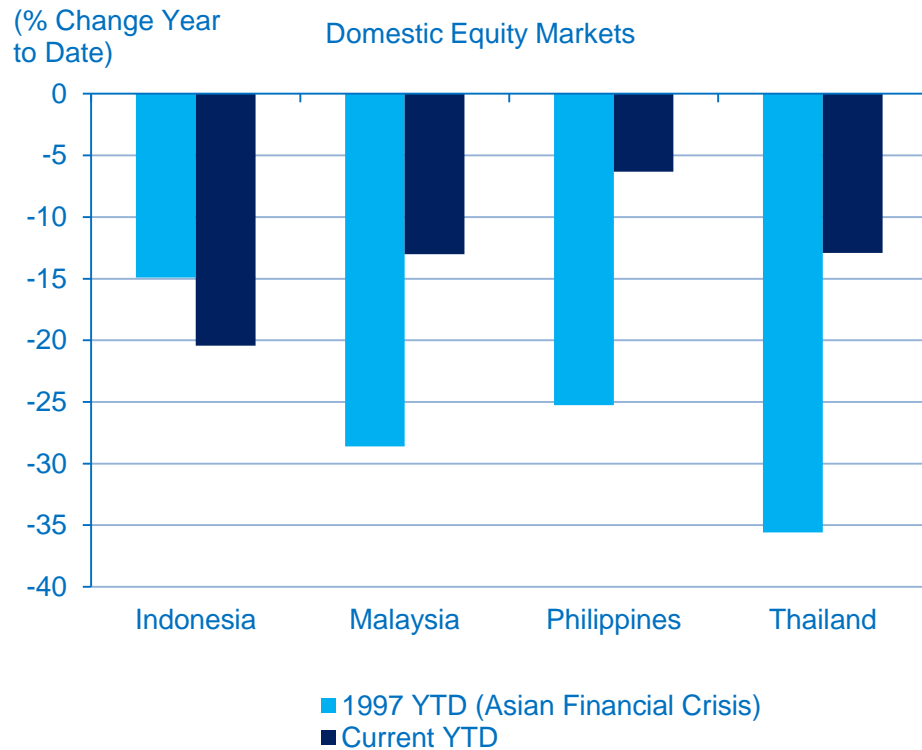
Oil

- Falling commodity and oil prices favor commodity importers
- Lower oil prices foster benign inflation, lift real income of households, enhance fiscal space
- However, softness in commodity prices taking a toll on Asian exports as price realizations erode

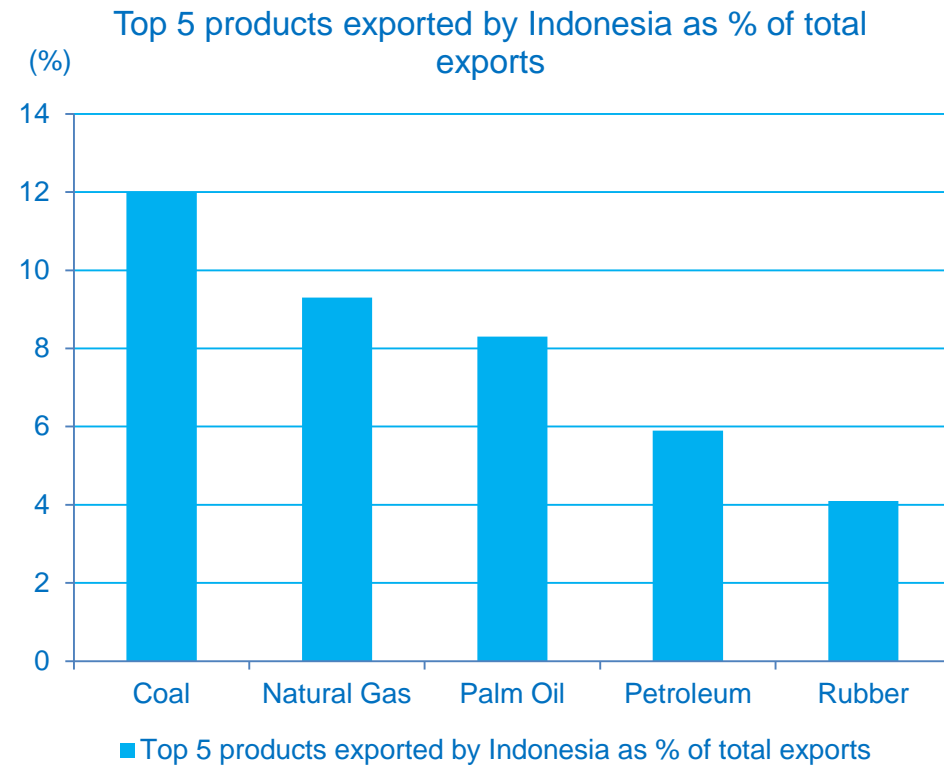
Reform

- International capital flows to favor high and sustainable growth and policy virtue
- Effective implementation of structural reforms - a key differentiating factor amongst Asian EMEs
- Asian economies try to establish manufacturing credentials amid rising labor costs in China

Ongoing financial turmoil revives grim memories from the past



Indonesia's close commodity trade links with China and the Asian region to weigh on growth



Yet, a repeat of the 1997 crisis looks unlikely today despite a challenging environment

Political Stability

- Unlike the highly unstable political environment in 1997-98, Indonesia today benefits from a stable political government at the center, headed by a popular leader - Jokowi

FX policy

- Indonesia has today adopted a managed float of its currency (Rupiah) unlike the fixed exchange rate regime in 1997, in turn according greater independence to monetary policy.

External finances

- Indonesia's short term external debt as a share of fx reserves have fallen to 40% today from more than 100% in 1997.
- FX reserves in months of imports has improved to 7 months from 3.2 months in 1997

Bank health

- Indonesia's banking sector is much more healthier than in 1997.
- Non-performing loans ratio has fallen sharply to around 3.5% today from 13% during 1997.

Reform

- Unlike policy inaction on reforms during 1997, the current government has focused on greater regulatory oversight, institutional and investment reforms and removing administrative bottlenecks to private investments.

Indonesia Economic Outlook 2015 – Growth inflation dynamics expected to improve gradually

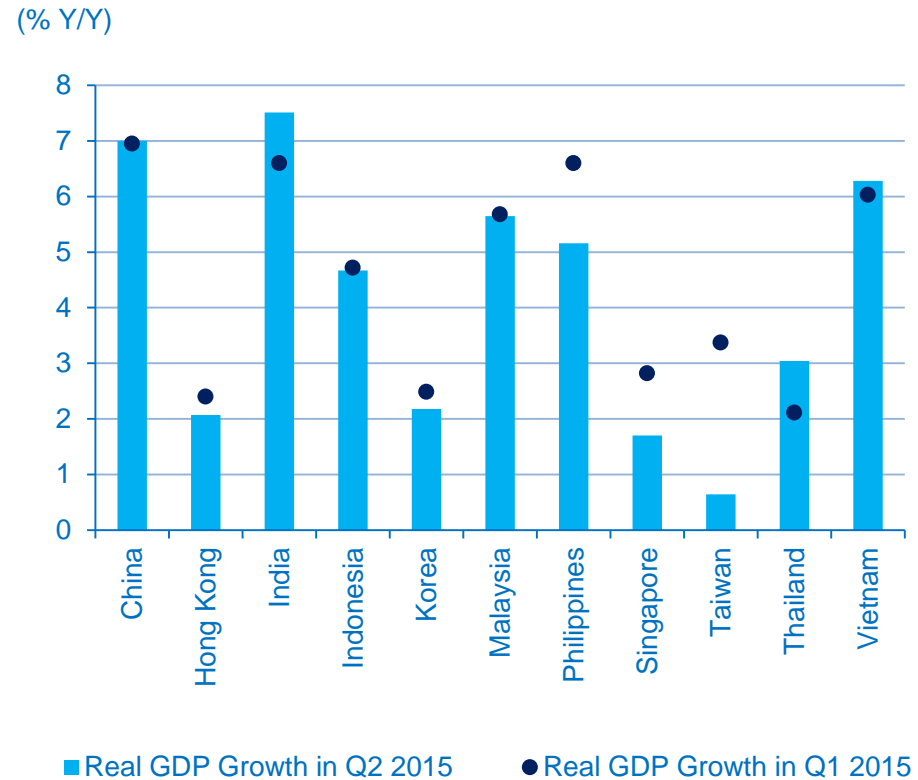
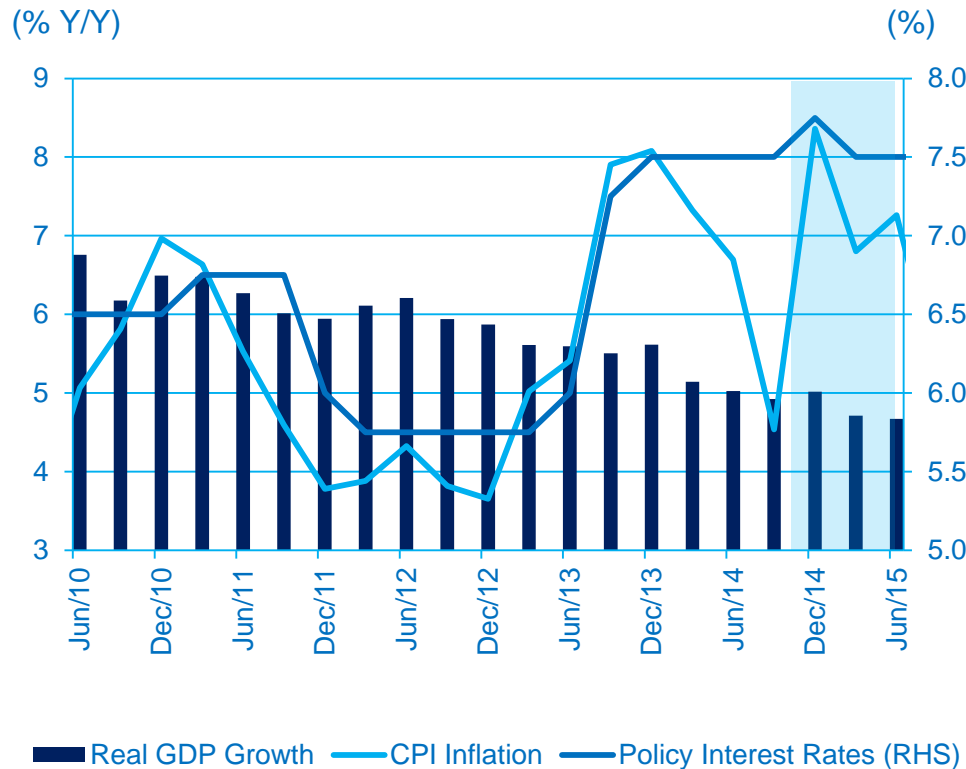
Growth

- 2Q15 GDP growth at 6 year low dragged by low rate of budgeted expenditure disbursement, weak private demand, sluggish investments and a protracted contraction in exports.
- Sequential GDP growth picked up 4.2% QoQ SA (vs. 3.8%) in Q2 led by GFCF.
- Growth outlook expected to improve in H2 2015 led by higher productive spending, albeit only marginally given slower global growth, commodity price slump and weak domestic demand.

Inflation

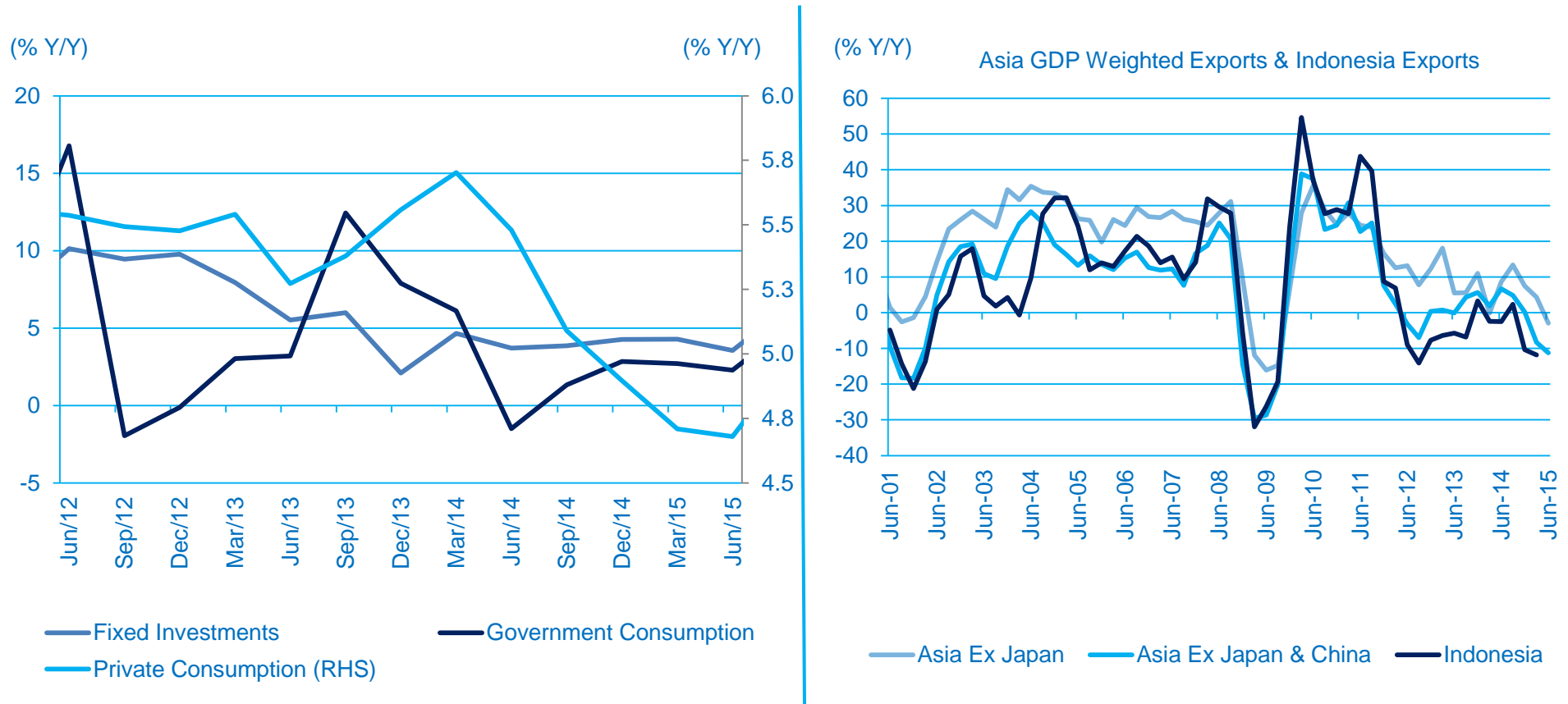
- Headline inflation remains above BI's 5.0% comfort level (7.3% y/y in July, avg. 6.9% YTD) amid weak IDR and elevated transportation and food prices.
- Looking ahead, inflation to moderate as upside pressure from high administered prices and risk of sub-normal rains are offset by weak demand and policy action to curb food supply shocks.

Indonesia's GDP hits six year low levels in 2Q15



*Hong Kong, India, Philippines and Thailand are yet to release 2Q15 GDP data. 1Q15 is compared with 4Q14 for these countries.

Broad-based weakness in Indonesia's growth matrix



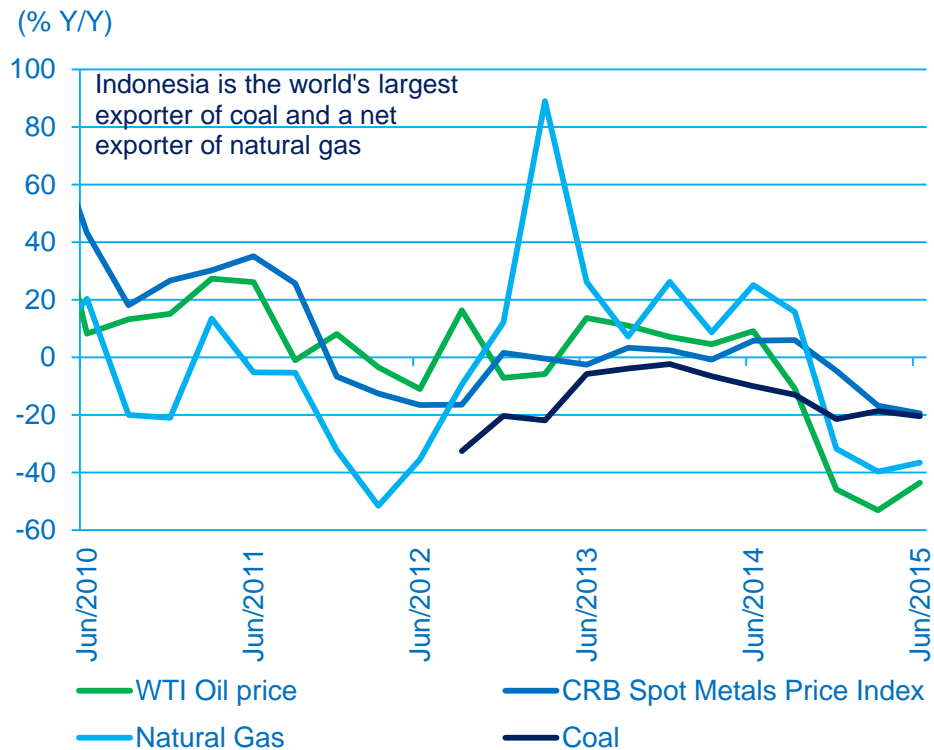
- Indonesia's major export markets – Japan: 13% ; China: 10% ; Singapore: 9.5%; US: 9.4%
- Indonesia's major import markets – China: 17.2% ; Singapore: 14% ; Japan: 9.5%; South Korea: 6.6%

Trade effects of commodity-currency interplay

- Slump in commodity prices has been a mixed bag for Indonesia
- Real trade wtd appreciation in the rupiah + sharp depreciation in USDIDR = Negligible support for exports

Global commodity prices have slumped

Source: CEIC data, BBVA Research



IDR is significantly weak in nominal terms but is flat on real trade weighted basis

Source: CEIC data, BBVA Research

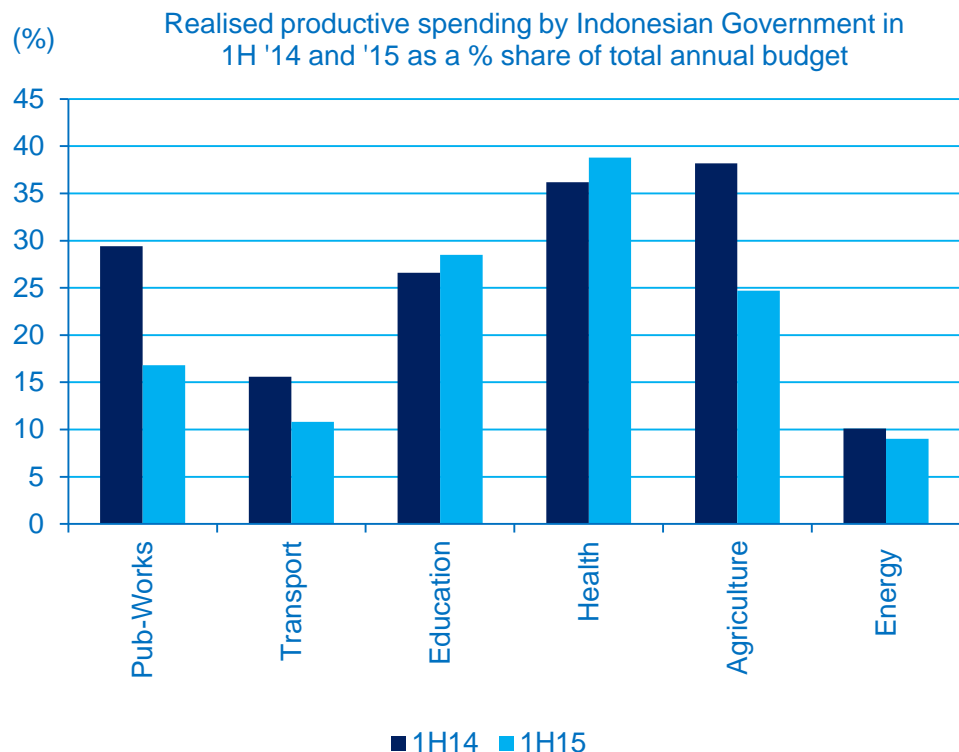


Indonesia Economic Outlook 2015 – A grinding investment led recovery in the offing

Economic Outlook

- Expect Indonesia's full year 2015 GDP growth at 5.0% y/y, lower than official estimates of 5.2%.
- Little room for more rate cuts in 2015 amid Fed lift-off, inflation and global financial uncertainty
- Significant improvement in external fundamentals is warranted
- High time to shift the pace of structural reforms into top gear and improve investment climate.

Need to fast-track productive spending to rev up economic growth in 2H15



- Realized budgetary productive spending increased to 13% of annual budgeted sum by mid July from 1.5% at end of Q1-2015. Capex disbursement remains low.
- Muted fiscal stimulus dragged on growth in 1H15. Reassuringly, 2H15 looks promising with the government keen on ramping up the capital expenditure disbursement rate.
- The Ministry of Public Works and Public Housing, which accounts for the bulk (40%) of capex disbursements, is expected to achieve 90% of its allocated budget this year.
- If effectively executed, higher productive capital spending would help crowd in long term foreign investments in key sectors such as transport, mining, real estate, and agriculture sectors, in turn aiding 2H15 GDP growth.

Government committed to structural reforms , but needs to shift gears

Key ongoing reforms in Indonesia
Scrapping low octane gasoline subsidies and cap on diesel subsidy
Five year infrastructure development plan to boost rail, road, port and power sector
Tax incentives to encourage foreign direct investments
Establishment of one-stop service (PSPT) for project approval (Pelayanan Terpadu Satu Pintu)
New land acquisition law to facilitate infrastructure development
National broadband plan to make internet more accessible
An ambitious “Smart Cities” project

- Unwinding of the global commodity super cycle and China slowdown has led to adverse terms of trade, which used to help fund domestic demand previously.
- Need to develop alternative growth engines to boost productivity and competitiveness of non-commodity sector.
- Reform momentum needs to be stepped up further to achieve higher and sustainable growth:
 - Infrastructure development
 - Make labor laws more flexible
 - Expedite land acquisition process
 - Ease process to secure business permits
 - Tackle governance issues and bureaucratic obstacles
 - Improve education attainment levels and boost investments in R&D
 - Enhance competitiveness of manufacturing sector

Asian EMEs are better prepared for Fed's lift-off

- Although knee jerk reactions to the Fed's lift-off involving short term capital outflows are inevitable, most Asian have seen improvements in external vulnerability indicators since the Fed's taper tantrum in May 2013.

External vulnerability indicators have improved for most Asian economies since the QE taper tantrum

Source: Haver Analytics data, BBVA Research

	Fiscal Sustainability		External Sustainability		Liquidity Management	
	Central Govt Debt (% of GDP)		Current Account Balance (% of GDP)		Short Term External Debt as share of FX Reserves (%)	
	May/2013	Current	May/2013	Current	May/2013	Current
India	46.8	43.7	-4.3	-1.0	33.6	23.8
Indonesia	22.8	27.1	-4.2	-1.8	49.0	41.0
Philippines	47.8	47.6	4.3	5.4	23.2	23.1
Thailand	28.7	30.9	-3.2	6.0	38.6	38.1
Malaysia	54.7	52.1	1.7	2.6	71.5	86.4

Source: Haver Analytics Data, BBVA Research

... but high debt ratios remain a weak link for Asia

Change in Debt to GDP ratio : 2007 to 2014 across Asia					
	Current total Debt to GDP ratio* (%)	Real Economy Debt Change, 2007 - 2014 (percentage points)			
		Total	Government	Corporate	Household
China	217	83	13	52	18
India	120	0	-5	6	-1
Indonesia	88	18	-5	17	6
Korea	231	46	15	19	12
Malaysia	222	49	17	16	16
Philippines	116	4	-3	9	-2
Singapore	382	46	15	19	12
Thailand	187	43	11	6	26
Japan	400	64	63	2	-1

Source: IMF, BIS, Haver Analytics, Mckinsey Global Institute Analysis, BBVA Research

* Total debt includes government, corporate and household debt

<= Leverage **<= Deleverage**

Indonesia Economic Outlook 2015 – Digital banking set to pick up amid concerted policy efforts

Digital Banking

- Relatively high per capita GDP (USD 3500 USD) but low rate of financial inclusion (36%)
- Indonesian banks are taking impressive strides towards a Digital Payments System.
- Ubiquitous ownership of smartphones (57 million individuals); social media penetration (69 million Facebook users); 1/3rd population with internet access to aid digital innovation efforts.

Indonesian banks – tightening liquidity has dragged on profitability

Indonesian Banks - slowing profitability and higher funding costs

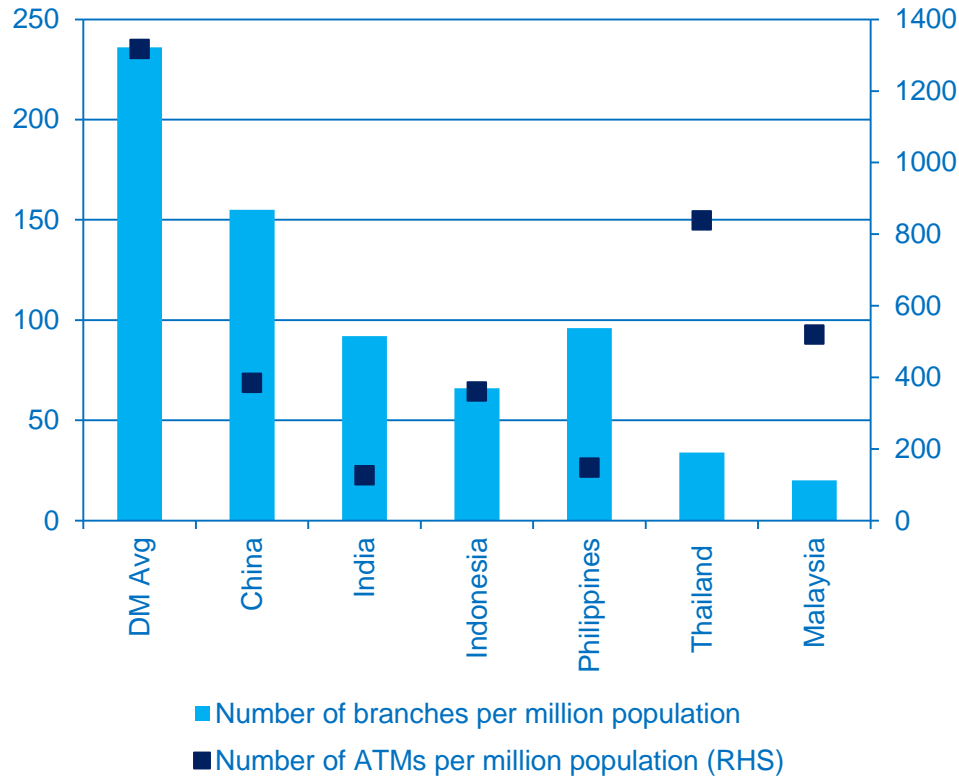
(%)	2011	2012	2013	2014
Return on Assets	3.0	3.1	3.1	2.9
Net Interest Margins	5.9	5.5	5.4	4.2
Loan to Deposit Ratio	78.8	83.6	89.7	89.4
Loan growth (% y/y)	24.4	24.2	22.0	12.0
Deposit growth (% y/y)	18.8	19.1	13.7	15.2
Source: OJK				

- Indonesian banking system is experiencing funding pressures led by a sharp slowdown in loan and deposit growth.
- Largely reliant on interest income, bottom line of banks is hurt by weak credit offtake.
- Intense competition for deposits has weighed on cost of funds .
- Banks with stronger deposit base will be able to defend their Net interest Margins.

Digital banking promises to plug Indonesia's financial inclusion gap

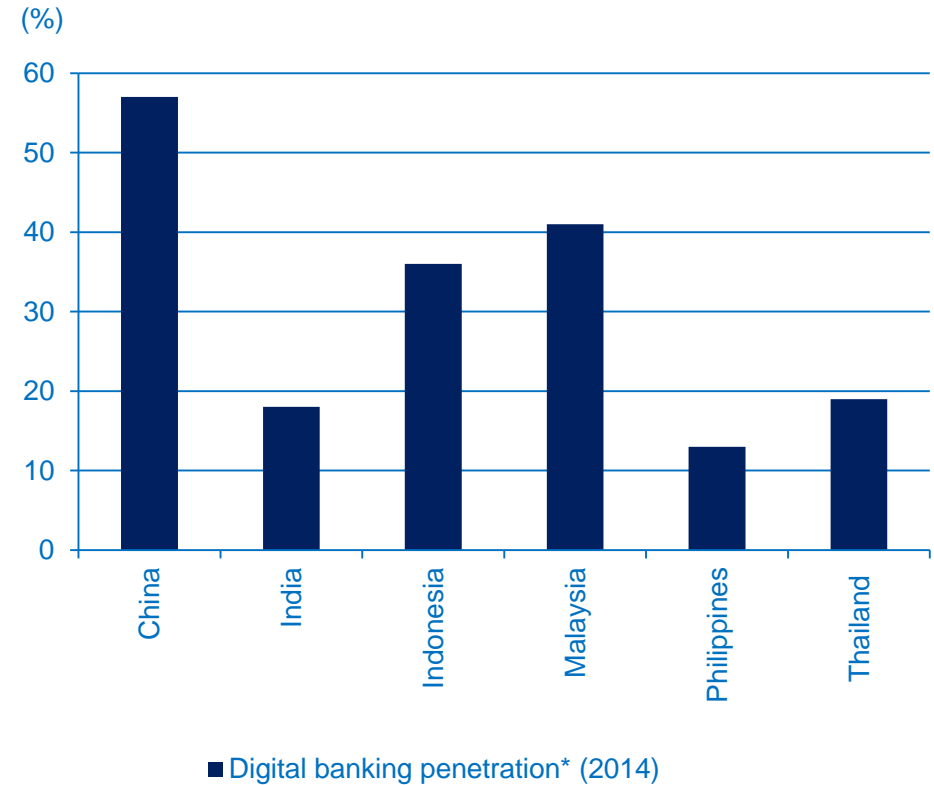
Branch penetration in Indonesia is low and unequally distributed across the region

Source: World Bank



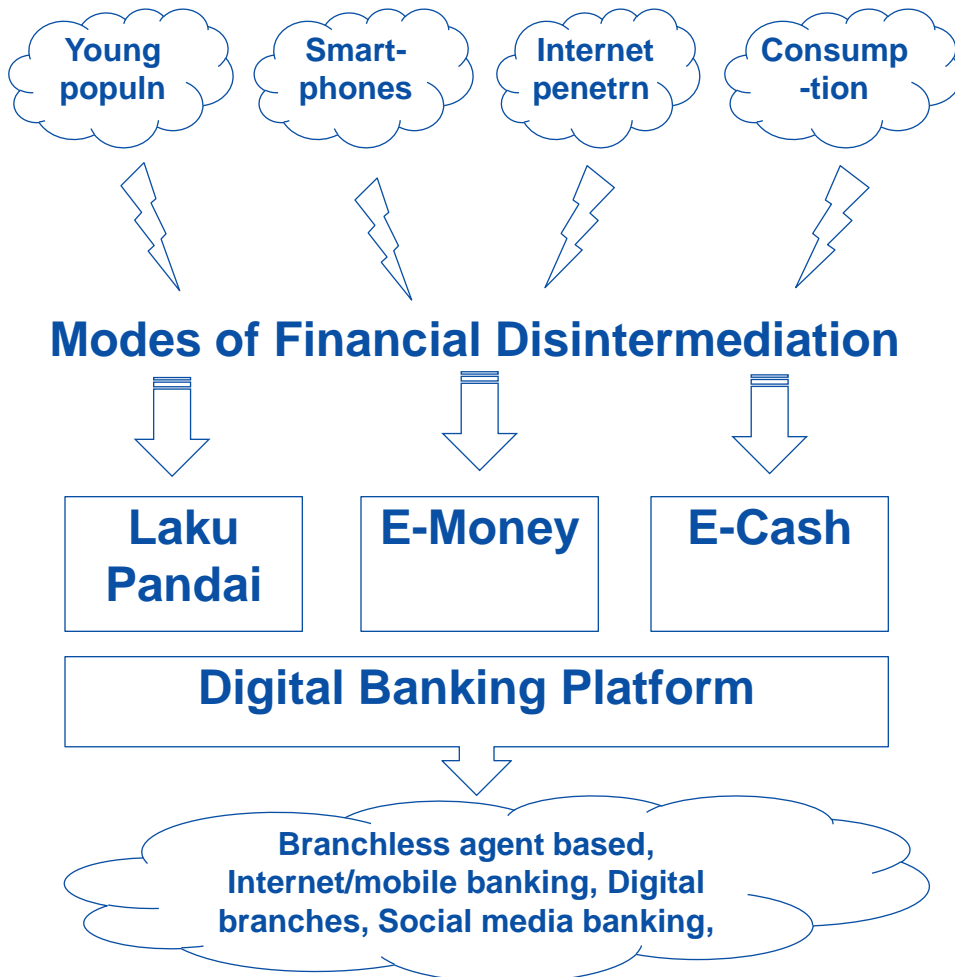
Digital banking promises to boost financial inclusion

Source: McKinsey Asia Personal Financial Services Survey, 2014



Digital Banking penetration is defined as the number of users of internet or smartphone banking divided by total banking consumers in each country

Indonesian banks have made impressive forays into digital payments, but it's a long road ahead



- Banks taking quick quality steps to enhance customer reach through branchless banking (Laku Pandai), e-money services and the 'E cash' platform.
- Branchless banking – Mobile based with agent : poor and vulnerable need assistance from reliable source
- Focus on involving airtime sellers, mom & pop stores to facilitate financial transactions – opportunity for banks to cross sell with million more customers
- Comprehensive regulatory framework that includes banks, telecommunication companies, Bank Indonesia, OJK, and the Ministry of Finance
- Concerns and Risks perceived by public for digital financial services :Complicated process; Concern of failed transactions; Security issues
- Need to upgrade Indonesia's digital and mobile infrastructure, invest in expanding agent base – As per McKinsey, Indonesia ranks 85th of 144 countries in digital infra and 77th in internet bandwidth and 61st in having a skilled workforce.

Thank you!

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