Euler Hermes Economic Research

Country Report

Indonesia

Slower but healthier

General Information

GDP	USD878.043bn (World ranking 16, World Bank 2012)
Population	246.86 million (World ranking 4, World Bank 2012)
Form of state	Republic
Head of government	Joko WIDODO
Next elections	2019, presidential and legislative

Strengths

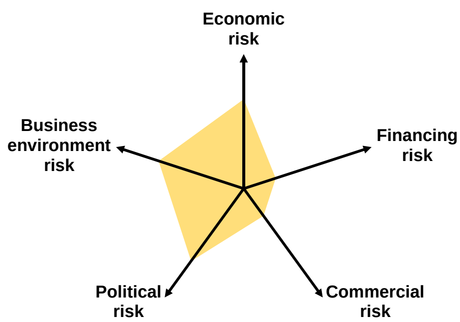
- Favorable demographics: large and young population
- Abundant natural resources
- Relatively good international relations (access to foreign assistance if needed)
- Track record of solid fiscal policies and relatively low public debt
- Banking system has shown overall resilience to the global financial crisis
- Relatively low external debt

Weaknesses

- Ongoing (often violent) social, religious and/or ethnic conflicts in several provinces
- Vulnerability to natural disasters (earthquakes, volcanoes, tsunamis)
- Exchange rate volatility and vulnerability to external shocks
- Lack of infrastructure compared its regional peers (Malaysia, Thailand)

Country Rating

B2



Source: Euler Hermes

Trade Structure

By destination/origin (% of total)

Exports		Rank		Imports
China	15%	1	20%	China
Japan	15%	2	13%	Singapore
United States	7%	3	10%	Japan
South Korea	7%	4	7%	South Korea
Singapore	7%	5	7%	Malaysia

By product (% of total)

Exports		Rank		Imports
Coals	14%	1	16%	Refined Petroleum Products
Fats	10%	2	6%	Crude Oil
Natural Gas	9%	3	4%	Iron Steel
Crude Oil	6%	4	4%	Engines
Non Ferrous Ores	5%	5	4%	Telecommunications Equipment

Source: Chelem (2012)

Economic Overview

Continued low growth in H2

GDP growth continued to slow in Q2 (+5.1% from +5.2% in Q1). The implementation of the mineral ore export ban and weak demand for coal and crude palm oil dampen export growth. Public expenditures decreased, reflected by delays in the distribution of social assistance funds (*Bansos*). Positive contribution to growth came from private consumption and to a lesser extent from investment. Currency pressure eased following (i) strong monetary response and (ii) welcome results from presidential elections (the new President was favored). However the country is not out of the woods yet as the current account deficit remains high compared to the long term average (1.0% GDP) and dependent on short term capital inflows.

However the outlook is set to improve: GDP growth at 5.2% in 2014, +5.8% in 2015

GDP growth is expected to remain at historically low levels in the short term bringing growth at +5.2% in 2014, +5.8% in 2015. This performance will be lower than the pre-crisis average but healthier as it should be accompanied by significant reforms (on fiscal management, industrial policy), while past imbalances (budget slippage, excessive credit growth) should be reduced. On the external front, slowing demand especially from big Asian partners will act as a drag on growth. Indeed, change in the Chinese growth model and its implications (reduction of overcapacity) induced a deceleration in demand (+7.5% in 2014). Japan's economy, which is the second largest market, is experiencing a contraction in activity following the rise in sales tax and without additional stimulus, GDP growth will be limited (+1.1% in 2014). On the domestic side, activity indicators point to a positive outlook. Capacity utilization rate and business surveys are on the rise suggesting increase in investment. Easing inflation would translate into a rise in purchasing power giving some leeway for future private consumption. However, high credit costs limit the overheating risk and strong fiscal discipline is expected to contain domestic demand growth, making it less buoyant than it was in the pre-crisis period.

Non-payment risk has decreased

We see less risks to the baseline scenario since political uncertainties have been reduced following the presidential election and exchange rate volatility has receded. On the domestic side, the main risk stems from the ability of Joko Widodo government to implement policies to enhance future growth. On the external front, first, it continues to rest on monetary policy orientation in advanced economies and capital flows from China. Second, it lies on Chinese and Japanese demand as they account for nearly 30% of total exports.

Strong fiscal discipline will be key to reducing imbalances

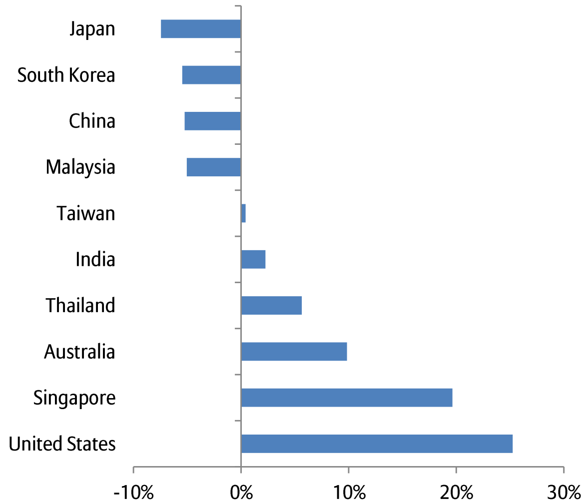
Public finance indicators are at adequate levels and their dynamics are sustainable. The fiscal deficit is among the lowest in the region and no major slippage is expected in the near term. However, the remaining current account deficit (-3.1% of GDP in 2014), despite strong monetary tightening, may induce more action from the government to speed up the adjustment and bring the current account deficit below -3% in 2015. In

Key economic forecasts

	2012	2013	2014f	2015f
GDP growth (% change)	6.3	5.8	5.2	5.8
Inflation (%, year average)	4.3	6.4	5.9	5.5
Fiscal balance (% of GDP)	-1.7	-2.1	-2.5	-2.4
Public debt (% of GDP)	24.0	26.1	26.9	27
Current account (% of GDP)	-2.7	-3.3	-3.0	-2.8
External debt (% of GDP)	28.8	30.5	33.5	31.0

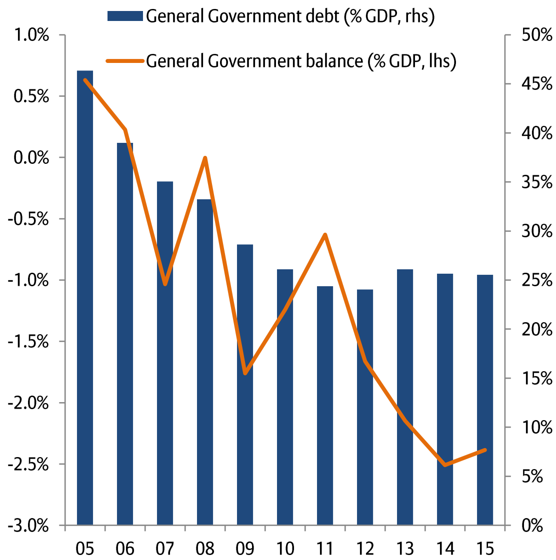
Sources: National sources, IHS, Euler Hermes

Exports from Indonesia to main partners (12m/12m, June 2014)



Sources: IHS, Euler Hermes

Public finances



Sources: IMF, IHS, Euler Hermes

particular, the Joko Widodo government is likely to improve tax collection and cut government expenditures. The tax base should be increased: while the country has approximately 70 million people who should pay tax, only 23 million are registered. The ratio of tax revenue to GDP is expected to rise by 4 pps to 16% by 2019. On the spending side, a cut in fuel subsidies (fuel subsidies amount to 2% of GDP) is in the pipeline but the reduction will likely be gradual.

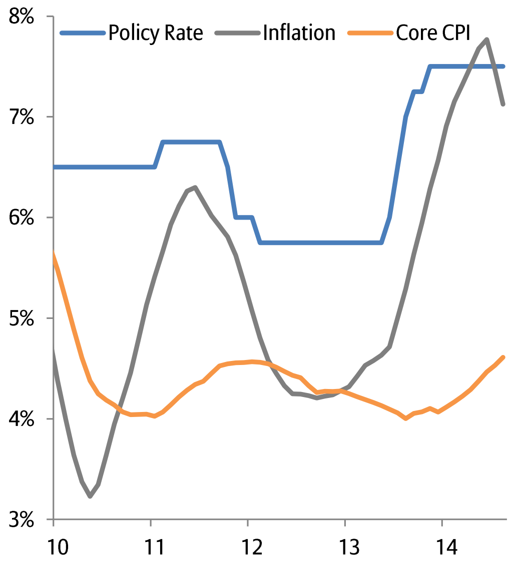
Monetary policy: the hawkish tone will be maintained to prevent the economy from overheating

The monetary policy framework is based on inflation targeting but, in practice, the Central Bank also aims at a certain degree of exchange rate stability and growth of credit. The risk of overheating and inflationary pressures decreased but a cautious stance is expected from the Central Bank. Indeed, credit growth remains high close to the range aimed by the Central Bank (between 15% and 17%). Inflation pressures are easing, benefitting from a favorable base effect but the outlook remains fragile. First core inflation remains elevated. Second, the current account balance remains stuck below -3% GDP, and renewed exchange rate pressures could generate upward pressure on inflation. Moreover, a cut in fuel subsidies will maintain the rate at high level, slightly above the target (4.5% and 4% with ±1% deviation in 2014 and 2015).

Resilience to external shock to improve

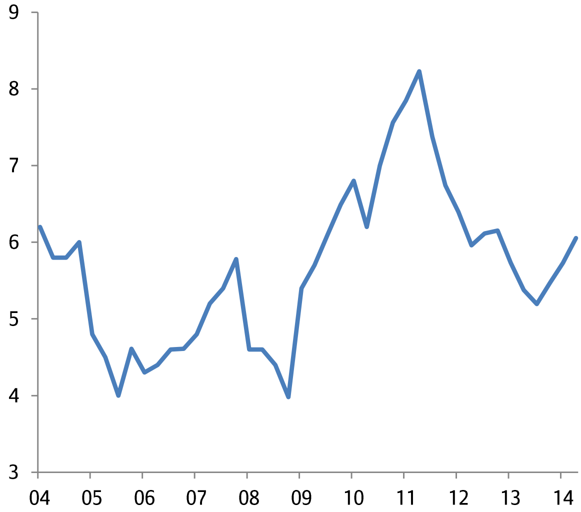
The external debt to GDP ratio and import cover are at acceptable levels, the only issue remains the current account evolution. Indeed, after 14 years of surplus, the current account balance turned negative in 2012. This performance was the result of a slowdown in global demand especially due to the US and the Eurozone but also of a rise in the oil import bill. This combined with a (small but) structural public deficit due to an elevated fuel subsidies bill, and decelerating growth, put the economy on the radar of the investors when FED tapering started, and led to a sharp currency depreciation. In Q2, currency volatility decreased and the outlook is broadly favorable. The current account is expected to stabilize close to -3% of GDP in 2014 and improve gradually on the back of global demand recovery, especially from the US and the Eurozone. Regarding external financing, the new government is expected to initiate reforms to reduce the dependency on short term capital inflows. These should include: reforms to raise national savings to finance domestic investment, speed up business environment reforms and a rise in infrastructure expenditures to make the country more attractive for long term investors.

Monetary policy and inflation



Sources: National sources, IHS, Euler Hermes

Reserve Asset Position, in months of imports



Sources: National sources, IHS, Euler Hermes

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