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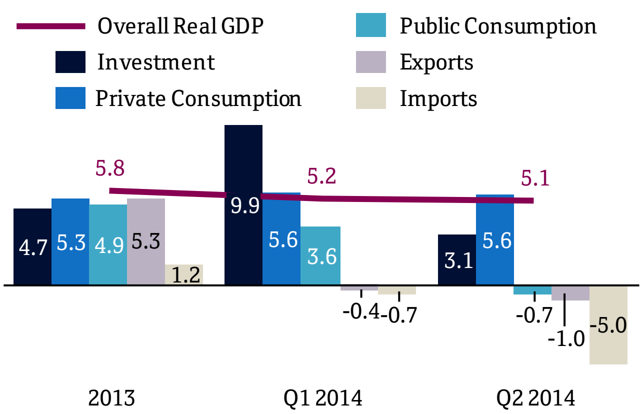
Indonesia's Economy Continues to Slow

The new administration of Indonesian President Joko Widodo (better known as Jokowi) that will be inaugurated on October 20, will face a number of major economic challenges. Real GDP growth slowed to 5.1% in Q2 2014 amidst declining exports and a slowdown in investment (although this may be partly related to the elections). The new administration will be constrained in its ability to respond to the unfavorable global environment, where rising short-term interest rates in advanced economies could lead to further capital outflows from emerging markets. We therefore expect Indonesia's real GDP growth to slow further in 2014-15. Nonetheless, Indonesia's long-term potential remains large if these challenges can be overcome.

Real GDP Growth
(% change, year–on–year)



Sources: Bank Indonesia

The tightening of global liquidity emanating from the tapering of Quantitative Easing (QE) in the US has led to periodic bouts of capital outflows from Indonesia since mid-2013 as well as a weaker exchange rate. In response, the central bank has hiked interest rates to combat inflation and used international reserves to support the currency, while the government has introduced export restrictions on raw minerals. This has contributed to a widening of the current account deficit to 4.3% of GDP in Q2 2014 at the same time as the economy slowed.

The authorities are relatively constrained in the stimulus they can provide to the economy in order to counteract this slowdown. The budget deficit (projected at 2.4% of GDP for 2014) is close to the statutory limit (3.0%) imposed by law. In addition, the latest data suggests that Indonesia experienced portfolio outflows in August (see our Economic Commentary dated September 7, 2014). There is, therefore, little room to cut interest rates or raise public spending.

The new administration plans to cut fuel subsidies to free up resources for spending on public services and infrastructure investment. However, the administration only controls about a third of the seats in parliament through its coalition party. It may, therefore, be difficult for Jokowi to garner the necessary support to cut fuel subsidies. Furthermore, the US Federal Reserve is expected to raise interest rates in 2015, which could spark another round of capital outflows, leading to a weaker currency and tighter monetary policy. This would have a negative impact on domestic demand.

Indonesia's short-term outlook is therefore bleak. Real GDP growth is likely to slow down further for the remainder of 2014 and 2015 to below 5%. However, the reforms of the new administration, if implemented, are likely to provide positive dividends for growth and investment over the medium term. Additionally, exports not covered by restrictions should also recover as the weaker currency supports Indonesian competitiveness and as global demand recovers. Export restrictions may also be lifted in time and some companies have already been exempted. This should lift growth back up above the 5% level by 2016. Beyond that, the main challenge will be to address the underinvestment in infrastructure, which has resulted in congested transport systems and shortages of power and water (see our Economic Commentary from July 26). This adds to the cost of doing business, erodes competitiveness, discourages investment and reduces Indonesia's growth potential.

With a rich endowment of natural resources and a large, growing, young and increasingly wealthy population, the long-term potential in Indonesia is large. Jokowi's major challenge will be to navigate through the difficult global environment over the next two years and implement the infrastructure investment that will unleash Indonesia's full economic potential from 2016 onwards.

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