Private Consumption Shields Indonesian Economy, But Tough Challenges Lie Ahead

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With 57% of gross domestic product (GDP) made up by private consumption, PEFINDO is of the view that Indonesia is in better shape to withstand the shocks from the global downturn than its emerging market peers, such as Malaysia (49%), China (36%), Russia (48%), and Thailand (54%), which are more dependent on export-related activities to developed economies. Exports only account for slightly over 20% of Indonesia's GDP, and the economy has grown over 5% in the past four years (2009-2012). In addition, Indonesia possesses a favorable demographic profile, with 50% of its population under the age of 29, and 60% under 39. As 52%-53% of the population live in urban areas and adopt modern lifestyles, there is strong support for the growth of domestic economy.

However, we believe that the economy is prone to several challenges in the near to medium term. It is still dependent on foreign direct investment (FDI), which made up two-thirds of total investment of IDR192.8 trillion in the first half of 2013 (1H2013). This is unlikely to change significantly.

Table 1

Investments	1H13	%	1H12	%	Target 2013	%
DDI (IDR Tn)	60.6	31.4%	40.5	27.3%	117.7	30.2%
FDI (IDR Tn)	132.2	68.6%	107.6	72.7%	272.6	69.8%
Total	**192.8**	**100.0%**	**148.1**	**100.0%**	**390.3**	**100.0%**

Source: BKPM

Table 2

Equities Ownership	7M13	%	FY12	%	FY11	%
Total	2,848.1	100.0%	2,500.3	100.0%	2,063.4	100.0%
Foreign (IDR Tn)	1,618.7	56.8%	1,476.1	59.0%	1,235.0	59.9%
Domestic (IDR Tn)	1,229.5	43.2%	1,024.2	41.0%	828.3	40.1%

Source: KSEI website

Table 3

Government Bond Ownership	8M13	%	1H13	%	FY12	%	FY11	%
Total	927.1	100.0%	888.5	100.0%	820.3	100.0%	723.6	100.0%
Foreign (IDR Tn)	284.0	30.6%	283.0	31.8%	270.5	33.0%	222.9	30.8%
Domestic (IDR Tn)	643.1	69.4%	605.6	68.2%	549.8	67.0%	500.8	69.2%

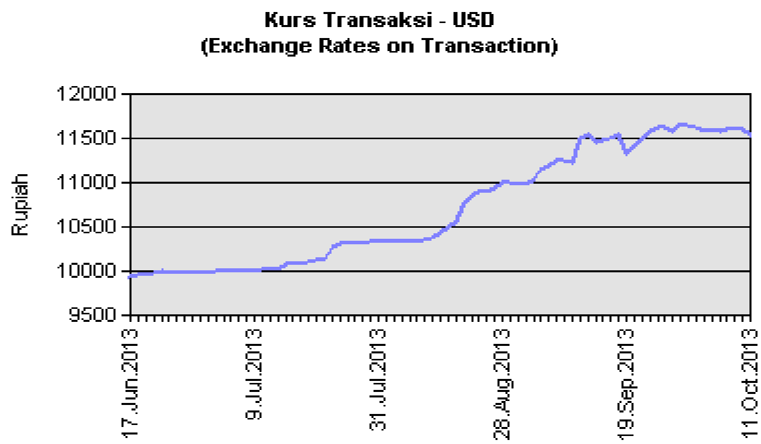
Source: DJPU website

Dependent on foreign investors

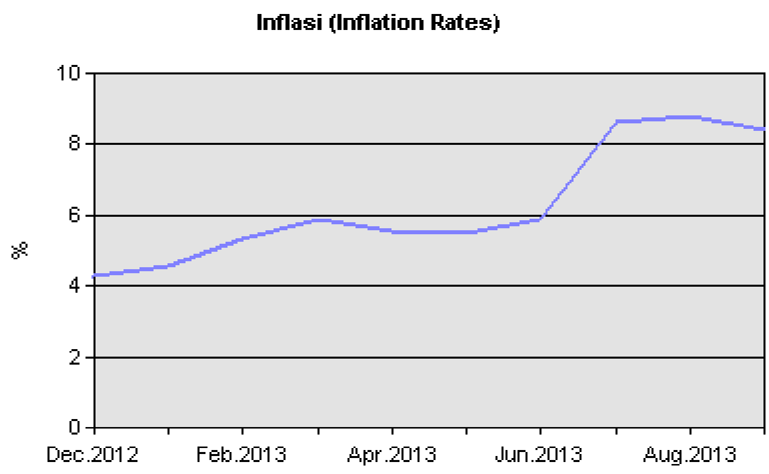
The dependency on FDI is also apparent in the ownership composition of Indonesian stocks and government bonds, as shown in Table 2 and 3, with foreign institutions owning nearly 60% of Indonesian equities, and around 30% of government bonds. Although this could be interpreted as foreign investors' confidence in the domestic economy, it also highlights vulnerability to global market sentiments. The global economic slowdown in Europe and the US, as well as the ongoing fiscal battle in the US, has caused negative fund flow in the capital market, higher interest rates, and a weakening rupiah which has depreciated by more than 15% since June 2013. Rising interest rates and a fluctuating domestic currency could slow down economic growth.

Another challenge facing Indonesia is its persistent trade deficit, which was USD657.2 million for September 2013, reversing the improving trend in August 2013 of a trade surplus of USD7.2 million, which brought the overall trade deficit to USD6.26 billion by the end of September 2013. The main reason for this was high oil and gas imports. Given the growth of car and motorcycle sales in recent years, and the lack of public transportation, oil consumption has been trending up since 2012 in both nominal amount and volume. Although the oil subsidy reduction saw oil imports fall from 4.63 million tons in July 2013 to 3.67 million tons in August and another 3.67 million tons in September 2013, overall oil and gas consumption is still rising, at 36.48 million tons in the first nine months of 2013 (9M2013), a 14% increase from 31.99 million tons for the same period in 2012. The trade deficit puts pressure on inflation and thus interest rates, as well as the rupiah.

Nevertheless, Indonesia is still faring better than its neighbors. With the GDP growth forecast lowered to 5.8%-6.2% for 2013 and 2014, it is still higher than Singapore (2.5%-3.5%), Malaysia (4.5%-5.0%), and Thailand (3.8%-4.3%). These countries have also recently cut their growth projections.



Source : Bank Indonesia



Source : Bank Indonesia

Watching United States: the world's largest economy

The largest economy in the world belongs to the United States, with GDP figure of USD15.7 trillion in 2012, in comparison to Indonesia's GDP figure at USD878 billion. The US economy is going through a fundamental shift, as it needs to reduce its ever-growing trade deficit of USD16.0 trillion (relatively the same as its GDP in 2013) without going back into recession. This is important because the US is a major export destination country for Indonesia (10.3% in 2012), as well as for many countries. Therefore, any economic disruption to the US would have a negative impact on the Indonesian economy.

There are two major issues in the US. One is slow economic growth (1.6% at June 2013), and the other is the huge debt level (USD16.7 trillion at 10M2013). The Federal Reserve's (Fed) initial plan to start tapering the quantitative easing 3 (QE3) funds sent shockwaves through financial markets across the globe, including Indonesia, pushing interest rates up, exchange rates down, and foreign money out of the country. The situation stabilized when the Fed decided against tapering the QE3 funds in September 2013 for fear of modest US economic growth, citing concerns over the high jobless rate (6.5%) and low inflation (below 2.5%). This policy should keep interest rates low in the US, which will be a positive development for emerging markets such as Indonesia that need a good supply of foreign funds.

The high debt level, however, may be a lingering issue. The differing views in the US of the Democratic and Republican parties on how to resolve the issue is at the heart of the matter, and resulted in partial government shutdowns in the past (1995–1996, and October 2013). The debt level, known as the debt ceiling, has been continuously raised in the past without much thought. However, the debt ceiling's new historic highs resulted in hard stances taken by both parties. Without the extension of the debt ceiling, the US Treasury will have to default on its obligations, which will hurt investor confidence, and cause catastrophic damage to the US and global economies alike. The current debt ceiling has been extended to February 7, 2014, but that only means more of the same process in a few months. It will be another nervous time for global markets, to say the least.

Impact on PEFINDO portfolio

The obvious impact of global economic volatility can be seen in the financial institution industry, especially in banking and multifinance. Within its portfolio, PEFINDO observes slower business growth and some deterioration of asset quality, particularly in the consumer financing and leasing sectors, as they must also cope with the new down payment regulation and a decline in commodity prices. However, given the sound capitalization as well as conservative approach taken by management teams, PEFINDO is of the view that the overall performance of these sectors should remain stable.

In the corporate sector, pressure can be seen in the plantation and mining industries. A sluggish recovery in the Eurozone and an economic slowdown in China have lowered demand for crude palm oil (CPO), while the mineral ore export ban, planned to be implemented in 2014, will likely cause a drop in revenue. We have assigned negative outlook for some companies in the plantation and mining sectors, but the majority of PEFINDO's corporate sector portfolio remains stable.