Indonesia Economic Insight

2013

Contents

Economics Team
economics@qnb.com.qa

Joannes Mongardini
Head of Economics
+974 4453 4412
joannes.mongardini@qnb.com.qa

Rory Fyfe
Senior Economist
+974 4453 4643
rory.fyfe@qnb.com.qa

Ehsan Khoman
Economist
+974 4453 4423
ehsan.khoman@qnb.com.qa

Hamda Al–Thani
Economist
+974 4453 4646
hamda.althani@qnb.com.qa

Editorial closing: November 26, 2013

Executive Summary

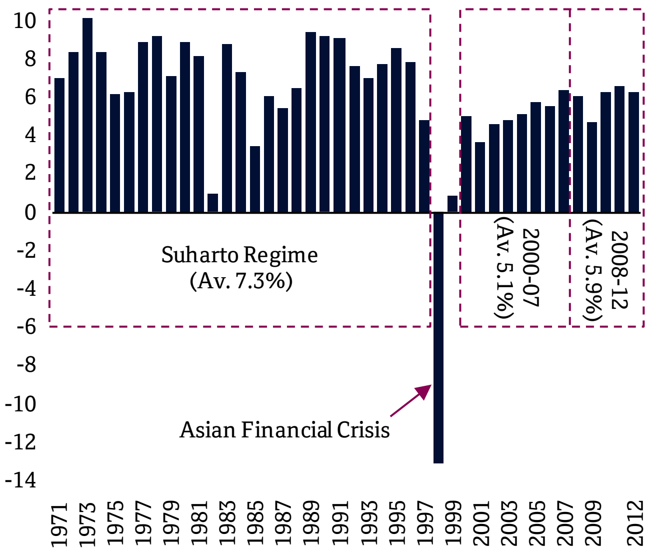
- Indonesia has **enormous long–term potential** based on a **rich endowment of natural resources** and its large, growing, young and **increasingly wealthy population**, which are driving the rapid emergence of a consuming middle class
- Indonesia was the **fourth fastest growing economy in the G20** during 2008–12, with an average growth rate of 5.9%
- However, **short–term instability** and **underinvestment** are expected to reduce the strong growth potential of Indonesia's economy to 5.5% in 2013 and 5.0% over the medium term as low infrastructure investment could lead to crippling supply bottlenecks
- The economy is currently facing a **slowdown in investment**, a softening of commodity prices and a **widening current account deficit (CAD)**
- This has led to **capital outflows** and a sharp **depreciation of the exchange rate** since mid–2013 and there is a short–term risk of higher capital outflows as a result of a potential tapering of Quantitative Easing (QE) in the US and political uncertainty about the outcome of the elections in 2014
- The central bank has responded by **hiking interest rates** to combat inflation and using reserves to support the currency
- The **budget deficit has widened on weak revenue**, prompting cuts to fuel subsidies and limiting the potential for fiscal stimulus in the short term
- Growth in the **banking sector is expected to slow** in 2014–15 on tighter liquidity and rising interest rates; low banking penetration however suggests scope for strong medium term growth

Background

Since the 1960s, Indonesia has transformed itself from an agrarian society to a global economic force

Since the mid–1960s, Indonesia has maintained consistently high real GDP growth, only interrupted by the Asian Financial Crisis in 1997–98. Over this period, the economy has been transformed from mainly agrarian to one of the fastest growing emerging markets, becoming the 16th largest economy globally with a nominal GDP of USD878bn in 2012. During the Suharto regime (1967–98), rising oil prices created windfall export revenue, which attracted large foreign direct investment (FDI). However, strong growth during that period masked deep–seated structural weaknesses: endemic corruption, rising public debt, a poorly–regulated banking system, protectionism, and a persistent CAD. This left Indonesia fully exposed to the 1997–98 Asian Financial Crisis as the CAD led to a drastic depreciation of the Indonesian Rupiah (IDR) and rampant inflation with a severe impact on growth. Real GDP fell 13.1% in 1998.

Real GDP Growth (1971–2012)
(%)

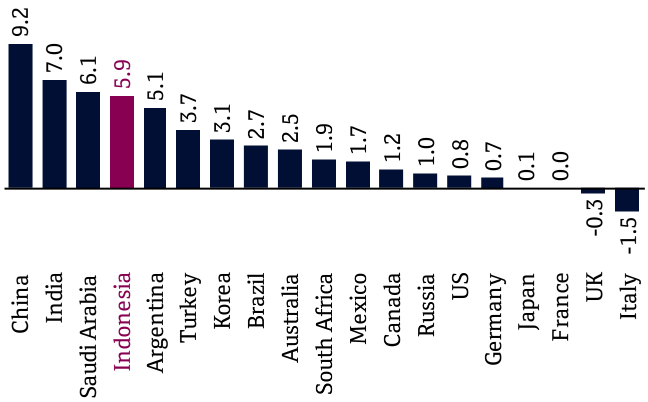


Sources: Global Insight and QNB Group analysis

Indonesia is now one of the fastest growing economies in the G20

Indonesia committed to significant structural and financial reforms under an IMF–supported program following the Asian Financial Crisis. Fiscal discipline helped bring down public debt while exchange rate flexibility and inflation targeting led to greater price stability. Real GDP growth averaged 5.1%[1] in 2000–07 as investment was supported by rising commodity prices and exports of natural resources. This placed Indonesia in a strong position to weather the Global Financial Crisis (2007–09) and slowdown in world economic growth. Real GDP growth actually strengthened to 5.9% in 2008–12, making Indonesia the fourth fastest growing economy in the G20.

G20 Real GDP Growth (2008–12)
(% CAGR)

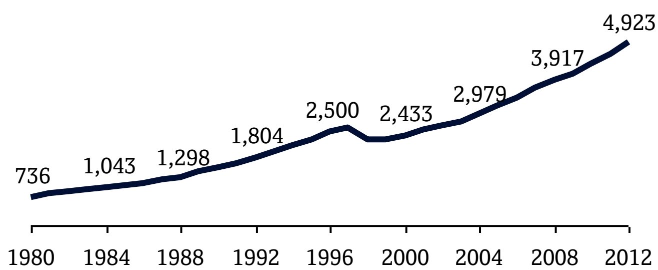


Sources: International Monetary Fund (IMF) and QNB Group analysis

Rising wealth and a young population are driving the rapid emergence of a large middle class

With 244m people, Indonesia is the world's fourth most populous country with the largest Muslim population. Its total population is expanding by about 3.4m people every year (1.4%). The population is youthful (37.7% under 20), which should drive labour force growth and provide a demographic dividend into the 2020s (see Demographic chapter). Economic development has led to steadily–rising affluence. GDP per capita has grown by an average 6.1% since 1980, with a rapidly–growing middle class.

GDP per capita (1980–2012)
(USD on a PPP basis)



Source: IMF

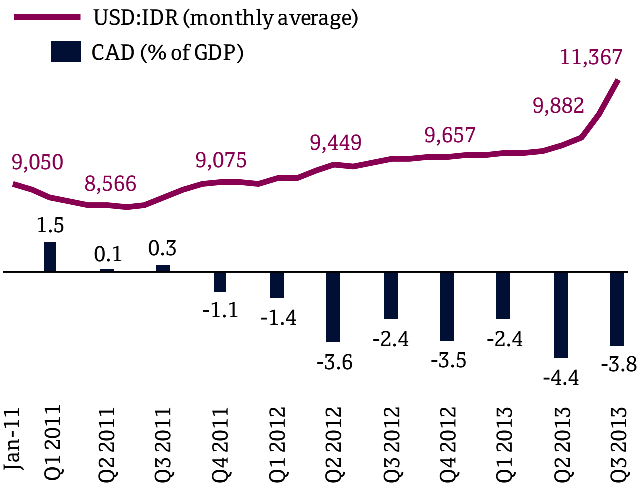
[1] This is the compounded annual growth rate (CAGR), which is a geometric mean. In general, unless otherwise specified, all multi–year growth rates mentioned in this report will be CAGRs rather than arithmetic means.

Recent Developments

A widening CAD and capital outflows have led to a weaker IDR…

In 2012–13, the CAD widened significantly on softer commodity prices (see Economic Sectors chapter). The sluggish global economy weakened external demand, leading to a drop in exports of natural resources (particularly to China and India) and lower commodity prices. At the same time, strong domestic demand pushed up the import bill and repatriation of income by foreign firms rose as the government introduced new tariffs in agriculture, mining and financial sectors to protect domestic producers. Investor confidence was further shaken by the announcement, on May 18, 2013, of the Federal Reserve's intention to taper its asset–purchasing program (the so–called Quantitative Easing [QE] Tapering). This led to capital outflows from emerging markets, including Indonesia, as USD liquidity tightened globally. The combination of a widening CAD and capital flight resulted in a sharp depreciation in the value of the IDR and a stockmarket correction of 23.9% from its peak in May to end–August 2013.

CAD and Exchange Rate (2011–13)

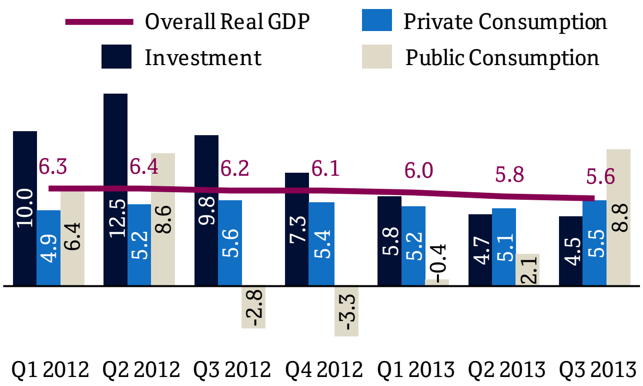


Sources: Global Insight and QNB Group analysis

…undermining investor confidence and contributing to a slowdown in real GDP growth

The deteriorating macroeconomic environment has reduced investor confidence. As a result, investment growth has slowed each quarter since Q3 2012. Weak external demand as well as exchange rate and price instability have discouraged FDI. Government reform has stalled ahead of elections in 2014, leaving a stifling regulatory environment in place, which is delaying vital infrastructure projects. The lack of government investment in basic infrastructure, particularly power and transport networks, is constraining private sector growth (see Infrastructure chapter). These factors have contributed to a slowdown in real GDP growth from 6.4% in Q2 2012 year–on–year to 5.6% in Q3 2013.

Real GDP, Investment and Consumption (2012–13)
(% change, year–on–year)

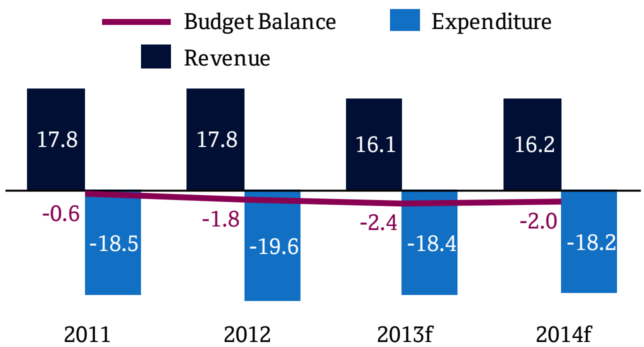


Sources: Global Insight and QNB Group analysis

Fiscal constraints reduce the scope for a fiscal stimulus

The fiscal deficit widened as weakening economic activity held back revenue in 2012–13. Although the government raised domestic fuel prices in mid–2013, higher international crude oil prices and a weaker exchange rate have eroded much of the expected reduction in subsidies. Accordingly, the fiscal deficit is estimated to rise to 2.4% of GDP in 2013. With revenue likely to remain relatively low, the government cannot provide a large fiscal stimulus in the short term given the legal limit on the fiscal deficit of 3.0% of GDP. In 2014, fiscal consolidation and the full–year impact of subsidy cuts should constrain spending, bringing the deficit down to 2.0% of GDP.

Fiscal Deficit (2011–14)
(% of GDP)

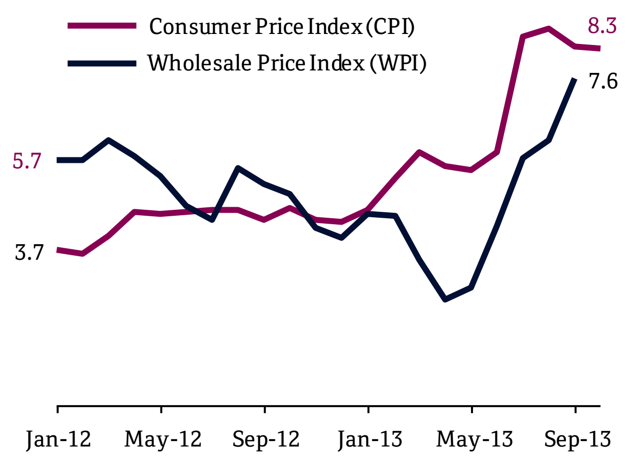


Sources: Global Insight and QNB Group analysis and forecasts

Inflation spiked on higher fuel prices while the weak IDR pushed up import prices

Inflation jumped above 8% in July 2013 as higher fuel prices and the weak exchange rate led to elevated consumer and wholesale prices. The cost of transportation rose sharply owing to the cuts in fuel subsidies with transport inflation averaging 14.8% year–on–year in Q3. The impact of the weak exchange rate is concentrated on food, which is mainly imported, with food inflation of 14.3% on average in Q3. Housing costs, which include electricity, gas and fuel, are also rising as a result of the subsidy cuts. Transportation, food and housing account for 64% of the CPI basket and these categories are driving the overall increase in inflation. A nationwide 20% increase in the minimum wage at the beginning of 2013 has also put upward pressure on consumer prices.

Inflation (2012–13)
(% year on year)

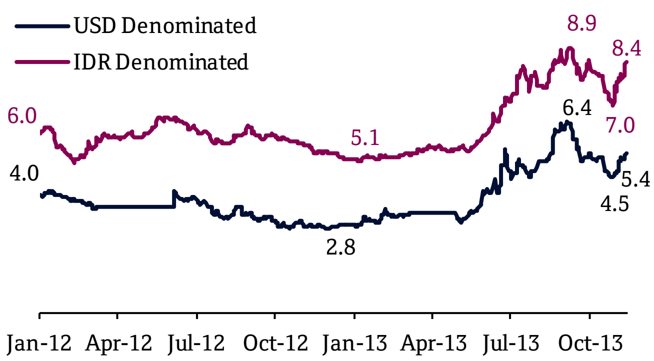


Sources: Global Insight and QNB Group analysis

Lower investor confidence in Indonesia has pushed up interest rates

The deterioration in the balance of payments resulted in a tightening of liquidity and higher interest rates. Long–term bond yields rose as capital flew out of the country, pushing up interbank borrowing costs and further weakening growth and investment. Long–term sovereign bond yields peaked in early September then eased back later that month after the Federal Reserve, surprisingly, decided not to taper QE. However, yields started rising again in November, an indication that concerns about QE tapering may be re–emerging.

Sovereign Bond Yields (2012–13)
(%)

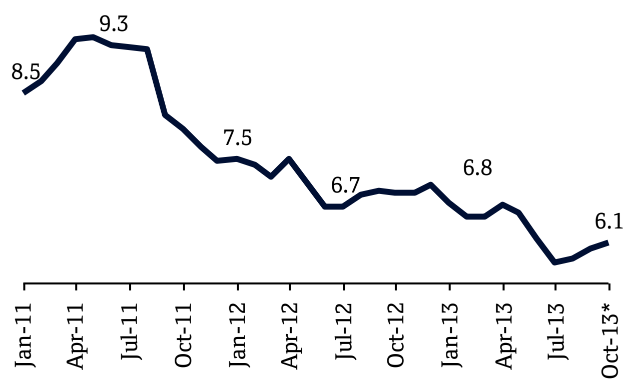


Sources: Bloomberg and QNB Group analysis

The authorities have sought to intervene to stabilize the exchange rate

In response to the crisis, Bank Indonesia (BI) raised its main policy rate 175 bps to combat inflation and the weak exchange rate, pushing up short–term interest rates. BI also intervened in foreign exchange markets to support the currency, eroding gross international reserves (although they have recovered since July as the crisis has eased). On the fiscal side, the crisis pushed the government to cut fuel subsidies in June in response to falling revenue. The government also introduced a fiscal package in August 2013 aimed at curbing imports, particularly of fuel. A number of food products were moved from quota to tariff systems with the intention to better protect local producers. A requirement that all fuel should have at least a 10% content of local biodiesel was also introduced, creating fiscal savings and reducing fuel imports at the expense of potential exports.

International Reserves (2011–13)
(Months of import cover, 12–month rolling imports)



Sources: Global Insight and QNB Group analysis;
*Import data not available for October, so estimated

Macroeconomic Outlook (2013–15)

The balance of payments is likely to remain the key macroeconomic risk in the short term...

A persistent CAD and concerns about QE tapering mean capital outflows are likely in the short run. A significant adjustment is required to redress Indonesia's CAD, but measures taken so far are insufficient. Fuel subsidy cuts should help bring down imports. However, high oil prices and weak IDR have already pushed up fuel import costs, eroding gains from higher domestic prices. Reforms to reduce imports require fuel to contain more domestic biofuel. However, as the biofuel would otherwise be exported, this is unlikely to impact the trade balance. Export competitiveness advantages from weaker IDR are limited by the utilization of imported intermediate goods in finished exports, so export growth is largely offset by higher import costs. Therefore, the CAD may persist in the medium term, which, along with concerns about the impact of QE tapering, will probably cause further capital outflows.

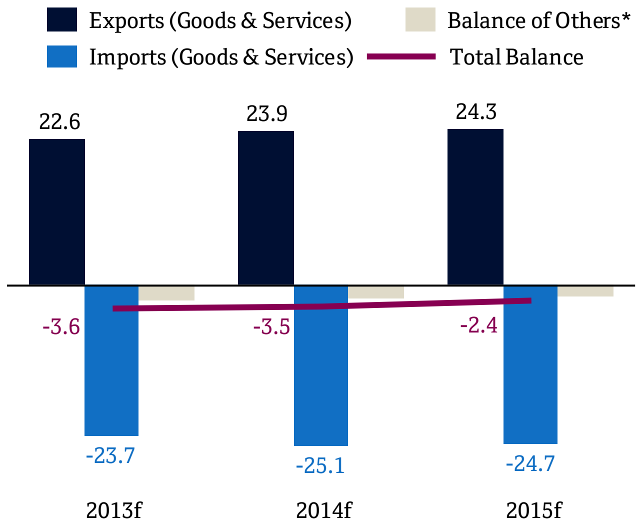
...which is expected to lead to further IDR weakness and higher inflation...

IDR weakness is likely to push up prices, prompting BI to hike rates further. We expect IDR to gently depreciate over the medium term owing to the CAD. The gradual lifting of subsidies, supply bottlenecks and IDR weakness will keep inflation above the historical average in the short term. We expect these pressures to weaken over the medium term and inflation to ease as the CAD is reduced. With upcoming elections, there is a small risk to our baseline scenario that the government could give in to higher wage demands as inflation rises, creating a wage–price inflationary spiral and weaker IDR.

...while rising prices and interest rates will dampen growth in 2013–15

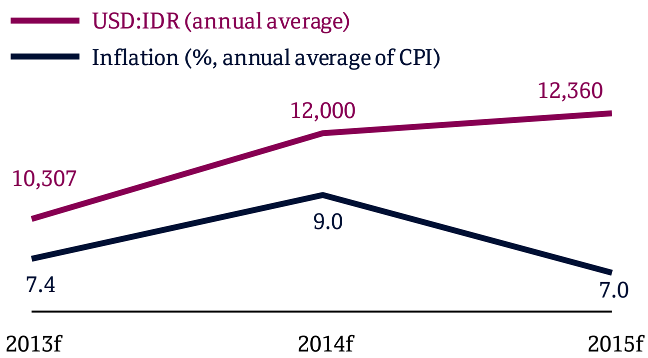
Higher prices and an elevated cost of borrowing may depress domestic demand in 2013–15. Other factors will also hold back short–term growth. First, strong expansion in inventories in 2010–12 means that significant drawdown on stocks is likely. Second, the fiscal deficit is legally restricted to 3.0% of GDP, constraining government spending and growth in public consumption. Third, with parliamentary and presidential elections in 2014, reforms have grinded to a halt, leaving little hope for decisive government action until late 2014. Fourth, investment is expected to slow further, at least until after the elections, owing to reduced investor confidence. We therefore expect these factors to lead to a slowdown in growth from 6.2% in 2012 to 5.0% in 2015.

Current Account (2013–15)
(% of GDP)



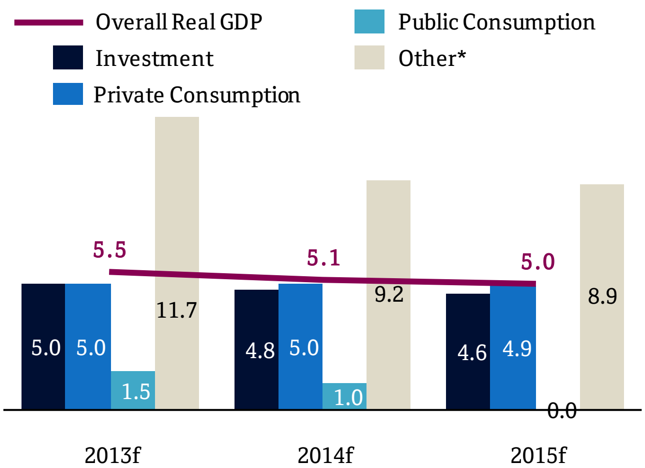
Source: QNB Group forecasts (f); *Flows of Income and Current Transfers

IDR and Inflation (2013–15)



Source: QNB Group forecasts

Real GDP Growth by Expenditure (2013–15)
(%)



Source: QNB Group forecasts; *Net Exports and Stock building

Strong fundamentals underpin medium term growth, but infrastructure is needed to unleash full potential

The economy is underpinned by positive demography and a vibrant private sector. The youthful, well–educated, and large population is growing rapidly, becoming increasingly wealthy (see Demographics chapter), and consuming more. Production is boosted by a dynamic, small–scale private sector. All this will support strong medium–term private consumption growth (which accounts for over half of GDP). Higher growth is possible, but is dependent on better infrastructure to unleash the private sector. Sluggish public investment could exacerbate supply bottlenecks, keeping medium–term real GDP growth repressed below potential, at 5% (see Infrastructure chapter).

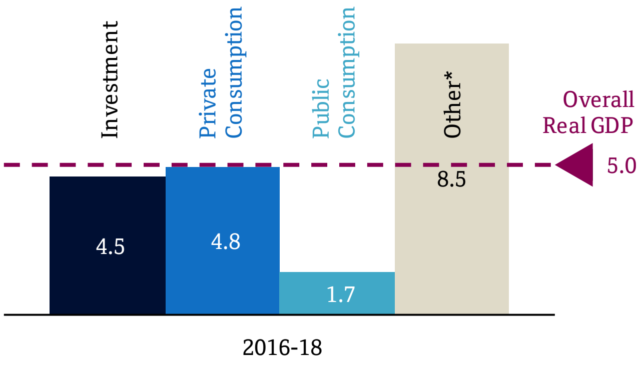
The CAD is expected to be financed by higher external debt over the medium term

External borrowing is likely to finance the CAD over the medium term to limit erosion of international reserves. We expect the CAD to narrow gradually over the medium term. Export growth will be largely dependent on a recovery in external demand from China and India, which is likely to be slow. Weaker domestic demand and fiscal tightening means import growth will be lower, which should help narrow the CAD. However, substantial structural reforms are needed to return to a surplus over the medium term, like the full removal of fuel subsidies, a reversal of nationalistic policies, and the implementation of a focused strategy for key sectors to boost exports. Such reforms are difficult to carry out and will require a more decisive government following the 2014 elections. As a result, the external debt to GDP ratio is expected to rise in 2013–15.

The fiscal balance should return to a surplus over the medium term, alleviating public spending constraints

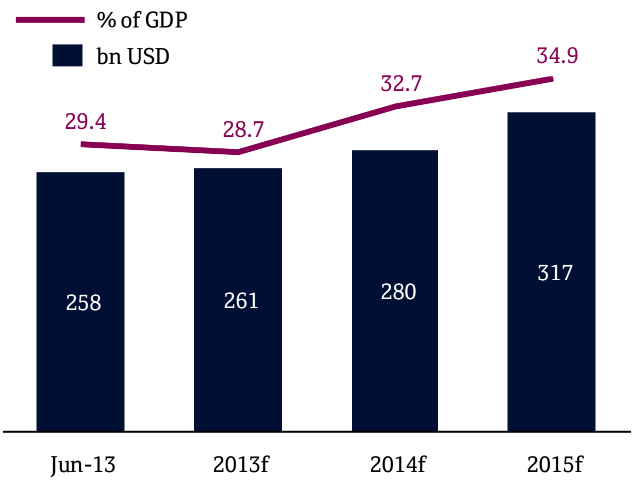
The updated 2014 budget aims to reduce the deficit from an expected 2.4% of GDP in 2013 to 2.0% in 2014. Deficit reduction beyond 2014 will require further public spending restraint, dragging down growth over the medium term. QNB Group expects the fiscal balance to return to surplus after 2015, which will ease some of the downward pressure on public consumption. We assume a gradual lifting of subsidies over the forecast period as strong political resistance will prevent cuts from being implemented upfront. Overall, fiscal adjustment will be a necessary precondition to narrow the CAD. However, this may limit the extent to which the government can finance much–needed infrastructure investment.

Medium–Term Real GDP Growth by Expenditure (2016–18)
(%, CAGR)



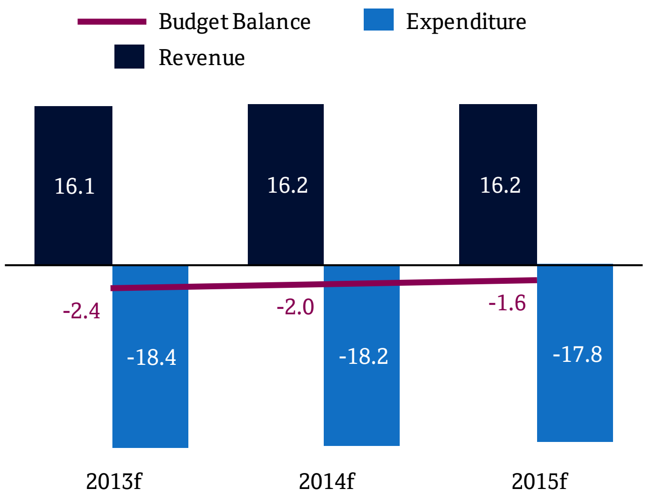
Source: QNB Group forecasts; *Net Exports and Stock building

External Debt (2013–15)
(end of period)



Source: QNB Group forecasts

Fiscal Balance (2013–15)
(% of GDP)



Source: QNB Group forecasts

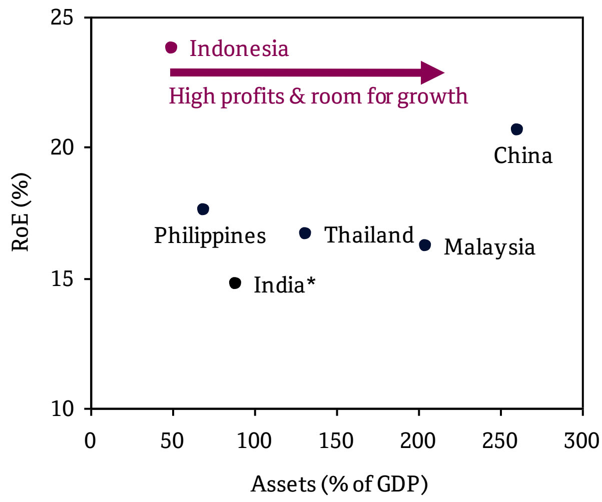
High profits, low penetration, strong capitalization and asset quality make the banking sector attractive

Indonesia has one of the world's most profitable banking sectors. The average return on equity (RoE) is around 24%, owing to high net interest margins of around 550bps underpinned by strong demand for credit. The banking sector is underpenetrated with assets accounting for just over 50% of GDP, leaving considerable room for growth. Government banks are the largest in the sector—the two largest state–owned institutions account for 27.6% of assets. Banks are expanding rapidly with asset growth averaging 16.4% year–on–year so far in 2013 (in IDR terms), driven by lending, compared with 20.2% average in 2012. The sector remains well–positioned to withstand a crisis: capital adequacy ratios (CARs) are high (18.1%) and non–performing loans (NPLs) extremely low (1.9% of total loans). However, dependence on external funding has led to tighter liquidity conditions recently. This is driving up interest rates and could slow lending growth further (see Banking chapter).

Tighter liquidity and higher interest rates may constrain lending growth in the short run despite large medium–term potential

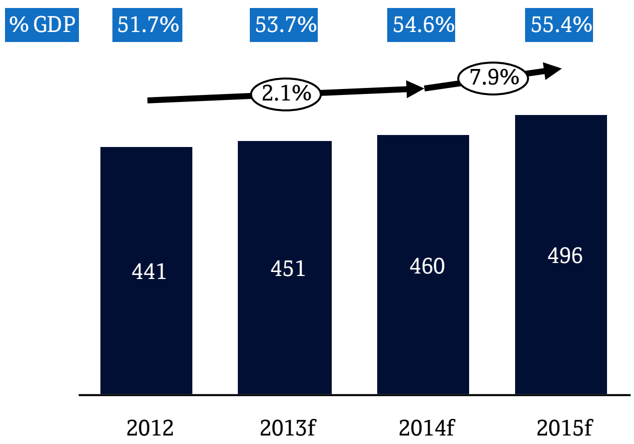
Lending growth is likely to be constrained in the short term. The loan to deposit ratio (LDR) rose from 80.9% at the beginning of 2012 to over 90% currently, as deposit growth slowed owing to capital flight. This is likely to lead to higher deposit rates, compressing NIMs and slowing loan growth in the short term. Therefore, we expect assets to grow 14.6% in IDR terms (2.1% in USD terms) in 2013–14. Over the medium term, asset growth is likely to pick up as lending recovers, driven by steady private consumption growth. Services sectors are therefore likely to see the strongest lending growth. Non–oil and gas manufacturing is also expected to perform well over the medium term owing to government requirements for banks to increase their exposure to Small and Medium Sized Enterprises SMEs (see Banking chapter).

Bank Returns and Penetration (Jun–13)



Sources: Bloomberg and QNB Group analysis
*Assets at end–March 2012 (latest available)

Banking Assets (2012–15)
(bn USD and % of GDP)



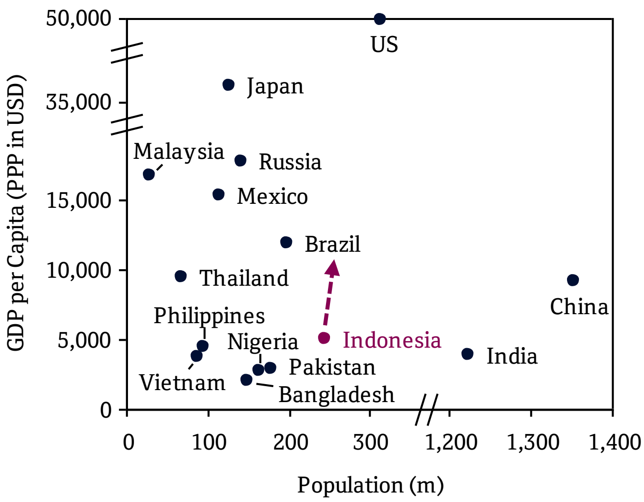
Sources: Global Insight and QNB Group forecasts

Demographics

Indonesia's long–term potential is underpinned by its large, young population and rising wealth

Indonesia is the world's fourth most populous nation with 244m people. It also has the world's largest Muslim population (213m). Population growth is steady at 1.4% per year (around 3.4m people currently) and GDP per capita is relatively low, suggesting major potential for long–term economic growth as the country develops. The population is concentrated in Java, the world's most populous island with around 140m people. A rapid process of urbanization is underway and the number of people living in cities probably overtook the rural population in 2011, helping to boost private consumption. Around 95% of the population are native Indonesians, but the country consists of over 16,000 islands with various ethnic groups, making it culturally diverse.

Population and Per Capita GDP (2012)



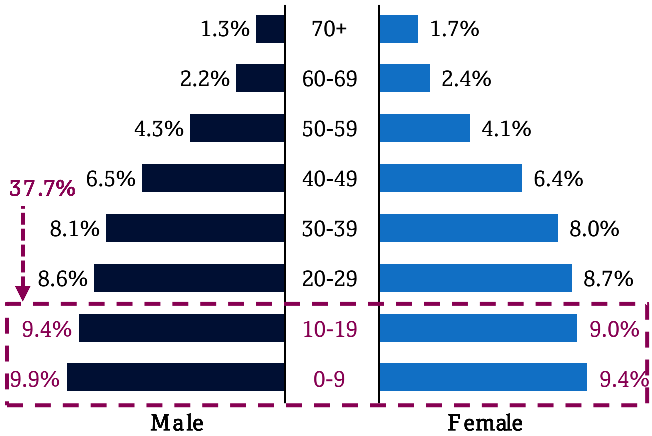
Sources: IMF and QNB Group analysis

The youthful population will provide a demographic dividend in the decades ahead

About 37.7% of the population is under 20, ensuring strong growth in the working age population. This will bring down the dependency ratio—the ratio of the working–age population (15–65) to those not of working age. This ratio is currently relatively high compared with peers (52% versus 42% in the East Asia and Pacific and 36% in China), but should fall over the medium term, freeing up a share of economic resources currently used to support dependents. This demographic dividend should support growth through the 2030s. The dividend will be augmented by strong public investment in education, which should improve the skill level of the workforce. Primary school enrollment rates and participation in higher education are rising.

Population by Age and Sex (2010)

(% of total population)



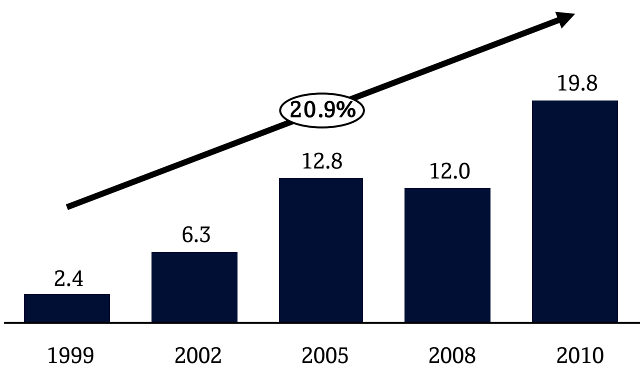
Sources: Statistics Indonesia (BPS) and QNB Group analysis

An increasingly wealthy population is driving the rise of the Indonesian consumer

The number of people with enough disposable income to carry out discretionary spending is rising rapidly. Only 2.4m Indonesians met this definition of consumers in 1999, but this had risen to 19.8m by 2010. McKinsey & Company, a consultancy, estimates that there is potential for 90m new consumers by 2030, when it expects consumer services to generate revenue of USD1.1tn annually.[2] With this scale of demand, the Indonesian consumer has the potential to become a significant global economic force. At a minimum, rising wealth should provide a solid basis for long–term private consumption growth.

People Earning More than USD2,000 (1999–2010)

(m people earning more than USD2,000 using 2005 USD in PPP terms*)



Sources: World Bank (WB) and QNB Group analysis;
*Lorenz curves used to estimate income distribution

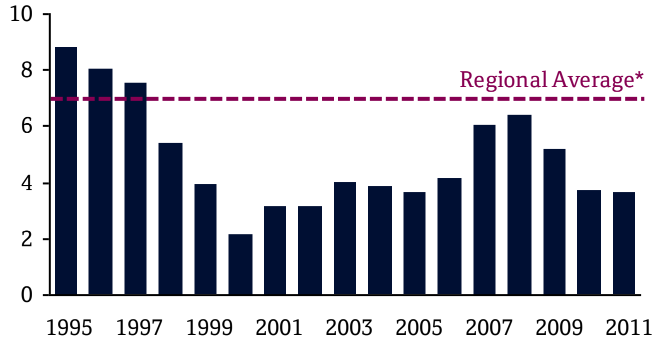
[2] McKinsey, September 2012, *The Archipelago Economy: Unleashing Indonesia's potential*

Infrastructure Gap

Underinvestment in infrastructure keeps growth below potential...

Since the Asian Financial Crisis (1997–98), investment in infrastructure has been weak. Infrastructure investment plummeted from over 7% of GDP prior to the Asian Financial Crisis to around 2% in 2000 and has mainly been constrained in the 3%–4% range since then. According to the World Bank (WB), this is well below average infrastructure investment levels of above 7% of GDP for neighboring countries: China, Thailand and Vietnam.[3] McKinsey estimates that deteriorating infrastructure is restraining GDP growth by 3–4 percentage points.[4] Growing infrastructure constraints are the main reason we forecast growth below trend at 5% over the medium term.

Infrastructure Investment (1995–2011)
(% GDP)

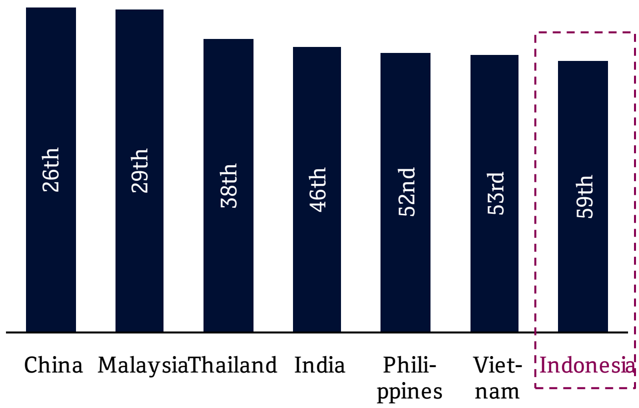


Source: WB; *Regional average comprises China, Thailand and Vietnam

...resulting in Indonesia's infrastructure being worse than its peers

Underinvestment has left trade and transport infrastructure in relatively poor conditions, clogging the economy. Indonesia suffers from heavy road traffic, delays and lack of capacity at ports, overcrowded airports, insufficient railways, power and water shortages and a sluggish data network. Indonesia performs poorly compared to peers in rankings assessing the quality of infrastructure. This adds to the cost of doing business, erodes competitiveness, discourages investment and reduces Indonesia's growth potential. Logistics costs are high, averaging 14.1% of sales in 2011, compared with 4.8% in Japan. It is 4–5 times more expensive to ship a container from Jakarta to West Sumatra (within Indonesia) than to Singapore, which is much further. Cement is ten times more expensive in Papua than in Jakarta. Power infrastructure is inadequate with at least 15m households lacking electricity access. Energy consumption per capita is the lowest amongst seven major East Asian Emerging Market (EM) peers. Indonesia has the lowest broadband and internet penetration of its peer group, except for India.

Infrastructure Indicator*, Selected Peer Group (2012)**
(Index, rank out of 155 countries)



Sources: WB and World Economic Forum (WEF)
*Logistics Performance Index from WB
**Peer group selected on basis of major East Asian EMs

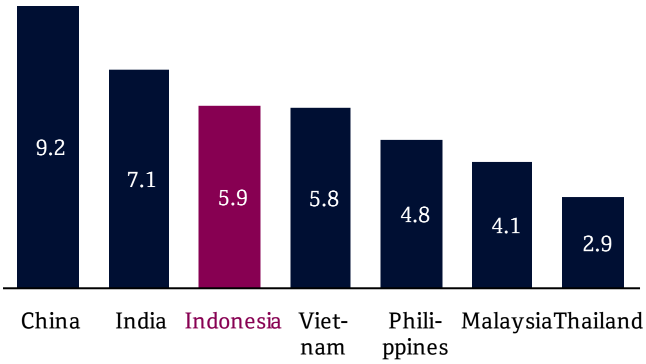
[3] World Bank, "*Indonesia Economic Quarterly; Pressures Mounting,*" March 2013.
[4] McKinsey, "*Asia's $1 Trillion Infrastructure Opportunity,*" March 2011.

Poor infrastructure is constraining growth compared with peers

The poor state of Indonesia's infrastructure may be keeping growth lower than China. Infrastructure development would help raise Indonesia's growth on par with leading Asian EMs. In China, investment in infrastructure has long been a government priority, with public infrastructure investment accounting for 8.5% of GDP in 2012. This contributed to sustaining China's high growth over the last three decades. With Indonesia's strong fundamentals (Demographics and Background chapters), the country should have GDP growth potential similar to China. However, infrastructure underinvestment threatens the economy with crippling supply bottlenecks over the medium term.

Real GDP Growth in Peer Group (2008–12)

(% CAGR)



Sources: IMF and QNB Group analysis

Large planned projects should help raise the quality of infrastructure, although many projects are delayed

Indonesia's Development Master Plan includes USD440bn of infrastructure investment for 2011–25, with half of this amount devoted to the congested transport system. The main transport infrastructure focus is on rail projects and toll roads. Coal and gas power plants and investment in power networks are also central to infrastructure plans. The government expects to finance around 30% of total investment, leaving enormous opportunity for private investment. The greatest interest in Public Private Partnership (PPP) projects is in new power plants and toll roads. The implementation of a number of projects has fallen behind schedule. A USD4.4bn coal–fired power plant project in Central Java recently pushed back its completion deadline to October 2014 from an original deadline of October 2012, attributing the delay to difficulties acquiring land. A number of toll roads are planned as part of a USD5.5bn trans–Java network. However, many of these roads also face issues with land acquisition (see below). Passenger and industrial rail lines are being developed, but these are taking even longer than the roads.

Top Ten Planned Infrastructure Projects (2013)

Project	Cost (bn USD)	% GDP
Sunda Strait Bridge, bridge from Java to Sumatra	16.5	1.9
New city at Maja, Banten	14.3	1.6
Trans Papua road	5.0	0.6
Coal–fired power plant, Central Java	4.4	0.5
Metro line for Jakarta	4.4	0.5
Broadband across Java	3.5	0.4
Bukit–Asam Transpacific coal railway	2.0	0.2
New Jakarta port at Tanjung–Priok	1.3	0.1
Probolinggo–Banyuwangi toll road	0.9	0.1
Railway from Jakarta to airport	0.3	0.0
Total	**52.5**	**6.0**

Source: Price Waterhouse Coopers (PWC)[5] and QNB Group analysis

The government has enacted reforms to support infrastructure projects

The government has taken steps to help boost infrastructure investment. A new land acquisition law was passed in 2012 permitting the government to expropriate private land for public works while compensating landowners. This should ease implementation of projects, although land acquisition negotiations that were already underway at the time the law was passed will be exempted until 2015. A law relating to PPP was amended in 2010 to improve the transparency and clarity of the tendering process for infrastructure projects.

Land Acquisition Act (Law No. 2, Jan–12)

- Land acquisition is widely seen as a barrier to infrastructure projects
- The Land Acquisition Act aims to ensure the timely acquisition of land for the public interest (it only applies to government projects or PPPs)
- It prescribes time for each step, legally limiting the process to two years
- Appeals processes are allowed with recourse to the Supreme Court
- Needed land can be acquired after consultation with landholders
- Compensation is based on independent land valuations and lost income
- Central government will provide court settlements if objections cannot be resolved by local government
- The law only applies to new projects; projects underway can apply the new regulations from the beginning of 2015
- Land registration issues persist, particularly among traditional settlers

[5] PWC report, Summer 2013, *Gridlines; Indonesia: A snapshot*

Indonesia has reached a crossroads in its development path

China/Malaysia and India/Philippines provide pertinent counter examples to Indonesia's potential future development. The right infrastructure could empower the private sector to increase value–added activities, enabling modernization of the economy, which has been successfully executed in China and Malaysia. Alternatively, Indonesia's infrastructure development could crumble under the weight of its growing population, crippling the evolution of the private sector as exemplified by India and the Philippines.

Quality of Infrastructure (2013–14)

(World Rankings out of 148)

	Malaysia	China	Indonesia	India	Philippines
Overall	**25**	**74**	**82**	**85**	**98**
Roads	23	54	78	84	87
Rail	18	20	44	19	89
Port	24	59	89	70	116
Airports	20	65	68	61	113
Electricity	37	67	89	111	93

Source: WEF

Economic Sectors

Services form the largest component of the economy and are expanding rapidly…

Over the last five years, services have grown rapidly, contributing to the diversification of the economy. All sectors exhibited high nominal growth rates of 12%–16% but Services increased their share of GDP more than the other major sectors between 2008 and 2012. Within the services sector Wholesale and Retail Trade (11.2% of GDP) and Communications (3.2% of GDP) stand out as potential beneficiaries of Indonesia's emerging middle class. Financial services constitute a relatively small share of GDP and banks an even smaller share (2.3%). This suggests room for financial deepening to drive growth in the banking sector. In Industry, manufactured products have grown in sophistication and include cars, printers and electrical equipment. The mining sector expanded despite declining crude oil production as output of coal, gas and metals rose.

…driven by strong private consumption and investment

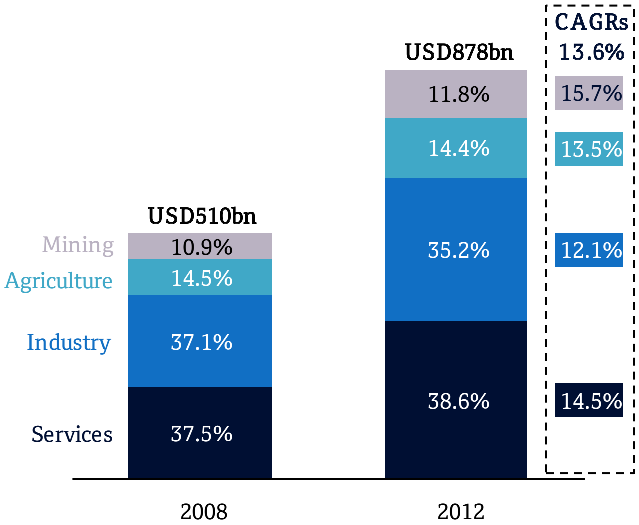
Private consumption accounted for over half of nominal GDP in 2012, reflecting the emerging middle class. Strong growth in private consumption (10.9% in 2012 in nominal terms) has also boosted investment, which accounted for one third of total GDP in 2012. Most of the investment is private and driven by the demands of the private sector, while public investment, particularly in infrastructure, is lagging behind (see chapter on Infrastructure Gap). The export sector continues to shrink (now less than one quarter of the total economy) and its contribution is being diminished by the growing appetite for imports of capital and consumer goods. The share of government consumption is relatively low (8.9%) by international standards as the government seeks to contain spending in line with budget deficit targets.

The potential of the Indonesian consumer is well exemplified by the scale of growth in the mobile segment…

The telecoms sector is a key beneficiary of the strong growth and scale of private consumption. Mobile subscriptions have more than doubled in the last five years to over 282m subscribers, reaching a penetration ratio (subscriptions per person) of 115%. From 2008–12, there were 144m new mobile subscribers. This provides a powerful example of the opportunities presented by the emergence of Indonesia's middle class.

Nominal GDP by Sector (2008–12)

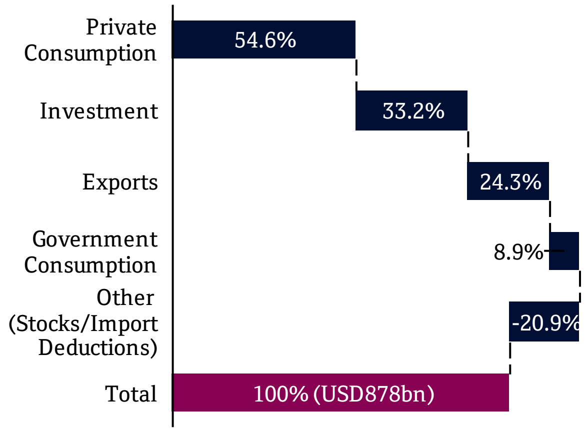
(% share)



Sources: Global Insight and QNB Group analysis

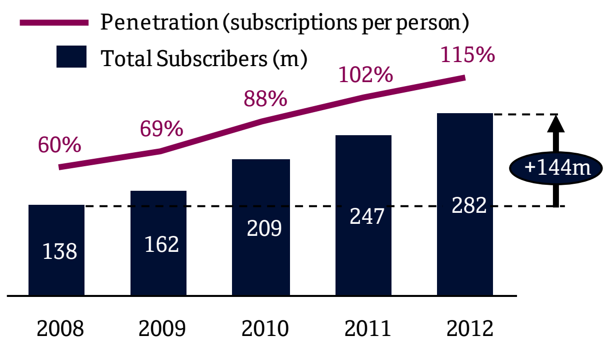
Nominal GDP by Expenditure (2012)

(% share)



Sources: Global Insight and QNB Group analysis

Mobile Subscribers (2008–12)



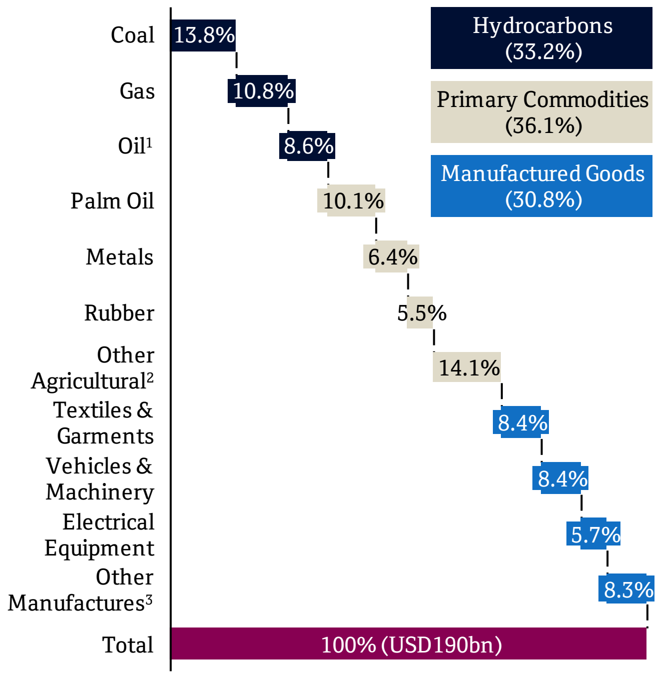
Sources: WB and QNB Group analysis

The export sector remains heavily dependent on primary goods and hydrocarbons…

Primary commodities account for the biggest share of exports. Palm oil, the largest traditional export in the 1960s and 1970s, now accounts for only 10.1% of exports, while the share of other agricultural commodities has risen in recent years together with exports of metals and rubber. Hydrocarbons (coal, oil and gas) account for about one third of export revenue. Rising production of coal and gas has led to growth in exports of these products. On the manufacturing side, the vehicle industry has grown in importance in recent years as Indonesia has attracted a number of factories for global brands, such as Toyota and United Tractors. Other exports include food manufacturing, another important sector that has also attracted global brands. For example, Unilever produces food, beverages, cosmetics and detergents with revenue of USD5.0bn in Indonesia in the twelve months to September 2013.

Merchandise Exports by Product (2012)

(% share)

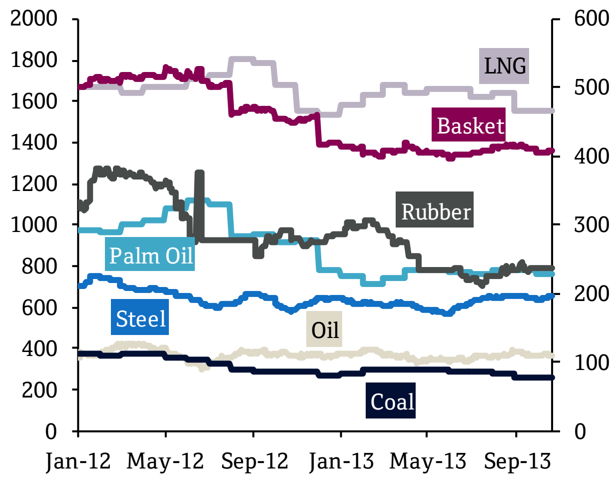


Sources: Ministry of Trade and QNB Group analysis; [1] Includes refined oil; [2] Food, Fish, Beverage and Tobacco Products; [3] Chemicals, Plastics, Soaps, Fertilizers, Pharmaceuticals, Dyes, Oils, Glass, Ceramics, Furniture and Accessories

Dependence on commodities leaves Indonesia vulnerable to declining international prices

Exports declined in 2012 and Q1–Q3 2013 as prices for Indonesia's key commodity exports fell on weaker global demand, particularly from China. A basket of Indonesia's main commodities (the basket accounts for around 55% of Indonesia's exports) fell 18.4% from the beginning of 2012 to Oct–13. Coal prices, Indonesia's largest export commodity, fell 31.8% over the same period, mainly on weaker demand from China and strong global supply. Similarly, weaker LNG demand led to lower Asian prices. Strong harvests around the world have led to high global supplies of edible oils and lower prices. Record supplies and stocks of palm oil in Indonesia have been a major factor in this segment. Rubber prices have also been depressed by strong global supply and higher stockpiles in China, the largest consumer of the commodity, which is used in tire manufacturing. While oil prices strengthened marginally in 2012–13, Indonesia is now a net oil importer and this, therefore, did not help the CAD.

Commodity Export Prices (2012–13)



Basket weights based on export shares in 2012
LNG: Japan, US cents/btu, left axis, basket weight 19.6%
Rubber: Indonesia, US cents/kg, right axis, basket weight 10.0%
Palm Oil: Indonesia crude, USD/ton, left axis, basket weight 18.3%
Steel: USD/rolled coil, left axis, basket weight 11.6%
Oil: Brent Crude, USD/b, right axis, basket weight 15.6%
Coal: Indonesia, USD/ton, right axis, basket weight 25.0%

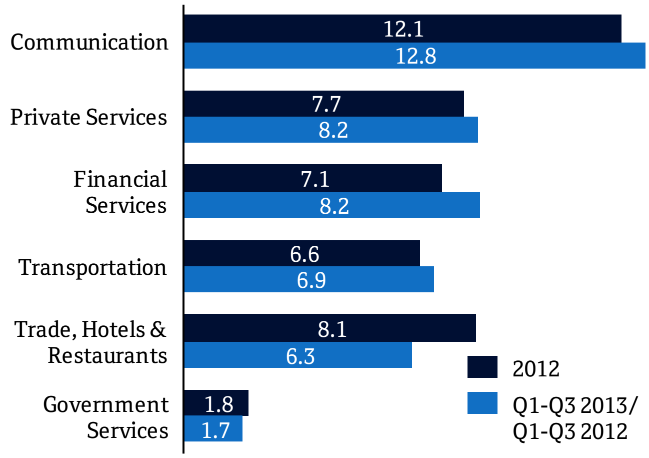
Sources: Bloomberg and QNB Group analysis

Private Services sectors are driving growth, especially communications

Private Services generally outpaced other sectors in 2012 and 2013 as private consumption remained robust. The fastest growing sector in 2012–13 was communication, driven by the ongoing expansion of mobile subscriptions and increased penetration. The sector contributed 0.8 percentage points to real GDP growth in Q1–Q3 2013 versus Q1–Q3 2012. Trade, Restaurants and Hotels stood out for its slow pace, attributable to a loss of consumer confidence amidst a deteriorating macroeconomic environment, a weaker exchange rate, and higher inflation. Government Services slowed as the growing budget deficit led to fiscal consolidation.

Real GDP Growth by Services Sector (2012–13)

(%)



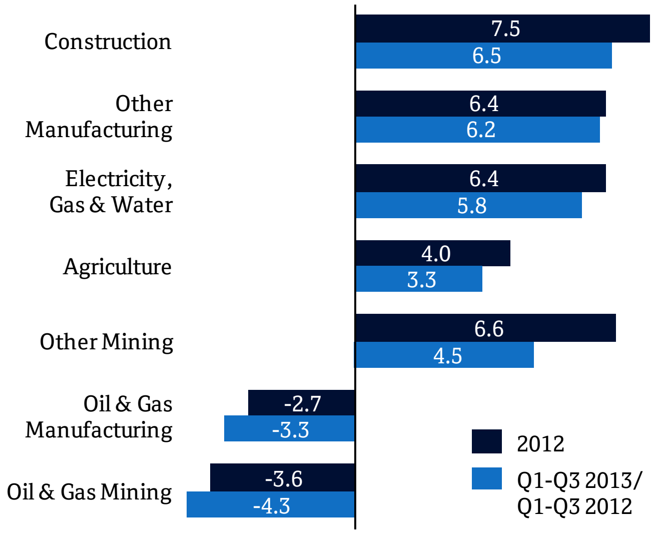
Sources: Global Insight and QNB Group analysis

Industrial growth is slowing on underinvestment and negative growth in the oil and gas sector

Non–Oil and Gas Manufacturing provided the greatest contribution to real GDP growth, accounting for 1.5 percentage points of annual growth so far in 2013. This is generated in subsectors such as Food Processing; Textiles and Garments; Vehicles, Machinery and Equipment; and Fertilizers, Chemicals and Rubber. All these sectors performed well, particularly Vehicles, Machinery and Equipment, which has grown at over 9%, annually so far in 2013. The impact of the recent investment slowdown was mainly felt in the Construction and Mining sectors. Growth in oil and gas sectors was negative due to weak commodity prices, slowing demand from China and other Asian countries, and declining oil production as fields mature. Oil and Gas Mining contracted 4.3% in the first nine months of 2013 (year–on–year). Agriculture slowed as poor harvests hampered production.

Real GDP Growth by Industrial Sector (2012–13)

(%)



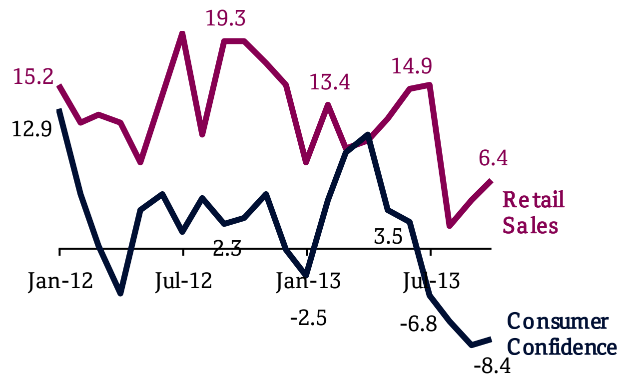
Sources: Global Insight and QNB Group analysis

Retail sales and consumer confidence fell sharply in H2 2013...

Following the announcement of QE tapering on May 18, capital flight and IDR weakness led to plunging retail sales and consumer confidence. This is likely to have impacted various sectors of the economy, particularly retail and demand for durable goods. Weak retail sale and confidence are expected over the next few months as the authorities struggle to take decisive actions, given the upcoming elections.

Retail Sales and Consumer Confidence Indices (2012–13)

(% change, year–on–year)

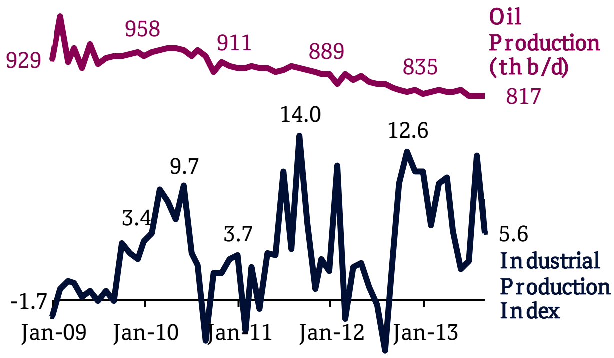


Sources: Global Insight and QNB Group analysis

...oil and industrial production also slowed...

Oil production is declining as Indonesia's oil fields mature and investment in exploration and redevelopment slows. Falling production and rising domestic consumption led to Indonesia becoming a net oil importer in 2003, which induced the government to increase fuel prices in 2008 and 2013. The government is providing incentives to explore new offshore areas, but this is unlikely to lead to a turnaround in production in the short term. Meanwhile, industrial production growth slowed to 5.6% in September (year–on–year), compared with an average of 8.1% in H1 2013. This is probably indicative of a broad economic slowdown on weaker domestic and external demand.

Oil and Industrial Production (2009–13)
(% change, year–on–year)

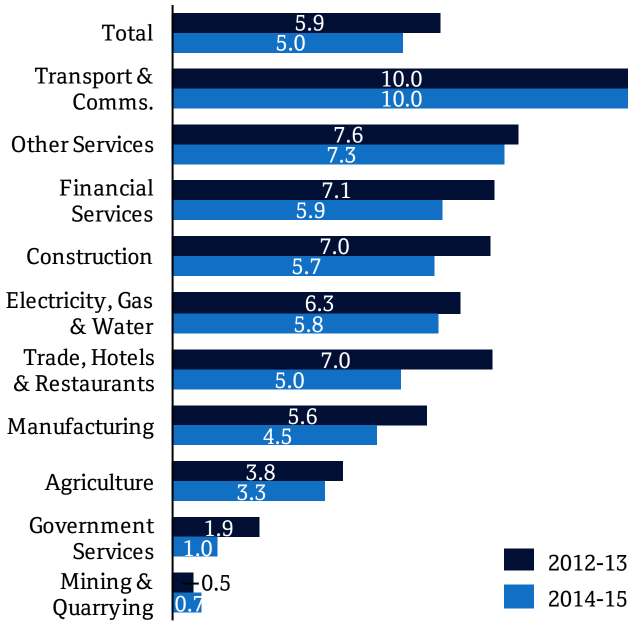


Sources: Joint Organizations Data Initiative (JODI), Global Insight and QNB Group analysis

...and we therefore forecast a growth slowdown across most sectors

We expect growth to slow to 5.0% over the medium term unless substantial structural reforms are enacted. Underinvestment will constrain domestic demand and push up logistics costs, undermining competitiveness. This will lead to a marked slowdown in sectors such as Construction and Manufacturing. Overall growth is forecast to fall to 5.0% over the medium term. Robust private consumption and services should support expansion, sustaining growth at relatively high levels in sectors such as Transport and Communications and other Services sectors. A sharp recovery in external demand could sustain an export–led acceleration. However, this is unlikely to make up for the slowdown in domestic demand as the impact of the infrastructure gap becomes an increasing constraint on growth.

Real GDP Growth by Sector (2012–15)
(%)



Sources: Global Insight and QNB Group analysis

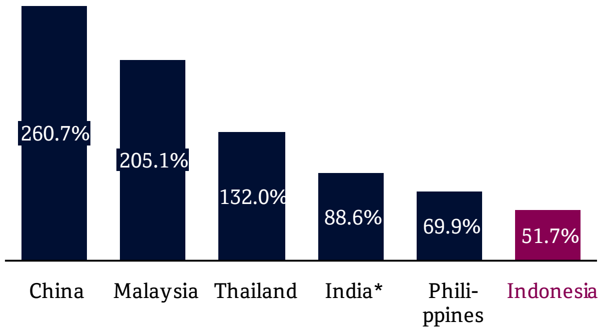
Banking

Banking penetration is low by international standards—only about ¼ of the population have bank accounts

Banking assets are only 51.7% of GDP in Indonesia, well below peers, leaving considerable room for growth. Commercial banks are focused on expanding into retail and rural areas. Out of a population of 244m people, only around 60m have bank accounts. Banking penetration is moving at a rapid pace, as the share of bank assets to GDP rose 6.5 percentage points since 2009. The large growing population and strong private consumption should underpin robust asset growth going forward. We expect the Indonesian banking sector to catch up with peers over the next 10–20 years.

Banking Penetration (2012)

(Commercial bank assets at end–2012 in % of 2012 GDP)



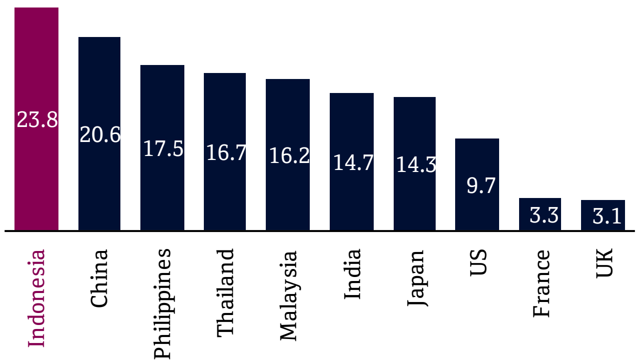
Sources: Bloomberg and QNB Group analysis;
*Assets at end–March 2012 (latest available)

The sector is one of the most profitable in the world as low penetration leads to high lending rates

Indonesia's banking sector is the most profitable in ASEAN–5. NIMs are high (around 550bps at end Jun–13) and average RoE is 23.8%. Average lending interest rates are in the double digits as low penetration implies high demand for credit is not matched by supply. Average RoE is high compared with regional peers and considerably higher than in advanced economies. However, rising interest rates could lead to lower NIMs going forward. Central bank interest rate hikes, higher sovereign yields and rising interbank rates have pushed up deposit rates, but this has not yet passed through to retail lending rates. If lending rates do not rise, this could compress NIMs further, constraining profitability.

RoE Comparison (Jun–13)

(%, RoE average of top five banks in each country, latest results)



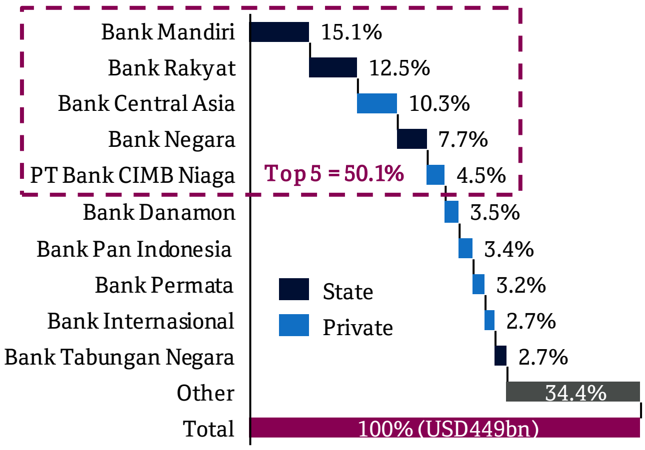
Sources: Bloomberg and QNB Group analysis

The banking sector has a few large state banks, but the sector overall is "unconcentrated"...

The top five banks account for half of banking sector assets and three of them are owned by the Indonesian government. There are 120 commercial banks in Indonesia: four are government–owned accounting for 37.9% of total assets; 66 are private (around 43% of total assets); 26 are regional development banks; 14 are joint venture banks; and ten are foreign banks. There are also 1,641 rural banks, but these are not permitted to take demand deposits and are confined to limited areas of operation. New BI regulations introduced in July 2012 limit foreign ownership of banks to 20%–40%, down from 99%. This could restrict foreign investment in the sector and delay industry consolidation. Nonetheless, the sector is "unconcentrated" with numerous banks with relatively low market shares.[6]

Top Ten Banks by Assets (Jun–13)

(% share of total assets)



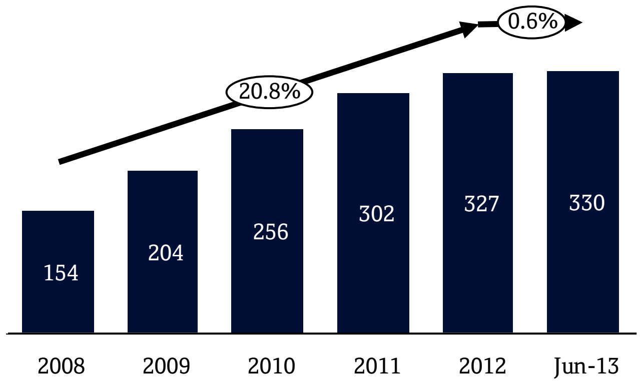
Sources: Bankscope, Global Insight and QNB Group analysis

[6] Based on the Herfindahl–Hirschman Index, Indonesia's banking sector scores 0.07, or unconcentrated as per the interpretation by the US Department of Justice, which views 0 to 0.01 as competitive; 0.01 to 0.15 as unconcentrated; 0.15 to 0.25 as moderately concentrated; and 0.25 to 1 as highly concentrated.

Retail deposits from the large expanding population provide a stable source of funding

Deposits are the key source of funding, accounting for 73.4% of total liabilities at end–June 2013. Deposits grew 17.1% from 2008–12 in IDR terms (20.8% in USD terms), underpinned by the retail sector with the large, steadily–growing population and rising incomes. Deposit growth slowed in H1 2013 as liquidity tightened owing to concerns about the depreciation of the Rupiah. The remainder of banks' liabilities are in the form of debt obligations and equity.

Deposit Growth (2008 – Jun–13)
(bn USD, CAGR)

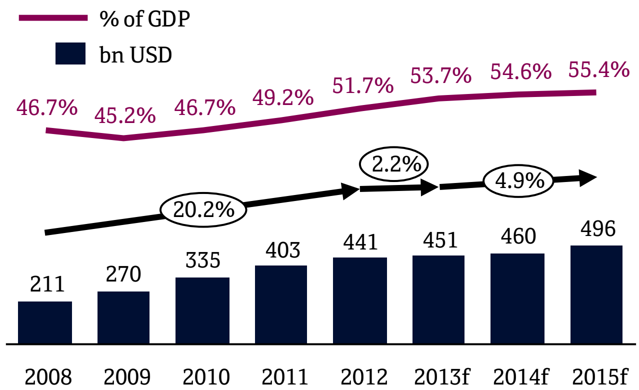


Sources: BI and QNB Group forecasts

Asset growth is likely to continue to outpace nominal GDP growth over the medium term

Bank assets grew steadily at 16.5% in 2008–12 in IDR terms (20.2% in USD terms). Growth was driven by lending, which accounted for 67.1% of total assets at end Jun–13 and grew 20.1% during 2008–12 in IDR terms (23.9% in USD terms). In 2013, bank asset growth is expected to slow to 17.9% in Rupiah terms (2.2% in USD terms owing to the weaker local currency) as a result of slowing growth and tighter domestic liquidity as the LDR has risen to over 90%. In Rupiah terms, bank assets are forecast to slow further to 11.2% in 2013–15 (4.9% in USD terms as we expect IDR depreciation, although less severe than in 2013) as growth continues to slow. This would still imply higher banking penetration, with bank assets expected to reach 55.4% of nominal GDP by 2015.

Bank Assets (2008–15)

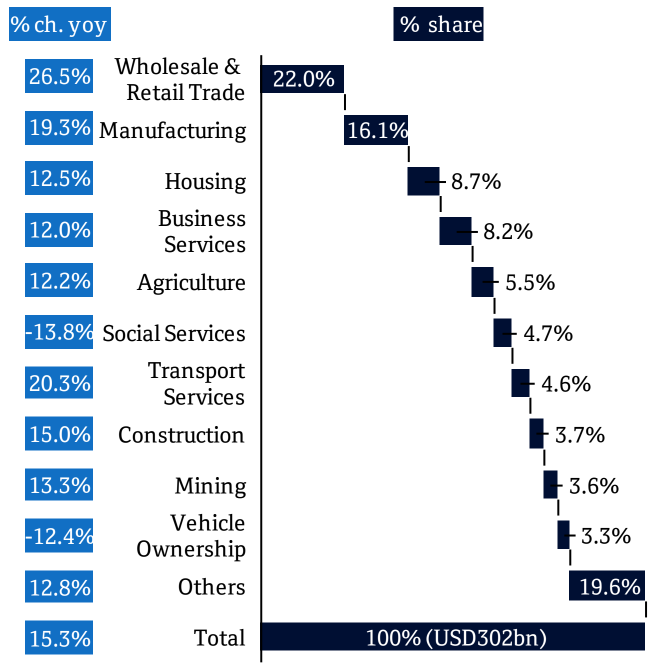


Sources: Global Insight and QNB Group forecasts

Lending growth is strong in most sectors, despite tighter regulations

Wholesale and Retail Trade is the largest and fastest growing sector in terms of lending. Credit to this sector was boosted in 2012 by strong growth in private consumption. Manufacturing, the next largest sector, also performed well, although most lending to this sector is for working capital rather than for investment. BI regulations introduced in 2012 require banks to have exposure to small and medium sized companies of more than 20% of their loan book by 2018, which will likely lead to higher lending to this sector. In 2012, BI tightened regulations on car, motorcycle, housing and credit card lending. This led to a contraction in lending for vehicle purchases, but credit to the housing sector continued to expand.

Loans by Sector (Jun–13)

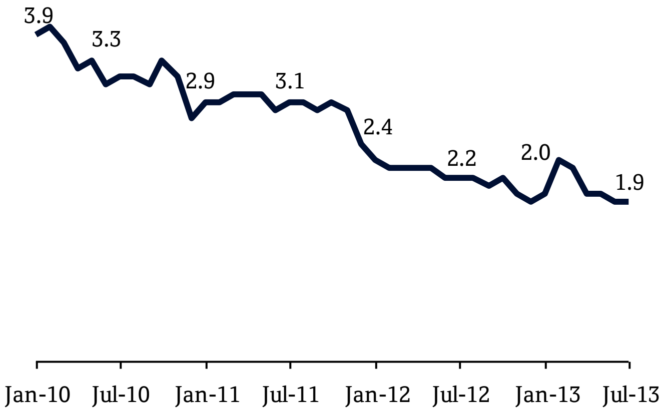


Sources: BI and QNB Group analysis

Banks are well positioned to withstand shocks

Asset quality is high with low and falling non–performing loans (NPLs) and high provisioning. The Capital Adequacy Ratio (CAR) is strong at 18.1% of risk weighted assets at end–June 13 on average across the banking system. This is well above BI's requirement for 8%–14% and one of the highest levels in the region. Average NPLs have steadily decreased over the last three and a half years and accounted for only 1.9% of total loans at end–July 13. According to Moody's most severe stress test scenario, rated banks have sufficient loss absorption capacity to withstand a severe deterioration in asset quality with NPLs rising to 17%.[7]

Non–Performing Loans (2010 – Jul–13)
(% of total loans)

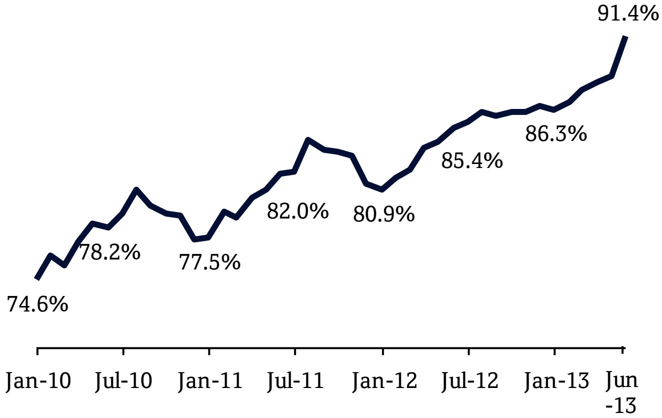


Sources: Bloomberg

Loans are growing faster than deposits, pushing up the loan to deposit ratio (LDR)

The LDR rose to 91.4% at end–June 2013 as lending growth outpaced deposits. Heightened volatility in financial markets in mid–2013 resulted in tighter domestic liquidity in anticipation of further depreciation of the Rupiah, constraining deposit growth. Meanwhile, lending was supported by strong demand from the retail sector. However, there may be some slowing of loan growth over the next 12–18 months as banks adjust to tighter liquidity conditions, slower economic growth and as interest rates may rise.

Loan to Deposit Ratio (2010 – Jun–13)
(Loans as % of deposits)

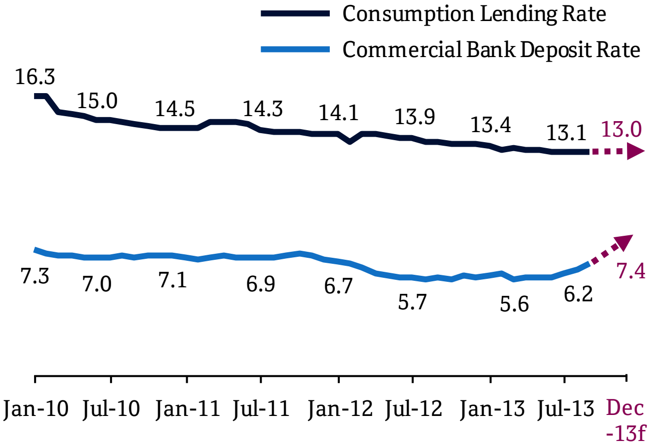


Sources: Global Insight and QNB Group analysis

Tight liquidity and BI rate hikes may push interest rates higher, restraining profitability

Tightening liquidity has pushed up deposit rates since mid–2013. Consumer lending rates have not yet risen, which could lead to lower NIMs. Should lending rates move higher and economic growth slow down considerably, NPLs are likely to start rising again. Either way, rising interest rates and/or provisioning are likely to restrain the profitability of banks in 2013–14.

Interest Rates (2010–13)



Sources: Global Insight and QNB Group forecasts

[7] Moodys, Banking System Outlook, Indonesia, Jan–13.

Macroeconomic Indicators

						Q1	Q2	Q3	Estimates & Forecasts		
	2008	2009	2010	2011	2012	2013	2013	2013	2013f	2014f	2015f
Nominal GDP (bn USD)	510	540	709	846	878	221	227	222	908	855	909
Real Sector (% change, yoy)											
Real GDP Growth	6.0	4.6	6.2	6.5	6.2	6.0	5.8	5.6	5.5	5.1	5.0
Private Consumption	5.3	4.9	4.7	4.7	5.3	5.2	5.1	5.5	5.0	5.0	4.9
Public Consumption	10.4	15.7	0.3	3.2	1.2	0.4	2.1	8.8	1.5	1.0	0.0
Investment	11.9	3.3	8.5	8.8	9.8	5.8	4.7	4.5	5.0	4.8	4.6
Exports	9.5	-9.7	15.3	13.6	2.0	3.6	4.8	5.3	4.7	4.5	4.4
Imports	10.0	-15.0	17.3	13.3	6.6	-0.1	0.6	3.8	0.5	2.5	2.4
CPI Inflation	9.8	4.8	5.1	5.4	4.3	5.3	5.6	8.6	7.4	9.0	7.0
Fiscal Balance (% GDP)	0.1	-1.8	-0.5	-0.6	-1.8	-	-	-	-2.4	-2.0	-1.6
Revenue	21.5	17.5	16.7	17.8	17.8	-	-	-	16.1	16.2	16.2
Expenditure	21.4	19.3	17.1	18.5	19.6	-	-	-	18.4	18.2	17.8
Public Debt	33.2	28.6	26.8	24.4	24.0	-	-	-	25.5	26.5	26.7
Current Account Balance (% GDP)	0.0	2.0	0.7	0.2	-2.8	-2.4	-4.4	-3.8	-3.6	-3.5	-2.4
Exports	27.4	22.2	22.3	23.7	21.5	20.4	20.1	19.8	20.0	21.1	21.5
Imports	-22.9	-16.4	-18.0	-19.6	-20.5	-19.7	-20.4	-19.9	-20.1	-21.4	-21.0
Services Balance	-2.5	-1.8	-1.3	-1.3	-1.2	-1.1	-1.4	-1.2	-1.1	-1.0	-0.9
Income Balance	-3.0	-2.8	-2.9	-3.2	-3.0	-2.8	-3.1	-3.0	-3.0	-2.8	-2.5
Current Transfers Balance	1.1	0.8	0.7	0.5	0.5	0.5	0.4	0.4	0.4	0.6	0.6
Capital & Financial Account Balance	-0.4	0.9	3.8	1.6	2.9	-0.1	3.7	2.2	1.3	0.8	2.5
FX Reserves (months of import cover)	5.3	8.9	9.1	8.0	7.5	6.6	6.2	6.0	6.6	4.9	4.7
External Debt	30.4	32.0	28.5	26.6	28.7	29.3	29.4	31.4	28.7	32.7	34.9
Monetary Indicators (% change)											
Broad Money Growth	14.9	13.0	15.4	16.4	14.9	13.2	12.6	12.6	16.7	10.6	10.4
Exchange Rate USD:IDR (av)	9,699	10,390	9,090	8,776	9,384	9,703	9,788	10,680	10,307	12,000	12,360
Financial Sector											
Bank Assets to GDP (%)	46.7	45.2	46.7	49.2	51.7	50.3	52.0	53.6	53.7	54.6	55.4
NPLs	3.8	3.8	2.9	2.6	1.9	2.3	1.9	-	2.3	2.6	3.0
10-Year Yields (%, IDR Debt)	11.9	10.0	7.6	6.0	5.2	5.5	7.1	8.5	8.5	8.8	8.9
JIBOR (3 month)	12.1	7.1	6.6	5.3	5.0	4.9	5.4	7.2	7.2	7.4	7.5
Deposit Rates (3 mth bank deposits)	11.2	7.5	7.1	6.8	5.8	5.6	5.7	6.6	6.7	7.0	7.2
Memorandum Items											
Population (m)	231.0	234.3	237.6	241.0	244.5				248.0	251.5	255.1
Population Growth (% change)	1.4	1.4	1.4	1.4	1.4	-	-	-	1.4	1.4	1.4
Unemployment	8.4	7.9	7.1	6.6	6.1	-	-	-	6.0	6.4	6.7

Sources: Global Insight, Bloomberg, BI, BPS and QNB Group forecasts

QNB Group Publications

Recent Economic Insight Reports

Saudi Arabia 2013

UAE 2013

Kuwait 2013

Qatar 2013

Oman 2013

Qatar reports

Qatar Monthly Monitor

Recent Weekly Economic Commentaries

Falling Land Prices in Qatar Should Keep a Lid on Rental Inflation
Iraq Continues to Expand Its Oil Resources, But Further Economic Diversification Is Needed
GCC Inflation in Check and no Threat to Growth
Indonesia’s Enormous Potential is Challenged by Short Term Instability and Underinvestment
GCC Countries Continue to Lead MENA Growth, According to QNB Group
The Kingdom of Saudi Arabia’s Non-oil Sector to Drive Growth in 2013-14
Where Is the Global Economy Heading
Political Deadlock Could Impact the Credibility of the US Dollar
Qatar’s Economy Maintains Its Strong Growth Momentum
GCC Capital Expenditure Expected to Rise in 2013
Positive Economic Data Clouds Weak Medium-Term Fundamentals for the UK Economy
Infrastructure spending will drive growth higher than expected in Qatar
Next Population Wave Hits Qatar’s Shores

QNB Group’s International Network

QNB Group Branches
France: +33 1 53 23 0077, QNBParis@qnb.com.qa
Kuwait: +965 2226 7023, QNBKuwait@qnb.com.qa
Lebanon: +961 1 762 222, QNBLebanon@qnb.com.qa
Mauritania: +222 4524 9651, QNBMauritania@qnb.com.qa
Oman: +968 24 725 555, QNBOman@qnb.com.qa
Singapore: +65 6499 0866, QNBSingapore@qnb.com.qa
South Sudan: QNBSouthSudan@qnb.com.qa
Sudan: +249 183 480000, QNBSudan@qnb.com.qa
UK: +44 207 6472600, QNBLondon@qnb.com.qa
Yemen: +967 1 517 517, QNBYemen@qnb.com.qa

QNB Group Subsidiaries
Egypt: NSGB, +202 2770 7000, Info.nsgb@nsgb.com.eg
India: QNB (India) Private, launching Q3–2013
Indonesia: QNB Kesawan, +62 21 515 5155, www.qnbkesawan.co.id
Iraq: Mansour Bank, +964 1 717 5586, www.mansourbank.com
Switzerland: QNB Banque Privée (Suisse) SA, +41 22 907 7070, Info@qnb.com.qa
Syria: QNB Syria, +963 11 2290 1000, QNBSyria@qnb.com.qa
Tunisia: QNB Tunisia, +216 71 750 000, www.tqb.com.tn

QNB Group Associates
Jordan: The Housing Bank for Trade and Finance, +962 6 500 5555, www.hbtf.com
Libya: Bank of Commerce and Development, +218 619 080 230, www.bcd.ly
UAE: Commercial Bank International, +971 4227 5265, www.cbiuae.com

Qatar National Bank S.A.Q.
P.O. Box 1000, Doha, Qatar

Tel: (+974) 4440 7407
Fax: (+974) 4441 3753

qnb.com.qa