

## The Momentum of Indonesia's Economic Recovery

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**Theme:** It is clear that no single country can be immune from the global recession, including Indonesia. The impact on the latter has distorted some of its economic indicators, especially growth and trade. In line with the efforts made by its government to handle the crisis, Indonesia held elections, both legislative and presidential, in 2009. This ARI looks at the implications of the elections and the prospects for Indonesia's economy after them.

**Summary:** After experiencing an economic downturn in the second half of 2008, Indonesia's economic recovery has begun to show some momentum following the legislative elections of 9 April 2009 and the presidential elections of 8 July 2009. Indonesia's government was quick to respond to the crisis by combining both monetary and fiscal policy instruments in order to minimise the effects of the global crisis. Swift action and a lack of panic in handling the impact since August 2008 have made all the difference. Indonesia has now become far more dependent on its own spending as an engine of growth.

**Analysis:** Indonesia's economy started showing some uncertainty in mid-2008, persisting onto the first half of 2009 as the global financial crisis continued to threaten the national economy, aggravated by the slump in other economies around the world. Indonesia had recovered from the East Asian Financial Crisis of 1997-98 with a stable and resilient economy against both internal and external shocks. The government's objective was not only economic stability, but also achieving high rates of growth. The economy continued to escalate slightly and was still on the right track to achieve high rates of growth until the second quarter of 2008. Furthermore, GDP growth had reached a high of 6.4% by that time. However, the economy started to experience some turbulence in the second half of 2008, especially in October, as the stock markets worldwide crashed and entered a period of high volatility. Consequently, economic activity slowed down as a result of the global pressure from food and crude oil prices and the financial crises breaking out in the region.

In line with the substantial capital outflow from Indonesia, the rupiah's exchange rate against the US dollar depreciated on high volatility at the end of 2008. It then gave a positive signal, appreciating after the legislative elections of 9 April 2009. However, the appreciation of the Rupiah also had a negative aspect, especially in terms of supporting exports. During the year 2008, the indicator of domestic financial market performance, the Indonesia Stock Exchange (IDX), fell quite significantly by up to 50% at the end of 2008 but started to experience a bullish trend after the first quarter of 2009. Following the legislative and presidential elections, Indonesia's composite index rose sharply and reached an all-time high of 2,400 in September 2009. This was mainly due to the growing positive sentiment of a global financial market recovery, as the stock market moved in line

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with the trend of the regional stock markets given the relatively high foreign exposure of the country's financial market.

### *Economic Growth*

In 2008, Indonesia's economic performance was ambiguous and uncertain. There was a sharp difference between growth at the beginning of 2008 and at the end of the year. Growth was at 6.3% in the first quarter of 2008, but fell to 5.7% by the fourth quarter. The International Monetary Fund (IMF) said this would probably be the trend for the following two years, and confirmed that global economic growth in 2009 would be a mere 0.5%. The effects of the global financial crisis, according to some economic experts, will persist around the world and will continue into the medium and long term, having started in the middle of 2007 and worsened in the middle of 2008.

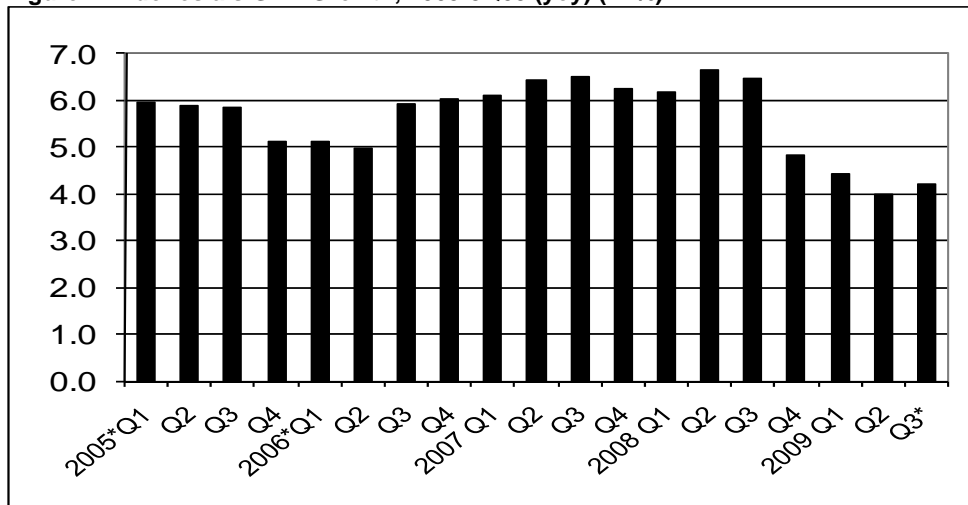
In such a context, where some countries in the region are experiencing or are on the verge of recession, Indonesia stands out as one of the better performing economies. During the second quarter of 2009, the country's economy grew by 4% (yoy) and outperformed other economies in the region such as Malaysia, Singapore, Thailand and the Philippines, that recorded growth rates of -3.9%, -3.5%, -4.9% and 1.2%, respectively. Indonesia's economy was among only a few to record positive growth, including Vietnam, India and China, which were up 4.5%, 6.1% and 7.9%, respectively, in the last quarter.

In the first quarter of 2009, Indonesia felt the negative impact of the crisis, affecting its real sector, export performance, financial market and Rupiah exchange rate. However, the second quarter of 2009 saw a reversal in these indicators' trends. Furthermore, inflation in 2009 has been relatively low, exerting less pressure on the tightening monetary policy. This could make the economy attractive to foreign investment, although there is some evidence of a sluggish reduction in the lending rate.

Indonesia's economy grew at a slower pace in the second quarter of 2009 compared to the previous three-month period, but was still among the fastest growing in South-East Asia. Its GDP grew by 4% (yoy) between April and June, supported by robust private consumption and stronger government spending to offset its negative export growth. This led to a January-to-June growth of 4.2%, slightly higher than the government's projection of 4.1%. On a yearly basis, GDP growth in the second quarter of this year can be estimated at a 4.8% (yoy) increase in private consumption, a 17% (yoy) increase in government spending, and a 2.7% (yoy) increase in investment. Nevertheless, exports are still down, with a 15.7% (yoy) decline compared with the second quarter of 2008. However, on a quarterly basis, exports improved, growing by 7.4% (qoq) from the first quarter, supported by growing demand from China and India. By industries, the transport and communication sectors contributed the most to second quarter GDP growth, up 17.5% (yoy), followed by utilities (electricity, gas and water), that were up 15.4%.

The rising trend in Indonesia's GDP growth started in the third quarter of 2009, that saw the start of economic recovery. Looking forward, the government expects a relatively high GDP growth of 4% to 4.5% this year. This could be achieved, since GDP growth was 4.2% in the third quarter 2009. Moreover, the presidential election has boosted the economy through campaign expenditure. The fiscal stimulus is also expected to enhance the economy in the second half of 2009.

Figure 1. Indonesia's GDP Growth, 2005-3Q09 (yoy) (in %)



Source: Bank Indonesia.

### Trade Performance

Exports have continued to fall since the second half of 2008, for two reasons: (1) the drop in commodity prices since mid-year; and (2) a weaker external demand since September of 2008. Since February 2009, exports have been on an upward trend as the global economy starts moving towards a recovery. Both the value and volume of exports have fluctuated from January 2008 to August 2009, but with non-oil and gas always dominating. In 2008-09 the proportion of non-oil and gas exports remained above 80%, except during the first semester of 2008, owing to the high oil prices.

Export growth in January 2009 dropped 36.08% yoy. For oil and gas exports, the decline was 57.8% on a yearly basis, with the proportion of oil and gas exports in total exports standing at 13.24%. Non-oil and gas exports, which dominated Indonesia's total exports (in January 2009 their share was 86.76%), dropped 30.64% (yoy). For the top 10 export commodities, the biggest month-on-month declines in export value in September 2009 were recorded for animal or vegetable fats and oil (HS 15) and mineral fuels and mineral oil products (HS 27), which saw 29.2% and 8.3% declines, respectively. The highest increase in September 2009 was in ores, slag and ash (HS 26), up 46.9%.

Exports of electronic products (HS 85) to all destination countries in 2008-09 recorded a positive trend until September 2008. Then both fell, reflecting the weakening external demand, with value and volume dropping to their lowest level in January 2009 at US\$219 million and 28 million kg, although rising afterwards. Electronic product exports have been mainly directed to ASEAN (Association of Southeast Asian Countries), including Singapore and Malaysia (at around 40% of the total). Another major destination for electronic exports is Japan (11.81%).

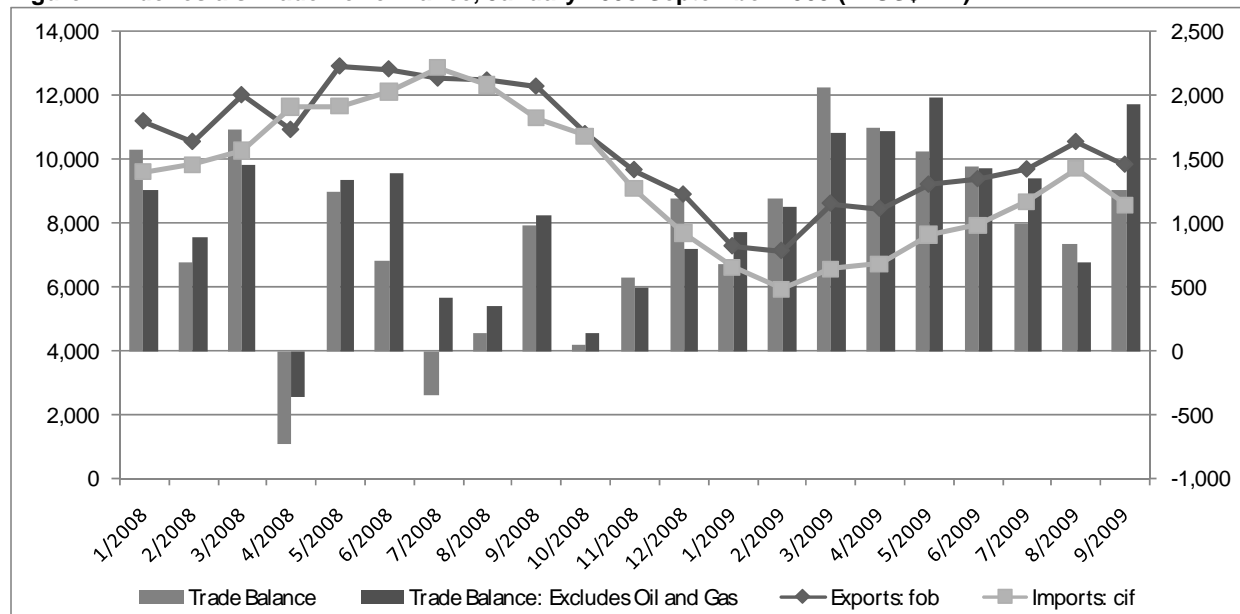
Diminishing demand, especially from its main destination countries, has clearly taken its toll on Indonesia's export performance. ASEAN is Indonesia's biggest trade partner (21.4% of total non-oil and gas exports), followed by the EU (13.6%). For individual countries, Japan and the US take the biggest share of the country's export market, accounting for 13.4% and 10.5%, respectively, in September 2009. China has become an important trade partner and accounted for 8.7% of Indonesia's export market.

Growth in the top 10 export products from Indonesia slowed down in January 2009. The export percentage growth to trade partners has dropped on a yearly basis: -41.1% to ASEAN countries, -16% to the EU, -33% to Japan, -24% to the US and -33% to China. Particular products destined to these countries are rubber (US), palm oil (EU), and coal and copper (Japan). For total non-oil and gas exports, there was falling demand among Indonesia's trading partners at the beginning of July 2008. Exports to ASEAN countries (the biggest trading partner being Singapore) started on a continuous declining trend in July 2008. Exports to Japan have also shown a similar trend since October 2008, whereas exports to major destination countries seemed to stabilise towards the end of 2008.

As export performance deteriorated, import numbers began to show signs of a slowdown; after surging significantly up to the third quarter of 2008, imports started to tumble. All categories of imported goods declined from January to September 2009. The biggest drop was for imports of raw materials/auxiliary goods, which declined 39%. A 4% decline in capital goods could reflect worsening conditions in real/manufacturing industry activities. Imports of consumption goods slowed down by 28.2% compared with January-September 2008.

Based on the information above, Indonesia's exports and imports were the sectors that were most significantly affected by the global financial crisis, recording a considerable drop in late 2008 and early 2009. The decline was at its worst in February 2009, but started to climb slowly in the second and third quarters of 2009 (see Figure 2).

**Figure 2. Indonesia's Trade Performance, January 2008-September 2009 (in US\$ mn)**



Source: Central Bureau of Statistics (BPS).

### *Prospects*

It is clear now that no single country can be immune from the global recession, including Indonesia. Moreover, the prospects for exports largely depend on the depth of the global recession. At least two economies influence Indonesia's external demand position, namely the US and Japan. Unless these two economies recover rapidly, the external demand for Indonesia's merchandise will slow down. Nonetheless, non-oil and gas exports are still continuing to grow, although at a slow pace. Remedies are needed to affect the trade balance situation: first, the government should ease export credit obstacles and, secondly, the duties and tax incentives on goods used as raw materials for exports. In fact, the latter has already been addressed by the government, while for the former the government should cooperate with other countries in the region.

From the growth perspective, the global financial turmoil has taken its toll since the fourth quarter of 2008, with the Indonesian economy slowing since then. Though some institutions, like the IMF and the World Bank, concluded that economic prospects for 2009 would be gloomy, growth in the first quarter of 2009 showed that the picture was not as gloomy as they thought. Government spending, through fiscal stimuli in infrastructure projects, should provide a boost. Income tax incentives are also expected to have an effect by encouraging private consumption. This forecast is also based on a solid domestic demand and a responsible banking sector that maintains investor confidence. The government's plan to increase civil servants' salaries should increase household spending.

Furthermore, from the monetary perspective, the central bank is expected to operate in a low-inflation environment over the next few months, or even for the whole year. The hike in world oil prices has not contributed significantly to domestic inflationary pressure. Although Indonesia's crude oil price has risen significantly since January of 2009, to around US\$60-80 per barrel, it is still much lower than the US\$125 per barrel recorded in May 2008. In spite of the fact that the central bank is quite careful in keeping the interest-rate differential competitive for Indonesia (ie, the difference between Indonesia's real interest rate and that of other countries; the real interest rate is broadly defined as the nominal interest rate minus inflation), the relationship between interest rates and the exchange rate seems to be weakening recently. Therefore, there is confidence in a reduction in the commercial banks' interest rates following the cut in the BI (Bank Indonesia) rate.

**Conclusion:** Equipped with important lessons from the previous crisis (1997-98), Indonesia's government was quick to respond to the current global crisis by combining both monetary and fiscal policy instruments in order to at least minimise its impact. Swift action and a lack of panic in handling the rapid depreciation of the Rupiah since August 2008 have made all the difference, and the country has managed to avoid the sudden meltdown of 1998. As the crisis is expected to worsen in developed countries, export and investment growth will be stagnant. Growth will be adversely affected. However, efforts to bring down unemployment and poverty should continue and these are very much influenced by the level of economic growth. Indonesia has now become dependent much more than before on its own spending as an engine of growth. Having assessed the situation, the government has prepared a stimulus package consisting of two parts.

The first is the tax-saving programme, which will go directly to households and businesses, while the second is additional spending on infrastructure projects that are expected to create big multiplier effects in household and private sector spending. In

addition, there are certain factors that can keep household spending up and in turn support the effectiveness of the fiscal stimulus package, namely low commodity prices on the international market owing to falling demand, good seasonal weather and the fact that 2009 was Indonesia's election year, where electoral (both legislative and presidential) candidates spent money on their campaigns. However, countries with a larger domestic demand, attractive asset markets, greater policy space and faster reforms might witness a stronger recovery from the global financial crisis.

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