Mizuho Insights: Indonesia

Economics & Strategy | Asia ex-Japan

January 26, 2021 | Lavanya Venkateswaran, Market Economist

2021 Outlook: Long and Bumpy Road to Recovery

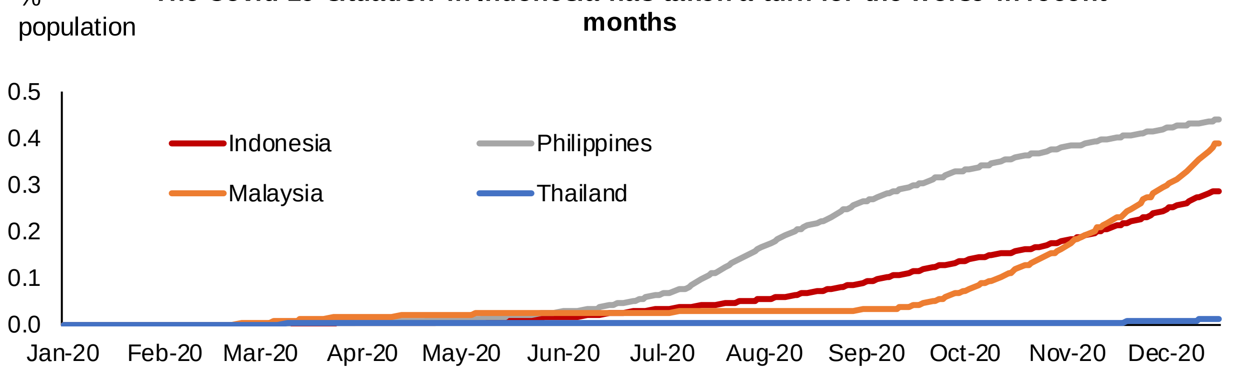
In a nutshell: *Indonesia's continued struggle to rein in COVID-19 will leave it exposed to a long and bumpy recovery, which is subject to a host of downside risks especially the re-emergence of new waves of infections. The mainstay for growth will remain fiscal policy while monetary policy will also lend a hand. We do not expect a deep rate cutting cycle, similar to 2020, rather just another 25bp to follow-through last year's cutting cycle and is squarely contingent on IDR stability. To that end, we expect the IDR to remain fairly stable against a backdrop of US dollar weakness.*

Pandemic situation continues to escalate

The government of Indonesia has struggled to rein in the pandemic since it began in early 2020. First, late detection led to the spread of undocumented cases and second, the government continues to struggle with striking the right balance between imposing social restrictions and managing livelihood needs. With COVID-19 cases escalating and the death toll hitting record highs in January 2021, **the current set of social restrictions** imposed in Java, Jakarta and Bali **have been extended until 8 February**. The social restrictions, imposed on 11 January, serve limit the capacity of restaurants to 25%, places of worship to 50% and stipulating that shopping malls close by 7pm.

Admittedly, **Indonesia is not unique in experiencing a resurgence in COVID-19 cases** – a trend being mirrored not just in neighbouring ASEAN countries (Figure 1) but globally as well. The **absence of decisive policies** and Indonesia **reliance on the vaccination drive to rein in the pandemic**, however, imply that the **impact of the pandemic will continue to be felt at least through H1 2021**. Although Indonesia has so far given 60,815 people the first dose of the Sinovac product, the timeline for vaccinating the majority of the population with both doses of the vaccination remains spread out through this year and challenging given the geography of sprawling archipelago (with connectivity problems). More importantly, the efficacy of the Sinovac products remains an unanswered question.

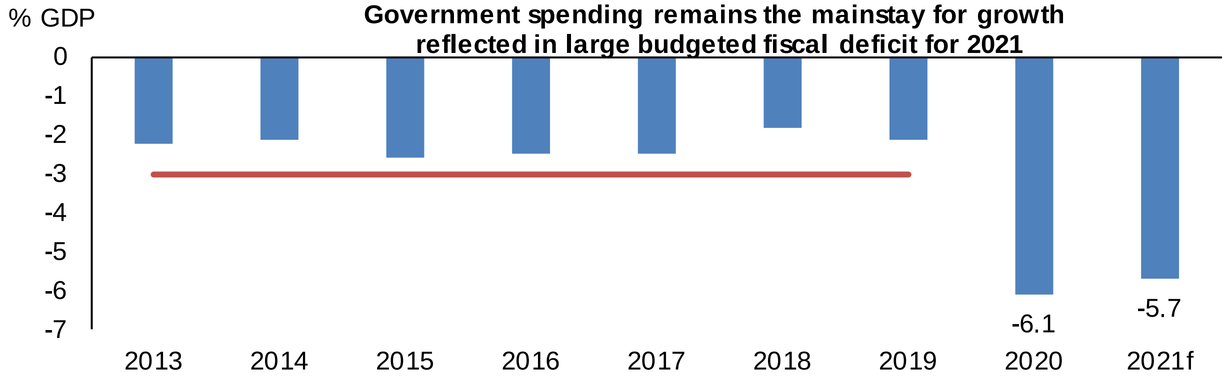
The Covid-19 situation in Indonesia has taken a turn for the worse in recent months



Source: Bloomberg; Mizuho Bank

Growth outlook to be subdued

Growth recovery will, therefore, be slow, uneven and mostly, in H2 2021. The lack of international tourists, weakened consumer and business sentiment and lacklustre export demand implies that government spending remains the mainstay for 2021 growth. The government has acknowledged as much by budgeting for a large fiscal deficit of 5.7% of GDP in 2021 versus a realized 6.1% of GDP in 2020 (Figure 2).



Source: CEIC; Mizuho Bank

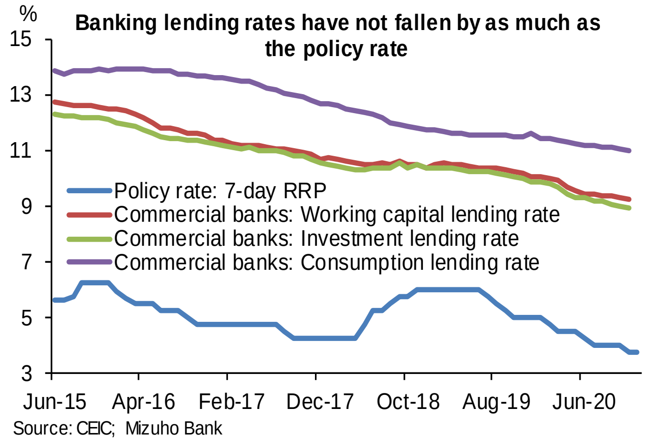
From a supply-side perspective, even though construction activities, provided the health and safety requirements are met, are allowed to continue during the period that social restrictions have been imposed; the hit on retail and other services sectors will likely be a big drag to growth. **Notwithstanding, given the low base, we expect 2021 growth to pick up to 2.5% from -2.4% in 2020, with growth in H1 2020 averaging 0.8% before picking up to 4.3% in H2.**

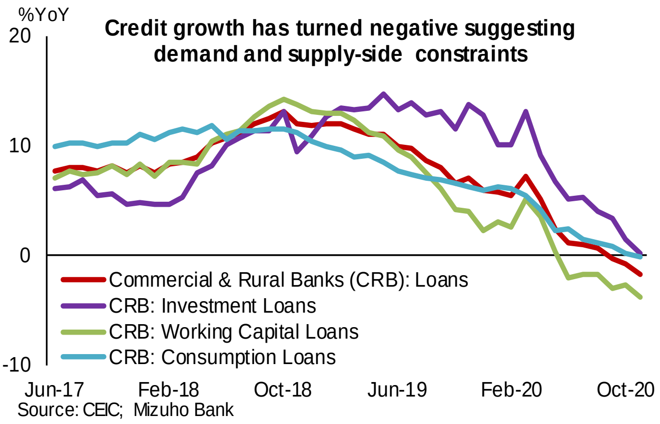
Assuming that vaccine distribution is well underway and the spread of the virus is brought under control, **GDP growth will rise to 7.3% in 2022.** To boost medium-term growth prospects, the government passed the 'Omnibus Bill' into law in 2020 with the aim to reduce labour market rigidities, attract FDI and improve the ease of doing business (see *Mizuho Insights: Indonesia: Omnibus Bill – Looks Good on Paper, But Implementation is Key*, 22 October 2020). Although the law looks promising on paper, implementation holds the key – for most the new changes, the implementing regulations have not been released yet making it hard to determine the real impact of many of these changes.

Bank Indonesia to refrain from a deep rate cutting cycle

After cutting its policy rate by a cumulative 125bp in 2020, **Bank Indonesia (BI) will likely cut only by another 25bp in Q1 2021, in our view**. Similar to 2020, BI will be remain opportunistic about the timing of the cut as the volatility of the IDR is the key constraining factor.

The biggest challenge for BI remains passing through the policy rate cuts into the real economy as lending rates and bond yields have not fallen as much as the policy rate (Figure 3). **Credit growth has turned negative pointing to not only weak demand, but also supply-side transmission challenges** (Figure 4). Importantly, with BI directly financing the government's fiscal deficit in 2020, communication around a coherent exit-plan will be invaluable to boosting BI's credibility.

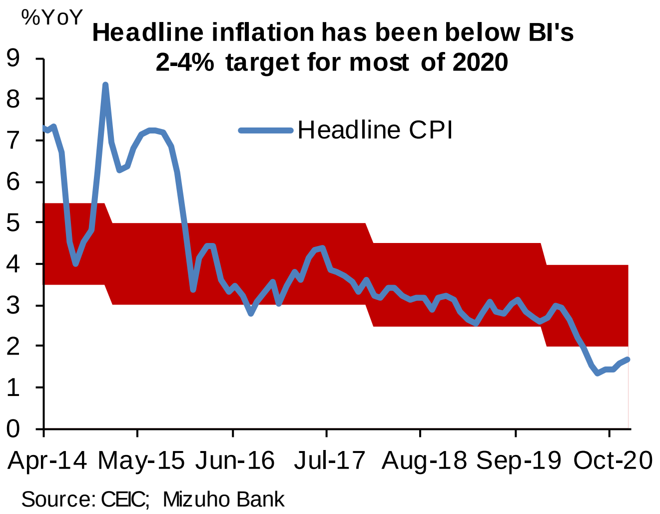


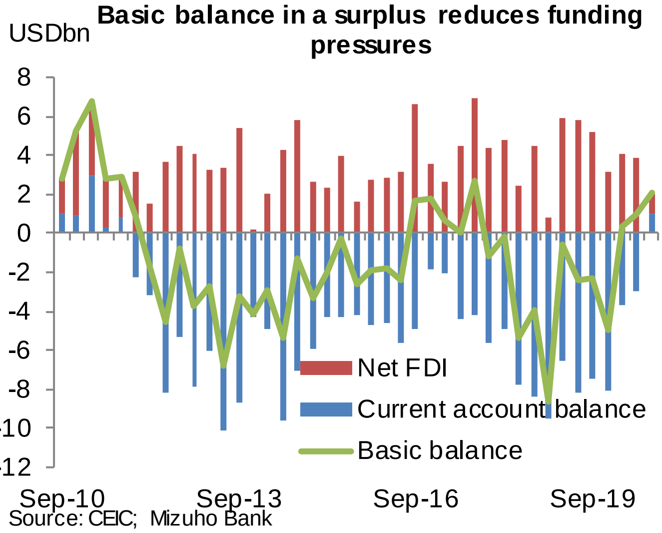


Even without engaging in a deep rate cutting cycle, **BI will maintain a dovish bias and continue to provide credit and liquidity support. The benign inflation backdrop will further support BI's dovish bias.** Headline inflation was below BI's 2-4% range for H2 2020, driven by lower retail fuel and utility prices (Figure 5). Although headline inflation will likely rise in 2021, it will still remain within BI's target range.

Furthermore, **the external position has improved dramatically largely driven by severe import compression**. The 2020 current account deficit (CAD) will likely be below 1.5% of GDP with the Q3 current account balance even registering a surplus. Further, the basic balance (current account balance + net FDI) has shifted to a surplus reducing external financing pressures (Figure 6). However, as the growth outlook improves (albeit in an uneven manner), import demand will rise and the CAD will widen.

Although the 'Omnibus bill' has opened up all but six sectors to foreign investors, the implementing regulation has not been released yet. Whether long-term funding pressures are reduced with greater FDI inflows will depend heavily on the implementing regulation in terms of attracting greater FDI.





IDR: Vulnerabilities persist against a generally favourable backdrop

Our broad view is for US dollar weakness to continue, albeit unevenly, through most of 2021. **IDR**, as a result, **will end 2021 marginally stronger against the USD than it began**. That said, **the path will be volatile** given Indonesia's domestic vulnerabilities and global risk factors.

Domestically, **the pandemic situation remains a cause for concern**. In addition, **fundamental macroeconomic vulnerabilities around the 'twin deficits' on the external and fiscal fronts persist.** If anything, with the pandemic raging on, the government may be forced to widen its fiscal deficit beyond the budgeted 5.7% of GDP.

On the global front, **tensions in US-China relations could put pressure on the CNY and in turn, many Asian currencies including IDR**. In addition, if the approved US fiscal stimulus package is well short of the proposed USD1.9trn, then reflation trade could reverse making IDR vulnerable to sharp bouts of depreciation.

	Q4 2020	Q1 2021	Q2 2021	Q3 2021	Q4 2021	Q1 2022
GDP (% y/y)	-3.6%	-1.5%	3.1%	3.6%	5.0%	7.1%
CPI (% y/y)	1.6%	1.4%	1.7%	2.2%	2.6%	2.6%
Policy Rate (%)	3.75%	3.50%	3.50%	3.50%	3.50%	3.50%
USD/IDR*	14004 - 14950	13590 – 14710	13780 - 14920	13210-14720	13310 – 14430	13410-14570
	14050	14000	14200	13900	13750	13850

Note: Values in black are historical whereas those in blue represent forecasts.

* Point forecast is for end-period.

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