Macroeconomics Analysis Series

Indonesia Economic Outlook

Q3-2023

LPEM FEB UI
UNIVERSITAS INDONESIA

Key Figures

GDP Growth (Q1 '23)
5.03%

Inflation (y.o.y. July '23)
3.08%

Credit Growth (y.o.y. June '23)
7.76%

BI Repo Rate (7-day, July '23)
5.75%

Current Account Balance (% GDP) (Q1 '23)
0.9%

IDR/USD (July '23)
IDR15,083

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The Need to Go Above and Beyond 5%

Highlights

- *Grew 5.03% (y.o.y) in Q1-2023, Indonesian economy has managed not only to reach the growth rate of 5% but also to grow beyond market consensus in the last six quarters.*
- *Being the biggest sector in the Indonesian economy with the share of more than one-fifth, manufacturing sector kept growing below national growth rate since 2012, indicating the potential emergence of premature deindustrialization.*
- *Looking at its expenditure component, all components recorded a positive growth, including government expenditure that posted four consecutive quarters of contraction in 2022.*
- *Household consumption, which makes up more than half of the economy, grew 4.54% (y.o.y), higher than the last quarter of 2022.*
- *Investment grew slower in Q1-2023 as it grew 2.11% (y.o.y), lower than 3.33% (y.o.y) in the previous quarter.*
- *Domestic banks demonstrated relatively strong indicators underpinned by adequate liquidity and improved asset quality. In April 2023, NPL ratio remained stable at 2.53%.*
- *In July 2023, inflation rate was recorded at 3.08% (y.o.y), plummeted to its lowest level in 16 months as inflationary pressures subside faster than expected.*
- *Trade surplus has been declining since last year with the current surplus only reach USD7.8 billion in Q2-2023 due to global commodity prices normalization.*
- *We estimate GDP to continue growing positively at 5.09% (y.o.y) in Q1-2023 and 4.9% - 5.0% for FY2023.*

With series of recent years turmoil, stemming from Covid-19 pandemic, war outbreak, global economic slowdown, worldwide supply chain disruptions, and spiking energy prices, Indonesian economy is able to weather the storm. Various economic progress are worth to highlight. Those achievements include sucessfully managed to brought down its state budget deficit within mandated level a year ahead ot the deadline, brought back inflation within BI's target range, continued the 5% growth streak in the last six quarters amidst ever-changing drivers of global uncertainty, having a stable and well-performed Rupiah, and put various policy reforms in place before entering political cycle. Contributed by these factors, Indonesia Is well-equipped to face the short-term and medium-term economic risks of global major economies slowdown, moderating commodity prices, ongoing structural reform, and the potential to reach 'high-income country' status.

In the first quarter of 2023, Indonesian GDP grew by 5.03% (y.o.y), increased from 5.01% (y.o.y) in Q4-2022. The economic growth of Indonesia in early 2023 has been driven by recovering sectors that has been massively hit during the pandemic. Amidst all these positive economic indicators, data on sectoral growth suggest a rather worrying trend. Being the biggest sector in the Indonesian economy, manufacturing sector kept growing below national growth rate and has been consistently occuring since 2012, signaling the potential issue of premature deindustrialization in Indonesia.

Table 1: LPEM FEB UI GDP Growth Forecast (y.o.y)

Q2-2023	FY2023
5.07% - 5.10%	4.9% - 5.0%

Looking at its expenditure component, all components recorded a positive growth, including government expenditure that posted four consecutive quarters of contraction in 2022. Indonesia's banking industry remains resilient amidst the global economic slowdown and global banking turmoil, particularly in developed countries. Domestic banks demonstrated relatively strong indicators underpinned by adequate liquidity and improved asset quality. Preparation for the 2024 election year will boost consumer spending and sectors that benefited the most, particularly manufacturing such as food & beverage and textile industry as well as service sectors such as media and communications, accommodations, consulting and professions, and transportation.

On the external side, the trade surplus has been declining since last year with the current surplus only reach USD7.8 billion in Q2-2023, only half of the surplus recorded a year earlier, due to global commodity prices normalization. Besides trade surplus, the performance of Rupiah is primarily derived from financial market. Fortunately, Indonesia's financial market continued to perform better in Q2-2023 supported by the robust demand for Indonesian bonds as the yield spread between Indonesian government bonds and US Treasury remains quite attractive following the less aggressive monetary tightening by the Fed. In addition, the current level of reserves is still adequate to support external sector resilience as it is capable to cover 6.1 months of imports and servicing government's foreign debt.

Critical Juncture of Industrialization

Industrialization Effort through Domestic Value-Added Creation

Industrialization is an important part of a country's long-term development agenda and also has been widely acknowledged as an important basis for economic growth (Kniivila 2008; Opoku and Yan 2019; Ndiaya 2018; Wonyra 2018; Szirmai and Verspagen 2015). Initially, agricultural policy plays an important role in the development of poor countries because most people are farmers and household farming can deliver big output; consequently, boosting consumption and moving the economy forward. However, the growth of a country cannot be sustained by relying on agriculture sector alone as returns from land reform and other improvement in agricultural sector begin to dwindle after some times and emerging economies have to transition into another phase of development. The next phase has revolved around manufacturing sector, historically. Currently, despite the domination of service sector in the rich economies, manufacturing remains a critical aspect of the rapid economic transformation from poor into rich countries. There are two reasons why manufacturing is vital in the economic transformation of emerging economies. First, manufacturing is based on the use of machines which allows poor countries to mitigate their shortfall of productive human skills and second, manufacturing products are much more traded freely in the world than services (Studwell, 2013). Furthermore, industrialization contributes to economic growth by enhancing productive capacity, job creation, innovation, and optimal resource use (Elfaki et.al, 2021).

Indonesia aspires to become a high-income country. The government of Indonesia (GoI) has set a target of becoming one and transforming its economy into the fifth-largest globally by 2045. Indonesia's abundant natural resource endowment, demographic dividend, and sizable domestic market provide the foundation to attain this goal (ADB, 2022). However, this will require more than the country's current growth momentum. For Indonesia to achieve high-income country status by 2045, a growth rate of about 6% to 7% per annum will be necessary, with inclusive and sustainable growth (Ministry of National Development Planning, 2023). To achieve this agenda, pushing the agenda of industrialization is of utmost importance.

Figure A: GDP Share by Sectors, 2011-2022

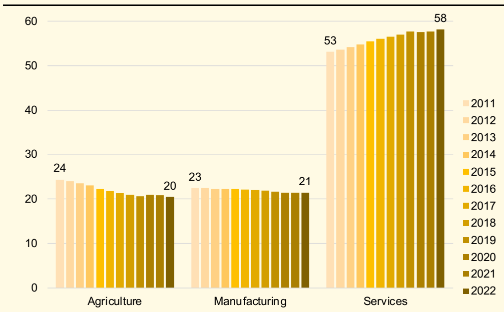
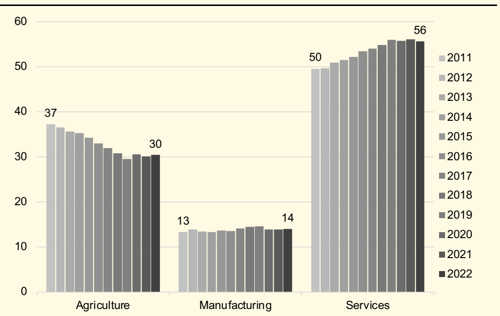


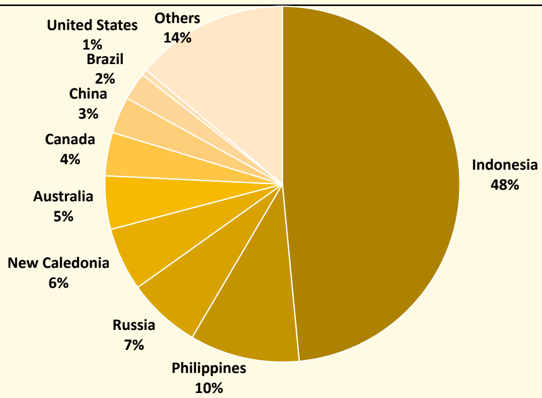
Figure B: Employment Share by Sectors, 2011-2022



Source: CEIC

Unfortunately, currently Indonesia is having a symptom of premature deindustrialization. Based on Figure A and B, share of manufacturing sector in Indonesian economy is stubbornly stagnant and even decreasing in the last decade. In 2011, manufacturing sector accounted for 23% of Indonesian GDP and declined to 21% in last year. In addition, the share of manufacturing labor to all employment in Indonesia has been slightly increasing during the same period, from 13% to 14%. This statistic demonstrates that there is an indication of decreasing productivity in manufacturing sector, as more labor produced less output. In addition, annual growth of manufacturing sector has also experienced a slowdown in the last ten years from 4.7% in 2010 to 3.45% in 2021. Even though the manufacturing industry's growth rate has increased to 4.89% in 2022 due to an increase in post-pandemic demand and a low base effect in 2021, the sectoral growth is always lower than the national economy's growth rate.

Figure C: Producers of Nickel by Country

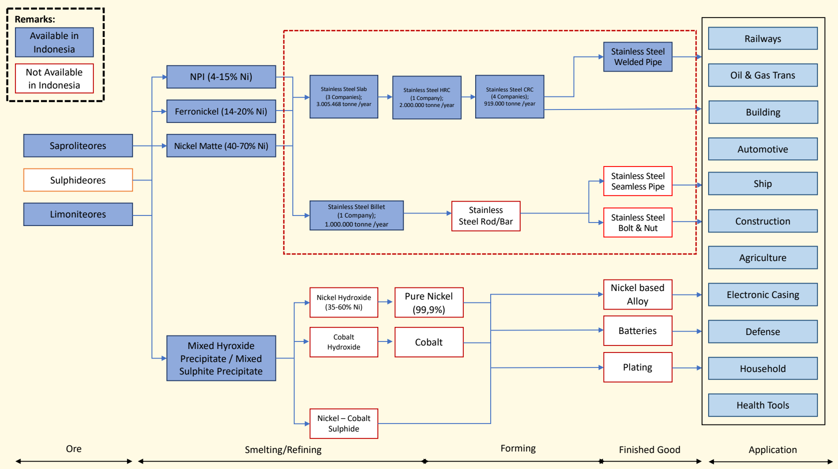


Source: International Energy Agency (2023)

The essence of industrialization is the process of transforming an economy from agriculture-based or low value-added manufacturing-based into higher value-added of manufacturing sector. As Indonesian economy is currently having a relatively low value-added manufacturing sector, the GoI is pushing for more creation of added value domestically. GoI is attempting to achieve this agenda by developing downstream industries in various commodities, with nickel as one of the main commodities to be focused on. There are at least two reasons why GoI is prioritizing to downstream the nickel industry. First, Indonesia is the main producer nickel products globally (Figure C), with the share almost half of global supply. In addition, Indonesia holds 21 tons of nickel in its reserves, adding up to about 22% of the total worldwide supply known to humans. Second, nickel is a vital raw material in the production of batteries. This puts nickel in a favorable position due to high global demand for batteries to support the development of electric vehicles and an integral part of climate transition agenda.

Due to the current and potential future high global demand of nickel raw materials and its refined products, Indonesia is in a strategic position to reap the benefit through producing more added value of nickel in domestic market. This serves as motivation for the GoI to developing nickel downstream industry. Despite the surging demand for nickel products in the past couple of years, the effort to develop nickel downstream industry in Indonesia could be traced back to 2009. The Law no.4/2009 on Mineral and Coal regulates mining companies to process and refine mining minerals in Indonesia and unprocessed mineral and coal products are banned to be exported after three years of the law being implemented. More recently, through Ministry of Energy and Mineral Resources (MEMR) regulation no.11/2019 amending MEMR Regulation No. 25/2018 on the Utilization of Mining Minerals and Coal, the GoI bans the export of nickel ore, effective in 2020. The rationale is that the nickel ore will be refined in Indonesia and will produce higher value before exported to international market. This is in accordance to the agenda of accelerating the development of nickel downstream industry as currently nickel industry in Indonesia only exists mostly on the upstream part (Figure D).

Figure D: Domestic Value Chain of Nickel Industry



Source: Ministry of Industry, Republic of Indonesia (2022)

Global Response of Indonesia's Nickel Ore Export Ban

Nickel ore export ban taken by Indonesia is considered excessive and illegal by the European Union (EU) since this measure limit market access to raw materials needed for stainless steel production as well as distort world market prices for nickel ore. The EU claims that the measures restricting the export of certain raw materials, including those requiring domestic processing requirements, domestic marketing obligations, and export licensing requirements, do not appear to comply with Article XI:1 of the 1994 GATT. In response, Indonesia argued that the European Union had failed to establish a prima facie case that the domestic processing requirements was inconsistent with Article XI:1 of the 1994 GATT. Further, Indonesia argued that the export ban and domestic processing requirements were exempt from the obligation in Article XI:1 as they were export prohibitions or restrictions temporarily applied to prevent an imminent critical shortage of a product essential to Indonesia within the meaning of Article XI:2(a) of the GATT 1994. Alternatively, Indonesia argued that the measures were justified under Article XX(d) of the GATT 1994. In the absence of a resolution, the EU requested the establishment of a Panel to World's Trade Organization (WTO).

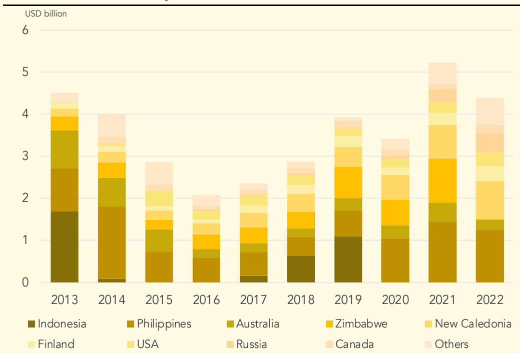
In the panel report released on November 2022, WTO confirms that Indonesia's export ban and domestic processing requirement on nickel ore violate WTO rules. First of all, it found that Indonesia's export ban and domestic processing requirement on nickel ore, which is used in the production of stainless steel, are inconsistent with the WTO's prohibition of export prohibitions and restrictions contained in Article XI:1 of the GATT 1994. Therefore, the WTO recommended that Indonesia bring its measures into conformity with its obligations under the GATT 1994, which aims to promote international trade by reducing tariffs and other trade barriers and eliminating discrimination. As a response, GoI decided to appeal the panel's report to the WTO's Dispute Settlement Body. However, because of a US blockade in the election of the Appeal Board, the GoI and the EU are still waiting for the formation of the WTO Appellate Body.

Through their 2023 Article IV Consultation document, IMF also urged the Indonesian government to gradually phase out the nickel export restrictions and refrain from extending the ban to other commodities in order to mitigate cross-border spillovers. The IMF recommends Indonesia to conduct costs and benefits analysis considering fiscal costs and annual forgone revenue, regarding its industrial downstream policies, as increased use of trade measures and industrial policies could destabilize the multilateral trading system. The release of the IMF document also immediately prompted a response from the GoI, which remains steadfast in its belief that the ban on raw mineral exports, coupled with the development of downstream industries, is an important driver of economic growth, trade balance improvements, and enhanced state revenues.

Cost and Benefit of Nickel Ore Export Ban

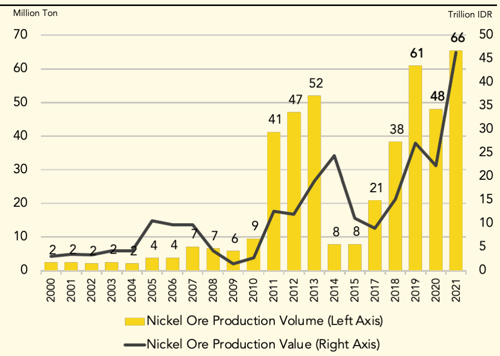
The GoI has insisted on entirely banning the exports of raw nickel in efforts to boost added value and expand the nickel downstream industry since January 2020, as stipulated in Ministry of Energy and Mineral Resources Regulation No.11/2019. Amid the expected benefits of prohibiting exports, this policy has several short-term economic implications. First, the intervention led to a sudden stop in nickel ore exports from around USD1 billion in 2019 to zero in the last three years (Figure E). Second, the lower export is expected to generate forgone revenue for foreign exchange reserves and export levies. The sudden disappearance of export has reduced the foreign exchange export proceeds or Devisa Hasil Ekspor (DHE) which aims to support Rupiah stabilization against any financial market uncertainty. Moreover, the GoI has missed the opportunity to collect export levies of nickel ores while the levies on nickel downstream products have not been implemented[1]. Assuming the constant value of nickel ore export and 10% of export levy tariff, the revenue from export levy was lowered by around IDR4.84 trillion during the first three consecutive years since the export ban was enacted.

Figure E: Export Value of Nickel Ores by Exporters, 2013 – 2022



Source: CEIC

Figure F: Volume and Value of Nickel Ores Production, 2000 – 2021



Source: Trade Map

Third, the lower nickel export has forced domestic mining companies to cut production as export demand declined while the capacity of nickel smelters was still limited. The production of nickel ores weakened by 21% in 2020 compared to a year earlier due to a mishmash of export ban policy and lower global demand during COVID-19. This declining trend was similar, albeit smaller, to the 85% (y.o.y) drop in nickel ore production in 2014 when the GoI initiated the raw nickel export ban for the first time (Figure F). There were only two smelters for processing raw nickel before the first nickel export ban. The upstream nickel industry has struggled until the relaxation of export ban in 2017, given the lack of new downstream smelter investment and a wider trade deficit. While gradually recovering, nickel ore producers must face the implementation of a full nickel ore export ban in 2020; making the lower production inevitable. The lower nickel ore production in 2020 deviated from the average yearly growth of 65% throughout 2017 – 2021.

Fourth, the aftermath from such lower production has also partly contributed to the lower state revenue from the mining sector, from IDR44,920 trillion in 2019 to only IDR34,650 trillion in 2020. The revenue from mining sector was contracted despite the two times higher royalty tariffs applied to mined nickel production since 2020. Not only lowered the state revenue, but the export bans on upstream nickel have also created a loss in the value of mining activity. As miners are forced

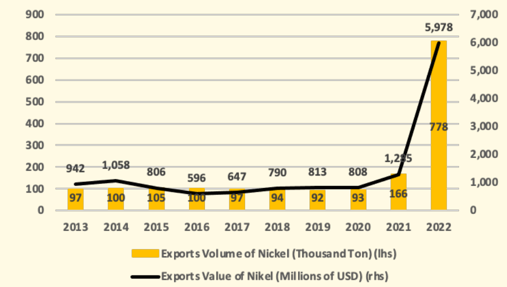
[1] Source: Ministry of Finance Regulation Number 39/PMK.010/2022

to sell the ores to domestic smelters with the price regulated by the GoI, they booked losses because of lower domestic prices compared to skyrocketing international market prices during 2020 – 2022.

The last repercussions comes from the international trade perspective. The export ban amplifies the risk of retaliation from trading partners, ranging from countries that used to rely on Indonesia's nickel ore to nickel non-importers. Recently, EU has filed dispute about Indonesia's export ban policy, which is assumed to violate the fair-trade practices agreed upon in WTO. Even though the EU has not directly imported nickel ore from Indonesia in the last ten years, this region is concerned about the potential global nickel volatility stemming from sudden shocks in nickel supply that will eventually lead to a dip in various downstream sectors using nickel as raw materials, particularly the steel industry[2]. As the largest producer of raw nickel with abundant proven reserves, the trade policy imposed by Indonesia can cause significant shifts in the supply chains. However, the number of mined nickels to meet the global demand remains ample. In the absence of Indonesia in the global market during 2020 – 2022, the market for this commodity has been shifted to other exporters, including the Philippines, New Caledonia, and other new miners (Figure D).

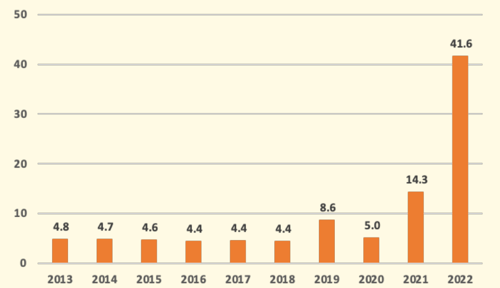
The costs of enforcing the nickel ore export ban as listed above are unavoidable, particularly in the short-term, while the promising benefits from this policy might be materialized as long as the investments to expand the downstream industry are obtainable. The economic benefits indicated by the output multiplier will reach an optimum if the nickel ore is processed domestically. Previous study from LPEM UI (2019)[3] calculated the economic benefits resulting from three downstream depth scenarios and found that the backward and forward multipliers created would be high if all nickel ore products were processed domestically. The total output multiplier is 3.07 if all nickel ore is processed domestically, higher than the other two scenarios, which are 2.24 if only 50% of nickel ore products are exported and 1.44 if all nickel ore products are exported.

Figure G: Exports Value and Volume of Nickel of Indonesia, 2013 - 2022



Source: Trade Map

Figure H: Share of Indonesian Exports Volume of Nickel, 2013 - 2022



Source: Trade Map

Aside from the higher output multiplier created by the downstreaming nickel domestically, the other benefit also seen in trade performance through higher export performance from nickel downstream products. After the implementation of export ban, both value and volume of nickel exported from Indonesia has indicated an increase. In 2021, value of nickel exports was reported at USD1,284.5 million, 58.9% increase from 2020 figure. In 2022, the figure continued to increase to USD5,977.7 million or a 365.4% increase from a year earlier. As for exports volume, in 2021, the volume of exports of nickel reached 166.4 thousand ton, rising by 78.5% compared to 2020 figure at 93.2 thousand ton. The volume of nickel exports was at 778.4 thousand ton in 2022, up

[2] Source: Indonesia's Nickel Export Ban: Impacts on Supply Chains and the Energy Transition, https://www.nbr.org/publication/indonesias-nickel-export-ban-impacts-on-supply-chains-and-the-energy-transition/

[3] LPEM FEB UI. 2019. Efektifitas Kebijakan Hilirisasi Minerba, dan Transparansi Tatakelola

by 367.7% compared to 2021 figure. Comparing exports volume of Indonesia compared to total exports volume of the world, it was reported at 14.3% in 2021 which then rose substantially to 41.6% in 2022. This figure is above the average of share of exports volume between 2017 and 2019, three years before the exports ban was implemented, at 5.8%.

Another positive outcomes seen in the higher realization of FDI in Indonesia due to surging domestic nickel processing industry. The GoI through MEMR has set a target to build 53 smelters by 2024; among which are 30 nickel smelters. Up to November 2022, Indonesia has 15 nickel smelters. Total investment value for the 30 nickel smelters is more than USD8 billion, however, only 6 months since the nickel ore exports ban has been in place, realized investment reached USD6.3 billion[4]. Investments from large companies to develop battery and electric vehicle ecosystems have also begun to enter Indonesia. LG energy Solution and PT HKML the Battery Indonesia factory began an electric vehicle battery factory projects with total investment value of slightly less than USD10 billion. There are also other companies from South Korea and Europe that each committed to start investing in Indonesia for downstream nickel ore into electric vehicle batteries[5]. As a result, between 2019 and 2022, the realization of FDI for Basic Metal Industry, Metal Goods, Non Machinery and Equipment has shown positive growth averaging 50.5%. At the end of 2022, the FDI realization for the aforementioned subsector was recorded at USD10.96 billion.

Apart from FDI, although increase was not apparent in the number of people working in manufacturing sector published by Statistics Indonesia, it was reported that nickel smelters has hired in total about 70,000 workers where only 4,000 of them are foreign workers[6]. In terms of fiscal implications, the downstreaming of nickel, if done properly, is expected to provide more added value to the economy, which then increase government revenue through three channels: individual income tax, corporate income tax, and value-added tax.

Historical Story of Export Ban Practices

Indonesia has a long record of applying restrictive trade policies, from exposing export taxes and quotas for several particular commodities to implementing an export ban. The decision to imply such policies usually stands under two main objectives. The first is to secure the supply and prevent the domestic market from the condition of scarcity, which can instantly lead to other consequences, such as an increase in price. The second objective is to achieve higher value-added within the country. This usually applies to primary commodities, such as natural resources, under the attempt from the government to develop downstream industries. There are at least two cases of past protectionist practices that can serve as lessons learned for implementing downstream industrialization policies.

- Log Export Ban

  The first example of the restrictive trade policies in Indonesia is the implementation of a log export ban. The regulation took place from 1980 to 1992 and was re-implemented in 2001 to 2002, while between 1992 to 1998, Indonesia imposed prohibitive tariffs. With a forest cover area of approximately 92 million Ha (FAO, 2020), Indonesia contributed 2.6% of the

[4] Source: Kilas Balik Larangan Ekspor Nikel RI Hingga Digugat dan Kalah di WTO (https://katadata.co.id/happyfajrian/berita/63a2ad298e4b8/kilas-balik-larangan-ekspor-nikel-ri-hingga-digugat-dan-kalah-di-wto)
[5] Source: Oleh-Oleh Jokowi dari Jerman, Investasi Baterai Rp38,34 Triliun! (https://ekonomi.bisnis.com/read/20230417/44/1647601/oleh-oleh-jokowi-dari-jerman-investasi-baterai-rp3834-triliun)
[6] Source: https://www.cnbcindonesia.com/news/20230704155544-8-451226/jawaban-ksp-soal-hilirisasi-sedikit-serap-tenaga-kerja-lokal

world's export of wood and wood articles products in 2022. In the global context, implementing a log export ban is classified as a generic policy often registered, especially by forest-rich countries. Before Indonesia, Brazil, with a significantly larger forest cover area of 493.5 million Ha, started to enforce the log export ban in 1969. The industries have been focusing only on secondary processed wood and plantation logs. Similar to Brazil, Canada has also employed a similar policy to limit and even ban log export since 1906.

The policy rationales behind the Indonesia log export ban were standing behind two main intentions of supporting local industries' development and conservation of forest areas by preventing the unsustainable practice of timber harvesting. Log export ban policy proponents argued that applying such policy will induce the activity of downstream log industries such as domestic mills and furniture producers. By applying the log export ban policy, loggers were forced to sell their products only to domestic industries, thus, securing the supply of logs in the domestic market. Moreover, through export-oriented producers, Indonesia will also enjoy significant additional revenue from the global market as they sell higher value-added products. Sounding a similar sound, conservationists also mentioned the estimated positive impacts of the log export ban on the lower deforestation rate by which it is determined in legal or illegal actions. As the rate of deforestation becomes limited, the forest may be able to preserve its capacity in reserving other essential parts of the ecosystem, such as biodiversity and groundwater availability.

Evaluating the policy, a study by Resosudarmo and Yusuf (2006) found that the log export ban did not benefit the country in the short term. Further, the policy decreased Indonesia's GDP and contributed to lower household income. The pipeline of impact was caused by the lower price and volume of logs when the export ban took place. Although derivative wood products produced the higher value-added, the final value recorded in GDP was comparably lower. In the long run, applying a log export ban is also considered to have negative impacts on employment. The condition will likely engage as job loss in upstream industries was estimated to be higher than job created in the downstream industries. The condition worsened as most upstream employees come from the agricultural sector, usually categorized among the country's poorest household groups. The study also mentioned that implementing an export ban to attract investment may cause excessive logs harvest practice in the long run. This is opposite to the environmental principle, which aims to lower the deforestation rate.

- Rattan Export Ban

Similar with wood commodities, since 2011 government of Indonesia has also implied export ban for raw rattan. The objective is to produce higher value-added product within the country, since Indonesia is among the main producers of raw rattan. By limiting the export of rattan, domestic furniture industries and enterprises are estimated to have secured and cheaper input material for their business. According to the data from Trademap in 2022, the export value of rattan furniture globally was accounted for USD115 million, on which Indonesia shared approximately 32% to the number. Aside from immense rattan stock, the quality of Indonesia rattan also known as the best with several unique characteristics that differentiate it from other rattan products. Prior to the ban, raw rattan producers sold most of their products to the global market with relatively higher price. Furthermore, exporting rattan was also preferred since it requires a lower transaction and delivery costs. This refer to the fact that most of furniture makers are located in Java, while the rattan trees grow in wide range of places from Sumatera to Sulawesi and Nusa Tenggara. With the export ban regulation, it is expected that downstream industries will grow larger in terms of capacity of existing producers and induce new furniture and craft makers to enter the market.

Unfortunately, the impacts of rattan export ban are contrary to the expectations of policy-maker. While it is valid that Indonesia generates larger gain from international trade because of the higher value-added products, the availability of raw rattan in Indonesia has been insignificantly affect the domestic price. Study by Myers (2015) found that in contrary, many downstream producers have experienced lower sales volume and profit since the ban. Moreover, the limited volume of raw rattan also contributed to the higher transaction cost because of low efficiency in rattan cane processing. The notion of secured supply of rattan for domestic furniture industries has not been able to be proven since many of them still face difficulty in accessing rattan material. Such condition often arises among the retailers as well as small furniture and craft producers, while big factories that have direct access to the raw rattan may encounter different situation. Therefore, many have suspected that the application of such protectionist policies only presents profitable significance to the elite and well-established factories. However, many stakeholders still believe that the application of rattan ban policy will offer favourable impacts in the long run as Indonesia is still classified as the main suppliers of raw rattan material.

The implementation of export ban policy in Indonesia has never met a smooth ride, with the impacts often contradictory to the plan of policy-maker. The main driver is unexpected market responses that comes from undetected feedback from variety of internal and external determinants. In the case of log and rattan export ban, the main objectives to create higher value added by promoting downstream industries was achieved at the price of unfavourable circumstances for other variables such as lower employment in primary sector which could not be exceeded by the additional employment in manufacturing. In addition, the export ban policy also negatively affected the market mechanism by pushing the price higher, thus, translated into expensive material for industries and declined income for households. The condition worsened as since the application of export ban was never followed by adequate investment for downstream industries, which then translated into lower value in GDP even though the higher value-added was generated.

The Way Forward: Improving Current Industrial Policy and Export Ban

Ultimately, export ban is not the sole strategy to promote downstream. It also does not work in all industries and must be based on sound economic arguments or evidence rather than economic nationalism. As mentioned before, the ban on nickel ore exports has both several costs and benefits. The advantageous impacts of this policy include increased value-added creation via a higher output multiplier, increased export value of downstream nickel products, increased investments particularly in smelter construction, and increased government revenue potential. Nonetheless, nickel ore export ban also leads to market distortions by halting upstream nickel production and exports, potentially driving the price even higher. There is also forgone revenue from foreign exchange reserves and export levies of nickel ores. Furthermore, this protectionism practice amplifies the risk of retaliation from trading partners as well as significant shifts in the supply chains towards other prospective markets. Learning from historical practices, protectionism must be accompanied by comprehensive industrial policies in order to enhance competitiveness, drive economic development, and mitigate potential negative impacts associated with export bans. Several fundamental aspects that GoI must consider in strengthening current industrial policies include:

First, establish 'national champions' which are specific sectors/commodities with competitive advantages. The success of the downstream policy in the medium to long term is highly dependent on how GoI shapes the economy by focusing on sector priority or 'national champions' rather than all sectors are as priority. Priority sectors can be selected based on their competitiveness as stated by David Ricardo, an economist from England in 1887. GoI needs to promote which mineral commodities have competitive advantages and how the potential of the downstream industries of these commodities is in the global market by studying future global demand trends for these downstream industries. Nickel protectionism policy on the one hand is beneficial to support the current downstreaming agenda since nickel is one of our champions when it comes to the size of reserve, production, and market share that Indonesia has in the global market. There is also growing global demand for batteries as one of downstream products from nickel to support the development of Electric Vehicles worldwide. However, there is no reason for the government to impose an export ban on other raw mineral products that do not have competitive advantages in the global market, such as tin and bauxite.

Second, invest in human capital and technological upgrading. A study from Porter (1990) stated that it often takes more than a decade for an industry to create a competitive advantage and the process entails the long upgrading of human skills, investing in products and processes, building clusters, and penetrating foreign markets. In order to reach a competitive level at the global market for downstream sectors, GoI needs to focus on providing vocational education, skillset upgrading and training for human resources that matches industry needs by collaborating with the industry, and providing R&D support. Furthermore, attracting investment that can provide knowledge and technological transfers through incentives and collaboration is critically needed during the initial industrialization process. Still, afterwards, the utilization of domestic own resources must be the priority.

Third, provide various fiscal incentives for downstream industries and impose punish and reward scheme for those specific sectors. GoI must continue to provide tax incentives for downstream industries in the form of import duty facilities, tax holidays, and tax allowances. However, the government must also establish Key Performance Indicators (KPI) for preferential treatments given to downstream industries and should penalize the given sectors if they are unable to compete in the global market within a certain period of time. Last, develop a "Grand Design for industrial development". This refers to a Roadmap document for the downstream mineral and metal industry based on spatial and industrial dimension. Spatial mapping of industrial strategies, associated with the provision of transportation infrastructure, energy, and local human resource readiness. Subsequently, it is also essential to figure out the industry's supply chain necessities and strengthen inter-industry synergies to ensure the supply of raw materials for domestic downstream industries.

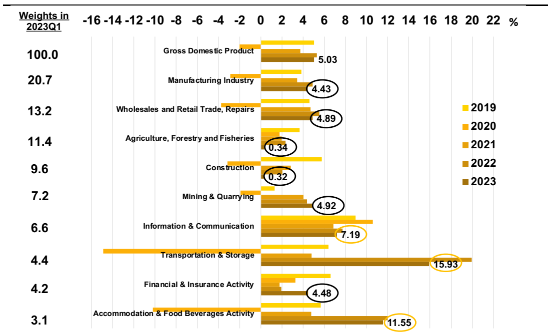
The export restriction has both costs and benefits to the downstream agenda, and Indonesia should be ready for any trade-offs that might arise from this policy. Although the ban on nickel exports has led to positive results in the short-run, as seen in recent hikes in investment in smelters and an increase in the export value of downstream nickel products, such as ferronickel and stainless steel, this policy may pose limited benefits if implemented for other metals (bauxite and tin) since Indonesia has less competitive advantage in those commodities. As a result, the GoI cannot apply both export bans and downstream facilities on other minerals to bear the same beneficial outcomes as nickel. These measures may result in a crowding-out effect, making potential investors reluctant to invest and instead look for other markets. Furthermore, the government also needs to ensure that the ultimate goal is to promote downstream nickel to enable it to be competitive in the global market, like was nickel ore. Therefore, a comprehensive industrial strategy should be taken by GoI simultaneously with different approaches in different sectors, fully benefiting from the current competitive advantage at the upstream industries while at the same time supporting tomorrow's leading downstream industries.

Well-Equipped to Fulfil its Growth Potential

"Indonesia are well-equipped to face the short-term and medium-term economic risks of global major economies slowdown, moderating commodity prices, ongoing structural reform, and potential to reach 'high-income country' status."

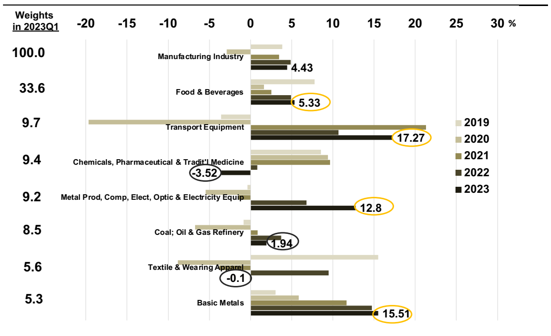
Indonesia is currently well-placed to take advantage of its growth potential. With series of recent years turmoil, stemming from Covid-19 pandemic, war outbreak, global economic slowdown, worldwide supply chain disruptions, and spiking energy prices, Indonesian economy is able to weather the storm. Various economic progress are worth to highlight. First, at the end of last year, Indonesia managed to brought down its state budget deficit below 3% of GDP in 2022 (realized at 2.38% of GDP), a year earlier than the target. Second, inflation rate in Indonesia has reached down into BI's target range after 11 months of overheating. In July 2023, inflation rate was recorded at 3.08% (y.o.y), plummeted to its lowest level in 16 months as inflationary pressures subside faster than expected. This is achieved while various countries across the globe are still dealing with high inflation rate. Third, Indonesia continued the 5% growth streak in the last six quarters amidst ever-changing drivers of global uncertainty. Fourth, Rupiah is rather stable with excellent performance compared to its peers. hovering around IDR14,800 to IDR15,000 in the past few months, Rupiah has recorded an appreciation rate of around 3.6% on a year-to-date basis while many emerging markets' currency recorded a depreciation. The stable and stronger value of Rupiah is even more notable as this is occuring during the prolonged episode of monetary tightening across the globe. Fifth, GoI has successfully put various policy reform in place before entering the political cycle, including fuel subsidy, health sector, labor, tax, and financial sector. These positive development helped Indonesia to reclaim its status as 'upper-middle income country' after two years of being classified as 'lower-middle income' status. Contributed by these factors, Indonesia Is well-equipped to face the short-term and medium-term economic risks of global major economies slowdown, moderating commodity prices, ongoing structural reform, and the potential to reach 'high-income country' status.

Figure 1: Growth of GDP and the Main Industries, 2019-2023Q1



Source: CEIC

Figure 2: Growth of Manufacturing Sector and Its Subsectors, 2019-2023Q1



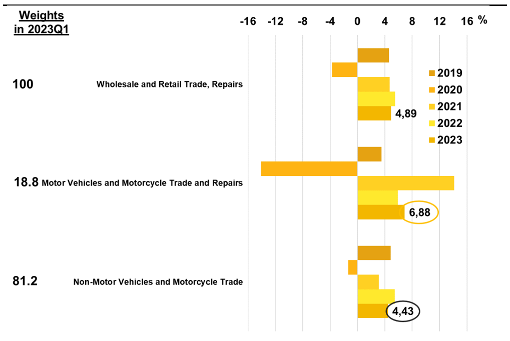
Source: CEIC

In the last six quarters, Indonesian economy has managed not only to reach the growth rate of 5%, but also to grow beyond market consensus. In the first quarter of 2023, Indonesian GDP grew by 5.03% (y.o.y), increased from 5.01% (y.o.y) in Q4-2022. The economic growth of Indonesia in early 2023 has been driven by recovering sectors that has been massively hit during the pandemic. Transportation and storage sector grew 15.53% (y.o.y) in Q1-2023, continuing the double-digit growth rate since a quarter earlier. Similarly, accomodation and food & beverages activity also recorded a double-digit growth. Despite decelerating from 12.01% (y.o.y) in Q4-2022, accomodation and food & beverages still robustly grew at 11.55% (y.o.y) in Q1-2023. Amidst all these positive economic indicators, data on sectoral growth suggest a rather worrying trend. Being the biggest sector in the Indonesian economy with the share of more than one-fifth, manufacturing sector kept growing below national growth rate. In Q1-2023, growth of manufacturing sector only recorded at 4.43% (y.o.y). Last year, this sector grew at 4.89% (y.o.y) while the national economic growth was recorded at 5.31% (y.o.y). The trend that manufacturing sector grew less than Indonesian GDP has been consistently occuring since 2012, signaling the potential issue of premature deindustrialization in Indonesia.

"Solid production activities of the Indonesian economy is reflected on the growth rate of manufacturing of machinery and equipment, and basic metal."

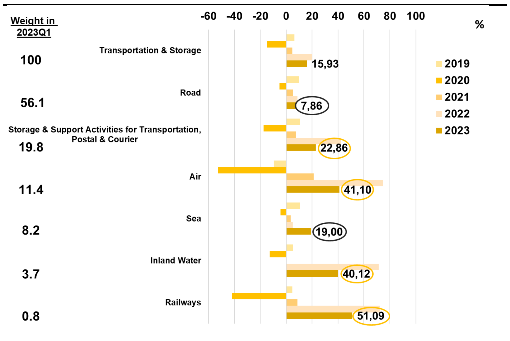
Within the manufacturing industry, metal-related products has become the fastest growth driver of the manufacturing industry in the year's first quarter, mainly due to increasing demand of major trading partners, which then increased domestic production activity. With the share of 5.3% and 9.2% within manufacturing industry, basic metal manufacturing and metal products, computer, electronic and electric equipment manufacturing recorded a notable double-digit growth. In Q1-2023, basic metal subsector growth increased to 15.51% (y.o.y) from 15.12% (y.o.y) in the previous quarter while the growth of metal products, computer, electronic and electric equipment manufacturing spiked to 12.78% (y.o.y) from 7.62% (y.o.y) during the same period. On the other hand, the global trend of subsiding energy prices produced a massive decline to the coal, oil, and gas refinery subsector as its growth rate substantially declined from 8.65% (y.o.y) in Q4-2022 to only 1.94% (y.o.y). in Q1-2023. The normalization of physical economic activity after Covid-19 was still affecting the transport equipment manufacturing. This subsector growth rate jumped to 17.27% (y.o.y) in the first quarter of this year from another double-digit growth of 10.95% (y.o.y) in the previous quarter.

Figure 3: Growth of Wholesale and Retail Trade and Its Subsectors, 2019-2023Q1



Source: CEIC

Figure 4: Growth of Transport and Its Major Subsectors, 2019-2023Q1



Source: CEIC

On a similar note, the wholesale and retail sector, the third highest contributor to Indonesian GDP, recorded slower growth in Q1-2023 compared to Q1-2022. Nonetheless, motor vehicles and motorcycles subsector displayed a growth of 6.88% (y.o.y), continuing the strong growth shown in Q3-2022 and Q4-2022. The positive

"Compared to Q4-2022, the transportation and storage sector is still enjoying sizeable growth in Q1-2023, albeit slower vis-à-vis the two preceding quarters, following the lifting of the cordon sanitaire PPKM and its derivative restrictions at the end of 2022."

trend was accomplished on the back of 1.82 million motorcycle sales in Q1-2023, a 44% increase from Q1-2022 sales at 1.26 million[7]. In light of this development, *Asosiasi Industri Sepeda Motor Indonesia* (AISI), the nation's motorcycle manufacturers, remains confident of achieving the 2023 sales projection of 5.6-5.8 million units. Correspondingly, automakers registered an impressive performance in Q1-2023, recording 282.1 thousand cars in wholesale (7.0% expansion compared to Q1-2022) and 271.1 thousand cars in retail market (13.7% growth y.o.y), largely propped up by the robust domestic consumption.

Compared to Q4-2022, the transportation and storage sector is still enjoying sizeable growth in Q1-2023, albeit slower vis-à-vis the two preceding quarters, following the lifting of the cordon sanitaire PPKM and its derivative restrictions at the end of 2022. Consequently, it remains as a sector with highest growth at 15.93% (y.o.y) in Q1-2023. Railways, air, and inland water subsectors stood firm as the backbone of the sectoral growth by virtue of passenger increase, registering annual growth of 51.09%, 41.10%, and 40.12% respectively. Storage activities slowed down marginally but remained relatively stable with a 22,86% (y.o.y) increase compared to 24.32% (y.o.y) in Q4-2022. Concurrently, sea transport saw substantial growth during Q1-2023, expanding by 19% (y.o.y) as opposed to a paltry 9.51% (y.o.y) in Q4-2022. On the contrary, the road transport subsector continued its relatively sluggish growth in the previous six quarters, noting a meager 7.86% (y.o.y) growth in Q1-2023 comparted to 9.52% y.o.y in Q4-2022, which result in a q.t.q decline of 4%.

Going into 2023, Indonesia's resolve for growth is tested by both internal dynamics and external challenges amidst the uncertainty stemming from prevalent rising inflation, the unremitting Russo-Ukrainian war, and the sunset of the commodity windfall. Slowing manufacturing and wholesale and retail as well as slacking agricultural growth could add complexity to the country's aspiration for higher and more sustained growth. Nevertheless, it has hitherto proved its resilience and ability to navigate chaotic global circumstances through sound fiscal and monetary policies.

Economic Indicators Returning to Its Growth Trajectory

Indonesia posted a faster-than-expected economic growth during January – March quarter in 2023 at 5.03% (y.o.y), inched up from 5.01% (y.o.y) in the last quarter of 2022 and higher than 5.02% (y.o.y) during the corresponding period of 2022. These figures indicated that the economic growth is now back at its auto-pilot growth level of around 5%. The continued growth was driven by household consumption and exports growth. Looking at its expenditure component, all components recorded a positive growth, including government expenditure that posted four consecutive quarters of contraction in 2022. After a contraction of 4.77% (y.o.y) in Q4-2022, government expenditure grew by 3.99% (y.o.y) in Q1-2023, suggesting an adequate budget absorption during the first quarter of 2023. As of 31 March 2023, government revenue was realized at IDR647.15 trillion, accounted for 26.27% of its 2023 target.

[7] Source: https://www.gridoto.com/read/223759471/honda-kuasai-penjualan-motor-baru-pada-kuartal-pertama-2023-skutik-enggak-ada-lawan.

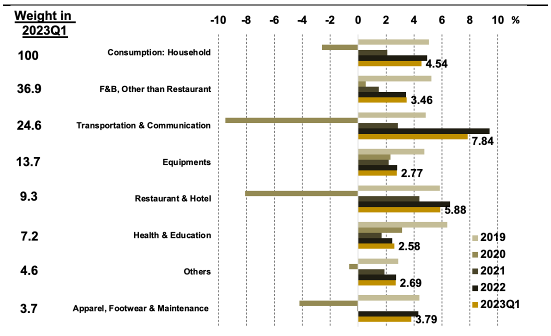
"The Q1-2023 growth indicated that the economic growth is now back at its auto-pilot growth level of around 5%, supported by growth in all expenditure components including government expenditure."

This figure rose by 28.98% (y.o.y) from 2022 figure due normalization of commodity prices and the impact of Law on Harmonization of Tax Regulations entering into force. Similarly, government expenditure was recorded at IDR518.66 trillion or 16.94% of its 2023 target. This figure increased by 5.70% (y.o.y) from 2022 figure. As of end of March 2023, budget surplus was recorded at IDR128.5 trillion or 0.61% GDP, higher than March 2022 at IDR 11.1 trillion at 0.06% GDP.

Household consumption, which makes up more than half of the economy, posted another growth of 4.54% (y.o.y), higher than the last quarter of 2022 growth at 4.48% (y.o.y). consumption of food & beverage, transportation & communication, and equipments, that make up for more than 75% of total consumption grew by 3.46% (y.o.y), 7.84% (y.o.y), and 2.77% (y.o.y), respectively. Growth in transport and communication sector was the main contributor of household consumption growth in the first quarter of 2023. Increased motorbike sales and passenger travel by land, sea, and air were indicators of the transportation sector's ongoing recovery.

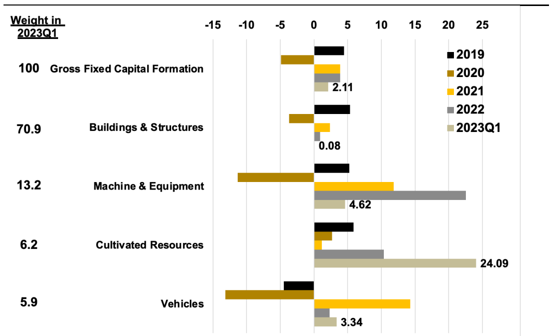
Moving on to investment, it experienced a positive growth of 2.11% (y.o.y) in the first quarter of 2023, lower compared to Q4-2022 figure at 3.33% (y.o.y). Investment in buildings and structures, which contributed to 72.7% of total investment, posted a positive growth of 0.08% (y.o.y). Investment in machine and equipment that accounts for 12.2% of total investment grew by 4.62% (y.o.y) in the first three months of 2023. Slowing investment growth could be explained by how investors are still in wait and see mode before investing in Indonesia amid of high global uncertainty and domestic uncertainty around the presidential election next year.

Figure 5: Growth of Household Consumption and its Components, 2019-2023Q1



Source: CEIC

Figure 6: Growth rate of Investment and Its Main Components, 2019-2023Q1



Source: CEIC

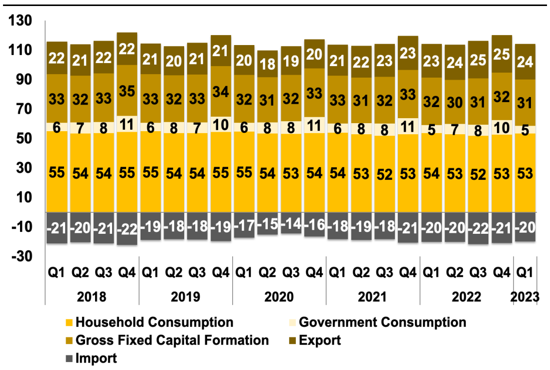
Meanwhile, in terms of banking credit performance, total credit grew at 10.36% (y.o.y) in Q1-2023, lower compared to 11.52% in Q4-2022. Consumption credit has continued to accelerate to 9.41% (y.o.y), slightly increased from 9.12% (y.o.y) in the preceding quarter due to improved purchasing power and a controlled inflationary level. While working capital and investment credit groups declined from 11.82% (y.o.y) and 13.56% (y.o.y) in Q4-2022, respectively, to 9.79% (y.o.y) and 12.33% (y.o.y) in Q1-2023, respectively. This indicated that those credit groups have gradually returned back to their normal growth trajectory at around 8-10%, since the higher growth trend in 2022 may be attributed to the sharp contraction in 2021. In the next quarter (Q2-2023), credit growth is expected to remain optimistic but at a lower rate than the previous trend. The most recent data in April 2023 showed that total credit grew by 8.08% (y.o.y), lower than 9.93% (y.o.y) growth seen in March 2023. Overall credit component grew but not as high as the previous month with the higher growth seen in investment with 10.12% (y.o.y). It was then followed by consumption credit at 8.68% (y.o.y) and working capital which was posted at 6.55% (y.o.y).

"Credit performance will continue to improve in the second quarter of this year along with its normal growth level. Consumption and business activity ahead of the election year are two factors that might stimulate credit growth in the rest of 2H-2023."

Based on the latest data from OJK, Indonesia's banking industry remains resilient amidst the global economic slowdown and global banking turmoil, particularly in developed countries. Domestic banks demonstrated relatively strong indicators underpinned by adequate liquidity and improved asset quality. In April 2023, NPL ratio remained stable at 2.53%. Third-party funds (DPK) decreased further to 6.98% (y.o.y) in the same period, resulting in a higher Loan to Deposit Ratio (LDR) at 81.09% in April 2023, up from 80.79% in March 2023, indicating slightly tighter liquidity.

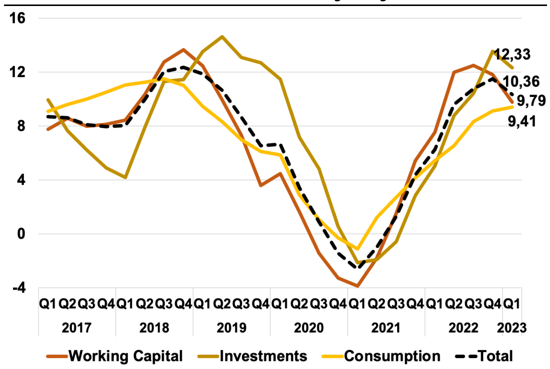
Looking forward, credit performance will continue to improve in the second quarter of this year along with its normal growth level. Consumption and business activity ahead of the election year are two factors that might stimulate credit growth in the rest 2H-2023. Preparation for the 2024 election year will boost consumer spending and sectors that benefited the most, particularly manufacturing such as food & beverage and textile industry as well as service sectors such as media and communications, accommodations, consulting and professions, and transportation. Furthermore, BI will increase macroprudential measures to stimulate financing growth. These include increasing and refining liquidity incentives such as lowering reserve requirements for banks lending to downstream sectors as well as sectors promoting financial inclusion such as MSME, microcredit, and green economy sectors.

Figure 7: Shares of GDP Components, 2018Q1-2023Q1 (%)



Source: CEIC

Figure 8: Credit Growth by Purposes, 2017Q1-2023Q1 (y.o.y, %)



Source: CEIC

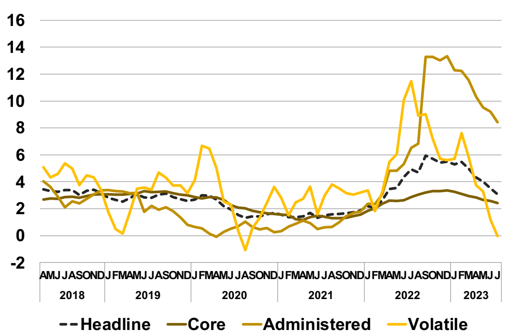
High-Base Effect on the Sloping Inflation

The annual inflation rate in July 2023 fell substantially to 3.08% (y.o.y) from the previous month's figure of 3.52% (y.o.y), within BI's target range of 3 ± 1% for the second consecutive months after exceeding the upper limit for the last twelve months. It was driven by a decline in all inflation components contributed by the consistency of the monetary policy response and coordination between BI and the GoI, regional governments, and other strategic partners in the Central and Regional Inflation Control Teams (TPIP and TPID) through the National Movement for Controlling Food Inflation (GNPIP) Program. In addition, Indonesia experienced a high level of inflation of 4.94% (y.o.y) in June 2022, mainly triggered by disruption in the food and energy supply chain following the heightened tension between Russia and Ukraine. Hence, there is a high-base effect that also influences the controlled inflation rate in July 2023.

"The annual inflation rate in July 2023 substantially fell to 3.08% (y.o.y) from the previous month's figure of 3.52% (y.o.y). On the other hand, the monthly inflation trend showed an increase where the overall prices accelerated by 0.21% (m.t.m) due to transportation and education group."

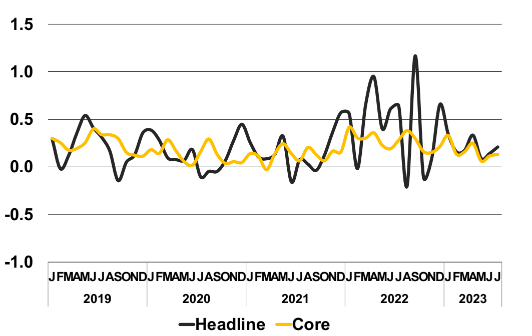
Core inflation was recorded at 2.43% (y.o.y) in July 2023, down from 3.52% (y.o.y) in the previous month. The slowdown in the annual inflation rate occurred after a massive increase at the end of the first quarter last year, following the increase in energy and food prices due to concerns over the impact of the Russian attack on Ukraine, as well as increases in non-subsidized fuel prices, non-subsidized LPG prices (5.5 kg and 12 kg LPG), and electricity tariffs for household customers above 3,500 VA. The administered prices inflation component has also decreased by 8.42% (y.o.y) in July 2023 compared to 9.21% (y.o.y) in June 2023. The volatile price component even recorded a deflation of 0.03% (y.o.y) in July 2023 compared to the previous month, which still experienced inflation of 1.02% (y.o.y).

Figure 9: Inflation Rate (%, y.o.y)



Source: CEIC

Figure 10: Inflation Rate (%, m.t.m)



Source: CEIC

On the other hand, the monthly inflation trend actually showed an increase where the overall prices accelerated by 0.21% (m.t.m) compared to a month earlier due to a higher frequency of activities following the school holiday season and an increase in school fees. The commodity group contributing to the highest inflation this July was the transportation group with inflation of 0.58% (m.t.m) and a share of 0.08%, then followed by the education group with inflation of 0.66% (m.t.m) and a share of 0.04%. Observing its components, core inflation slightly increased to 0.13% (m.t.m) in July 2023 from 0.12% (m.t.m) in June 2023. Similarly, administered prices component also experienced a substantial pick up from deflation of 0.02% (m.t.m) in June 2023 to inflation of 0.44% (m.t.m) in July 2023. However, there were a number of commodities that actually experienced price reductions as well, including gasoline, rice, filter clove cigarettes, housing contract rates, and intra-city transportation rates.

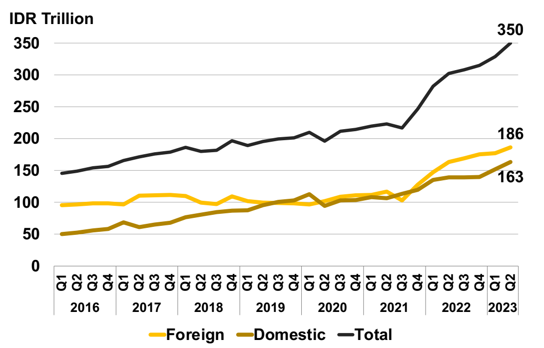
Indonesia Remains a Favorable Country for Investment

The Investment Coordinating Board (BKPM) recorded an investment realization of IDR349.8 trillion in Q2-2023, 48.5% of the 2023 investment realization target of IDR 1,400 trillion. This number increased by 15.7% (y.o.y) compared to the same period in 2022. Around 46.7% or IDR 163.5 trillion of the total investment realization was from domestic investment (DDI) category. Then the remaining 53.3% or IDR 186.3 trillion is from foreign investment (FDI). The achievement of FDI that surpassed DDI shows that the level of trust in the international business community in Indonesia is good and even shows an increase of 14.2% compared to the same period in the previous year.

"The Investment Coordinating Board (BKPM) recorded an investment realization of IDR349.8 trillion in Q2-2023, 48.5% of the 2023 investment realization target of IDR 1,400 trillion."

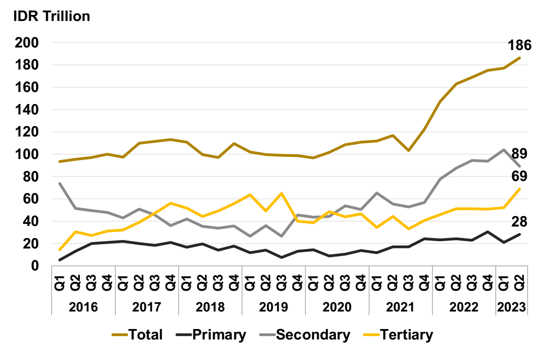
According to the sector, the transportation, warehouses and telecommunications is the largest contributor to investment realization in Q2-2023, with an investment value of IDR43.0 trillion. Then the basic metal, metal goods, non-machinery and equipment industries amounted to IDR42.4 trillion; mining IDR37.9 trillion; and industrial and office areas IDR30.4 trillion. Overall, the manufacturing industry contributed 47.9% of the total investment realization in Q2-2023. Between 2022 and the second quarter of 2023, the manufacturing industry sector consistently ranked at the top as one of the largest contributing sector for investment in Indonesia.

Figure 11: FDI and Domestic Investment (Nominal)



Source: CEIC

Figure 12: FDI Realization by Sectors (Nominal)



Source: CEIC

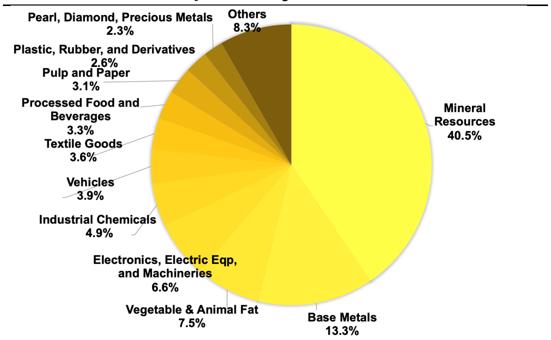
Investment realization outside Java reached IDR182.0 trillion or 52.0% of the total realization in Q2-2023. Meanwhile, realization in Java was recorded at IDR 167.8 trillion or 48.0% of the total realization. The top three investment locations in Q2-2023 include West Java (IDR53.7 trillion), DKI Jakarta (IDR43.0 trillion), and East Java (IDR31.1 trillion). The top five main investor countries include Singapore (USD3.4 billion), China (USD2.6 billion), Hong Kong (USD2.0 billion), Japan (USD1.0 billion) and the United States (USD0.8 billion). This is a promising sign from investment and an opportunity for GoI to maintain economic growth in 2023.

Trade Surplus Shrinks Amid Lower Exports

Amidst the global commodity prices normalization, Indonesia continued to record trade surplus in second quarter of this year. However, the trade surplus has been declining since last year with the current surplus only reach USD7.8 billion in Q2-2023. The current surplus is only half of the surplus recorded in a year earlier at USD15.6 billion and lowered by 30% compared to the figure a quarter earlier. The decline was influenced by several factors with the main driver is the faster pace of non-oil and gas exports deceleration than imports. After constantly growing, quarterly exports experienced downward trend for the first time since the second half of 2020. The total exports was down 17.9% (y.o.y) in Q2-2023 from the same period in a year earlier. Looking at its component, the 18.1% (y.o.y) deceleration of non-oil and gas exports was mainly contributed to the lower overall exports during the second quarter of 2023. The exports of non-oil and gas, which is dominated by commodities, was reduced due to the lower global prices for coal and palm oil as well as GoI interventions to ban mineral exports. Since June 2023, the GoI has agreed to implement the ban for bauxite, joining the export ban of nickel ore. At the same time, exports of oil and gas was also decreased by 15% (y.o.y) in Q2-2023 compared to the same quarter in previous year.

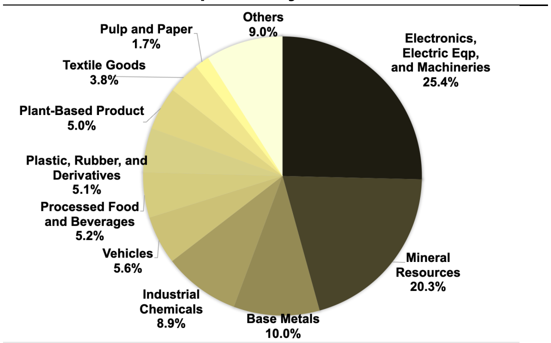
"The exports of non-oil and gas, which is dominated by commodities, was reduced due to the lower global prices for coal and palm oil as well as GoI interventions to ban mineral exports."

Figure 13: Indonesia Export Profile (April-May 2023)



Source: CEIC

Figure 14: Indonesia Import Profile (April-May 2023)



Source: CEIC

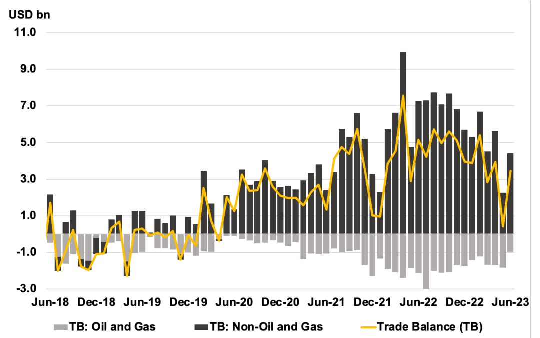
Apart from lower exports, the moderate trade surplus in Q2-2023 was also influenced by the significant drop in imports. Indonesia's overall imports decreased by 9.4% (y.o.y) in Q2-2023 compared to same period in 2022. On quarterly basis, the total imports was down by 2.1% (q.t.q) from Q1-2023. Both oil and gas and non-oil and gas imports contracted compared to a year earlier at 23.3% (y.o.y) and 6.3% (y.o.y), respectively. While the decline in oil and gas import was driven by lower global oil price, the non-oil and gas imports decreased following the smaller demand for raw and auxiliary goods imported from abroad. Indonesia is still reliant on productive goods imports, with electronics, electric equipment, and machineries

(25.4%), mineral resources (20.3%), and base metals (10.0%) accounting for the majority of imports.

The decreasing trend of trade surpluses since early of this year has partly contributed to the narrowed current account surplus to only USD3.0 billion surplus (0.9% of GDP) in Q1-2023 from USD4.2 billion of surplus (1.3% of GDP) in previous quarter. Given by the lower trade surplus in Q2-2023, the current account balance may be reduced further for the remaining quarters of this year due to the combination of lower trade surplus in goods and larger deficit in services. Yet, the positive current account balance has brought impactful contribution to the Rupiah stabilisation amid the global financial market uncertainty. In 2022, Indonesia's was one of the few developing countries that booked positive current account balance, while the remaining countries, such as Thailand, Philippines, Brazil, and Mexico experienced the deficit trade in goods. The sound trade surplus has successfully cushioned the effect of the ongoing monetary tightening by the Fed on Rupiah depreciation as higher exports than imports indicate more foreign exchange liquidity in the market.

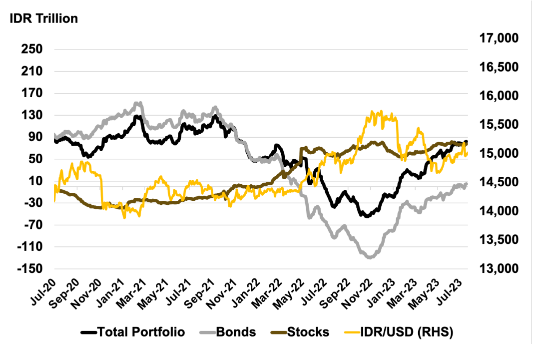
"Fortunately, Indonesia's financial market continued to perform better in Q2-2023 supported by the robust demand for Indonesian bonds as the yield spread between Indonesian government bonds and US Treasury remains quite attractive following the less aggressive monetary tightening by the Fed"

Figure 15: Monthly Trade Balance (Nominal)



Source: CEIC

Figure 16: Exchange Rate and Accumulated Short-Term Capital Inflow



Source: CEIC

Besides trade surplus, the performance of Rupiah is primarily derived from financial market. Fortunately, Indonesia's financial market continued to perform better in Q2-2023 supported by the robust demand for Indonesian bonds as the yield spread between Indonesian government bonds and US Treasury remains quite attractive following the less aggressive monetary tightening by the Fed. The amount of total capital inflows into Indonesia has almost doubled from only USD2.67 billion at the end of March 2023 to USD5.29 billion at the end of June 2023. The recent Fed rate pause in June has also continued to maintain the capital inflow to a total of USD5.48 billion in mid-July. The relatively stable financial market is also reflected in the sufficient amount of reserves at USD137.5 billion in June, although it slightly weakened from USD139.3 billion in May due to GoI's obligation to pay external debt. The current level of reserves is still adequate to support external sector resilience as it is capable to cover 6.1 months of imports and servicing government's foreign debt.