LPEM FEB UI
UNIVERSITAS INDONESIA

Macroeconomics Analysis Series

Indonesia Economic Outlook

2024

Key Figures

GDP Growth (Q2 '23)
5.17%

Inflation (y.o.y. Oct '23)
2.56%

Credit Growth (y.o.y. Sept '23)
8,96%

BI Repo Rate (7-day, Oct '23)
6.00%

Current Account Balance (% GDP) (Q2 '23)
-0.5%

IDR/USD (Oct '23)
IDR15,916

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Political Transition amidst 'Higher-for-Longer' Era

Highlights

- *GDP to grow 5.05%-5.09% in Q3-2023, 5.0%-5.1% in FY 2023, and rather stagnant at 5.0%-5.1% in FY 2024.*
- *Resuming its accelerating growth since the last quarter of 2022, Indonesian economy expanded by 5.17% (y.o.y) in Q2-2023.*
- *Although growth in manufacturing industry, the major pillar of the nation's economy, accelerated to 4.88% (y.o.y), it is still below the economic growth.*
- *All expenditure components, except exports and imports, experienced a positive growth, including govrnment spending that indicated a jump in growth to 10.62% (y.o.y) in Q2-2023.*
- *Simultaneous general election and global monetary situation will be the main domestic economic driver in 2024.*
- *Global monetary stance will influence the depreciation and global demand that could affect domestic economy through external trade, borrowing cost, and investment growth.*
- *The positive impact of election period will come in the form of boost in money injection for campaign spending, politically driven public expenditure and increase in private consumption.*
- *The downside risk of election period is on the investment growth as investors might hold its 'wait-and-see' position until the election results settled.*

Political climate and global monetary condition will be two of the key themes that will affect Indonesian economy 2024. The upcoming general election may have mixed effects on growth and other macroeconomic indicators in 2024. On one hand, Indonesia will carry out its first ever simultaneous elections (Pemilu Serentak) from national to city level; consequently stimulate massive money injection to the economy induced by campaign spending and other polically driven public expenditure. Hefty money multiplier will boost domestic consumption throughout 2024 as the subnational level election might be held near the end of next year. On the other hand, the long transition period until the next administration assume the office will prolong the wait-and-see sentiment by private sector and might stun the growth of credit and investment.

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

Q3-2023	FY2023	FY2024
5.05% - 5.09%	5.0% - 5.1%	5.0% - 5.1%

Tight labor market and uncomfortably high inflation in several advanced economies has pushed major central banks to create 'higher-for-longer' interest rate

environment. Current tight monetary regime has squeezed capital flows out of emerging markets, including Indonesia, and rapidly depreciating their currencies. As a repercussion, BI is 'forced' to actively intervene in foreign exchange market and even raise policy rate to stabilize the currency volatility. In 2024, we are in view that the room for BI to ease monetary policy will be dictated by the stance taken by the Fed, to a certain extent. Shall the Fed prolongs its tight monetary regime then BI might keep its policy rate high. Under this scenario, high borrowing cost will put pressure on credit growth in 2024. Furthermore, tight monetary policy adopted by major central banks also weakens global demand and drive down commodity prices. This might have further implications for Indonesia on the trade performance due to high reliance of export performance on commodity prices. In addition, prolonged depreciation could increase the risk of imported inflation. Considering 90% of Indonesia's import profile are capital goods and raw materials, depreciation will increase domestic production costs, jeopardizing manufacturing performance and future investment growth. The combination of capital outflow and potential decline of trade balance in the upcoming year might also run the risk of increasing current account deficit.

All in all, we see GDP to grow by 5.1% (y.o.y) in 2024, rather stable with our revised forecast for 2023 (5.0% – 5.1%). Besides the upcoming downside risk from external and domestic front, Indonesian economy marked a notable performance in the first half of 2023. Grew by 5.17% (y.o.y) in Q2-2023, Indonesia's GDP is currently on its upward trajectory, thanks to various sesonal factors. Going forward, it is imperative to ensure stability of consumer confidence, price level and exchange rate in preserving short-term economic growth amidst future uncertainty.

Macroeconomic Effects of the Quinquennial Event

General election can have a major impact on policies, laws, and regulations. Policy volatility may come from incumbent's motivation to employ economic policy instruments to win reelection. The incumbents may be motivated to manipulate fiscal and monetary policies to appease the median voter even though this may have negative consequences for macroconomic stability and fiscal sustainability.

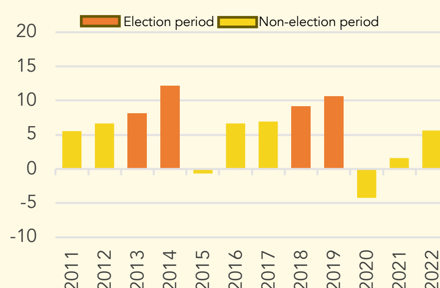
Previous theoretical and empirical studies, such as Rogoff (1988), have shown that the political budget cycle is indivisible with macroeconomic policy variables, as macroeconomic performance in the period leading up to an election have a role in influencing voters decisions. For example, high GDP growth and low inflation may boost support for the incumbent government, while the struggling economy may hinder the political trust in the incumbent government. The political budget cycle theory also suggested that leaders may manipulate fiscal policy tools to improve their chances of reelection. Electoral calendar may have an impact on the composition of tax revenue, particularly when incumbent leaders hold power. As a result, the government tends to engage in expansionary fiscal or monetary policies to stimulate the economy or introduce popular policies prior to and during the election year.

Macroeconomic Trends during Election Period

Before looking at how macroeconomic policy indicators move during an electorally induced cycle, it is worth noting that the general elections in Indonesia occurred under varying domestic and external circumstances. At least two elections in Indonesia were held right after unfavourable global economic conditions, including the 2008 Global Financial Crisis (GFC) and 2013 taper tantrum, both of which had considerable impact on the economy. This specific context of each election might lead to variations in the correlation between election event and macroeconomic policy.

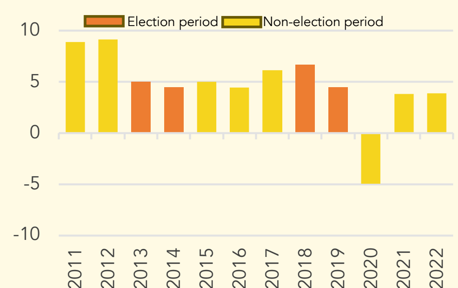
One of the most visible evident of the interaction between the macroeconomic indicators and political business cycle was demonstrated by the growth in Non-Profit Institutions Servings Household (NPISH) consumption, which follows election cycle. According to GDP historical data starting back to 2010 and covering 2014 election and 2019 election, the growth of NPISH consumption has consistently peaked in election years (Figure A). The increase was probably due to increase spending of political parties and competing candidates on election campaigns during the election years compared to the non-election years. However, this surge was only ephemeral, and consumption fell significantly after the election. Moreover, the average contribution of NPISH consumption to the overall economy was relatively limited, accounting for only 2% of the total GDP in 2022.

Figure A: NPISH Consumption Growth (%, y.o.y), 2011-2022



Source: CEIC

Figure B: GFCF Growth (%, y.o.y), 2011-2022

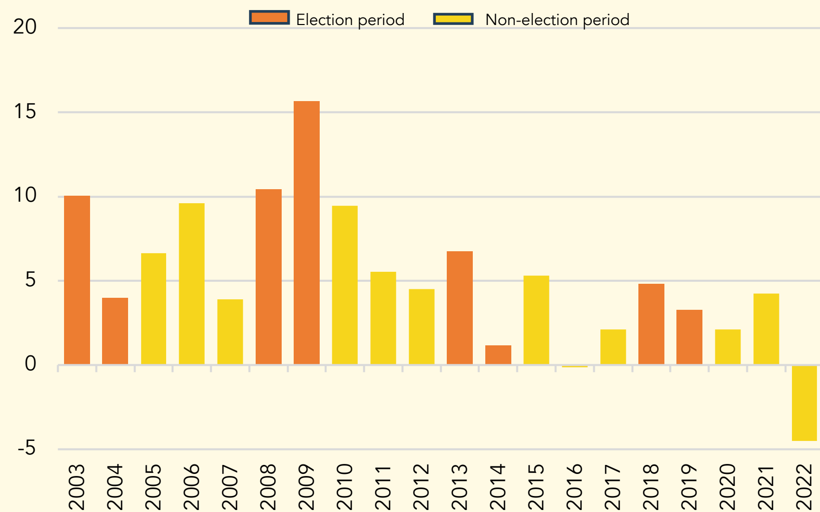


Source: CEIC

In contrast to the surge in political party expenditure, the growth of Gross Fixed Capital Formation (GFCF) declined during election period as investors adopted a wait-and-see approach (Figure B). The investment tends to increase in a year after the election period, except for the lower capital formulation growth in 2020 due to the Covid-19 pandemic.

On government consumption side, the jump in the growth of government consumption to GDP was apparent throughout the election period, notably in a year prior to election year compared to non-election period. After picking up, the government consumption tended to fall significantly in the election year before increasing again when the new administration started fiscal spending in the post-election year. The deceleration of government consumption growth in election year was attributable with the high-base effect from a year earlier. However, this was not the case in election years when the incumbent government was interested in winning the re-election, such as the 2009, when government consumption growth soared in the election year. For the 2019 election year, even though the government consumption growth was lower in 2019 than a year earlier, the decline was only slight in comparison to huge drops in 2004 and 2014 election years where the incumbent government was in their second and final term of the administration.

Figure C: Government Consumption Growth (%, y.o.y), 2011-2022

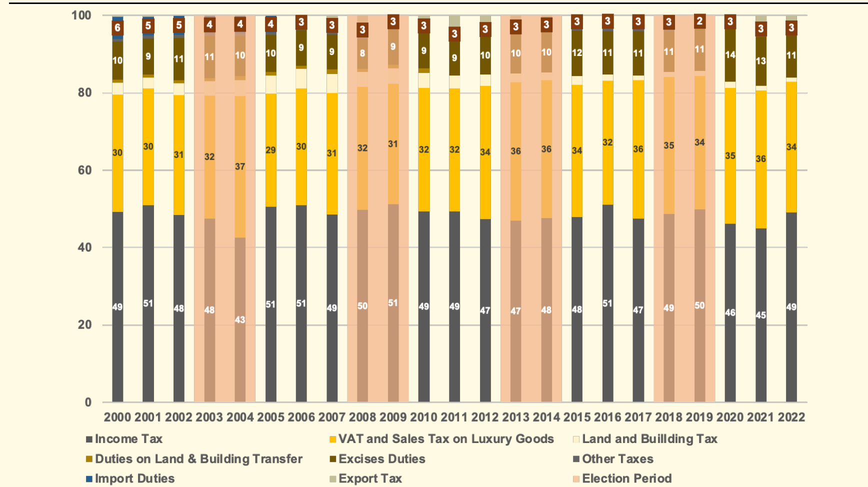


Source: CEIC

Fiscal policy

In developing countries where stock of capital owned by the median voters is less than the average endowment and a high portion of citizens work in the informal sector, these voters are believed to prefer lower indirect taxes and higher direct taxes (Ehrhart, 2013). However, this did not happen in Indonesia, at least during the last four election periods. Share of income tax to tax revenue, a direct tax, was relatively stable between 2000 – 2022, except during the 2004 election when share of income tax dropped from 48% in 2013 to 43% in 2014. On the contrary, during the 2004 election, share of VAT and sales tax on luxury goods rose from 32% in 2003 to 37% in 2004. Relatively low tax ratio, with an average of 10.91% of GDP between 2000 – 2022 would suggest there is almost no room for the GoI, even the incumbent leaders, to lower tax revenue.

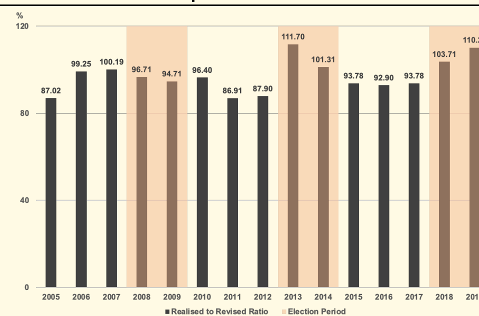
Figure D: Tax Structure, 2000 – 2022



Source: CEIC

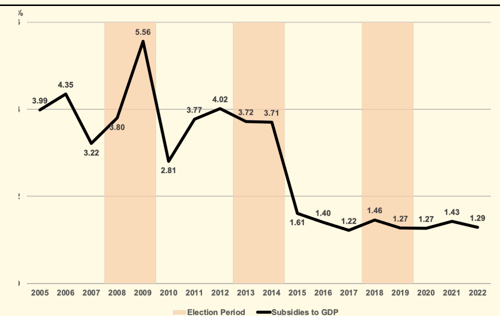
On the spending side, the opportunistic behaviour of the current leaders may result in an expansionary fiscal policies during election years, especially for incumbent leaders. During this period, government is expected to spend more on projects with high visibility (Rogoff, 1990) and increase discretionary spending to convince voters that they are doing a good job and secure reelection. Comparing revised and realised social assistance expenditure, one of the discretionary spending, it can be seen that during election period, particularly in 2014 and 2019 elections, realised social assistance expenditure is always higher compared to revised social assistance expenditure. Putting aside the realised to revised social assistance expenditure during the Covid-19 pandemic, this ratio has always been lower than 100% in a non-election years. Increase in discretionary spending is also apparent in subsidy expenditure to GDP ratio. During the 2004 and 2009 elections, subsidy expenditure to GDP is higher during the election years compared to pre or post election years. Political motivation by the leaders to win the election or to act on the interest of voters may serve as a justification for this trend.

Figure E: Realised to Revised Social Assistance Expenditure, 2005 - 2019



Source: CEIC

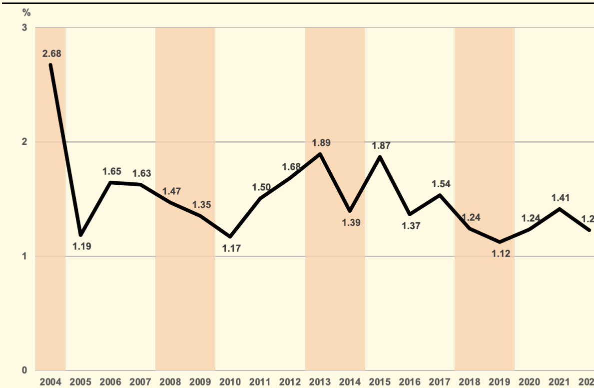
Figure F: Subsidy Expenditure to GDP, 2005 - 2022



Source: CEIC

In terms of capital expenditure, there are there are two perspectives on its trend. While some agrees that leaders may increase visible government expenditure, including capital expenditure, during election periods due to signaling by incumbents, the others argue that leaders would spend less on public investment, such as infrastructure, as they are mostly long-term investment that the benefits would come into realization during the next term of office. In Indonesia, data suggested that during election years, capital spending decreased compared to pre-election years. This is true for 2009, 2014, and 2019 elections.

Figure G: Capital Expenditure to GDP, 2004 - 2022



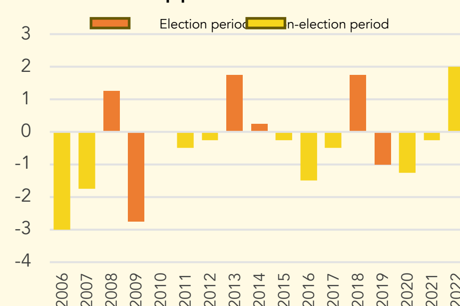
Source: CEIC

Monetary policy

The interaction between election year and monetary expansion policies has gained attention within academic literatures. However, the findings were not compelling as it was tough to unveil evidence of interaction between central bank and the government, particularly in a country with independent central banks. One of the popular political monetary cycle concept was the opportunistic political business cycles, in which the incumbent government seeking re-election performed a surprise monetary expansion before an election in order to lead to a temporary increase in economic activity followed by an increase in inflation. After the election, the central bank adopted monetary tightening policy to cool down the economy and reduce inflationary pressures (Nordhaus, 1975).

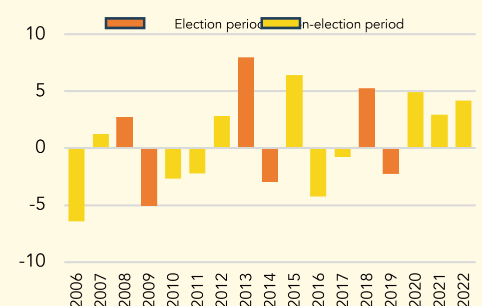
The evidence in Indonesia's historical data was not definitive. BI's main monetary policy instrument, namely policy rate, exhibits wider rises in a year preceding the election before declining during the election year. The pattern initially indicates the expansionary monetary policy pattern around election year, however, it might also be explained by the historical circumstances, such as the GFC in 2008-2009, taper tantrum in 2013, and US-China trade war in 2018. Such occurrences necessitated the central bank's monetary tightening policy in order to maintain exchange rate stability amid financial market uncertainty, as seen by the large interest rate increases in 2008, 2013, and 2018. When the period of uncertainty comes to an end, central bank normalizes monetary indicators by lowering interest rates. The external shocks events corresponded to the depreciation rate data, which peaked in a year before the election year and moderated throughout the election year.

Figure H: BI Policy Rate/BI-7DRR Change (pp), 2006 – 2022



Source: CEIC

Figure I: Depreciation Rate (%, ytd), 2006 – 2022

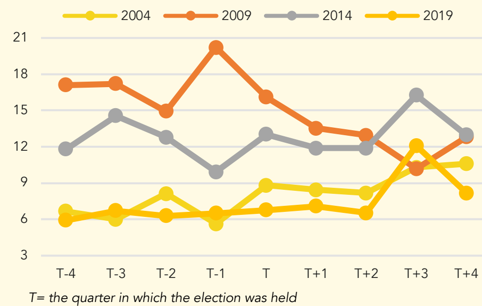


Source: CEIC

On more political nuances, even if the central bank most likely does not directly intervene in the election, particularly in countries with independent central banks, they have to react to the increased money supply due to higher election campaign spending prior to the election, high inflation pressure, currency instability amid investors' wait-and-see approach, and expansionary fiscal cycle. Such circumstances often lead to a monetary cycle (Willett, 1983; Beck, 1987).

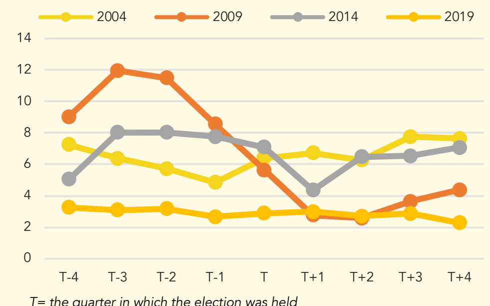
On quarterly basis data surrounding the previous election period, higher election campaign spending has historically increased the money in circulation throughout the quarter in which the election was held, except for the anecdotal lower money supply growth in 2009 election due to the high-base effect a quarter before the election. Moreover, inflation was moderated prior to the elections and picked up thereafter. The inflation response to the higher money supply was lagged for approximately two quarters. It was somewhat consistent with empirical findings of monetary performances during the pre-electoral business cycles, with money growth rates rising before and during the election and inflation rising after elections.

Figure J: Quarterly Money Supply Growth (%, y.o.y)



Source: CEIC

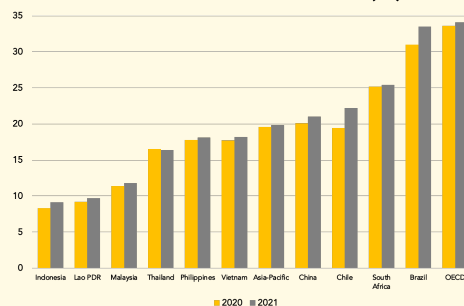
Figure K: Average Inflation Rate (%, y.o.y)



Source: CEIC

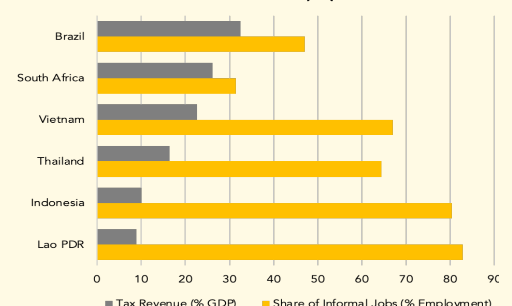
The Ongoing Reforms

Figure L: Tax-to-GDP Ratio in Developing Countries 2020 vs. 2021 (%)



Source: CEIC

Figure M: Tax Ratio and Share of Informal Jobs in 2020 (%)



Source: CEIC

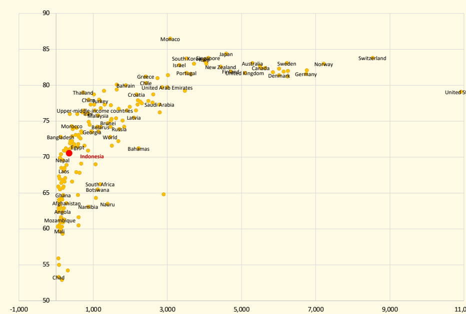
The current administration has carried out numerous reforms to address structural problems in Indonesia, ranging from health, taxation, to fuel subsidies, which are often an issue in every government administration. Indonesia is one of the countries with the lowest tax-to-GDP ratio compared to its peers. The attempt of improving tax-to-GDP ratio by increasing tax revenue and formal labor participation has been made by the current administration through Omnibus Law on Job Creation and Law on Tax Harmonization. In 2020, Indonesia's tax ratio decreased the most because of the Covid-19 pandemic which limited people's economic activities. Meanwhile in

2021, Indonesia's tax ratio increased and finally exceeded pre-pandemic levels in 2022 in line with strengthening tax performance and national economic recovery from the impact of the pandemic. One of them is also caused by tax reform through the implementation of the Law on Tax Harmonization. However, improving tax revenue and labor market transformation should be continued by the next administration.

In terms of health aspect, Indonesia's life expectancy has been stagnant for years. Looking at the global pattern, life expectancy correlates positively with healthcare expenditure per capita. However, due to limited fiscal space, healthcare spending may not solely rely on state budget. The percentage of Indonesia's health expenditure per total government expenditure when compared with several ASEAN countries and developed countries is in a moderate position, namely 10.1% in 2020. However, in terms of health spending per GDP, Indonesia is one of the lowest among peer countries. Density of physicians is also an issue in Indonesia. In 2020, WHO data suggested there is only 0.6 physician, including generalists and specialist medical practitioners, for every 1,000 population. This figure is lower compared to Thailand, Malaysia and Singapore where there is 0.9 physicians, 2.3 physicians, and 2.5 physicians (2019 data), respectively, for every 1,000 population. Furthermore, the gap is even higher compared to advanced countries as the density for the US is 3.5, UK is 3.1, and 4.1 for Australia, for every 1,000 population. In addition, the maternal mortality rate in Indonesia is 305 per 100,000 live births and the prevalence of toddler stunting is 24.4%. Indonesia is also ranked 3rd in the world in terms of TB incidence at 301 per 100,000 population in 2020. Therefore, health has become one of the issues being resolved based on the vision of 'Indonesia Emas 2045', where the targets include life expectancy to reach 80 years, maternal mortality rate to reach 16 per 100,000 population, stunting prevalence of 5%, tuberculosis incidence of 76 per 100,000 population, and national health insurance coverage of 99.5%.

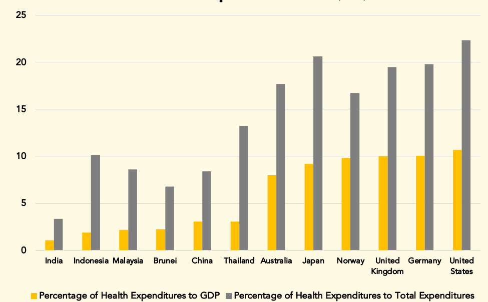
Th aforementioned health-related issues is expected to be resolved through UU No. 17 of 2023, which has just been passed, where mandatory spending is removed because health budgeting will be performance-based in accordance with the RPJMN to achieve efficiency, effectiveness and rationality in budgeting. While the ratification of this bill is the first step for GoI to achieve Indonesia's Vision 2045 in the health sector, reform in the health sector must remain on the agenda of the next government.

Figure N: Life Expectancy and Healthcare Expenditure per Capita



Source: Our World in Data

Figure O: Percentage of Health Expenditure to GDP and Government Total Expenditure (%)



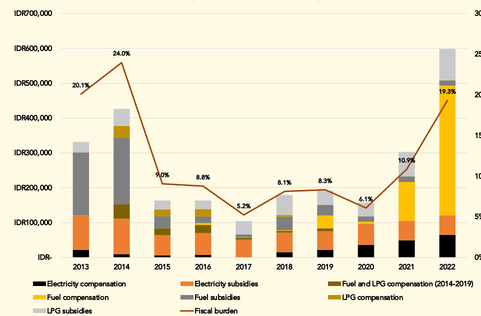
Source: WHO

The next remaining issue is fuel subsidy. Fuel subsidy reform in Indonesia was previously implemented in 2014 when Indonesia spent almost IDR450 trillion on energy subsidies that year. The reform succeeded in saving around IDR300 trillion in the following year, which was then reallocated for social protection, poverty alleviation and other redistribution programs. After the reform, spending on energy subsidies and compensation never exceed IDR200 trillion until 2021. To maintain prosperity and prevent a significant increase in poverty rates due to post-pandemic inflation and soaring energy prices, Indonesia sets the prices of several types of fuel which forced

the government to issue a large amount of compensation for fuel, worth almost IDR 300 trillion in 2022.

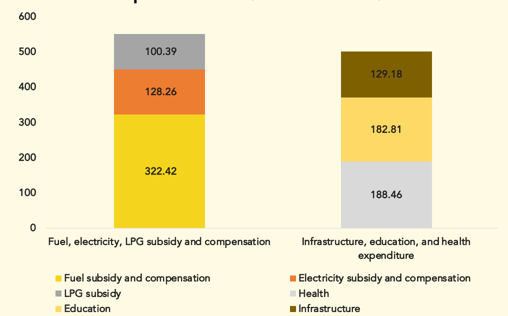
In 2022, total central government expenditure for subsidy and compensation of brown energy reached around IDR552 trillion. As a proportion, total brown energy subsidy and compensation contributes to the staggering portion of 24.2% of central government expenditure in 2022. This amount is bigger compared to other development spending items, such as health, education, and infrastructure which cumulatively amounted to around IDR501 trillion. In comparison, the total brown sector subsidy and compensation is amounted to 143% of total interest payment and 74% of regional transfer allocation. This further emphasize the need for reforming current fuel subsidy and compensation scheme in the next administration, considering its massive amount and degree of inefficiencies.

Figure P: Indonesia's Subsidies Amount (IDR Trillion)



Source: CEIC

Figure Q: 2022 Central Government Expenditure (IDR Trillion)



Source: CEIC

Rarity of Reforms during Election Period

In every election year, scholars, public experts, and the general populace invariably engage in discourses concerning governmental policies, with a particular focus on reforms. The records of the Republic of Indonesia's history bear witness to the predominant role of policy reforms in shaping the country's political and economic landscape. According to Bennett and Howlett (1992) and Hill (2013, cited in Basri, 2017), a reform can be construed as a sustained modification of existing frameworks and institutional structures, undertaken with the overarching goal of enhancing the general welfare.

The impact of reforms on the macroeconomic landscape has been a subject of considerable interest. Alesina et al. (2020) finds that reforms in general are widely beneficial to the broader economy. However, benefits of the reform tend to manifest gradually over time, necessitating a degree of patience. Alesina et al. (2020) notes the temporal lag associated with the realization of the effects of reforms is estimated to be approximately four years. Policy reforms often demand upfront costs with benefits realized in the long term. However, approaching the election cycle, politicians aim for immediate boosts on their political support and might not be willing to spend their political capital to support the reform that the benefit might not be realized in time for the election. This creates a mismatch on the incentive mechanism faced by the government and officials to carry out the reform during political years.

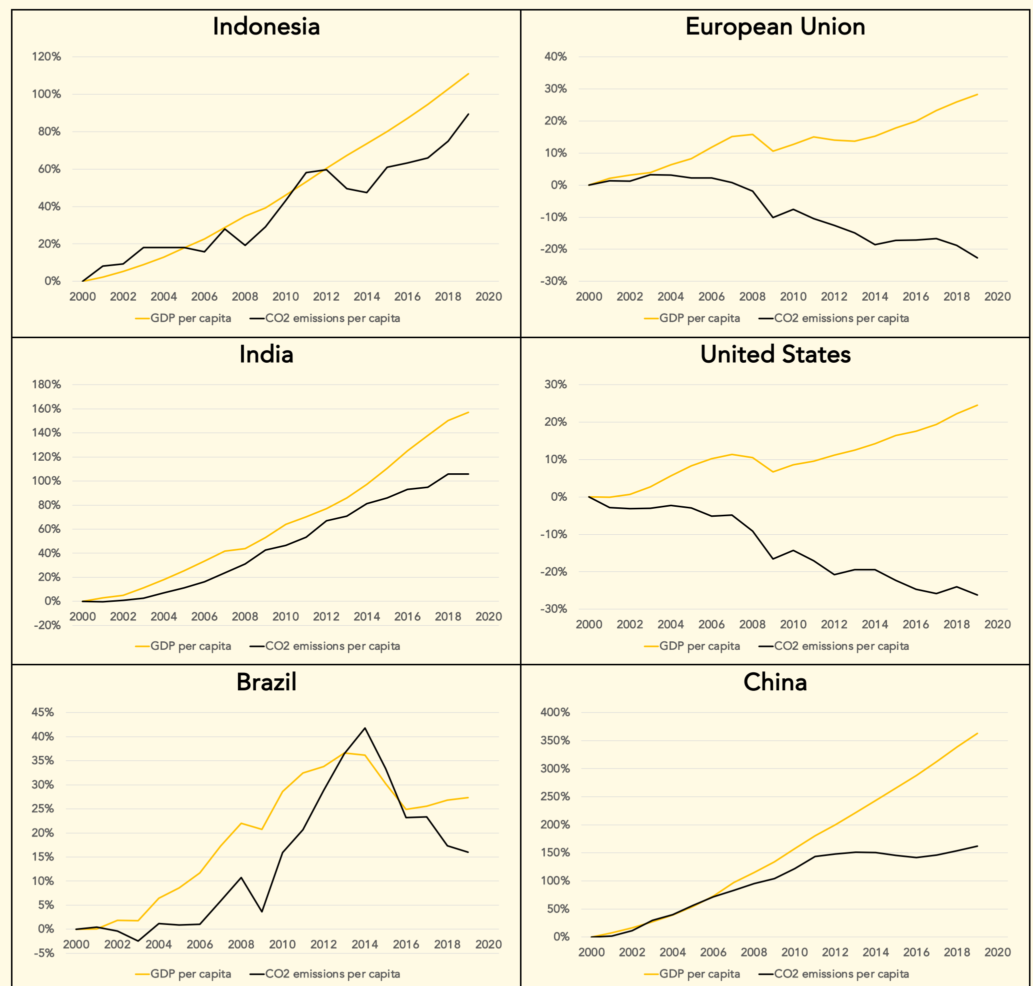
As a result, politicians and governments facing upcoming elections may find it less attractive to pursue comprehensive reforms. Instead, they may be tempted to resort to populist policies, which offer quick and visible rewards to the public but may not necessarily be in the best long-term economic interest of the country. Therefore, it is a rarity form the reform to be enacted in the vicinity of election years. Thus, while the current administration has put various progressive

reforms in place during the past few years, other potential reforms might not be occurring anytime soon as the political and election cycle begins.

The Unresolved Homework

While GoI has put in place numerous reforms in the past few years to tackle structural issues, various development and economic issues remain unresolved and there might not be enough time to be addressed during the term of the current administration. These issues are crucial for achieving long-term development agenda and advance the socioeconomic state of Indonesia.

Figure R: GDP and CO_2 Emission Growth (per capita, indexed to 2000)



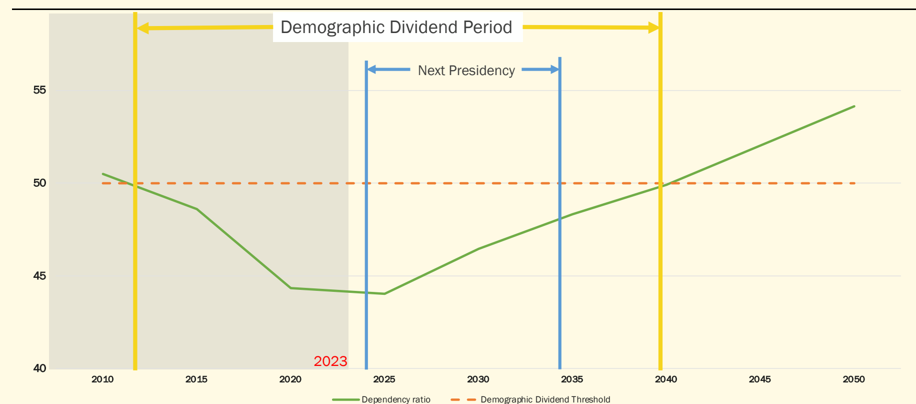
Source: World Bank, Global Carbon Budget

The first vital issue that needs to be prioritized by the next administration is economic growth target and climate target. In terms of long-term agenda, Indonesia aims to gain a 'high-income country' status by 2045. In order to achieve this, it is estimated that Indonesia needs to grow its economy by 6% for 20 years or 7% for 17 years. Having the current growth trend of about 5%, Indonesia needs to massively boost its economic engine to reach the adequate growth level to stay on the trajectory towards high-income country by 2045. On the other hand, Indonesia has set another equally ambitious target in the long-run; achieving net-zero emission (NZE) by 2060 or earlier. NZE target suggests that, going forward, Indonesia needs to consistently and substantially reduce its emission production.

Maintaining a steady 5% growth rate in the last two decades came at high price for Indonesia from environmental perspective as it involves major deforestation, excessive consumption of coal, and high use of fossil fuel. Furthermore, economic activity is driven by manufacturing, which is highly carbon intensive. In 2019, Indonesia was the fourth biggest polluter in the world, with around 1959 MtCO2e produced (CAIT, 2020). Figure R illustrates that increase in economic activity results in increasing emissions due to high reliance of carbon-intensive energy sources. The current state of Indonesian economy transpires the long-term agenda of achieving 'high-income' country status and NZE 2060 into a dichotomy. Attempting to reach 'high-income' country status neccesitates the economy to grow beyond its normal level and this would result in even higher level of emission; thus, pushing forward for growth agenda will jeopardize the decarbonization agenda, vice versa.

Without any drastic measures taken, Indonesia will continune facing this dichotomy and is likely doom to fail in achieving both long-term targets of growth and decarbonization. It is imperative for the next administration to come up with strategic reforms and workable solutions for decoupling the growth and emission during its term for the next ten years. If elected two-terms, achieving these two target solely depends on the success of the next President to resolve this issue. If proven unsucessful, the chance to become 'high-income' country by 2045 and reach net-zero by 2060 is almost non-existent as the window of opportunity has passed and the subsequent President will be too late to make any meaningful and adequate progress. While the necessary effort and commitment required to decouple the economic and emission growth is extremely high, achieving it is not impossible. Sustaining growth and simultaneously reducing carbon emission has been successfully demonstrated by China and various Advanced Economies (Figure R).

Figure S: Demographic Dividend Remaining Period



Source: Statistics Indonesia

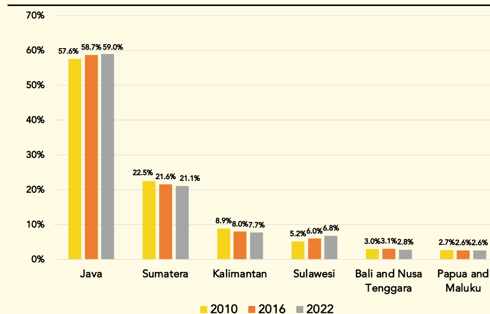
The second issue that should be on the priority list of next administration is reaping the remaining benefit of demographic dividend. Since 2012, dependency ratio in Indonesia has fallen below 50, suggesting the share of productive age population is larger than non-productive ones (so-called demographic dividend phase) and estimated to last at least until 2035 (Figure S). Having vast amount of population with productive capacity provides Indonesia with massive growth potential. However, this requires the productive-age population to be actually productive; lest, the growth potential will not be realized. There is a potential concen for productivity aspect in Indonesia. Since entering the demographid dividend era, the issue of youth unemployment, stagnant education level, and low quality of labor has not seen any meaningful progress.

Besides the perspective of the importance in reaping demographic dividend, the issue of urgency is even more worrying. 2023 is somewhat the middle point of demographic dividend. The remaining period of demographic dividend is around 12 years and in the previous 12 years we

have not seen any concrete form of productivity increase that signals the success of reaping demographic dividend potential. The success of demographic dividend will be mainly determined by the hand of the next administration. If elected two-full terms, the next President and his administration will be in the office for ten years (out of 12 demographic dividend remaning period) and in charge of putting reforms to fundamentally improve productivity and quality of human capital. The failure to enhance productivity of labor by the next administration means that Indonesia will lose its window of opportunity and certainly miss the substantial potential growth. In addition, not being able to transform productive-age population in productive labor will pose significant burden on the future Indonesian economy as the demographid pyramid is being reserved and the economy will bear the burden of aging population. Considering its importance and urgency, this agenda is also considered as non-negotiable to be addressed by the next administration.

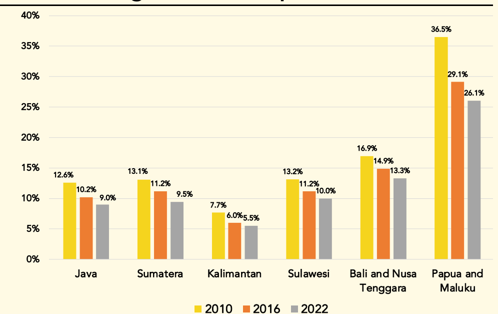
The third item on the list of yet-to-be-resolved issues in Indonesia is economic disparity. While it has been a popular 'campaign promise' to narrow the economic gap between western and the eastern part of Indonesia by presidential candidates during past elections, not much of a progress has been seen in the actual data. Based on the economic activity, Java has been dominating the national economy with the share of almost 60% of Indonesian GDP (Figure T). Meanwhile, Sumatra 'only' accounts for around a third of Java's GDRP, and Kalimantan, Sulawesi, Bali, Nusa Tenggara, Maluku and Papua combined GDRP is even less than Sumatra's. Not only there has been no significant improvement in redistributing economic activity outside Java, the disparity seems to be worsened in the last decade. Since 2010 the economic activity is even more concentrated as the share of Java's GDRP is consistently increasing while the other regions were continuously contributing less to the Indonesian GDP (except Sulawesi).

Figure T: Share of GDRP by Region (% of National GDP)



Source: CEIC

Figure U: Percentage of Poor People by Region (% of Population)



Source: CEIC

The concentration of economic and business activity in Java or western part of Indonesia has repercussion on the distribution of job opportunity distribution across Indonesia. Although in the last ten years or so the percentage of poor population has been uniformly declining throughout regions, non-western parts of Indonesia are relatively having higher percentage of poor groups. In 2022, more than a quarter of population in Papua and Maluku are considered as 'poor' while Java and Sumatera only have less than 10% of poor population. Despite not having a direct consequences towards overall national economic performance, a more distributive economic activity could provide the 'justice' aspect and ensure that the pie of economic growth is to be enjoyed more equally by all population across Indonesia. Successfully making any discernible progress towards narrowing the regional disparity by the next administration will mark an achievement that has never been done by its predecessor and will set a notable precedent to be followed the subsequent administrations in the future.

Beyond these three issues, there are obviously many other challenges that needs reform by the next administration. One recurring problem faced by Indonesia is the institutional aspect. This is

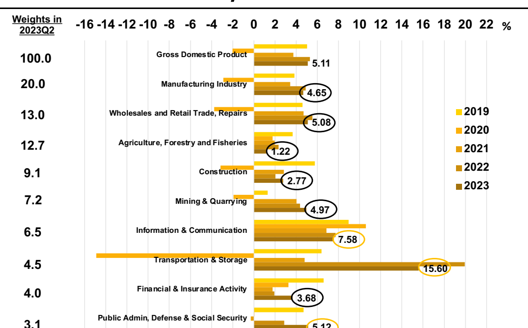
arguably quite fundamental as the quality of institutions could have an extensive impact on the quality of economy, development, and society as a whole. For instance, a relatively mediocre capacity of institution has resulted in a relatively unfriendly business and investment climate. The issue of increasing FDI to support economic growth has been consistently and stubbornly met by regulatory and institutional problems. Though there has been some improvement in the past few years, Indonesia's business and investment environment is still rather unattractive. Indonesia's score for FDI Restrictiveness Index is 0.35 (the score is between 0 for open and 1 for closed); making Indonesia as the second-highest most restricted FDI environment compared to other developing countries, only behind Philippines. World Governance Indicators (2020) suggest that Indonesia has a relatively mediocre score for 'Control of Corruption Index' and 'Rule of Law Index', which cover extensive indicators that matters for the business and investment decision by foreign entities to engage in partnership with Indonesia. On these measurements, Indonesia is behind of the Middle East and North African average, Upper-Middle Income Countries average, and Latin America and Caribbean Countries average. Quality of institutions matters greatly in supporting the growth and establishing stability and confidence in society. If done properly, improvement in institutional capacity could have a positive wide, trickle-down effect to many aspects of the economy, such as investment.

Global Headwind and Domestic Tailwind

Grew by 5.17% (y.o.y) in Q2-2023, Indonesia's GDP is currently on its upward trajectory. Thanks to the seasonal factor of Ramadan and Eid Al-Fitr events and series of national holiday throughout Q2-2023, robust household consumption played a role in the expansion of economic activity. The indication of strong consumption in the expenditure component is confirmed by the sectoral growth figure. Wholesale and retail trade, and transporation and storage sectors grew substantially in the second quarter of 2023. Beside private consumption, growth of construction sector also contributed to prolong the momentum of accelerated growth as it reached its highest growth rate in more than three years. The notable performance of construction activity stems from the push by GoI to accelerate the completion of various infrastructure projects as the current administration nears its term.

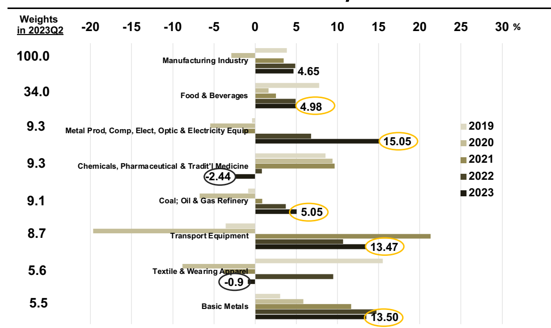
"The notable performance of construction activity stems from the push by GoI to accelerate the completion of various infrastructure projects as the current administration nears its term."

Figure 1: Growth of GDP and the Main Industries, 2019-2023Q2



Source: CEIC

Figure 2: Growth of Manufacturing Sector and Its Subsectors, 2019-2023Q2



Source: CEIC

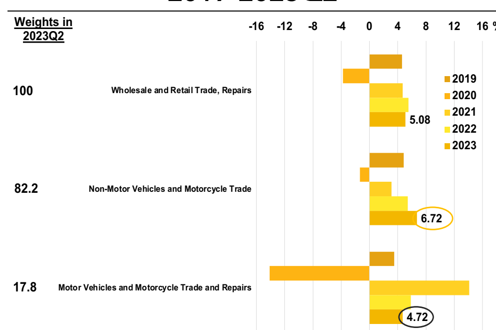
Manufacturing industry as a whole has accelerated again in Q2-2023 to 4.88% (y.o.y) from 4.43% (y.o.y) in the previous quarter. Main drivers of manufacturing growth

acceleration are attributed to coal, oil and gas refinery subsector and metal and electronic products subsesctor as both subsectors recorded massive jump in the second quarter of this year. Coal, oil, and gas refinery growth spiked to 8.16% (y.o.y) in Q2-2023 from 1.94% (y.o.y) in the previous quarter, thanks to numerous newly operated oil and gas refinery plants. Similarly, metal and electronic products grew by 17.32% (y.o.y) compared to 12.78% (y.o.y) during the same period. This came as a notable achievement as metal and electronic products reached an unprecedented level of growth in at least the last 15 years. The remarkable performance of this subsector is mainly supported by the increase in global price for these products as export for machinery and electronic equipments jumped by 14.82% (y.o.y), despite the exported volume dropped by 8.03% (y.o.y). On the other hand, food and beverages manufacturing experienced a stunted growth in Q2-2023 to 4.62% (y.o.y) from 5.33% (y.o.y) in Q1-2023. The global price factor for CPO products also play a significant role in growth moderation of food and beverages manufacturing subsector. While the export volume of animal and vegetable oil products increase substantially by 56.44% (y.o.y), the export value actually decreased by by 11.22% (y.o.y) in Q2-2023. Being the biggest subsector within manufacturing industry, the growth decline of food and beverages manufacturing moderated the massive expansion of coal, oil and gas refinery subsector and metal and electronic products manufacturing on the overall manufacturing industry growth figure.

"Although still growing faster than the overall sector, the slowdown in motor vehicle trade is mainly caused by the moderation of pent-up demand for automotive after Covid-19."

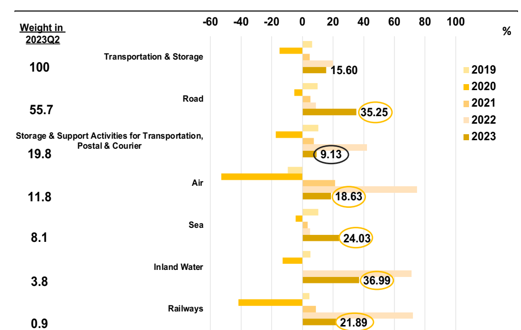
Persistent sub-5% manufacturing growth and high reliance on global commodity price volatility provides a prolonged signal that Indonesia is an ongoing struggle to reindustralize its economy. These phenomena also shows how Indonesia missed the opportunity of courting global manufacturers that has relocated from China and advanced economies due to rising production costs. Indonesia also missed the opportunity of ultra-low interest rate era to bolster investment to increase manufacturing value-added. However, there might be a glimmer of hope as Indonesia has recently done various effort to boost value-added creation, especially in the critical mineral sector. To ensure these efforts will eventually bear frutition, consistency and commitment towards reindustrialization is of utmost importance as the results of these efforts are yet to be seen.

Figure 3: Growth of Wholesale and Retail Trade and Its Subsectors, 2019-2023Q2



Source: CEIC

Figure 4: Growth of Transport and Its Major Subsectors, 2019-2023Q2



Source: CEIC

The rise in consumer confidence is reflected well in the trade sector performance. With the monthly average reaching 127.2, Consumer Confidence Index in Q2-2023 was recorded at its highest since the second quarter of 2019. This is translated into growth increase of wholesale and retail trade sector to 5.25% (y.o.y) in Q2-2023 from 4.92% (y.o.y) in the previous quarter. Consumer goods enjoyed considerable increase in sales, as suggessted by the rise in non-motor vehicle trade from 4.47% (y.o.y) in Q1-2023 to 4.97% (y.o.y) in Q2-2023, stimulated by seasonal event of Ramadan and Eid Al-Fitr. Despite painting an encouraging picture of sectoral accelerating growth, subsector of motor vehicle trade experienced a growth decline. Motor vehicle trade, with only 17.8% of contribution in trade sector, grew less to 6.56% (y.o.y) in Q2-2023 from 6.88% (y.o.y) in Q1-2023. Although still growing faster than the overall sector, the slowdown in motor vehicle trade is mainly caused by the moderation of pent-up demand for automotive after Covid-19. This claimed is supported by the motor vehicle sales that records a drop in quarterly figure of around 20% in Q2-2023, making it the worst quarterly sales decline since the beginning of the pandemic.

"The impact of election cycle could also boost private consumption, general trade and spending for communication, media, and advertising purposes."

Besides the Ramadan and Eid Al-Fitr events that has benefitted the trade sector, Q2-2023 was also blessed by the occurrence of various national holidays; allowing society to take up vacation and other leisure activities. Thus, transportation and storage sector still enjoyed rapid growth rate of 15.28% (y.o.y) in Q2-2023, albeit slightly decelerated from 15.93% (y.o.y) in the previous quarter. Road transport remains the main driver of transportation sector growth, with the contribution of more than half to the overall sector and recorded a first double-digit growth in the last two years. Grew by 10.41% (y.o.y) in Q2-2023 from 7.86% (y.o.y) in the previous quarter, road transport performance capture the increased mobility and physical economic activity in response to several holidays period. Long-distance transportation activities to holiday destinations is also partially reflected in the massive growth rate of air transport. Despite decelerating, air transport activity still grew substantially by 32.88% (y.o.y) in Q2-2023. Similarly, sea transport and storage activities recorded a notable growth rate despite decreasing from previous quarter. In Q2-2023, sea transport grew by 18.26% (y.o.y) (vs 19.00% (y.o.y) in Q1-2023) and storage activity by 32.88% (y.o.y) (vs. 41.10% (y.o.y) in Q1-2023). Rapid growth rate of these subsectors reflects robust wholesale and retail trade activities due to high demand for storage and cargo shipment, unsurprisingly coincided with the growth figure of trade sector and other consumer activity indexes.

Second half of 2023 and 2024 is expected to be rather eventful, both domestically and globally. From domestic front, the general election is a couple months away. This could have repercussion on the sectoral dynamics as the election could boost the growth of public administration sector due to the increase in social spending (as it is often the case in the previous election cycle) and the effort by current administration to accelerate the completion of various infrastrucutre and strategic national projects. Even in Q2-2023, public administration sector already grew rapidly by 8.15 (y.o.y), compared to only 2.09% (y.o.y) in Q1-2023. Similarly, construction sector grew rather substantially to 5.23 (y.o.y) from 0.32% (y.o.y) during the same period. The impact of election cycle could also boost private consumption, general

trade and spending for communication, media, and advertising purposes. From external front, weakening global demand, 'higher-for-longer' monetary stance by major central banks pushed capital outflows from emerging markets including Indonesia; resulting massive pressure and rapid depreciation of Rupiah. This could dampen the growth of manufacturing sector for the rest of 2023 as Indonesia's exports are quite dependent on global commodity prices while imports profile is dominated by raw material and capital goods. High imported inflation could result in rising domestic production costs and could hurt manufacturing sector performance. To ensure the minimum impact on domestic sectoral performance, managing stability of consumer confidence, price level and exchange rate is of utmost importance.

Remarkable Growth Continues

In the second quarter of 2023, Indonesia witnessed an impressive growth of 5.17% (y.o.y), accelerating from 5.03% (y.o.y) in the first quarter of 2023 and resuming its accelerating growth since the last quarter of 2022. Although not as impressive as 5.46% (y.o.y) growth in the same quarter a year earlier, it can be seen that the current growth rates reflects a normal growth rates of around 5% as low base effects subside. While all expenditure components, except exports and imports, posted a positive growth, household and government consumption as well as investment drove the economy toward another higher-than-expected growth in Q2-2023. Growth in government spending jumped sharply from 3.45% (y.o.y) in Q1-2023 to 10.62% (y.o.y) in Q2-2023. One of the source of this significant growth is the disbursement of the 13th month salary for civil servants. As of 30 June 2023, government revenue was recorded at IDR1,407.9 trilllion or 57.2% of its 2023 target, almost 10% annual increase from the same period last year. Meanwhile, government expenditure was realised at IDR 1,254.7 trillion, contributed to 41.7% of 2023 expenditure target. On the back of high amount of tax revenue collected, budget surplus was reported at IDR152.3 trillion or 0.71% of GDP in the first semester of 2023.

"Growth in government spending jumped sharply to 10.62% (y.o.y) in Q2-2023 due to the disbursement of the 13th month salary for civil servants."

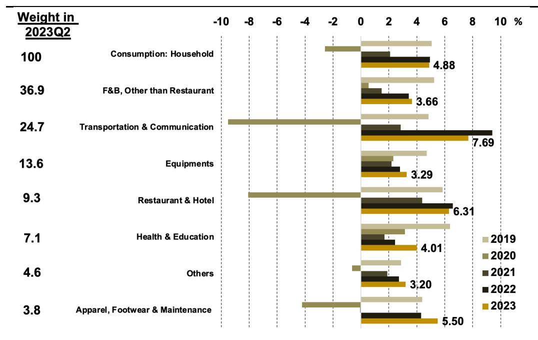
Household consumption, the main driver of Indonesian economic growth, experienced a solid growth of 5.23% (y.o.y) in the second quarter of 2023. Ramadan festivities coupled with Eid Al Fitr and Eid Al Adha celebrations as well as school holiday season contributed to the surge in household consumption in Q2-2023, assisted by the issuance of religious holiday allowance (*tunjangan hari raya* (THR)), the 13th month salary for civil servants, which increased the purchasing power of citizens. This is apparent in growth in transport and communication, which accounts for 24.7% of total household consumption, at 7.53% (y.o.y) in Q2-2023. The second and third highest growth happened in apparel, footwear, and maintenance (7.02%, y.o.y) and restaurant and hotel (6.76%, y.o.y), respectively. These two spending groups made up 13.2% of total household consumption. Consumption for food and beverage, which contributed to 36.9% of total household consumption, grew by 3.84% (y.o.y) in April to June quarter of 2023.

Investment grew by 4.63% (y.o.y) in the second quarter of 2023, higher than previous quarter growth of 2.11% (y.o.y). Accelerating growth may be attributable to

expedited infrastructure investment as President Joko Widodo will end his term in 2024. Investment in buildings and structures, which account for 72.8% of total investment, rose by 3.32% (y.o.y) in Q2-2023 compared to 0.08% (y.o.y) in the first three months of 2023. In addition, investment in machine and equipment that contributed to 12.5% of total investment grew by 7.64% (y.o.y) in the second quarter of 2023 compared to 4.62% (y.o.y) growth in Q1-2023.

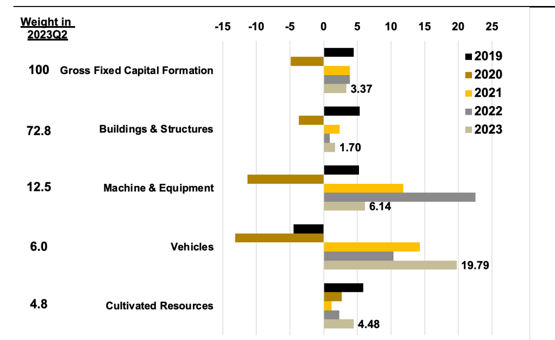
"The higher interest rates era causes businesses to take the wait and see approach before deciding to invest."

Figure 5: Growth of Household Consumption and its Components, 2019-2023Q2



Source: CEIC

Figure 6: Growth rate of Investment and Its Main Components, 2019-2023Q2



Source: CEIC

In terms of the performance of banking credit, the total credit expanded by 8.40% (y.o.y) during the second quarter of 2023. This growth rate is notably lower when compared to the 10.36% (y.o.y) rate witnessed in the first quarter of 2023, marking the most sluggish pace of growth since Q2-2022. This deceleration was partially mitigated by positive developments experienced in May 2023, particularly propelled by sectors, such as industry and social services. During the same period, consumption credit demonstrated a growth rate of 9.11% (y.o.y), marginally below the 9.41% (y.o.y) recorded in the preceding quarter. Meanwhile, the working capital and investment credit categories continued to experience contractions, declining from rates of 9.79% (y.o.y) and 12.33% (y.o.y) in the first quarter of 2023 to 6.63% (y.o.y) and 10.79% (y.o.y) in the second quarter of 2023, respectively.

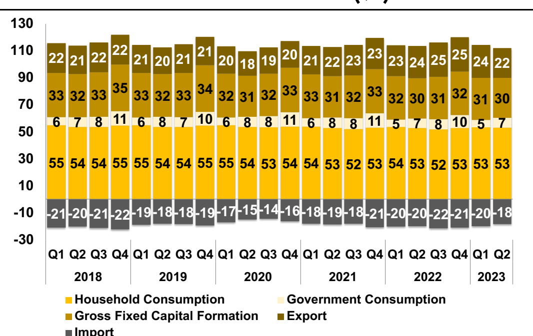
The slowdown in banking credit is attributed to reduced demand for credit from businesses and corporations, which have shown a tendency to expedite loan repayments in anticipation of the forthcoming general election. In addition, the higher interest rates era causes businesses to take the wait and see approach before deciding to invest. Moreover, the state budget surplus of Rp 152.2 T in H1-2023, a departure from its deficit design, indicates a cautious approach to government spending, thus affecting credit growth.

For the rest of 2023, credit growth is expected to grow marginally higher. The most recent data in September 2023 showed that total credit grew by 8.96% (y.o.y), slower than 9.06% (y.o.y) growth seen in August 2023 but higher than 8.54% read in July 2023. Such growth was propelled by growth in investment credit (11.19%, y.o.y).

Based on the latest data published by OJK, the Non-Performing Loan (NPL) ratio declined from 2.50% in August to 2.43% in September. Third-party funds (DPK)

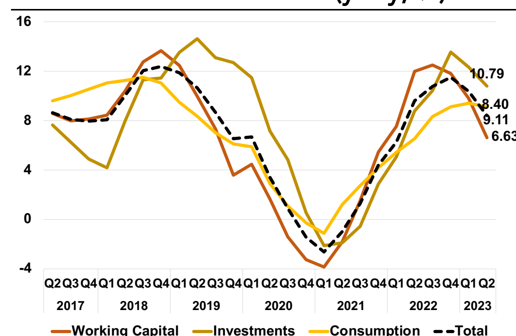
experienced an annual growth of 6.54% in September, marking an improvement by 30 percentage points relative to the August figures. Furthermore, the Loan-to-Deposit Ratio (LDR) increased to 83.92% in September, up from 83.38% in August. It is noteworthy that the LDR has been on an upward trajectory since December 2022 (78.78%). This increase, alongside a more pronounced credit demand relative to supply, suggests a tightening liquidity.

Figure 7: Shares of GDP Components, 2018Q1-2023Q2 (%)



Source: CEIC

Figure 8: Credit Growth by Purposes, 2017Q2-2023Q2 (y.o.y, %)



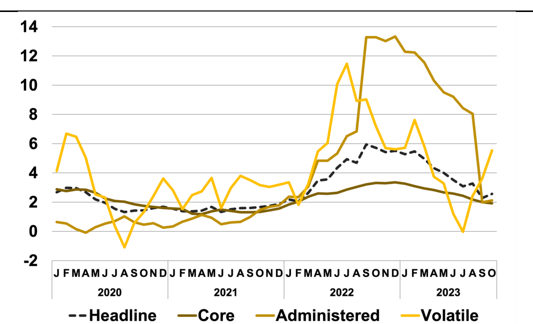
Source: CEIC

"In October 2023, the headline inflation rate rose again after experiencing a sharp decline in September 2023. The inflation rate in October 2023 stood at 2.56% (y.o.y), up from 2.28% (y.o.y) in the previous month."

Inflation Remains Manageable despite El Nino Shock

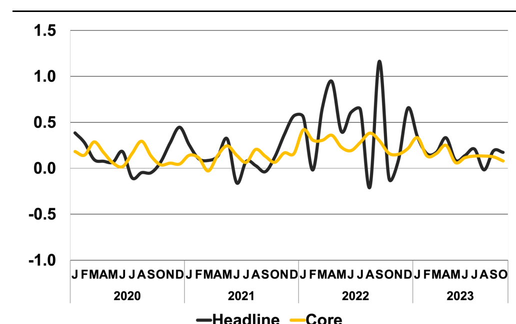
In October 2023, the headline inflation rate rose again after experiencing a sharp decline in September 2023. The inflation rate in October 2023 stood at 2.56% (y.o.y), up from 2.28% (y.o.y) in the previous month. The increase in the inflation rate is still within BI's target range, which is 3.0±1%. This increase, when viewed from its constituent components, was mainly due to an increase in the price of volatile goods, as reflected in volatile inflation which rose by 5.54% (y.o.y), higher than the previous month of 3.62% (y.o.y). Of this figure, foodstuffs were the main contributor to the increase in the volatile goods inflation rate. The food inflation rate rose from 3.59% (y.o.y) in September 2023 to 5.33% (y.o.y). Meanwhile, the trend of low inflation from energy commodities due to the high base effect in the previous year continued. The inflation rate of energy commodities only rose slightly to 0.11% (y.o.y) compared to 0.10% (y.o.y) in the previous month.

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



Source: CEIC

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



Source: CEIC

Inflation of administered price was also observed to have slightly increased from 1.99% (y.o.y) in September 2023 to 2.12% (y.o.y) in October 2023 due to adjustment in various non-subsidized fuel prices. This increase finally occurred after the previous inflation rate experienced a downward trend since January 2023. Meanwhile, core inflation in October 2023 fell again by 1.91% (y.o.y) and continued the downward trend of core inflation for 10 consecutive months. This might indicates a moderating domestic demand.

On a monthly basis, inflation occurred in various expenditure groups, except in the clothing and footwear (-0.04% (m.t.m)) and information, communication, and financial services (-0.02% (m.t.m)) sectors. Inflation this month was dominated by the transportation expenditure group, which reached 0.55% (m.t.m) with a contribution of 0.07%. This inflation was mainly influenced by the increase in gasoline prices by 0.04% and airfares by 0.02% (m.t.m). This increase was allegedly due to the increase in the price of non-subsidized fuel by Pertamina since the beginning of October, as well as an increase in the price of avtur caused by the strengthening of the dollar and the Israeli-Palestinian conflict. The impact of the prolonged drought caused by El Nino, which has resulted in a decline in domestic agricultural production and induced 22 countries to halt rice exports, also began to show in inflation in the food, beverages and tobacco expenditure group at 0.20% (m.t.m) with a share of 0.05%, which became the second largest contributor to monthly inflation.

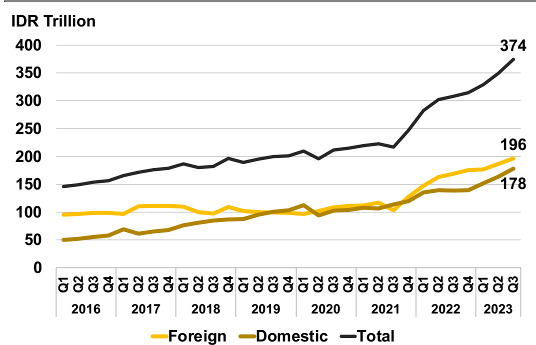
Investment Realization Benefitted by the Fruition of Downstreaming Policy

The Investment Coordinating Board (BKPM) recorded an investment realization of IDR374.4 trillion in Q3-2023, an increase of 7.0% compared to the previous period and 21.6% compared to the same period in 2022. Cumulatively, investment realization data during the January – September 2023 period reached IDR1,053.1 trillion or an increase of 18.0% compared to the same period in 2022. This value has reached 75.2% of the 2023 target of IDR1,400 trillion. Around 47.6% or IDR178.1 trillion of the total investment realization was from domestic investment (DDI) category. Then the remaining 52.4% or IDR196.2 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 16.2% compared to the same period in the previous year.

"The Investment Coordinating Board (BKPM) recorded an investment realization of IDR374.4 trillion in Q3-2023, 75.2% of the 2023 investment realization target of IDR 1,400 trillion."

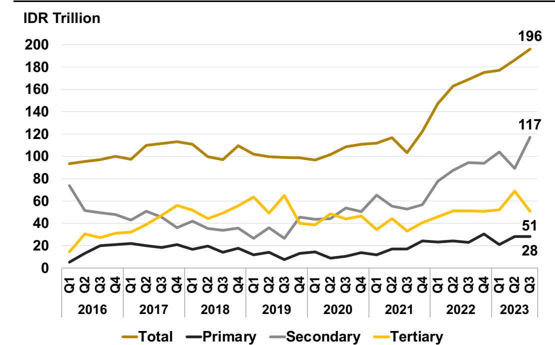
Investment realization outside Java reached IDR190.9 trillion or 51.0% of the total realization in Q3-2023. Meanwhile, realization in Java was recorded at IDR 183.5 trillion or 49.0% of the total realization. The top three investment locations in Q3-2023 include DKI Jakarta (IDR50.9 trillion), West Java (IDR49.5 trillion), and East Java (IDR38.9 trillion). The top five main investor countries include Singapore (USD4.4 billion), China (USD1.8 billion), Hong Kong (USD1.7 billion), Japan (USD1.3 billion) and the Malaysia (USD0.9 billion).

Figure 11: FDI and Domestic Investment (Nominal)



Source: CEIC

Figure 12: FDI Realization by Sectors (Nominal)



Source: CEIC

"According to the sector, the basic metal, metal goods, non-machinery and equipment industries is the largest contributor to investment realization in Q3-2023"

According to the sector, the basic metal, metal goods, non-machinery and equipment industries is the largest contributor to investment realization in Q3-2023, with an investment value of IDR56.9 trillion. Then mining which amounted to IDR41.9 trillion; transportation, warehouses and telecommunications IDR40.9 trillion; mining IDR37.9 trillion; and chemical and pharmaceutical industries with IDR28.7 trillion. Overall, the manufacturing industry is the main contributor of the total investment realization in Q3-2023. Between 2022 and the third quarter of 2023, the manufacturing industry sector consistently ranked at the top as one of the largest contributing sector for investment in Indonesia. This positive contribution comes from, among other things, Indonesia's downstreaming policy. The investment realization value for downstreaming for the January - September 2023 period is IDR266.0 trillion, covering five sectors. The five sectors are the downstream mineral sector worth IDR151.7 trillion consisting of nickel amounting to IDR97.0 trillion, bauxite amounting to IDR7.1 trillion, and copper amounting to IDR47.6 trillion; downstream agricultural sector originating from the palm oil and oleochemical industries with a value of IDR39.5 trillion; downstream forestry sector originating from the pulp and paper industry worth IDR34.8 trillion; downstream oil and gas sector originating from the petrochemical industry worth IDR31.6 trillion; and the downstreaming of the electric vehicle ecosystem which comes from the electric vehicle battery manufacturing industry worth IDR8.4 trillion.

Heightened External Pressures

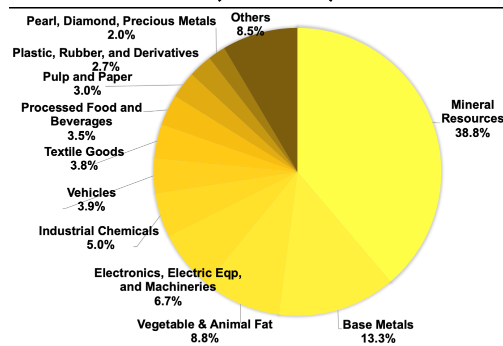
Amidst the trend of moderating commodity prices and the global economic slowdown, Indonesia's external sector performance remained strong in the third quarter of this year. Indonesia's trade balance continues to record a surplus for 41 consecutive months. In Q3-2023, the trade surplus reached USD3.42 billion, decreased from USD7.8 billion in Q2-2023. The overall trade surplus from January to September 2023 was recorded at USD27.8 billion, lower than the surplus of USD39.8 billion in the same period the previous year. This decline was influenced by the downward trend in global commodity prices, particularly coal, nickel, and palm oil. This decline is in line with a World Bank report, which estimates that global

commodity prices will moderate by -21.2% in 2023 compared to 2022 due to the risk of global economic slowdown.

The continuation of price normalization after skyrocketing in 2022 has played a key influence in the decreased Indonesia's export value in 2023. In Q3-2023, the exports were only USD63.6 billion, a 18.6% (y.o.y) decline compared to the same period in 2022. The slowdown in non-oil and gas exports of 19.2% (y.o.y) due to the decline in palm oil demand from India as a result of increased CPO stocks and decline in coal prices compared to last year's high base price, was one of the biggest contributors to the overall decline in exports in the Q3-2023.

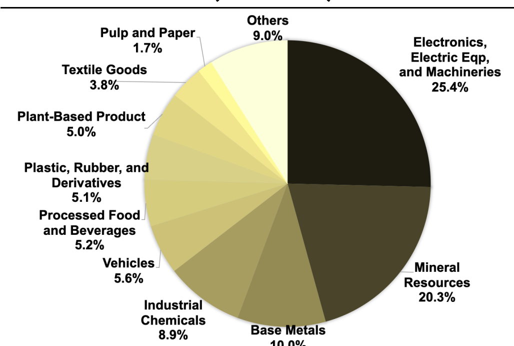
"...current account deficit was also attributable with the wider trade deficit in services, since revenge tourism activities have been engaged following the lifting of community activity restrictions. The current account balance is expected to remain in negative territory in the remainder quarters of this year.:

Figure 13: Indonesia Export Profile (Q2 2023)



Source: CEIC

Figure 14: Indonesia Import Profile (Q2 2023)

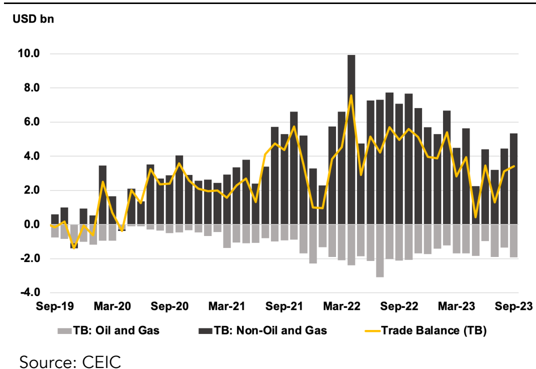


Source: CEIC

Even though export performance weakened, trade remained in surplus territory as the imports also declined in Q3-2022. Indonesia's overall import value decreased by 11.9% (y.o.y) compared to the same period in 2022. Breaking it down, imports in the oil and gas sector declined by 21.2% (y.o.y), while non-oil and gas imports decreased by 9.8% (y.o.y) in Q3-2023 compared to the same quarter in the previous year. The reduction in oil and gas imports can be attributed to lower global oil prices, while the drop in non-oil and gas imports can be explained by the weaker export outlook due to the risks of global economic slowdown. The signs of weaker economic performance have slashed Indonesia's demand for raw materials and auxiliary materials imported from abroad this year. This was particularly influenced by the gloomy outlook for China's economy, one of Indonesia's major trading partners.

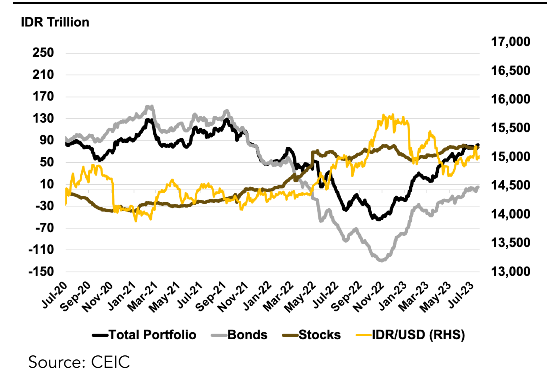
Despite the continuing of trade surpluses, the amount of the surplus has gradually declined. This lower trade surplus from January to September 2023 has pushed the current account balance back into negative territory. In Q2-2022, the current account balance decreased to a deficit of USD1.9 billion, which is equal to 0.5% of GDP, after achieving a current account surplus of USD3.0 billion or 0.9% of GDP in the previous quarter. In addition to the reduced trade surplus in goods, the current account deficit was also attributable with the wider trade deficit in services. This is due to an increase in revenge tourism activities following the lifting of all community activity restrictions at the beginning of this year and the momentum of the long holiday season in the second quarter. The current account balance is expected to remain in negative territory for the remaining quarters of this year.

Figure 15: Monthly Trade Balance (Nominal)



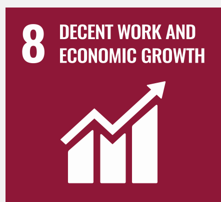
Source: CEIC

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



Source: CEIC

"…rising uncertainty in global financial market, as a result of various circumstances, has put pressure on investors in developing countries, including Indonesia."



On the financial and capital flow front, rising uncertainty in global financial market, as a result of various circumstances, has put pressure on investors in developing countries, including Indonesia. The unfavourable event in Q3-2023 was caused by, first, market expectations that the Fed will remain "higher for longer" with many predicting that policy rate will not be reduced until the second half of the following year or later. Moreover, the resumption of geopolitical tensions in Middle East has triggered investors to shift away from riskier to safer assets. China's unimpressive economic data has also weakened investor confidence towards developing countries' assets, particularly in country with substantial exposure to China. In the case of Indonesia, the event of presidential election in early next year had also heightened the market uncertainty in the second half of this year as investors has become more cautious over any political risks. These factors have caused massive capital outflow amounting to USD4.44 billion from the beginning of August 2023 to mid-October 2023. The outflow has put Rupiah under pressure, causing it to depreciate to around IDR15,800 as of October 19,2023. However, the relatively manageable current account deficit, thanks to persistent surplus in trade balance, has cushioned the impact of ongoing market uncertainty on Rupiah depreciation. The Rupiah has still performed better than most other developing countries, ranking second only to the Brazilian Lira.

To combat external pressures, BI performed pro-stability measures, which was reflected in the deceleration of foreign exchange reserves to USD134.9 billion in September 2023, down from USD137.1 billion in August 2023. It was marked as the second largest drop in foreign exchange reserves this year. However, these reserves are adequate to finance six months of imports plus the government's foreign debt, which is significantly higher than the international adequacy threshold of only around three months of imports. The current foreign reserves position was still capable of supporting external sector resilience and maintaining macroeconomic and financial system stability. Furthermore, BI has surprisingly raised the policy rate by 25 bps to 6.00% in October 2023 to preserve the attractive yield spread between Indonesian government bonds and US Treasury in the face of growing global financial uncertainties. BI is likely to retain its pro-stability policies for the remainder of the year, while maintaining the already subdued inflation.