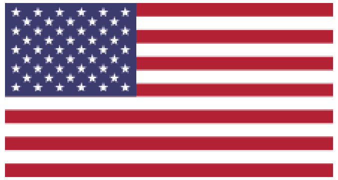
# Global economic risks and implications for Indonesia

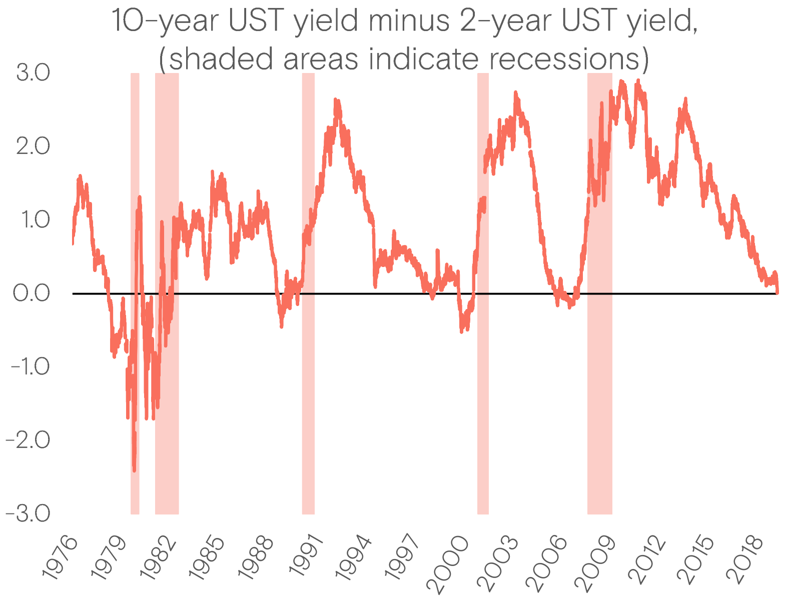
September, 2019


THE WORLD BANK
IBRD • IDA

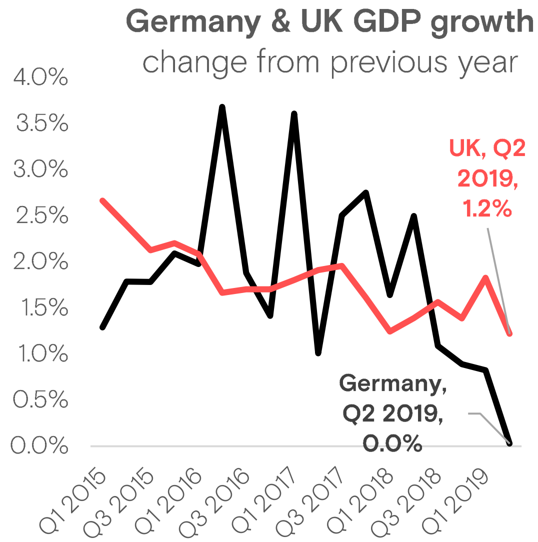
# Global economic growth is slowing down and a recession looks increasingly likely

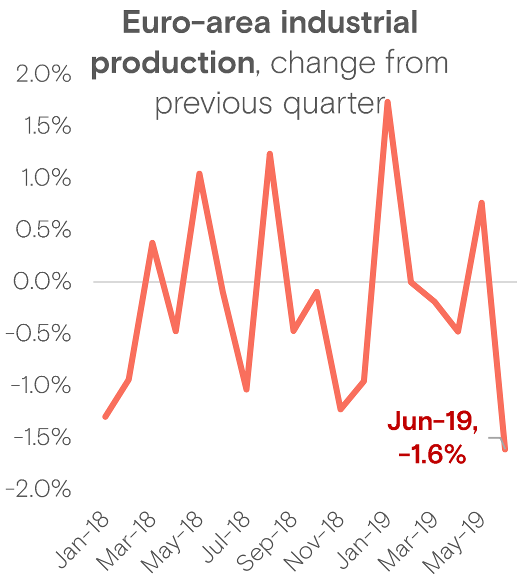


## US: Signs of recession in government bond markets




## Europe's economic engines are slowing




## Weakness in China

In July:

Fixed asset investment ↓

Retail sales ↓

Industrial production growth was the lowest in 17 years ↓

Sources: Federal Reserve of St. Louis; Federal Statistical Office of Germany; UK Statistics Authority; Eurostat; National Bureau of Statistics of China

# The China-US trade war and other geopolitical risks are intensifying

## China-US trade war could start a crisis

- **The trade war has escalated** with a fresh round of tariff hikes by China and the US, and President Trump ordering US companies out of China
- **Tariffs could increase further** as US trade law allows tariffs to go up to 50% - President Trump "regrets not raising tariffs on China higher"
- **The trade war is spreading beyond trade** - restrictions on tech-related investments (Huawei) could be broadened, and restrictions on Chinese access to the US financial sector are possible
- **Trade wars could become currency wars** – Yuan broke sensitive 7/USD1 level

## Flashpoints everywhere

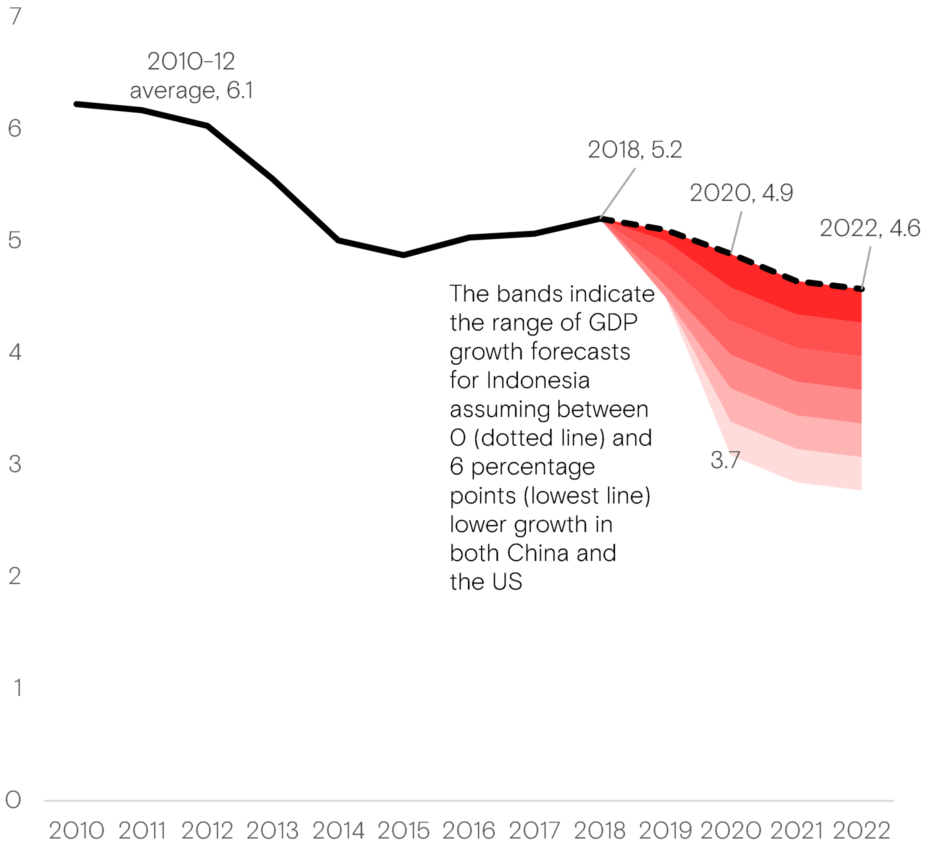
Brexit, 2020 elections in US, Japan-Korea trade tensions, Hong Kong protests, Iran sanctions and shadow war with Israel, Argentina debt restructuring, Kashmir crisis

# Growth in Indonesia has been slowing down and will weaken further with the global slowdown – a global recession would be damaging

GDP growth year-on-year, percent

Source: BPS via CEIC, World Bank Staff projections

Note: Solid line indicates actual GDP growth through 2018, Dotted line indicates WB forecasts for 2019, and projected potential output growth for 2020-2022




Indonesia's GDP growth will continue to decline because of weak productivity and slowing labor force growth

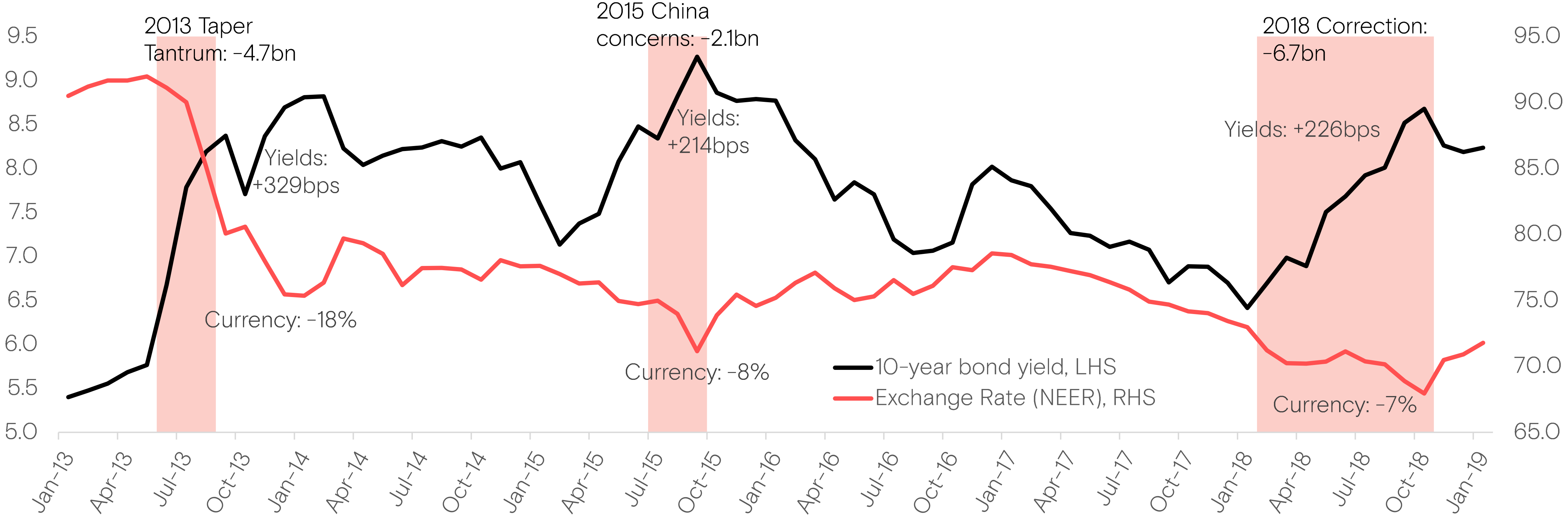
A global slowdown causes lower commodity prices, which will hurt Indonesia's GDP growth even more

- If growth goes down by 1.0 percentage point in China, Indonesia's growth will decline by 0.3 percentage point
- **In the global recession of 2009**, global growth declined by 6.2 pp from 2007, commodity prices plummeted, and **Indonesia's economy slowed by 1.7 pp**

Fiscal and monetary stimulus in Indonesia would be limited

# These risks could cause a negative economic shock with severe portfolio capital outflows

## Outflows could be larger than what Indonesia faced in the past 10 years – and lead to even higher interest rates and more Rupiah depreciation




Source: CEIC and World Bank staff calculations. Note: Shaded areas correspond to periods of sharp portfolio capital outflows.

# Indonesia will suffer because portfolio capital finances the current account deficit (CAD)

CAD: $33 billion per year

FDI: $22 billion per year
less Indonesian investment abroad: $5 billion per year

>> Need at least $16 billion per year in external financing inflows to close the gap under normal circumstances…

… much more if there are capital outflows

# The solution is **not** to reduce the CAD. The solution is to increase FDI.

**Lower CAD equals lower GDP growth**

Current Account Balance = Savings – Investment

To reduce the CAD, Indonesia needs a combination of higher savings or lower investment:

Higher savings means lower consumption today…

…and lower investment means lower growth today and tomorrow

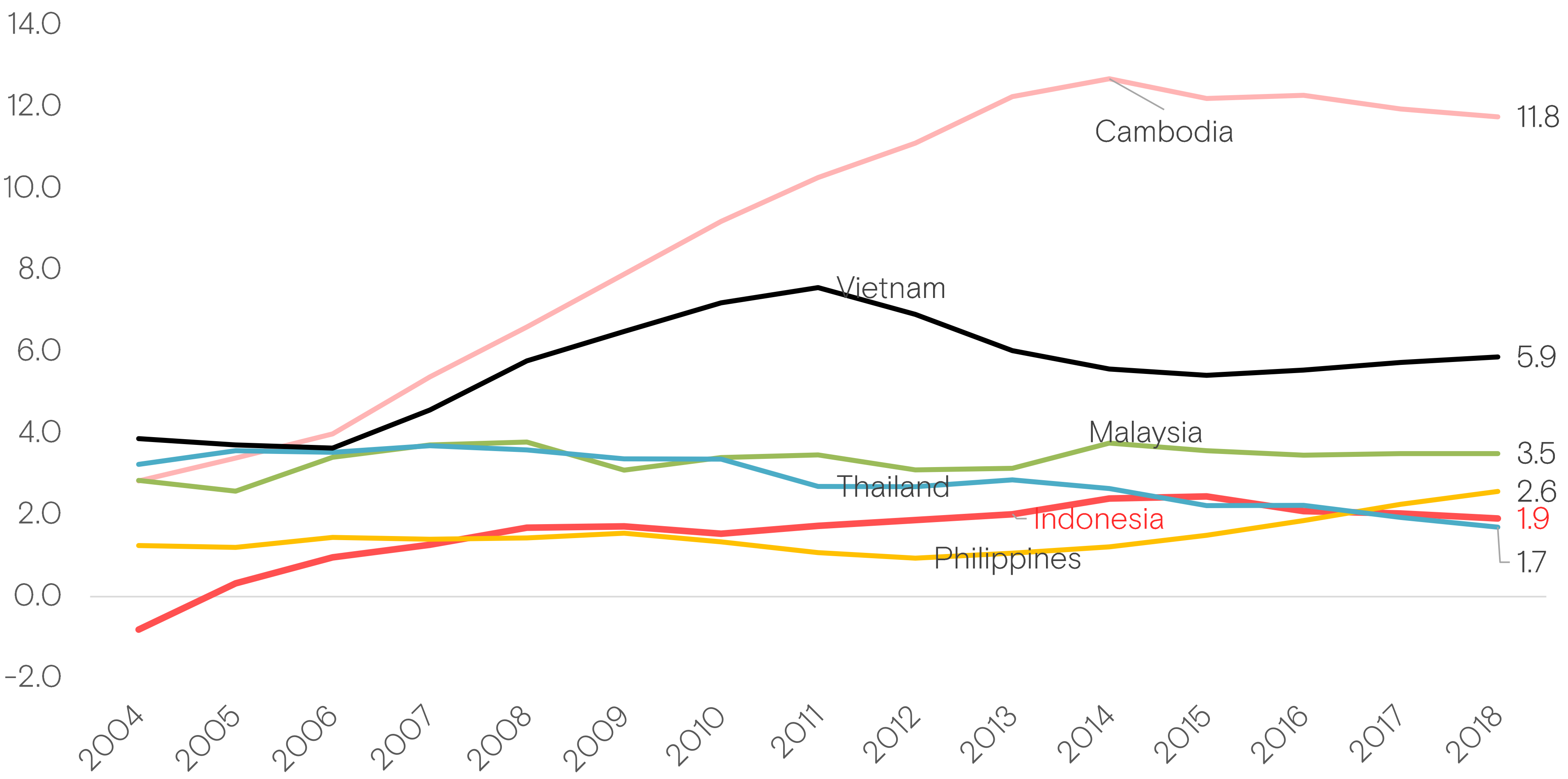
Importing capital to finance high investment growth is not a problem – **the problem** is that Indonesia finances the CAD with volatile capital from portfolio investors

**The solution is to finance the CAD with stable capital from export-oriented FDI investors who create good jobs and cannot easily take their investments out of the country**

# FDI is not coming to Indonesia

Foreign Direct Investment, net inflows (percent of GDP, 5-year moving average)

Source: World Development Indicators



# FDI is going to other countries

**Businesses are moving out of China but are not coming to Indonesia because Indonesia's neighbors are more welcoming**

- Moving factories from China to Indonesia is risky, complicated, and would take at least one year if not more…
- …while the process is certain and much shorter in Vietnam, Thailand, Malaysia, Singapore, Taiwan
  - Korean washing machine factories moved from China to Vietnam and Thailand in sixty days after the US imposed tariffs in 2016, and exports jumped soon after
- Between June and August 2019, 33 Chinese-listed companies have announced plans to set up or expand production abroad: 23 of them are going to Vietnam and the remaining 10 are going to Cambodia, India, Malaysia, Mexico, Serbia and Thailand
- In 2017, 73 Japanese firms moved operations from Japan, China and Singapore to Vietnam, 43 to Thailand, 11 to the Philippines and only 10 to Indonesia

# Other countries have implemented ambitious reforms

NIKKEI ASIAN REVIEW

Editor's Picks | Business | Asia300 | Politics | Economy | Opinion | Life & Arts

**ECONOMY** October 10, 2018

## Vietnam to remove 49% foreign ownership cap on listed companies

Banking and aviation limits also expected to be raised, but not above 50%

JakartaGlobe

Search...

HOME | JG.TV | NEWS | BUSINESS | INTERNATIONAL | SPORTS | LIFE & 

0

0

November 2, 2018

## Philippines Relaxes Investment Rules to Woo Foreign Capital

*Philippine President Rodrigo Duterte has signed an executive order further liberalizing investment rules to lure much needed foreign capital and help boost economic growth. (Reuters Photo/Lean Daval Jr.)*

**By : Karen Lema** | on 6:00 AM November 02, 2018
**Category : International, SE Asia**

**Manila.** Philippine President Rodrigo Duterte has signed an executive order further liberalizing investment rules to lure much needed foreign capital and help boost economic growth.

The order removed ownership restrictions and further opened certain sectors and activities to foreigners to get more investment flows into the country, in step with Duterte's promise to make the Philippines more competitive

**Piyush Goyal**
@PiyushGoyal

FDI Policy gets a major boost: Govt. reforms FDI norms in various sectors including single-brand retail, contract manufacturing and coal mining etc. It will boost exports, promote Make in India and create massive job opportunities. #IndiaMeansBusiness https://t.co/pypBPY7JBB https://t.co/bsBJAR3Z9Y

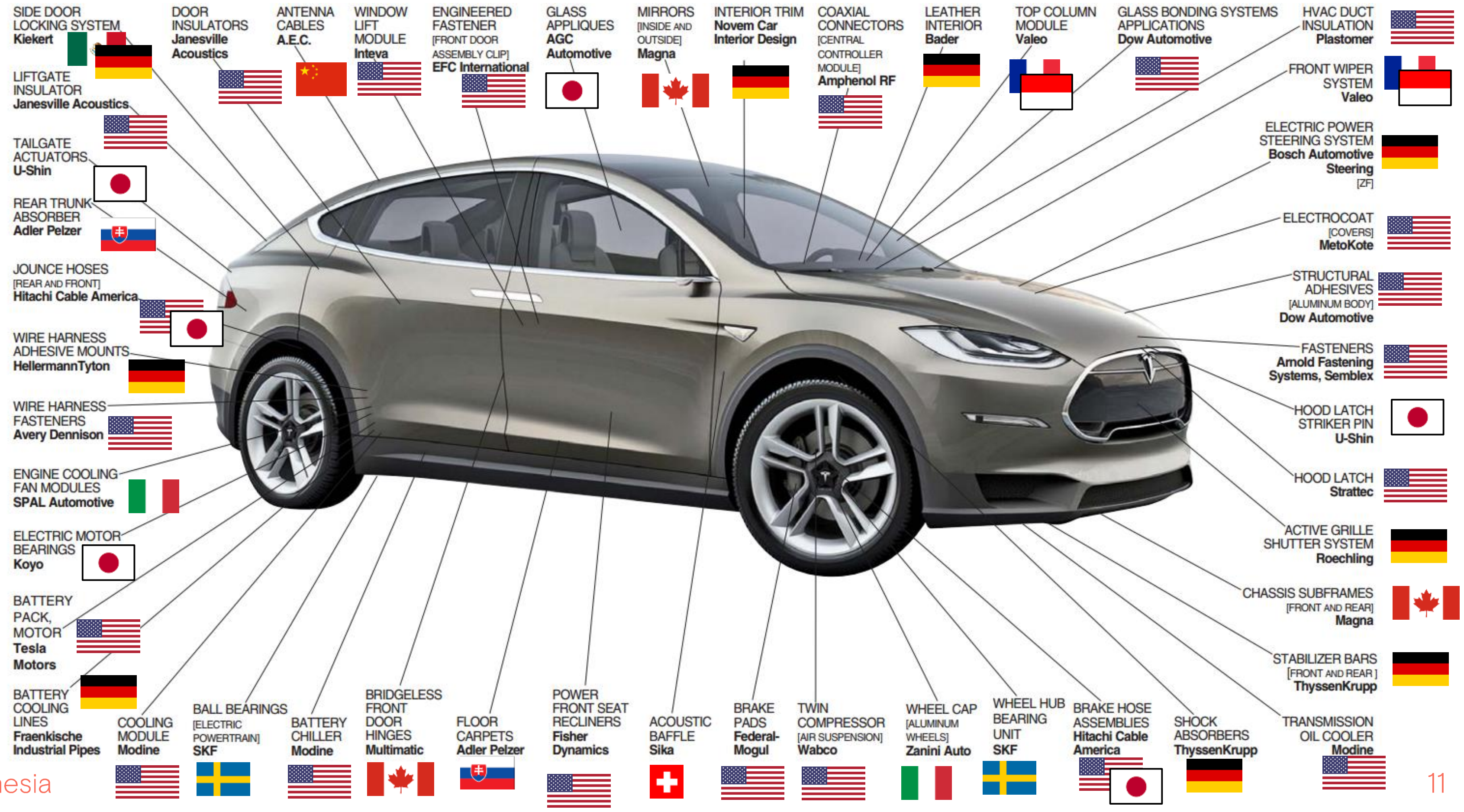
Twitter · 28/8/19 9:30 pm

**Does Indonesia also mean business?**

# For example, Indonesia cannot export electric cars because it is not part of global supply chains

Exporting cars requires being part of integrated supply chains across multiple countries

Indonesia is largely cut-off



# Indonesia is cut-off from global supply chains in manufacturing of exports because:

- Imports of inputs to produce exports are subject to costly, time-consuming, and discretionary "**Non-Tariff Measures**":
  - **pre-shipment inspections** (Laporan Surveyor) by 2 SOEs (Sucofindo and Surveyor Indonesia) at the port of departure (e.g. coil and bolts for brake systems, steel pistons and tires)
  - **import approval** and **recommendation letter** from Ministry of Industry, which uses discretion in deciding whether and how much can be imported (e.g. hot-rolled steel, tires and steel pistons)
  - third-party verification of compliance with the national standards (**SNI**) (e.g. car windows, insulated cables, tires)
- Exports are not competitive because the majority of inputs are subject to **import tariffs**: e.g. 15% for tires, 10% for cable igniters, petrol engines and gear boxes, 15% for coil and bolts
- Indonesia does not have enough Production **Engineers**, Process Engineers and Design Engineering Managers, Production Planning and Inventory Control and HR **managers**
- Restrictions to FDI (**DNI**) make **logistics costs** higher and **electricity** more expensive and less reliable than in neighboring countries

# Discretion in rule-making and enforcement is a very big problem for exporting – some examples

- Producers in Free Trade Zones such as Batam are exempted from import procedures for inputs to produce exports – in practice, that is often not the case
- Ministry of Industry's recommendation letter for imports is supposed to take a maximum of 5 days but it typically takes between 3-6 months or even longer
- Bridgestone stopped a production line because the Ministry of Industry and the Ministry of Trade could not decide whether imports of vulcanized tires require a recommendation letter
- Since 2016, the Ministry of Industry requires importers of steel tubing and casing (used in oil and mining explorations) to obtain a letter from each domestic producer stating they cannot supply these products with the required specifications

No amount of tax incentives and/or holidays can correct these problems and make Indonesia internationally competitive in the automotive, textile, electronics, pharmaceutical and other manufacturing industries.

# Instead...

# Indonesia must surprise investors with bold reforms that create

**Credibility** that Indonesia is really open for business

**Certainty** that rules are predictable and not discretionary

**Compliance** with President's policy

# Credibility: Indonesia is really open for business

Integrate into supply chains

- Eliminate letters of recommendation for importing industrial inputs
- Eliminate Pre-Shipment Inspections
- Convert SNI verification of key inputs with limited risks for health and safety into self-certification
- Eliminate import tariffs on key inputs for manufacturing

Not only invite investors but also welcome them

- Relax foreign equity limits in the negative investment list (DNI) for key sectors

Allow investors to hire the right skills to develop the business

- Reduce restrictions on work permits for highly skilled professionals



Details of proposed reforms

# Certainty: rules are predictable, not discretionary or inconsistent

Create certainty that policies will not be undermined or reversed by discretion of ministries…

- Vet all laws and regulations, assisted by a regulatory oversight team/body under the President's authority that must consider (1) the costs and benefits to businesses, citizens and government; (2) consistency with government policies; and (3) whether public consultations have been open and balanced
  - Start with laws and regulations related to investment and export, and—as capacities grow—expand to other regulatory domains
- Remove contradictions, inconsistencies and opportunities for discretion in key laws related to business registration and licensing

…or by subnational governments

- Create instruments to stop subnational governments from issuing regulations that contradict central government regulations

Details of proposed reforms

# Compliance: with President's policy/strategy

Previous efforts did not create credibility and certainty because of limited ambition, and lack of compliance

- Empower a team accountable to the President to identify arbitrary administrative decisions and lower level regulations that are contradicting Government Regulations and Laws affecting investors and there should be negative consequences for officials who undermine or deviate from the President's policy directions
- Reduce the ability of shadow powers to issue arbitrary administrative decisions and lower level regulations that contradict Government Regulations and Laws

# Thank You


THE WORLD BANK
IBRD • IDA

# Additional slides

# Global monetary policy is out of ammunition – USD 17 trillion in bonds is at negative interest rates

JYSKE BANK — SWITCH, CONTACT

HOUSING | Home loans | Rain on housing | Buying a home | Your mortgage

## More good news for homeowners: Mortgages below 0% at fixed interest rates

08/05/2019

Jyske Realkredit is ready with a fixed-rate mortgage with a nominal interest rate of minus 0.5%.


Yes, you read right. You can now get a fixed-rate mortgage with a maturity of up to 10 years, where the nominal interest rate is negative. However, you are not exactly going to make money borrowing. Namely, there must also be paid, among other things, establishment fees and contributions, and there will be a loss of prices.

"In practical terms, it will be experienced that the mortgage loan repayment will be greater than it would be with a positive interest rate. The negative interest rate will act as a 'subsidy' to the repayment. And the repayment portion will become smaller and smaller as the debt is reduced," explains Jyske Bank housing economist Mikkel Høegh.

*How is that possible?*

"Yes, I hardly understand it either. In fact, I said it can't be said. But we have figured out the extremes well, and it can be very possible to have a bond rate of minus," explains Jyske Bank's home economist.

It is about there is repayment on such a loan and when the interest rate is negative then the repayment on the loan will be increased. It is increasing the withdrawal of the bond rather than sending money to the investor.

## UBS to charge super-rich for cash deposits

**Move means savings of £1.7m would attract fee of £10,700 for clients in Switzerland**

▲ UBS holds £1.9tn on behalf of many of the world's richest people. The Swiss franc is a safe-haven currency. Photograph: Ruben Sprich/Reuters

Swiss banks are to start charging their super-rich clients to look after their piles of cash.

UBS, the world's largest wealth manager, told its ultra-wealthy clients on Tuesday that it would introduce an annual 0.6% charge on cash savings of more than €500,000 (£461,000). The fee, to be introduced in November, rises to 0.75% on savings of more than 2m Swiss francs (£1.7m).

The minimum fee is €3,000 a year. Savings of 2m francs would attract an annual charge of 15,000 francs.

**Bloomberg**

Markets

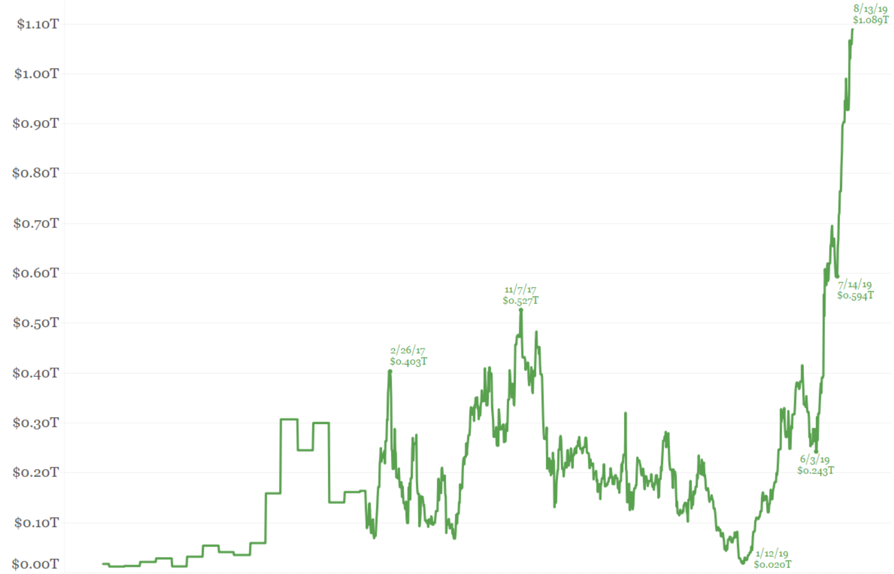
## Investors Are Paying to Lend to McDonald's, Not Just to Eat There

By Molly Smith
July 23, 2019, 11:43 PM GMT+7

- Sub-zero yields in euro market seen in bonds from U.S. issuers
- Pepsi, AT&T and IBM euro bonds also trade with negative yields

LIVE ON BLOOMBERG
Watch Live TV >
Listen to Live Radio >

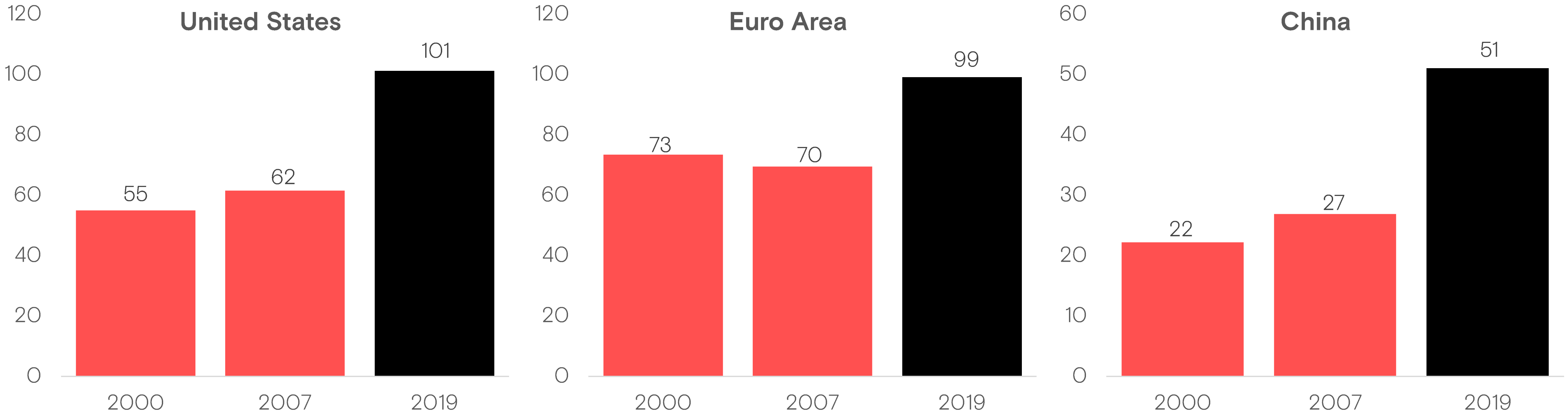
**Total Negative Yielding Corporate Bonds Outstanding**




Source: Bloomberg

# Global fiscal policy is also out of ammunition because of high debt in large economies and politics

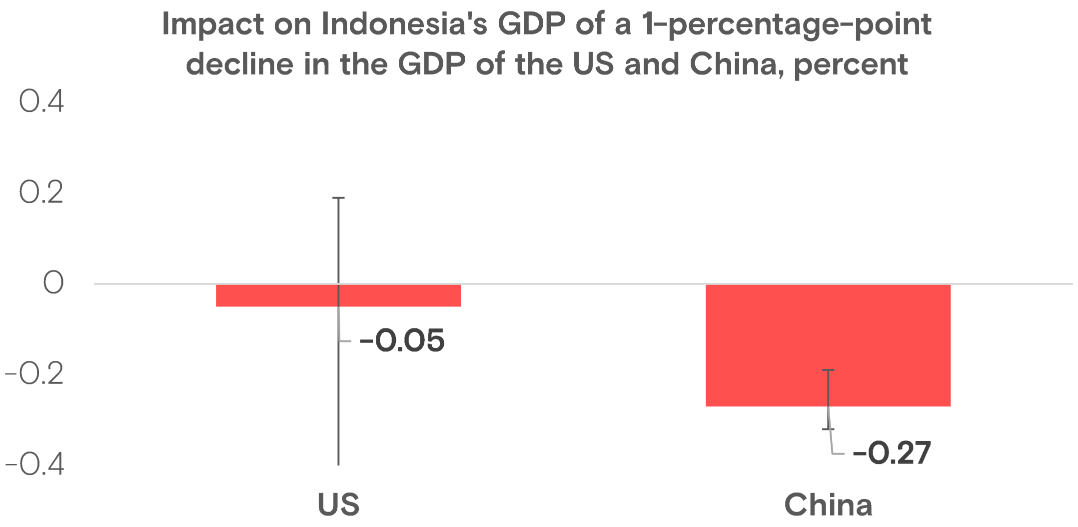
Government debt-to-GDP ratios, percent




Source: Institute for International Finance. Note: figures are for end-March of the respective year.

# Estimates of the impact of a global slowdown in Indonesia

- The impact of slower growth China and the US on Indonesia's GDP growth is likely to happen mainly through the price of commodities, which are likely to fall in a slowdown or recession – as they did in 2008/2009
- If growth in both the US and China goes down by 1.0 percentage point, Indonesia's GDP growth is estimated to decline by 0.3 percentage point




Source: Cashin, Mohaddes, and Raissi 2016; and IMF staff estimates.
Note: Lines represent the 16th and 84th percentile error bands.



Back to main slide

# Short-term stimulus policies may damage Indonesia's most important asset…

**A prudent macroeconomic policy framework has been Indonesia's source of credibility in the face of global shocks…**

- Without structural reforms and the resulting low levels of exports and FDI, the hard-earned (and expensive) credibility of macroeconomic management has been Indonesia's main asset in recent years
- The cost of managing capital outflows in 2018, although still high if compared to other countries with a stronger external position, was lower than in 2013 because of increasingly credible macroeconomic management

**… and aggressive monetary or fiscal stimulus could undermine credibility and raise future costs of managing capital flows**

# …and in any case can offer only limited help

## Monetary policy unlikely to work effectively to increase growth

- Because Indonesia's financial sector is small, lower policy interest rates do not boost domestic investment and consumption either sufficiently, or quickly enough
  - A relatively large share of investment is funded through retained earnings or foreign borrowings

## Little room for fiscal stimulus, with at best modest impact

- Proposed 2020 fiscal deficit (1.8 percent of GDP) offers no more than 1 percentage point (pp) of GDP in room for possible fiscal stimulus while remaining within the fiscal rule
  - Indonesia's fiscal multiplier is 0.2, which means the impact on GDP growth would be at most 0.2 pp
- Magnitude of possible fiscal stimulus likely constrained to much less than 1 pp of GDP because:
  - **Revenues are likely to disappoint (and the actual deficit to be higher) in the event of a shock** because of lower commodity prices and weaker economic activity; the current target of 9 percent revenue growth already ambitious (2019 MoF forecast: 5 percent)
  - **Additional Government borrowing may be constrained** by limited liquidity in domestic and external capital markets



Back to main slide

# The cost of managing capital flows has declined because of strong macro policies - but remains high compared to countries with a stronger external position

| | 2013 (Taper Tantrum) | | 2018 (Market Correction) | |
|---|---|---|---|---|
| | **Indonesia** | **Thailand** | **Indonesia** | **Thailand** |
| Current account plus FDI, percent of GDP, full year | -0.6 | +2.6 | -1.1 | +9.6 |
| Peak portfolio capital outflows (USD billion) | -4.7 | -4.8 | -6.7 | -4.7 |
| Change in bond yields (percentage points) | +3.3 | +0.8 | +2.3 | +0.4 |
| Fx change (NEER; percent; negative: depreciation) | -18.0 | -8.4 | -6.9 | -0.5 |

Source: CEIC, IIF and World Bank staff calculations.

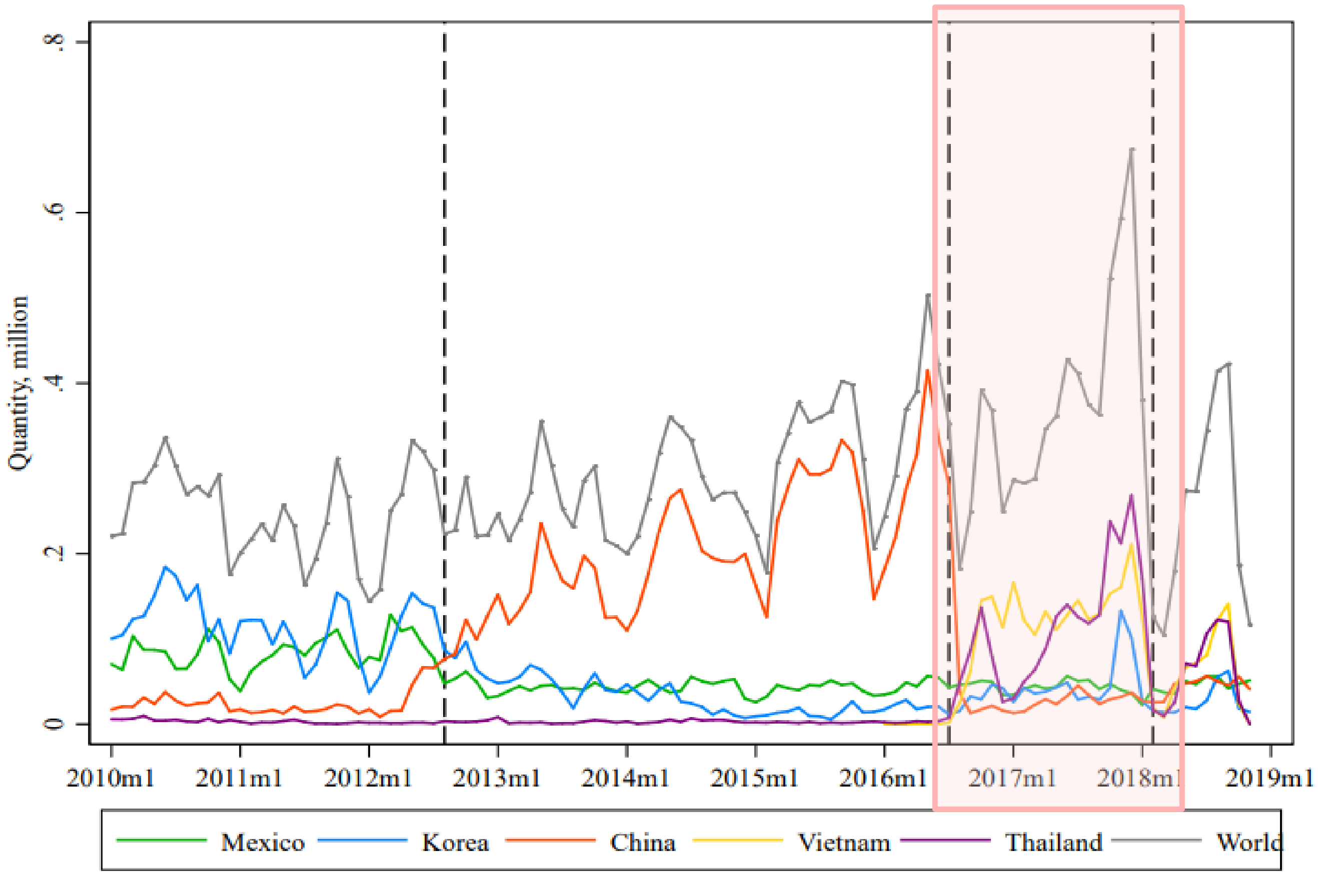


Back to main slide

# Vietnam and Thailand's washing machine exports jumped as production relocated because of trade wars

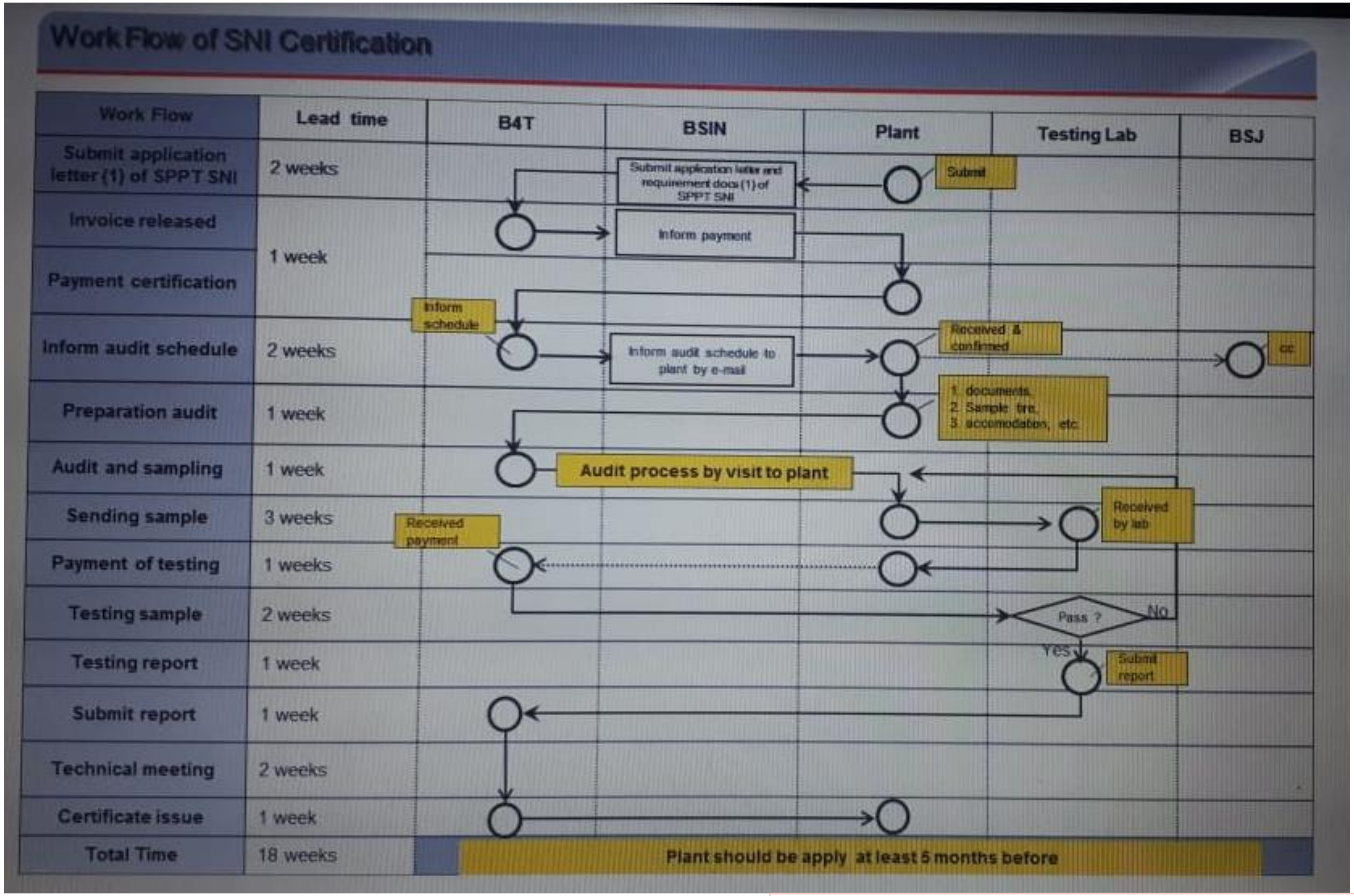
(a) Monthly U.S. Imports of Washing Machines by Country (Quantity)

Source: Faaen, Hortaçsu and Tintelnot (2019)




Back to main slide

# SNI certification is cumbersome, time-consuming and unpredictable






Back to main slide

# Details of proposed reforms

Back to main slide

| Reform objective | Intervention required |
|---|---|
| **1. Connect Indonesian firms to international markets** | |
| **Eliminate Pre-Shipment Inspections** | PerMen by Ministry of Trade |
| **Eliminate letter of recommendation on industrial inputs** | PerMen by Ministry of Trade and PerMen Ministry of Industry |
| **Convert SNI verification of key inputs into self-certification** | PerMen by Ministry of Trade and PerMen Ministry of Industry |
| **Eliminate import tariffs on key manufacturing inputs** | PMK (MoF) on import tariffs |
| **2. Relax restrictions on foreign investments** | PP on DNI raising foreign equity limits to 100% in key sectors without reducing limits in other sectors |
| **3. Improve the availability of critically scarce skills** | PerMen (MoManpower) to relax restrictions on foreign worker permits including simplification of Rencana Penggunaan Tenaga Kerja Asing and reduction of performance requirements for foreign workers |
| **4. Create certainty that policies will not be undermined or reversed by discretion of ministries or by subnational governments** | Amendment of Law or PP to establish regulatory oversight function under the President<br>PerPres on public consultation standards and Regulatory Impact Assessment requirements<br>Amendment of Laws related to business registration and licensing (e.g. Laws 3/1982; 25/2007) |

# Too many and contradictory rules create uncertainty for investors

**Ministers are making too many rules, and increasingly so.** During 2015-2018, more than 6,300 ministerial regulations were issued, representing 86% of central government laws and regulations (up from 5,000 and 82%, respectively, during 2011-2014).

**Processes to ensure ministerial regulations are in line with government policy lack teeth.** InPres 7/2017 resulted in more coordination meetings, but not in ministerial regulations being rejected.

**No single entity is accountable for ensuring laws/regulations serve government policy priorities.** Various ministries/agencies have limited roles related to regulatory coordination and review: State Secretariat, Cabinet Secretariat, BAPPENAS, Coordinating Ministries and Ministry of Law and Human Rights, and for subnational regulations also the Ministries of Home Affairs and Finance.

**Subnational government regulations often contradict higher level central government regulations**—according to a 2017 review of 1,084 local regulations related to the levies and business licensing in 61% of the cases.



Back to main slide

# Additional slides: Financial Sector

# The Indonesia Financial System appears generally resilient to shocks. However, two areas require immediate policy action:

## 1. ENHANCING THE VISIBILITY OF RISKS BY ASSESSING THE SOUNDNESS AND RESILIENCE OF FINANCIAL CONGLOMERATES

***THE PROBLEM:***

- Financial Conglomerates (FCs) represent 88% of banking assets
- **But there are severe gaps in their regulation and supervision**
- OJK’s progress towards integrated supervision is constrained by the silo-based governance arrangements embedded in the OJK Act
- OJK's legal and regulatory reach does not include holding companies heading FCs

***HOW TO FIX IT:***

1. Assign the supervision of conglomeration risks of the most diversified FCs to a single team and initiate a revision of the OJK Act
2. Require OJK to harmonize regulations, supervisory risk assessment processes and ratings across sectors
3. Amend the OJK law to (i) remove the responsibilities of individual commissioners for specific sectors and (ii) Include holding companies within OJK's legal and regulatory perimeter

## 2. PRESERVING THE CREDIBILITY OF THE FINANCIAL SYSTEM BY ADDRESSING WEAKNESSES IN THE INSURANCE SECTOR

***THE PROBLEM:***

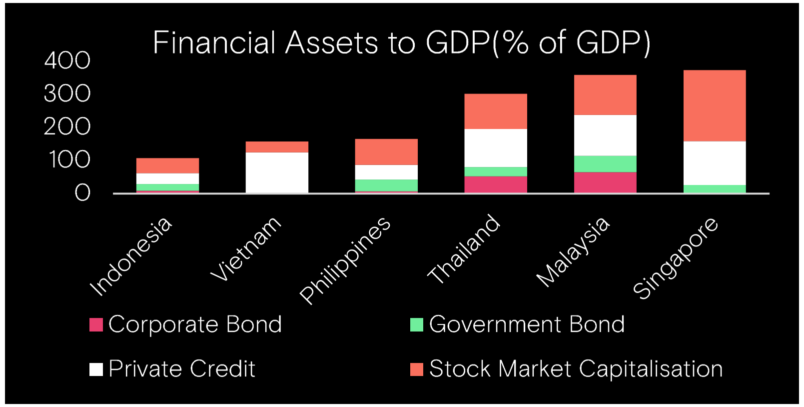
- The two largest national life insurers (Asuransi Jima Bersama Bumiputera 1912 and Asuransi Jiwasraya) have not been able to fulfill their liabilities.
- **The companies might become illiquid and require urgent attention**
- An estimated 7 million people (with over 18 million policies) are involved (mostly low and middle income)

***HOW TO FIX IT:***

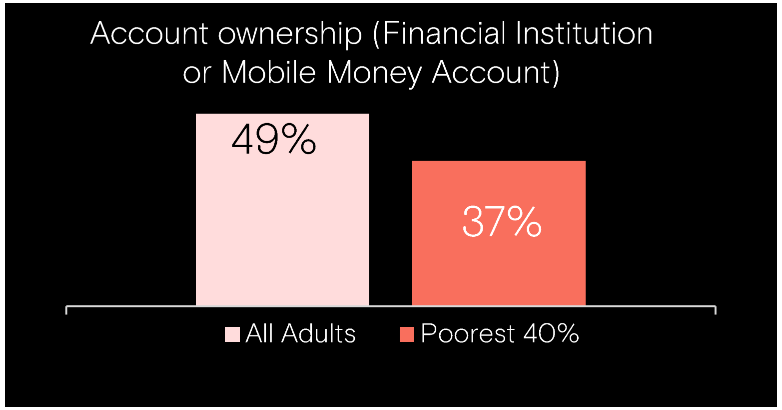
1. Conduct a detailed assessment of the actuarial gap
2. Based on the assessment either a recovery or a resolution in an orderly manner should be pursued

# The financial sector plays a critical role to sustain Indonesia's growth. However, to date, the Indonesian Financial Sector is…

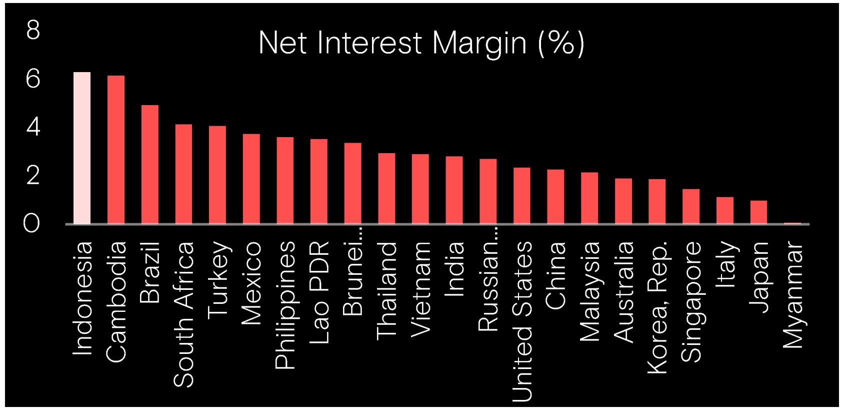
## small…



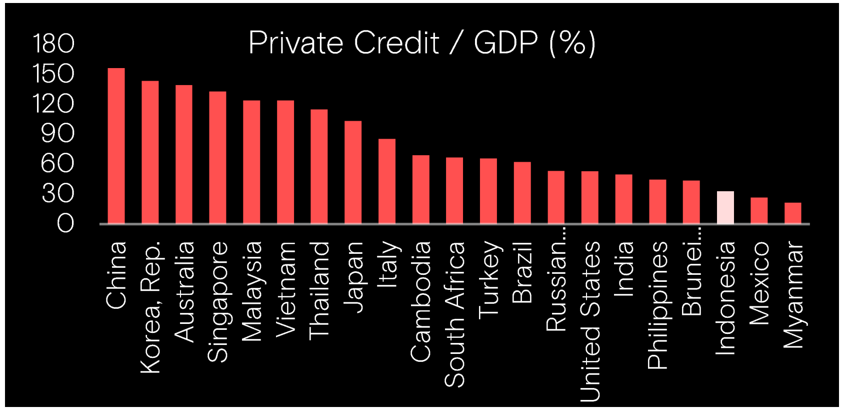

*95 million adults in Indonesia (and two thirds of the poorest adults) do not have an account at a financial institution*



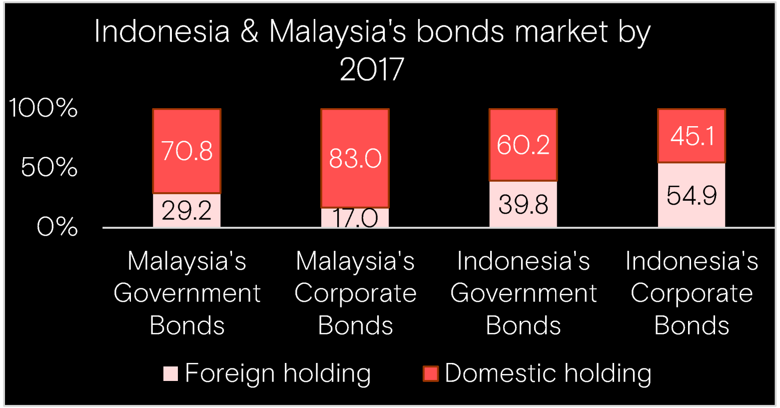

## …costly…



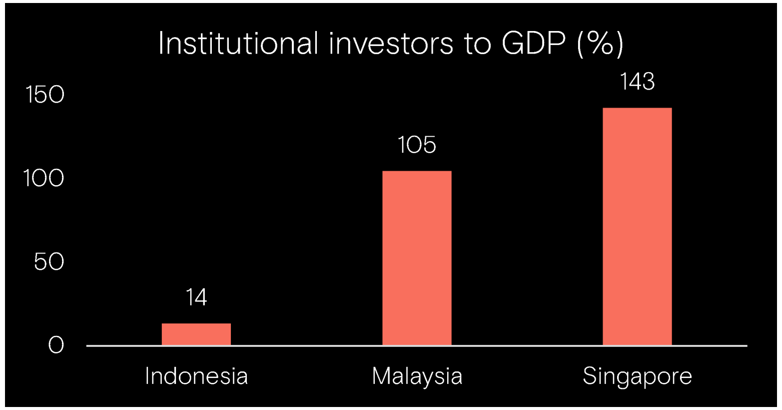

*High interest spreads can negatively impact domestic savings and investment, and inhibit bank lending.*




## …and exposed to global risks




*The combination of shallow markets and high foreign participation can act as an amplifier of financial market volatility*



# Yet, a series of key reforms can help to address structural weaknesses and make the financial sector…

## DEEPER…

**Increasing access and usage by:**

1. Improving the effectiveness of agent network programs
2. Expanding non-cash social assistance distribution channels beyond state-owned banks

**Broadening financial market products by:**

3. Establishing a tax level playing field of capital markets instruments
4. Developing a derivatives market for risk hedging


**Mobilizing long-term savings by:**

5. Promoting pension and long-term saving schemes
6. Incentivizing institutional investors to invest at longer term

## …MORE EFFICIENT…


**Strengthening insolvency and creditor rights by:**

1. Improving performance of insolvency practitioners
2. Amending the Bankruptcy Law to enhance creditor rights

**Protecting consumers and personal data by:**

3. Supporting the law on protection of personal data
4. Enabling market conduct supervision of financial services providers


**Promoting interoperability by:**

5. Supporting the adoption of QR and other relevant standards by financial services providers to offer integrated and inexpensive mobile payment options

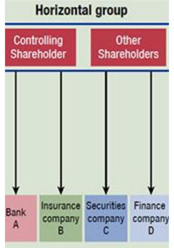
## …MORE RESILIENT

**Promoting sustainable finance by:**

1. Supporting the application of sustainable finance practices by all banks
2. Establishing a monitoring system for compliance with those practices

**Strengthening the resolution framework by:**

3. Implementing resolution planning and resolvability assessments for systemically important banks
4. Strengthening insured deposit payout function in case of bank closure




**Supporting integrated supervision by:**

5. Harmonizing regulations and supervisory processes across sectors
6. Amending the OJK law to remove silos in the OJK structure and include holding companies of FCs under OJK