

India and Indonesia

Economics India

A year of divergence

This report is not a product recommendation.

- ◆ Inflation rates for both India and Indonesia have fallen in the past year, but on other macro fronts, divergence has emerged
- ◆ Rise in India's services exports has been a driver of growth and stability amid global commodity price swings and protectionism
- ◆ One lesson is clear – both need to keep moving up the value chain and diversifying their exports at a time of global volatility

Rewind back a year. India and Indonesia were both the darlings of the markets. Both were exhibiting renewed growth momentum, led by the emergence of new growth sectors. Both were also seeing falls in their headline inflation rates despite unfavourable weather conditions stoking food prices. And both were witnessing falls in their core inflation rates, led by similar drivers – declines in commodity prices, the import of Chinese disinflation, weak services demand, and hawkish central banks.

But that is where the similarities ended. Across other macro variables, a divergence has emerged. On the fiscal front, India continues on its gradual fiscal consolidation path while Indonesia awaits clarity on the new president's fiscal plans. On the external front, India's current account deficit has narrowed over the past year as its FX reserves have risen. For Indonesia, its current account deficit has swung from a surplus to a small deficit, and FX reserves have fallen. In terms of economic growth, the negative output gap has halved in India but remained unchanged in Indonesia over the past year.

What really went on? We believe the divergence has been led by the countries' vastly different export mixes. Let us explain. About 50% of India's non-oil export basket is composed of services, which have risen over the past few years. Unlike goods, services have not faced the wave of protectionism or commodity price volatility. And this matters. India's current account deficit has narrowed from the pre-pandemic period, led by higher services exports. As a result, India's reserve adequacy has improved, putting it more in control of the rupee's stability. Furthermore, the rise in services exports has added an average 1ppt to GDP growth annually for the past three years, which in turn has contributed to higher tax revenues and allowed the Reserve Bank of India to focus on its inflation targeting mandate.

Meanwhile, in Indonesia, the current account balance has improved by 2.6% of GDP from the pre-pandemic period, but as commodity prices fell in 2023, the balance worsened. Notwithstanding the bout of dollar weakness over the last few days, Bank Indonesia has raised rates to stabilise the currency on two occasions in recent months. This has pushed up real rates and is arguably impacting the growth recovery.

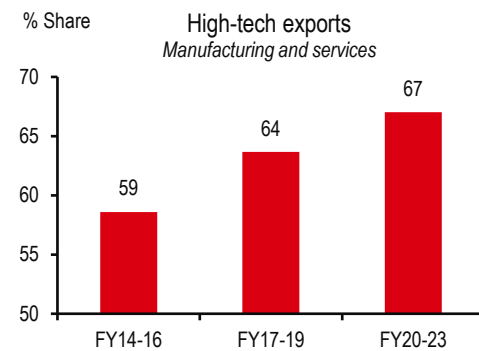
What does this imply? We think this divergence underscores the importance of robust external accounts through constantly innovating to move up the production value chain (at a time of commodity price volatility), and having a diversified export mix (to better withstand protectionism). Though India has fallen into a sweet spot of higher services exports, that might fall in periods of global weakness and disruption. As for Indonesia, while it has evolved from exporting ores to exporting metals, it may be time to move even higher on the value chain.

Rewind back a year

India and Indonesia were the darlings of the markets a year ago. Both economies were exhibiting renewed growth momentum, led by new growth sectors and a slew of government reforms.

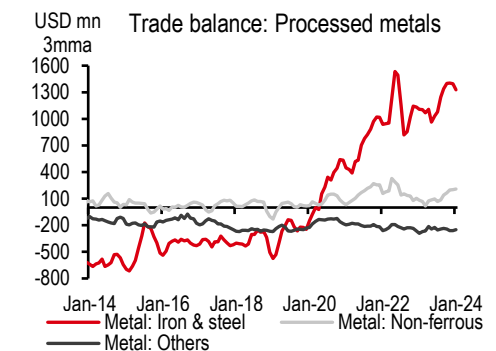
- ◆ **For India**, two new sectors emerged during the pandemic. First, there was a rise in high-tech exports, both goods and services (chart 1). Second, there was a rise in tech start-ups, attracting foreign capital into the economy and providing digital solutions to real economy problems.
- ◆ **For Indonesia**, there was a clear move up in the manufacturing value chain. Since the bans on exports of certain raw ores, the economy has doubled down on expanding its refining capacity, resulting in a sharp increase in the exports of metal products, such as iron and steel (chart 2). With the world's largest nickel reserves, Indonesia also aspires to be a meaningful producer of batteries for electric vehicles.

Chart 1: India's high-tech exports have been on the rise



Source: CEIC, HSBC

Chart 2: Indonesia has ramped up its exports of refined metals



Source: CEIC, HSBC

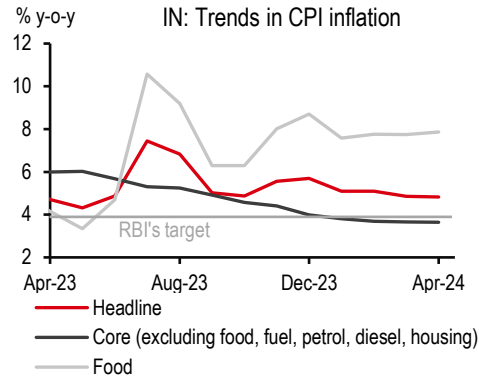
Some positive developments followed

Over the past year, both India and Indonesia saw falls in their headline inflation rates despite unfavourable weather conditions (see charts 3 and 4)¹. Indeed, despite 2023 being an El Niño year, leading to a rise in food inflation, both the economies witnessed a rapid fall in core prices. We believe four common factors helped to pull down the core inflation rates for both countries:

- ◆ **First** and foremost, the fall in commodity prices led to the fall in input prices (see chart 5), and producers were able to cut output prices without sacrificing profitability (see chart 6).
- ◆ **Second**, both economies are likely to have benefitted from falling inflation in China. Amid falling export prices and rising export volumes in China (see chart 7 and 8), economies like India and Indonesia are likely to have imported some of the disinflation.
- ◆ **Third**, the two economies remain among a handful for which services inflation has been low (and even lower than goods inflation, see chart 9), keeping a lid on core prices. We believe both India and Indonesia have witnessed K-shaped recoveries wherein low-to-mass-level consumption hasn't been strong, keeping a lid on services demand.
- ◆ **Finally**, central banks in both economies have been hawkish. The RBI continues to reiterate its objective of reaching the 4% inflation target sustainably. BI has raised rates twice despite low inflation in a bid to stabilise the rupiah.

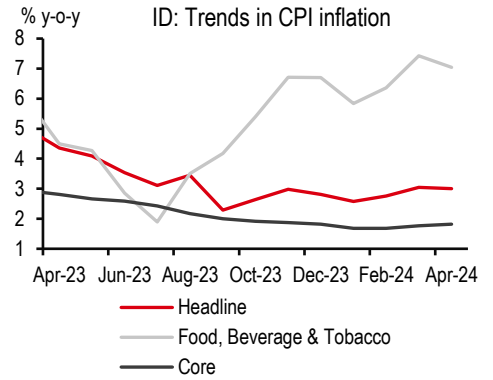
¹ CPI inflation in India came in at an average of 5.0% in Jan-Apr 2024 versus 5.8% for the same time last year. And CPI inflation in Indonesia came in at average of 2.8% in Jan-Apr 2024 versus 5.0% for the same time last year.

Chart 3: India's inflation has declined despite unfavourable weather conditions...



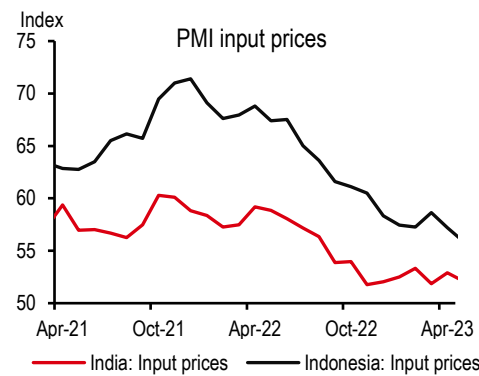
Source: CEIC, HSBC

Chart 4: ... and a similar trend is visible in Indonesia



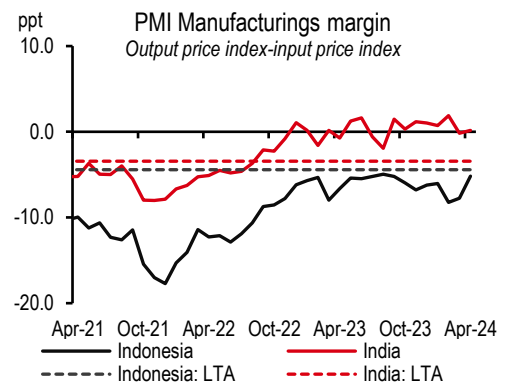
Source: CEIC, HSBC

Chart 5: A fall in commodity prices led to a fall in input prices



Source: S&P Global PMI, HSBC

Chart 6: Producers were able to cut output prices while holding onto profitability



Source: S&P Global PMI, HSBC

Chart 7: India and Indonesia have benefitted from falling export prices in China ...

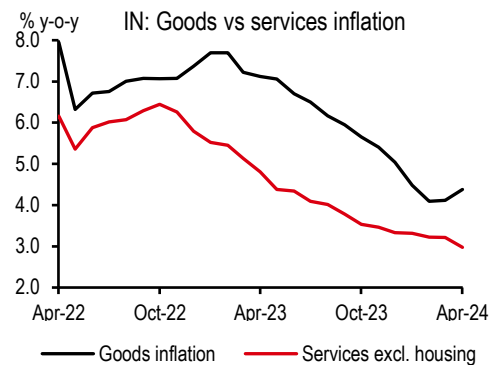


Source: CPB, HSBC

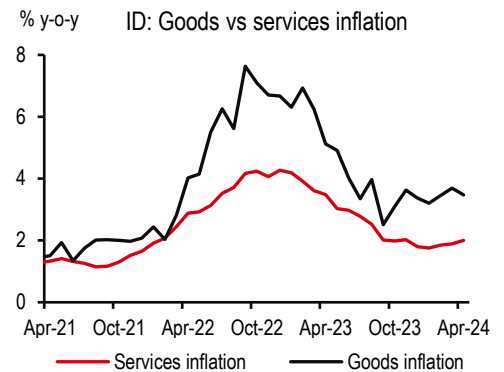
Chart 8: ... at a time when China's export volumes are only rising



Source: CPB, HSBC

Chart 9: India and Indonesia have lower services inflation ...


Source: CEIC, HSBC

Chart 10: ... than goods inflation


Source: CEIC, HSBC

But then some divergent trends arose

Falling inflation rates are where the similarities ended. Across the other macro-economic variables, a divergence of sort took hold between India and Indonesia over the past year:

- ◆ **Fiscal accounts** – India has long been associated with an elevated fiscal deficit. However, after the spike during the pandemic years, the deficit levels are gradually falling in line with the government's glide path (see chart 11).

Meanwhile, the fiscal deficit in Indonesia has been much lower and even surprised to the downside in 2023. But in 2024 and beyond, fiscal finances will depend on the new government's plans. Until those are known (the new government will take office in October 2024), the fiscal backdrop may remain clouded by uncertainty.

- ◆ **External accounts** – The current account deficit in India fell to 1.2% of GDP in December 2023 from 2% in December 2022. This was led by falling global oil prices as well as the continued rise in services exports. And since then, FX reserves have only risen (from USD623bn in December 2023 to USD642bn in early-May 2024).

In Indonesia, the current account balance improved sharply during the pandemic. But over the past year, it moved from a surplus of 1.1% of GDP in December 2022 to a deficit of 0.4% of GDP in December 2023, led by weaker goods exports. FX reserves have fallen so far in 2024 (from USD146bn in December 2023 to USD136bn in April 2024).

- ◆ **Economic growth** – One way to think about growth is the catch-up since the pandemic, i.e., the closing of the output gap. On that front, the gap has been narrowing for India, with GDP at 13% below the pre-pandemic trend in June-2021, to 6% below the pre-pandemic trend in December 2022, and further down to 4% in December 2023.

Meanwhile, for Indonesia, the GDP gap narrowed from 8.8% below the pre-pandemic trend in September 2021 to 7.4% in March 2023 but has been stuck at those levels for the last year. It is fair to say that the economic recovery has been slow in Indonesia (see chart 13 and chart 14).

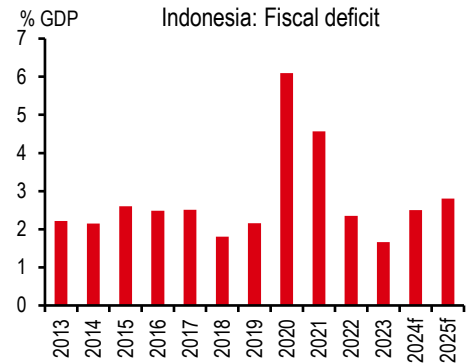
In short, over the last year, India saw improvements in its external finances and economic growth momentum while sticking to the fiscal consolidation path. And Indonesia saw some worsening in its external accounts while growth remained lacklustre and its fiscal situation in wait-and-watch mode.

Chart 11: India's fiscal deficit is falling gently in line with the glide path



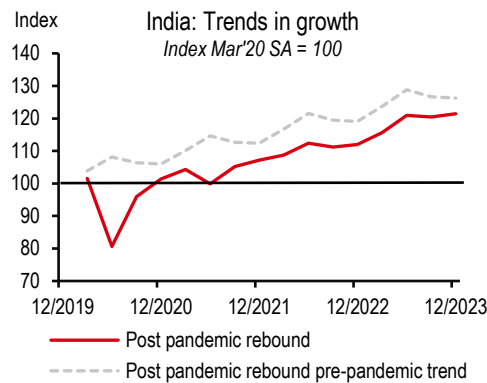
Source: CEIC, HSBC estimates

Chart 12: Indonesia's fiscal future is in wait-and-watch mode



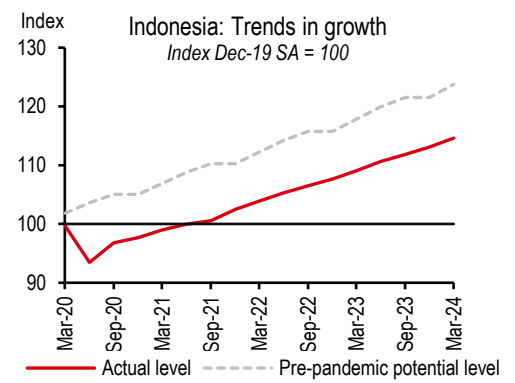
Source: CEIC, HSBC estimates

Chart 13: India's GDP remains 4% below the pre-pandemic trend and the gap has narrowed



Source: CEIC, HSBC

Chart 14: Indonesia's growth is 7.4% below the pre-pandemic trend for the last year



Source: CEIC, HSBC

What really went on?

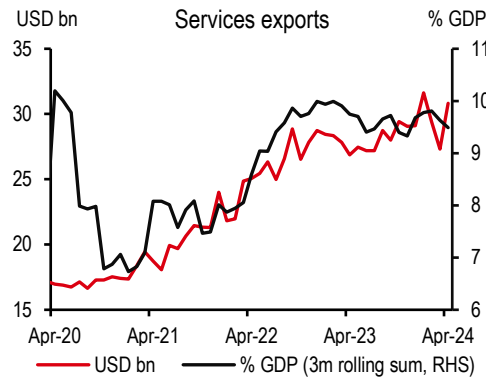
What was it that contributed to this divergence between India and Indonesia over the past year? We believe it was largely led by one big difference between the two economies – **their export mixes**.

Let us explain. About 50% of India's non-oil export basket is comprised of services, and they have been rising over the past few years (see chart 15). As we have written in the past, India's services exports have moved up the value chain, and the country is now selling not just software services but also a host of professional services like legal, accounting and research and development (see chart 16). Services exports, unlike goods have not faced the wave of protectionism or commodity price volatility. In fact, even as the world is deglobalising in goods trade, it continues to globalize in services trade.

And this matters. Compared with the pre-pandemic levels, India's current deficit has narrowed by 1.3% of GDP (FY19-FY24f, see chart 17). And during this period, net services exports have risen by 1.6% of GDP (and net goods exports have declined by 0.2% of GDP).

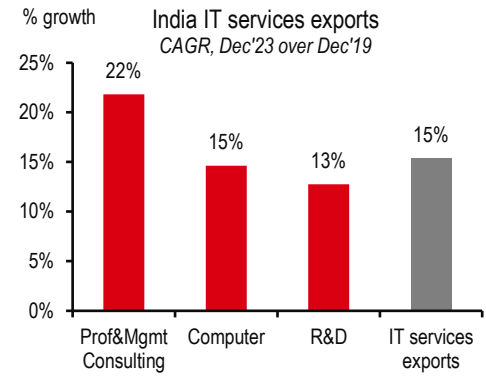
Had it not been for the rise in services exports, FX reserve accumulation, and the ability to keep the rupee stable would have been lower². This trend of higher services exports improving India's FX reserves adequacy has also been clear in the more recent data, i.e., over the last year.

Chart 15: Services exports have been on a rising trend for most of the last few years



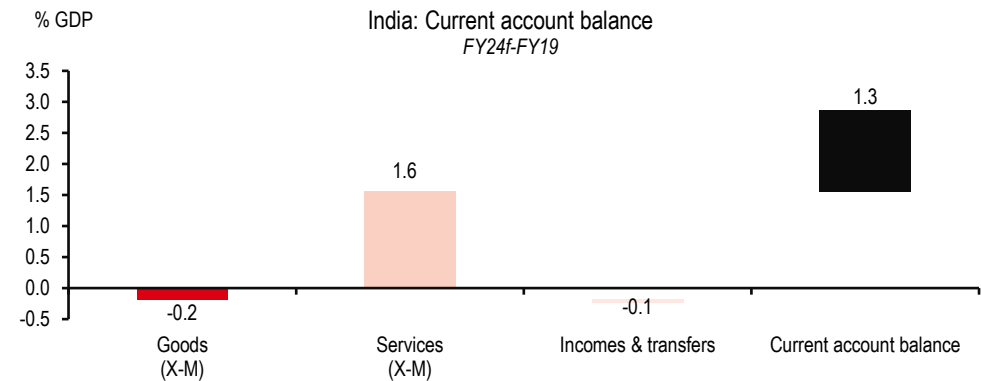
Source: CEIC, HSBC

Chart 16: India's professional services exports have grown quickly



Source: CEIC, HSBC

Chart 17: Rise in net services exports kept India's current account deficit from widening vis-a-vis pre-pandemic levels



Source: CEIC, HSBC

Furthermore, we estimate that the rise in services exports has added an average of 1ppt to GDP growth annually over the past three years, playing an important role in narrowing the output gap referred to earlier. This has even contributed to higher tax revenues and the gradually improving fiscal situation. Finally, with growth being robust, the RBI has focused more squarely on its inflation targeting mandate.

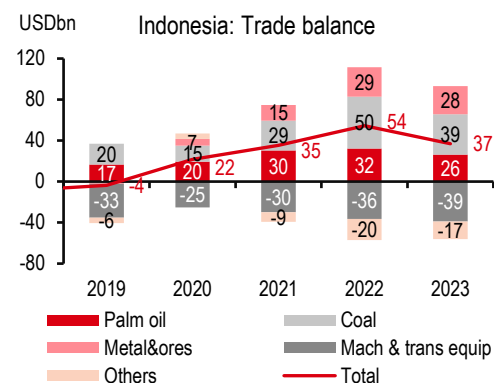
Meanwhile in Indonesia, the current account balance has improved by 2.6% of GDP from the pre-pandemic period (2019-23). Higher oil and coal prices as well as higher metals exports have all played a role (see chart 18).

But as commodity prices fell in 2023, so did Indonesia's goods exports, leading to a widening of the current account deficit over the last year (see chart 19). As mentioned earlier, FX reserves fell as well. Indeed, Indonesia's exports have remained sensitive to commodity price movements.

² India's FX reserves have risen from 15.3% of GDP (USD413bn) in FY19 to 18.2% (USD646bn) in FY24.

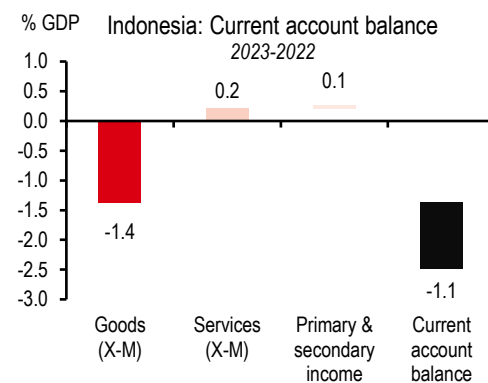
Furthermore, in two separate occasions when the USD strengthened, BI raised rates to stabilise the currency (October 2023 and April 2024). With its real rates among the highest in the region, it is no surprise that Indonesia's growth dynamics did not improve further over the last year.

Chart 18: Indonesia's current account balance improvement was led by higher commodity prices and metal exports



Source: CEIC, HSBC

Chart 19: Commodity prices led fall in exports have worsened the c/a balance over the past year



Source: CEIC, HSBC

What does this all imply?

We believe our comparative assessment of India's and Indonesia's performances over the past year underscores the importance of robust external accounts at a time the global backdrop has become rather volatile.

Our assessment highlights both the importance of moving up the value chain of production (given commodity prices can be rather volatile) and having a diversified export mix (to better withstand protectionism).

It also highlights the importance of continually innovating. While India has fallen into a sweet spot of higher services exports, that too might fall into periods of weakness (for instance, net services exports fell to a nine-month low in April), or disruption (for instance, if artificial intelligence hurts India's service export prospects).

And for Indonesia, while it has moved from exporting ores to exporting metals, it may be important to move higher up the value chain and have a more varied export basket to secure external stability.

Disclosure appendix

Additional disclosures

- 1 This report is dated as at 21 May 2024.
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