

INDONESIA

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ROBUST GROWTH BUT DETERIORATING GOVERNANCE

Indonesia is facing two external shocks: rising energy prices and capital outflows. The decline in governance quality has indeed impacted foreign investor confidence. Assuming that the conflict in the Middle East subsides, pressures on external accounts and energy subsidy costs are expected to ease. However, oil prices are expected to remain consistently above their early-2026 levels, perpetuating the risk of fiscal slippage. Investors remain cautious, and rupiah volatility is high.

STRONG GROWTH

In Q1 2026, real GDP growth accelerated sharply to 5.6% y/y, a rate not seen since 2012 (excluding the post-pandemic rebound). The main driver was household consumption, bolstered by wage increases and distribution of free meals. Activity was also bolstered by increased government spending and accelerated investment, supported by an accommodative monetary policy.

The growth outlook for 2026 remains positive. Real GDP growth is expected to remain robust at 5%, although it is expected to fall short of the government's 5.4% target, partly due to rising real interest rates impacting investment decisions.

CONSUMER PRICE INFLATION STILL UNDER CONTROL

To mitigate the impact of the energy shock caused by the conflict in the Middle East on households, the government has kept petrol prices unchanged for all fuels except Pertamina, which saw its price double but accounts for only 7% of petrol consumption. Consumer price inflation has so far remained manageable (+3.3% y/y in June). However, producer price increases (+6.5% y/y in June) will gradually feed through to consumer prices (Chart 1).

Despite inflation remaining within the target range (+2.5% $\pm$ 1pp), the central bank has raised its policy rate twice since the conflict began, primarily to counter downward pressure on the rupiah (+75bps to 5.75%).

INCREASING RISK OF FISCAL SLIPPAGE

For two decades, Indonesia has managed to maintain its fiscal deficit at 3% of GDP (excluding the pandemic period) while keeping public debt at a reasonable level, despite modest revenue. However, since taking office in October 2024, the Prabowo government has implemented several budget adjustments that deviate from the conservative fiscal approach of the Widodo administration. This shift raises concerns about fiscal slippage, especially as public finances were already strained by the pandemic.

In 2025, the fiscal deficit increased by 0.6pp to 2.9% of GDP—an unprecedented level outside the pandemic period. In addition to the widening deficit, the sharp decline in revenue (-1.3pp) is concerning, as it fell to just 11.6% of GDP, the lowest among the ASEAN-6 countries. This situation highlights inefficiencies in the implementation of a centralised tax system and the allocation of state-owned enterprise dividends to the sovereign wealth fund Danantara (-0.4% of GDP). Furthermore, the postponement of the VAT hike (from 11% to 12%), which was initially proposed by the Widodo government for all consumer goods but was ultimately applied only to luxury items, has deprived the government of an estimated revenue boost of 0.3% of GDP. For 2026, the likelihood of the deficit exceeding the 3% of GDP threshold set by Parliament has increased due to rising energy subsidy costs, further exacerbated by the depreciation of the rupiah.

Economic forecasts

	2022	2023	2024	2025	2026e	2027e
Real GDP growth (%)	5.3	5.0	5.0	5.1	5.0	5.2
Inflation (CPI, year average, %)	4.1	3.7	2.3	1.9	3.5	3.2
Gen. Gov. balance / GDP (%)	-2.4	-1.7	-2.3	-2.9	-3.0	-3.0
Gen. Gov. debt / GDP (%)	39.7	39.2	39.4	40.5	40.6	40.9
Current account balance / GDP (%)	1.1	-0.2	-0.6	-0.1	-1.2	-0.7
External debt / GDP (%)	30.1	29.8	29.6	29.9	30.0	30.1
Forex reserves (USD bn)	124	133	140	135	123	130
Forex reserves, in months of imports	5.5	6.0	6.1	5.6	5.0	5.3

TABLE 1

e: ESTIMATES & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

Inflationary pressures remain limited so far

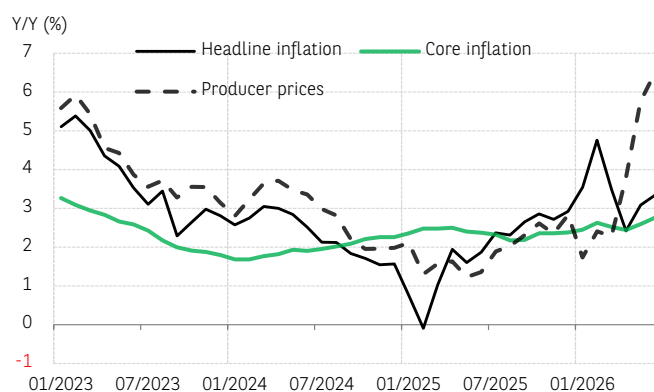


CHART 1

SOURCE: BI, BNP PARIBAS

Over the first five months of the year, the fiscal deficit widened by 0.6% of GDP compared to the same period last year. Energy subsidies increased in tandem with oil prices, reaching 0.8% of GDP — the level initially projected for the entire year. The worsening fiscal deficit is also attributed to higher civil servant wages. To mitigate the deficit expansion, the government has cut other expenditures, particularly the budget allocated to the free meal distribution programme, which could see a reduction equivalent to 0.3% of GDP, bringing it down to 1% of GDP. But this may not be sufficient. Oil prices in H2 2026 are expected to remain consistently above early-2026 levels. Assuming an average price of USD 81.6 in H2 2026 (vs. USD 91.8 in H1 2026), annual energy subsidies could reach 1.6% of GDP.


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Additionally, interest payments on government debt are set to rise further in 2026. They have steadily increased since 2023, reaching 2.2% of GDP in 2025 (or 19% of revenue, compared to 16.1% in Malaysia and 6% in Thailand). So far, the moderate increase in interest rates and a favourable debt structure (with long maturities and approximately 97% fixed-rate) have limited the growth in interest burden. However, bond yields — which have risen by 114bps between January and mid-July 2026 — could continue to climb, further reducing the government's fiscal room for manoeuvre.

As a result, the fiscal deficit could increase from an average of 2.3% of GDP over the past five years (excluding the pandemic) to 3% of GDP over the next five years. Government debt, which remains relatively low (40.5% of GDP at end-2025), could exceed 42% by 2028. While this level is still moderate, the risks are skewed to the upside. The debt-to-GDP ratio could rise further if the rupiah depreciates (as 29.5% of the debt is denominated in foreign currency). Above all, the main risk lies in the potential increase in debt refinancing costs, as Indonesia faces significant foreign investor distrust that currently hold 37.1% of the total government debt.

EXTERNAL ACCOUNTS UNDER PRESSURE

Indonesia ranks among the Southeast Asian countries least affected by the energy shock, alongside Malaysia, with a modest oil and gas trade deficit standing at 1.4% of GDP in 2025, compared with 3.6% in the Philippines and Vietnam, and 5.9% in Thailand. Nevertheless, between January and mid-July, the rupiah recorded one of its worst performances against the dollar (-7.3%), breaching the IDR 18,000/USD threshold in early June, a historically low level.

This downward trend, which began in mid-2025 and was exacerbated by the Middle East conflict, can be attributed to: i) a decline in the trade surplus, which fell by 73.8% y/y in the first five months of 2026, resulting in a current account deficit that widened to 1.1% of GDP in Q1 2026, compared to just 0.1% in 2025, and ii) heightened foreign investor distrust.

Foreign direct investment (FDI), which had already declined significantly in 2025 to just 1% of GDP, down from 1.8% over the previous five years, further decreased to only 0.3% of GDP (annualised) in Q1 2026. FDI is no longer sufficient to cover the current account deficit, making the country reliant on portfolio investment.

However, portfolio investment outflows have accelerated sharply. In the first five months of the year, foreign holdings of all market securities plummeted by 32.9%, now accounting for just 35.6% of total issued securities, marking the lowest level on record. The Jakarta stock index fell by over 32% between January and early June, representing the worst performance in Southeast Asia.

Two factors explain this loss of confidence in Indonesia, despite its robust growth and strong macroeconomic fundamentals: i) the government's shift towards a less conservative fiscal policy, and ii) deteriorating governance quality.

Currently, foreign currency refinancing risk remains manageable. Although foreign exchange reserves have been declining since early 2026 (USD -12.3bn), they still cover 1.5 times the country's external financing needs. However, the depreciation of the rupiah has led to an increase in the external debt-to-GDP ratio, which stands at a modest 29.5%, and exposes unhedged sectors, such as services and construction, to currency risk.

External accounts have deteriorated

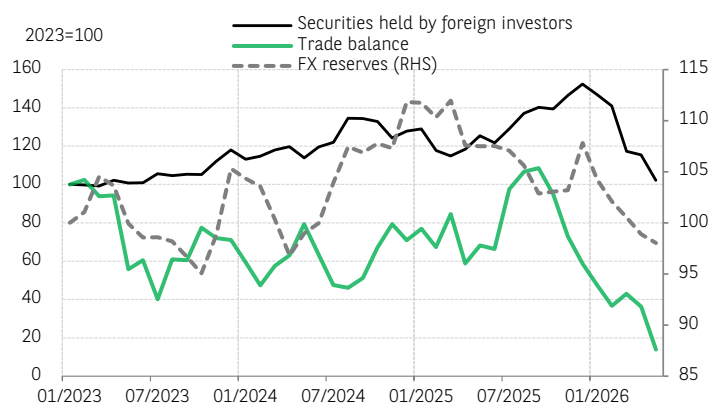


CHART 2

SOURCE: BI, BNP PARIBAS

Since mid-June, the rupiah has experienced a temporary reprieve due to higher domestic interest rates and lower oil prices. However, the potential for further depreciation remains high, and the volatility of the rupiah is heightened. Additionally, while MSCI upheld Indonesia's designation as an «emerging market» in June 2026, there is still a risk of being downgraded to a «frontier market» in the upcoming November review. Such a downgrade could trigger accelerated capital outflows and a lasting deterioration of the country's external position.

Deteriorating governance quality

Since Prabowo Subianto took office, governance quality has declined. The mechanisms for oversight, transparency and conflict-of-interest prevention within the sovereign wealth fund Danantara are deemed insufficient by international standards. Furthermore, the government has increased interventions in the economy, notably by centralising exports of strategic commodities through Danantara — a move that is both protectionist and unpredictable, raising investor concerns about legal certainty and policy consistency. Furthermore, the independence of the central bank has been called into question following the appointment of the president's nephew as its governor, amid increasing centralisation of economic decision-making by the executive.

TOWARDS A SHIFT IN ENERGY STRATEGY?

The Middle East crisis could prompt the Indonesian government to prioritise rapid energy self-sufficiency over ecological transition. While the economy is less oil-dependent than its regional counterparts (with oil accounting for less than 30% of its energy mix, compared to 47% in Thailand), it remains vital for the population, posing social and political risks. Consequently, the priority may shift towards reducing oil imports by expanding biodiesel (derived from palm oil) and, more crucially, increasing the use of domestic coal for electricity generation (particularly for electric vehicles). Indeed, Indonesia has abundant coal reserves.

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