Indonesia

Strong resilience

Economic growth slowed in Q1 2019, but for the moment the economy seems to be fairly resilient to the decline in world trade. In the short term, dynamic household consumption, stimulated by measures to boost purchasing power, will continue to offset the slowdown in exports. In the longer term, real GDP growth is hardly expected to exceed 5-5.5%. After his recent reelection, it is vital for President Widodo to take advantage of his clear cut victory to push through the necessary reforms to stimulate foreign investment and foster growth, while reducing the country's dependence on volatile capital flows. Foreign direct investment has declined for the past six quarters and no longer suffices to cover a swelling current account deficit.

Economic growth decelerates slightly

After reaching 5.2% in 2018, real GDP growth slowed slightly to 5.1% in Q1 2019, reflecting in part the uncertainty in the run up to April's general elections, but also declining prices for some of Indonesia's export commodities in the midst of escalating trade tensions between China and the United States. Household consumption and government spending were both dynamic, while investment slowed after peaking at 33% of GDP in 2018. Exports contracted by 2.1% y/y, but this was largely offset by a sharp drop in imports (-7.8% y/y), triggered by a slowdown in investment. Infrastructure spending slowed due to delays in implementing key projects, while the slowdown in investment in machinery and capital goods was notably caused by international trade tensions.

Growth slowed in agriculture and manufacturing, with contractions in key commodity producing sectors (rubber and coal) and in transport equipment.

Yet household and business confidence indicators are still looking upbeat, even though the PMI in manufacturing sector decreased in June (50.6). Several factors will continue to boost household consumption, including purchasing power gains (thanks notably to mild inflationary pressures), a buoyant labour market and the increase in social welfare spending. Companies are confident, especially concerning their domestic order books.

In the medium to long-term, growth prospects are hardly expected to exceed the average of 5% reported over the past five years, which is well below President Widodo's target of 7% set during his first term in 2014. According to the IMF, the potential growth rate is unlikely to reach 6.5% by 2022 unless the new government steps up reform efforts to raise the level of education, to develop infrastructure further and to improve the business environment.

Public finances are still solid

Over the past five years, the Widodo administration has managed to consolidate public finances by reducing the share of rigid expenditures, notably oil subsidies.

In 2018, the fiscal deficit was trimmed by 0.7 percentage points to only 1.8% of GDP, the smallest deficit since 2012. This improvement can be attributed to a 0.8 pp increase in the revenue-to-GDP ratio (to 13.1%), which halted a five-year decline. In 2017, President Widodo offered tax amnesty for repatriating revenues held abroad, and this programme apparently increased revenues by 0.3 pp.

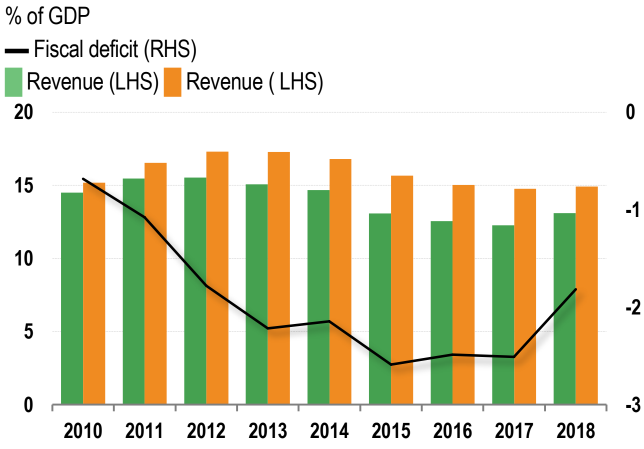
At the same time, the government managed to limit spending increases to 14.8% of GDP, despite a 0.3 pp increase in energy subsidies and a 0.1 pp increase in interest expenses (which is still relatively small, accounting for only 13.3% of government revenues). Although the cost of subsidies has increased, it is still 2 points of GDP lower than it was before the Widodo government launched the reform in 2014. The temporary freeze on gasoline prices adopted in 2018 was lifted in 2019.

1-Forecasts

	2017	2018	2019e	2020e
Real GDP growth (%)	5.1	5.2	5.0	5.0
Inflation (CPI, year average, %)	3.8	3.2	2.6	3.0
Gen. Gov. balance / GDP (%)	-2.5	-1.8	-1.8	-2.0
Gen. Gov. debt / GDP (%)	29.0	30.1	29.8	29.2
Current account balance / GDP (%)	-1.6	-3.0	-2.4	-2.0
External debt / GDP (%)	34.7	36.2	34.6	34.0
Forex reserves (USD bn)	124	114	119	126
Forex reserves, in months of imports	6.2	6.0	5.4	5.4
Exchange rate USDIDR (year end)	13 567	14 380	14 100	13 900

e: estimates and forecasts BNP Paribas Group Economic Research

2- Consolidation of public finances



Source: Finance Ministry, CEIC

In the first five months of 2019, the fiscal deficit widened compared to 2018. This slight deterioration can be explained mainly by increased spending on social welfare and education.

Revenue has reached only 33% of the full-year target. Revenue increased only 6.3%, whereas the government is targeting a full-year increase of 11.5%. At the same time, expenditure has increased by 9.8% (34.7% of the full-year target). As part of its strategy to boost household purchasing power in order to stimulate consumption in the midst of a global economic slowdown, the government has sharply increased social welfare spending (+75%). One goal is to increase spending on education to 3% of GDP.

Despite the rapid narrowing of the fiscal deficit, government debt has increased 11.7% over the past twelve months to 30.3% of GDP in Q1 2019. This increase is partly due to a currency effect triggered by the rupiah's depreciation, as 41.5% of debt is still denominated in foreign currency. Short-term refinancing risks are limited because 89% of the debt matures in more than one year. Nonetheless, debt refinancing is still exposed to the volatility of international financial markets since non-resident investors still held 40.6% of government debt at the end of last year.

External accounts are deteriorating somewhat

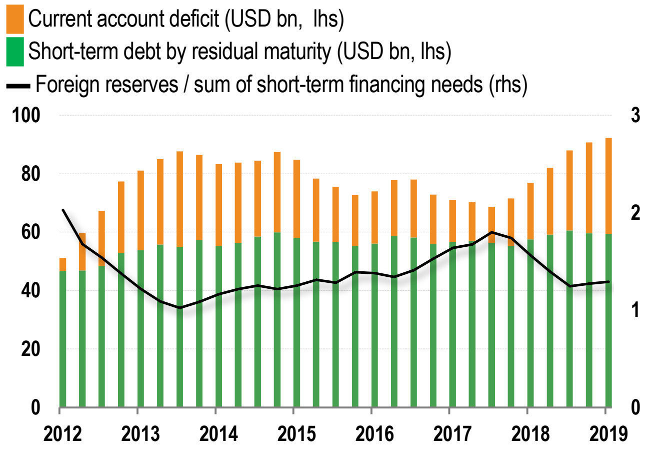
After three years of consolidation, Indonesia's external accounts eroded in 2018 due to higher oil prices and the decline in net capital inflows at a time of strong financial market volatility. Net capital inflows did not cover entirely the current account deficit, which was the highest since 2014 (3% of GDP compared to 1.6% of GDP in 2017). As a result, foreign exchange reserves declined by USD 9 bn between year-end 2017 and year-end 2018, and the rupiah depreciated by 5.7% against the US dollar.

In the first five months of 2019, the situation has stabilised. Foreign investment picked up and the trade deficit narrowed as the decline in exports (-8.7% over the first five months) was offset by a contraction in imports (-9.2%). Foreign exchange reserves and the rupiah have both remained stable since the end of 2018.

Indonesia is still vulnerable to commodity price fluctuations, which accounted for 57% of exports in 2018.

The deterioration in the external accounts since 2018 is not a real source of concern. Foreign reserves are holding at a comfortable level. At the end of May, they covered 1.3 times the country's short-term financing needs. In contrast, the decline in foreign direct investment (FDI) since 2015 is more problematic. In 2018, FDI represented only 1.9% of GDP, compared to 2.8% of GDP at the end of 2014, despite major efforts by the Widodo government to open up the economy. The decline in FDI increases the country's dependency on portfolio investment flows to cover the financing of its current account deficit. In Q1 2019, Indonesia's basic balance (sum of the current account balance and FDI) showed a deficit for the sixth consecutive quarter (0.7% of GDP).

3- Short-term financing needs are on the rise



Source: Bank Indonesia, CEIC

To reduce its dependency on volatile capital flows and stimulate economic growth, the country must attract more FDI. After President Widodo's re-election in April, the strategy for his second term will continue to focus on improving the business environment, creating special economic zones, and further developing infrastructure in order to stimulate industry and reduce the reliance on commodities. Yet Indonesia also needs to raise the level of education and encourage the diversification of exports. Considering his big victory in April's general elections, President Widodo should benefit from sufficient political manoeuvring room to drive through these reforms.

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