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MACRO UPDATE:

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In a nutshell

- Indonesia's growth performance remains commendable and positive. Having successfully navigated the 2008 Global Financial Crisis (GFC) and the end of the China-driven commodity boom, it has chalked up almost 20 years of continuous economic growth. Going forward, growth is expected to remain resilient on the back of a stable and large domestic demand, thanks to a growing middle class and rapid urbanisation. In 2018, gross domestic product (GDP) expanded at a faster-than-expected pace of 5.17% despite a marked weakening of exports growth momentum late in the year. GDP growth in 2019 will likely moderate given global growth and trade concerns, though the government has set an ambitious target of 5.3%. Not surprisingly, the latest available data show 1Q2019 GDP growth coming in at a lower-than-expected 5.07% pace y-o-y.

- Against a backdrop of rising global headwinds, the monetary authorities remain on a balanced and prudent policy path. The new central bank governor has indicated that the central bank will become more pre-emptive, frontloading, and more ahead of the curve in interest rate response under his watch. He is seen as preferring a mix of macroprudential measures, intervention, and policy action to contain currency and market volatility. Meanwhile, the inflation trajectory remains benign. With recent stable administered prices, inflation averaged 3.2% in 2018, lower than the previous year's 3.8% average. Thanks to benign inflation, the monetary authorities had been able to focus on their financial stability mandate during the May-November emerging market sell-off. The latest available data show inflation pace falling further to an average of 2.8% in the first five months of 2019.

- In 2018, Indonesia's fiscal deficit narrowed to 1.8% of GDP, well below the legal deficit ceiling of 3.0% of GDP. Revenue had risen significantly by 17.3%, largely due to the government's tax amnesty programme that ran from July 2016 until March 2017. While the amnesty programme may have been a success, the fact remains that the capacity of the tax system is still low, as evidenced by Indonesia's low tax ratio. For 2019, the finance ministry is projecting a tax ratio of just below 12%, lower than the 15% threshold required to stimulate inclusive growth. Meanwhile, central government debt remains modest at 29.8% of GDP as of end-2018. The debt maturity profile improved in 2018 with the proportion of the long-term portion rising to 97.7% from 93.0% in the previous year.

- In April 2019, Indonesia simultaneously held its presidential and parliamentary elections. According to a full vote count released by the General Elections Commission, President Joko Widodo captured 55.5% of the vote, with a winning margin that was more than double what he had garnered in 2014. His re-election win is seen as positive as it should lift the political uncertainty that had been weighing on the economy. In addition, it is good for policy continuity. In his first term as president, he had rolled out a USD350 billion infrastructure drive, the biggest in Indonesia's history. His proposed continued public infrastructure spending, especially on urban and digital projects to boost economic growth, should help improve the overall well-being of Indonesians.

Exhibit 1: Indonesia: selected economic indicators

Growth (% change)	2013	2014	2015	2016	2017	2018
Real GDP (%)	5.6	5.0	4.9	5.0	5.1	5.2
CPI inflation (%, annual average)	6.4	6.4	6.4	3.5	3.8	3.2
Fiscal balance (% GDP)	-2.2	-2.1	-2.6	-2.5	-2.5	-1.8
Central government debt (% GDP)	24.9	24.7	27.5	28.3	29.4	29.8
Current account balance (% GDP)	-3.2	-3.1	-2.0	-1.8	-1.6	-3.0
Gross external debt (% GDP)	29.1	32.9	36.1	34.3	34.7	36.2
International reserves (USD billion)	99.4	111.9	105.9	116.4	130.2	120.7
Unemployment, total (% of labour force)	6.3	5.9	6.2	5.6	5.5	5.3

Sources: World Bank, CEIC, MARC Economic Research

Growth outlook remains favourable despite constraints

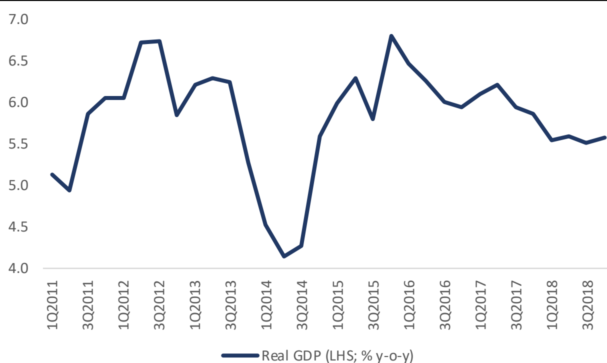
- Indonesia's GDP growth pace remains below the 7% growth target set by President Joko Widodo when he became president in 2014. Growth performance, however, remains commendable and positive. It has chalked up almost 20 years of continuous economic growth, having successfully navigated along the way the 2008 GFC and the end of the China-driven commodity boom. Growth is expected to remain resilient on the back of a stable and large domestic demand, thanks to a growing middle class and rapid urbanisation.

- In 2018, GDP growth came in higher than expected at 5.17%, the fastest pace in half a decade. This was despite a marked weakening of exports growth momentum late in the year as shipments to China and other key markets tumbled. GDP growth in 2019 will likely moderate given global growth and trade concerns, though the government, according to the 2019 state budget, has set an ambitious target of 5.3%. Risks to the outlook are tilted to the downside. They mainly stem from external sources that include trade tensions, tight global financial conditions, weaker-than-expected growth in China, and large commodity price swings. Not surprisingly, the latest available data show 1Q2019 GDP growth coming in at a lower-than-expected 5.07% pace y-o-y.

- President Joko Widodo has called for an increase in capital spending, which he expects to bolster GDP growth to between 5.3% and 5.5% in 2020. Considering Indonesia's massive infrastructure gap, that is good news because a lot needs to be done to ease bottlenecks, especially in transport and electricity. According to the World Economic Forum's Global Competitiveness Report 2018, Indonesia is ranked at number 71 out of 140 countries in terms of infrastructure. He is also expected to spend more on education and training to cater to the growing number of millennials entering the labour market, as well as to ensure that Indonesia reaps the benefits of demographic dividend.

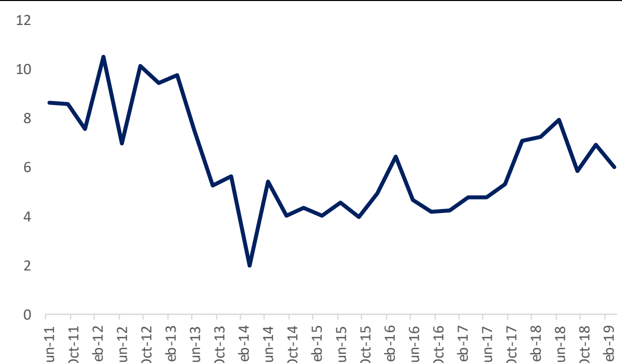
- With Indonesia remaining reliant on natural resources, the industrial sector continues to lag that of its regional peers in terms of exports. As such, concerns have been raised about the government's continued lack of focus on technology, productivity and competition in its long-term economic strategy. For example, the aims of the government's 'Nawa Cita' agenda for national development, which mostly addresses existing development gaps (namely infrastructure, power generation and people's welfare), do not provide a long-term vision.

Exhibit 2: Real GDP growth (% year-on-year)



Sources: CEIC, MARC Economic Research

Exhibit 3: Gross fixed capital formation (% year-on-year)



Sources: CEIC, MARC Economic Research

Balanced and prudent monetary policy

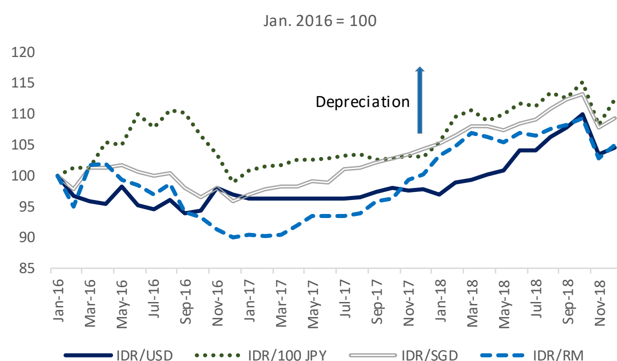
- Against the backdrop of rising global headwinds, the monetary authorities remain on a balanced and prudent policy path. The new central bank governor, Perry Warjiyo, who was sworn into office in May 2018, will helm the central bank until 2023. Seen as pro-growth and pro-stability, he has indicated that the central bank will become more pre-emptive, frontloading, and more ahead of the curve in interest rate response under his watch. He is also seen as preferring a mix of macroprudential measures, intervention, and policy action to counter currency and market volatility.

- To contain depreciation pressures on the Indonesian rupiah (IDR) and stem portfolio outflows during the emerging market sell-off between May and November last year, the central bank had hiked its key interest rate by a total of 175 basis points. Given Indonesia's twin deficit situation, there were concerns that financial instability stemming from volatile capital flows could trigger another crisis à la the Asian Financial Crisis (AFC) of 1997-1998. The fears were largely unfounded, however, thanks to lessons learned during the AFC. Indonesian banks are now stronger, and the financial sector far less vulnerable to foreign risks. Meanwhile, measures (e.g. reserve requirement averaging and the adoption of the Global Master Repurchase Agreement) have been put in place to develop the money and foreign exchange markets to enhance monetary policy transmission.

- The inflation trajectory remains benign. In 2018, inflation averaged 3.2%, lower than 2017's 3.8% average. The inflation pace was significantly lower because of the government's bid to support people's purchasing power by keeping administered prices of commodities stable. This is not surprising given that 2019 was a presidential election year. In any case, that was just as well because benign inflation allowed the monetary authorities to focus on their financial stability mandate during the May-November emerging market sell-off.

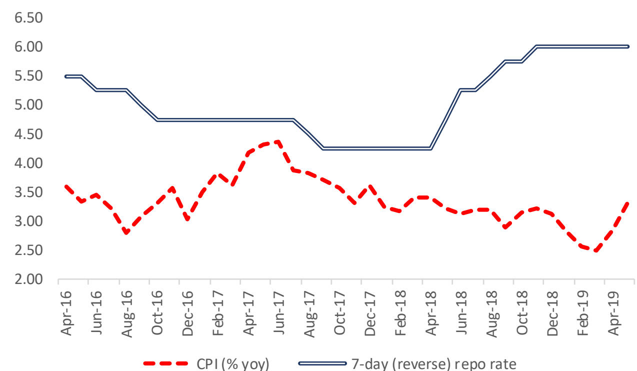
- The latest available data show the pace of inflation falling further to an average of 2.8% in the first five months of 2019, thanks in part to a good harvest that helped keep food prices under control. Should commodity pressures rise, or the IDR weaken, the government's freezing of retail fuel and electricity prices until end-2019 should contain any pass-through of inflationary impact. Given low inflation expectations and the fact that inflation is well within the central bank's target band of 2.5% to 4.5%, there is room for a supportive monetary policy stance in 2019. The central bank has kept its benchmark interest rate unchanged at 6.00% since November last year.

Exhibit 4: IDR exchange rate – against selected currencies



Sources: CEIC, MARC Economic Research

Exhibit 5: CPI inflation and central bank policy rate



Sources: CEIC, MARC Economic Research

Fiscal deficit narrows, government debt remains modest

- Indonesia's historically prudent and conservative fiscal policy remains focused on keeping aggregate fiscal discipline. In 2018, the fiscal deficit narrowed to 1.8% of GDP, well below the legal deficit ceiling of 3.0% of GDP. Revenue had jumped significantly by 17.3% largely due to the success of the government's tax amnesty programme. The programme, which ran from July 2016 until March 2017, had led to the declaration of assets worth around USD330 billion.

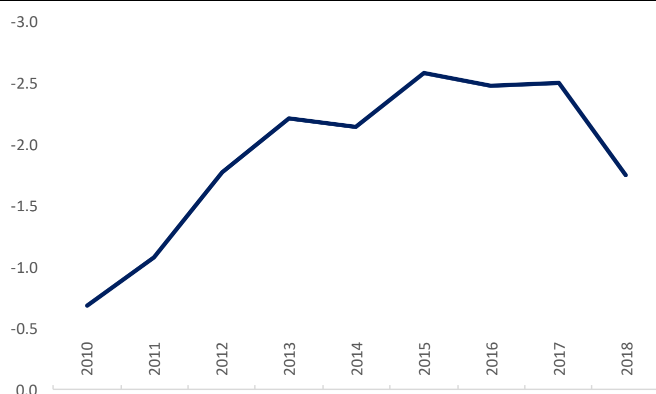
- Meanwhile, central government debt remains modest at 29.8% of nominal GDP as of end-2018. Thanks to a prudent fiscal stance anchored by a fiscal rule that limits government debt to below 60% (besides the legal deficit ceiling), government debt has fallen significantly from above 85% of GDP in 2000. In 2018, the debt maturity profile improved with the proportion of the long-term (by original maturity) portion rising to 97.7% of the total from 93.0% in the previous year. Meanwhile, the proportion of debt held by external creditors fell significantly to 40.6% as of end-2018, in part a reflection of the May-November emerging market sell-off.

- The tax amnesty programme may have been a success, though the fact remains that the capacity of the tax system is still low and tax evasion continues to be a critical issue even with rising compliance. For more than two decades, government tax receipts had reached less than 11% of GDP. During the 2014 presidential election campaign, then candidate Joko Widodo had promised to increase tax revenue to 16% of GDP. In the coming years, the government aims to raise the tax-to-GDP ratio by around two percentage points. For 2019, the finance ministry is projecting a tax ratio of just below 12%, which is lower than the 15% threshold required to stimulate inclusive growth.

- Indonesia, which trails its regional neighbours in terms of tax ratio, needs to boost revenue collection and increase its tax ratio. Besides improving fiscal sustainability, it needs more revenue to fund spending on infrastructure, human capital and social protection, which would also spur GDP growth, reduce poverty and raise overall well-being. In addition, a higher tax ratio would also reduce its dependence on volatile oil revenues.

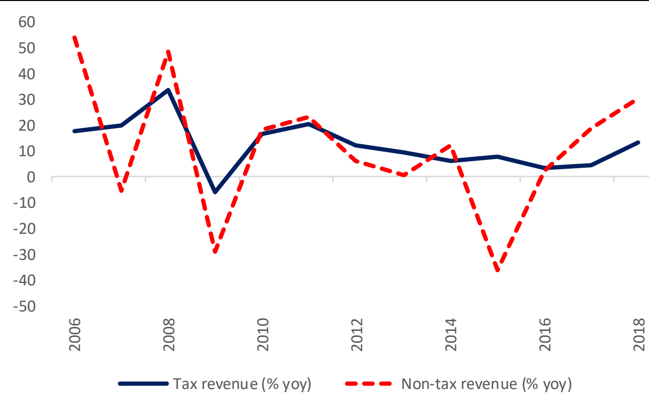
- To ensure that measures aimed at improving the tax ratio do not dent growth or exacerbate inequality, the government will need to, among other things, improve the design of various taxes, e.g. broadening the bases of income and consumption taxes. This should also reduce distortions. Meanwhile, the expansion of property taxation, if properly implemented, could provide local governments with additional funds. It could also expect to increase revenue from its natural resource wealth through the strengthening of property rights and fighting illegal extraction.

Exhibit 6: Budget deficit (% of GDP)



Sources: CEIC, MARC Economic Research

Exhibit 7: Tax and non-tax revenue



Sources: CEIC, MARC Economic Research

Incumbent's re-election win good for policy continuity

- In April 2019, Indonesia simultaneously held its presidential and parliamentary elections. In the divisive presidential election, the incumbent President Joko Widodo again faced Prabowo Subianto, the conservative former general and leader of the Great Indonesia Movement Party. According to a full vote count released by the General Elections Commission, Joko Widodo captured 55.5% of the vote, well ahead of his rival. His winning margin was more than double what he had garnered when they went head-to-head in 2014.

- Joko Widodo's victory had been expected given his strong approval ratings and the fact that he had nominated a senior cleric, Ma'ruf Amin, as his running mate. It is also likely that his rival's alliance with hard-line Islamists, which had raised concerns, helped. Joko Widodo's strongest showing was in areas with large populations of religious minority groups. All in, he won in 21 out of a total of 34 provinces.

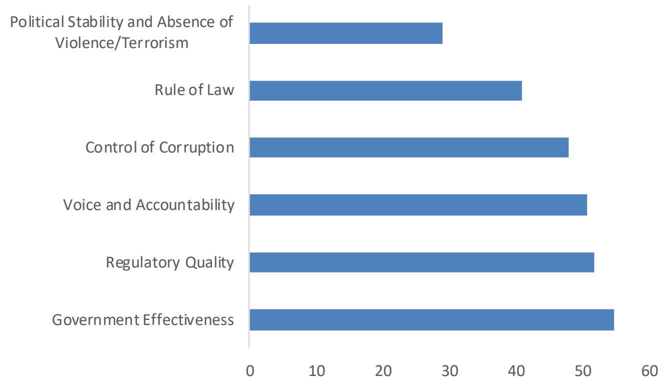
- Prabowo and his running mate Sandiaga Uno, in a bid to overturn the election results, have filed a lawsuit with Indonesia's Constitutional Court. He had made a similar bid five years earlier to overturn the 2014 election results after losing to Joko Widodo by 6.3 percentage points. It is important to point out, though, that the results of a national election have never overturned by the Constitutional Court.

- Joko Widodo's re-election win for a second term in office is positive as it should lift the political uncertainty that had been weighing on the economy. In addition, it is good for policy continuity as it would give him another five years to build on his performance. In his first term as president, he had rolled out a USD350 billion infrastructure drive, the biggest in Indonesia's history. His proposed continued public infrastructure spending, especially on urban and digital projects to boost economic growth, should help improve the overall well-being of Indonesians.

- Besides continuing to focus on infrastructure and the welfare of ordinary Indonesians, he also pledged to cut red tape that continues to hamper investment in Indonesia. Given Indonesia's poor percentile rank performance in all components of the World Bank's World Governance Indicators project, he will need to pursue bolder economic reforms in his second term which runs until 2024. It remains to be seen, though, whether he is prepared to take on powerful vested interests and shake up a huge bureaucracy that continues to stand in the way of reform efforts. In any case, he only has a narrow window to take advantage of "political capital" stemming from his re-election victory to lock in reforms.

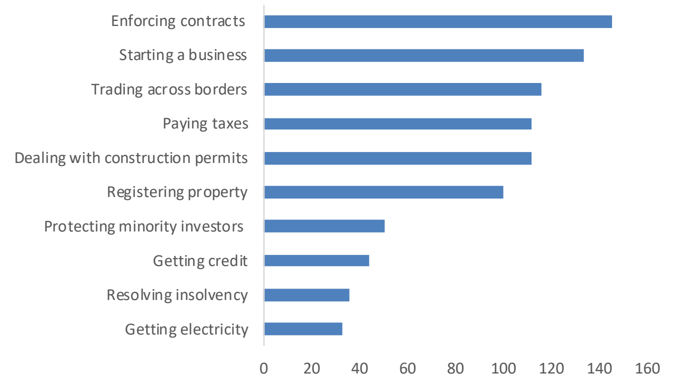
- Due to its issues with governance, it is not surprising that Indonesia does poorly in the World Bank's Ease of Doing Business report. In the latest edition of the report, Indonesia came in at number 73 overall out of 190 countries. It did especially poorly in the areas of "starting a business" and "enforcing contracts" where it was ranked 134 and 146.

Exhibit 8: Worldwide Governance Indicators, 2018 Update



Note: percentile rank
Sources: World Bank, MARC Economic Research

Exhibit 9: Doing Business 2019



Note: rank
Sources: World Bank, MARC Economic Research

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