Economic Analysis

Indonesia's GDP growth steadies in Q4 2014 as investment pick-up offsets weaker consumption

Sumedh Deorukhkar / Le Xia

Beating expectations of a sharper slowdown, Indonesia's real GDP growth steadied at 5.0% y/y in Q4 2014 (Consensus: 4.9%), a pace that matched the previous quarter; and led by a pick-up in investment activity, which offset weaker consumption expenditure and a deeper contraction in exports (See Figure – 1). The latest GDP outturn closes a challenging year for the Indonesian economy with average annual GDP growth slowing to a 5 year low of 5.0% in 2014 from 5.8% in 2013 and 6.3% in 2012. A key factor dragging consumption (66% share in Indonesia's GDP) in Q4 was a 33% hike in subsidized fuel prices last November and the subsequent policy rate hike by Bank Indonesia (See Figure – 2).

Looking ahead, we believe that risks to Indonesia's growth remain broadly balanced. Oil-led moderation in inflation pressures and the new government's commitment to enact structural reforms and pro-investment policies has helped improve business and consumer confidence. While this bodes well for growth prospects, Indonesia's economic recovery is likely to be uneven in 2015 as policymakers' battle external pressures emanating from 1) a protracted slowdown in commodity prices, particularly coal and palm oil, which are key export commodities of Indonesia 2) sluggish global demand and 3) looming normalization of US Fed rate which, we believe, would keep Bank Indonesia on a tight monetary policy stance throughout 2015.

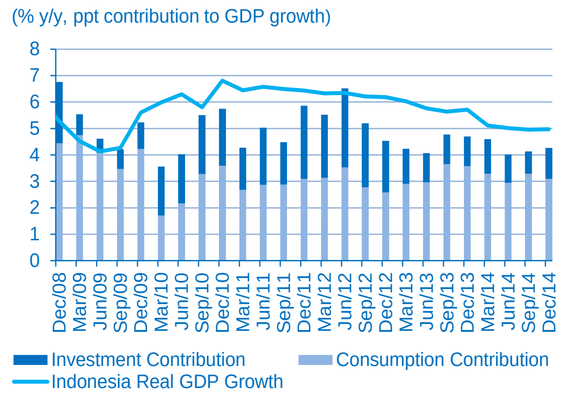
Meanwhile, domestic challenges related to effective implementation of structural reforms remain a concern despite waning opposition for the Jokowi government in pushing through its reform agenda. Against this backdrop, we expect Indonesia's Q1 2015 GDP growth to improve marginally to 5.2% y/y and project full year 2015 growth at 5.4% y/y, lower than the recently downgraded official budgeted target of 5.7% for 2015.

The Jokowi administration has stepped up efforts to boost investor confidence: Since taking office last October Jokowi has announced a series of initiatives aimed at enhancing fiscal space for productive spending, fast-tracking project clearances, streamlining an overbearing bureaucracy, improving transparency and cutting red tape. Chief amongst these include – 1) Move to scrap low octane gasoline subsidies and cap diesel subsidy at IDR 1000 per liter with subsequent savings to the 2015 state budget - to tune of IDR 230 trillion (USD 18.4 bn) - to be channelized towards infrastructure development and 1) Creation of a One Stop Services (OSS) center that acts as a single window clearance system for all licensing and non-licensing procedures of investment in Indonesia.

Furthermore, the new government's soon-to-be-approved revised budget for 2015 includes pro-business measures such as tax incentives for investments in manufacturing, close monitoring of infrastructure projects, expediting land acquisition and widening the tax base.

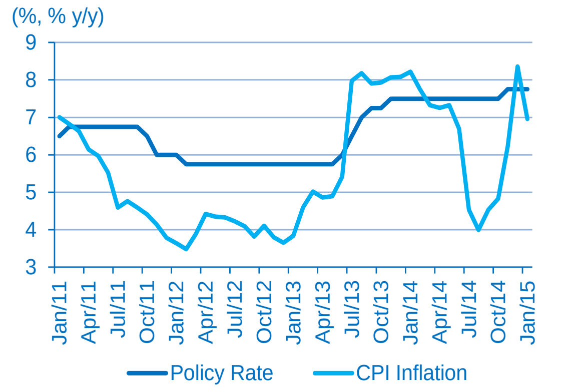
Effective implementation of reforms remain a key: Jokowi has hit the ground running on hard reforms while successfully building consensus within a once hostile parliament. However, risks to effectively implementing reforms remain significantly high for the new President. Particularly so given the fluid nature of Indonesia's politics and the inherent complexities in Indonesia's administrative system, where sub-national governments manage 50% of central government's budget. Monitoring projects and social spending is thus critical. If effectively executed, we believe that the new Government's reform efforts would spur long term foreign investments, fast-track key infrastructure projects and expand Indonesia's manufacturing base, in turn creating positive externalities on financial stability, inflation and the current account.

Figure 1
Q4 2014 GDP growth steadied near five year low as investment pick-up offset weaker consumption



Source: BBVA Research, CEIC

Figure 2
BI has kept monetary policy tight amid high inflation and risks from Fed policy normalization



Source: BBVA Research, CEIC

DISCLAIMER