Economics

DBS Focus

Indonesia: Surfacing economic weakness

Economics/Indonesia/Growth

Group Research

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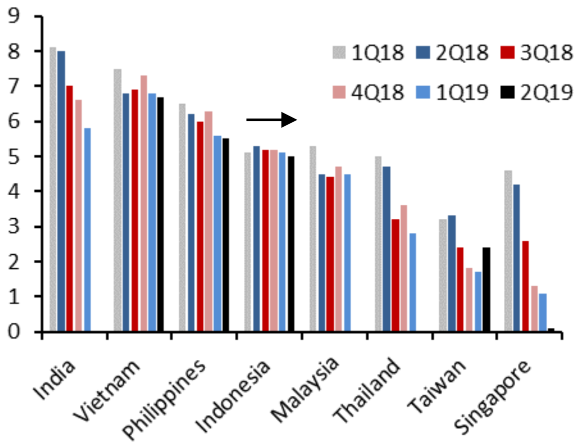
- *Growth was resilient in 2Q19 at 5%, supported by public and private consumption.*
- *Consumption and investment are likely to pick up as political uncertainty related to this year's elections ease. Expansionary fiscal and monetary policy should help.*
- *Some dark clouds linger, with a widening current account deficit, unrest in global markets, and weak commodity prices*
- *Fiscal policy could be more effective in supporting growth as monetary policy transmission to growth is lagging and constrained by tighter liquidity.*
- ***Implication for forecast**: We downgrade our growth forecast to 5.0% in 2019 and policy rate to be cut by 50bps in the coming months.*
- ***Implication for investors**: We remain positive on Indonesian assets, with slight preference over Indo govvies 5-10Y.*

Resilient growth in 1H19

Indonesia recorded a stable growth of 5% in 2Q19, contrary to the downward growth trend elsewhere. Main driver of growth in 2Q19 was consumption, both public and private. Total consumption was growing at 5.7% (way above the five-year average of 4.8%), with private and non-profit institution growing at 5.2% and government at 8.2% consecutively.

Indonesia's growth is relatively resilient
Real GDP growth (% YoY)



Source: CEIC, DBS

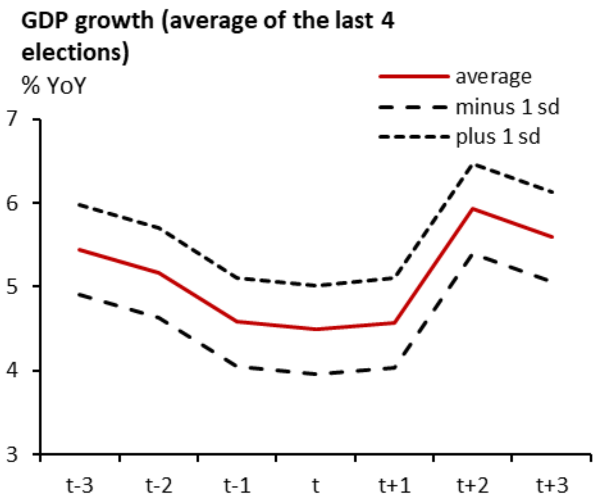
Investment growth eased, up 5% in 2Q19 (vs 6.9% in 1H18). We think government infrastructure focus could still support investment growth although not as strong as last year. Recent Purchasing Manufacturing Index (PMI) reading is still indicating expansion territory at 52.1.

We see risk to trade balance still tilt to the downside with continuing US-China trade tension and CNY depreciation. Imports has slowed down in recent months, but exports deterioration could last longer. Moreover, unlike countries such as Vietnam and Taiwan, Indonesia has not benefitted from production shift related to the trade war.

Widening trade deficit in 2H19 was due more to externally driven terms-of-trade deterioration, rather than volume. Exports volume (in YoY 3mma) is higher than imports. Further widening of deficit could be cause by imports volume growing faster than exports as infrastructure development continues.

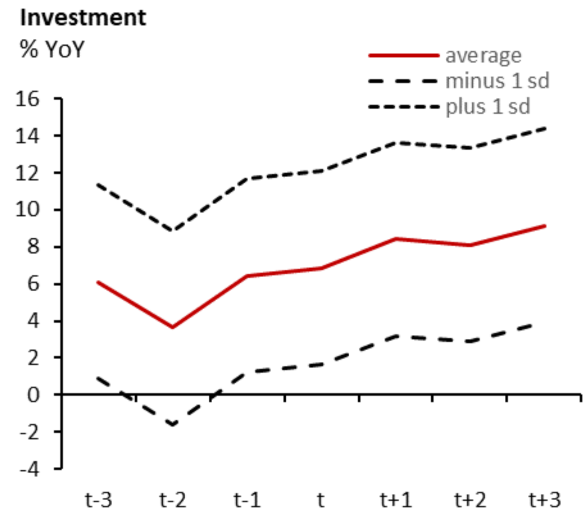
Possible growth levers this year

We think despite external sector slowdown; Indonesia's growth could still stay close to its potential at 5.0%. After-election boost via higher investment growth could be a critical factor. We did a simple event analysis assessing four democratic elections in the reformation era (1999, 2004, 2009 and 2014). We calculate the average and 1-standard-deviation bands around the average of the variables under study. **On average, growth slows down two quarters prior to the elections and rebound by an average of 0.7% in the next two quarters.** If the same trend persists this year, we still think that growth could stay above 5.0% this year.



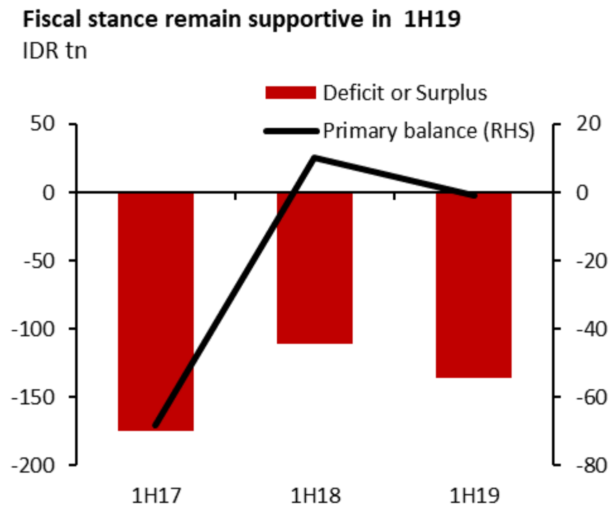
Source: CEIC, data transformations by DBS Group Research

Our event study exercise also shows that consumption inches up prior to the election and normalize after election. Investment grows slower prior to the election and accelerate afterwards as the wait-and-see behavior subside. On average, investment pick up by 0.6%, t+2 after the election.



Source: CEIC, data transformations by DBS Group Research

Additionally, fiscal lever could sustain growth momentum. Overall fiscal position was slightly more expansionary in 1H19 compared to 1H18, gauging from the primary balance turning negative from positive in 1H18. Yet, comparing to 1H17, fiscal has been more expansionary in 2018 and 2019, hence we think fiscal policy still have rooms to support growth further this year.



Source: CEIC, DBS

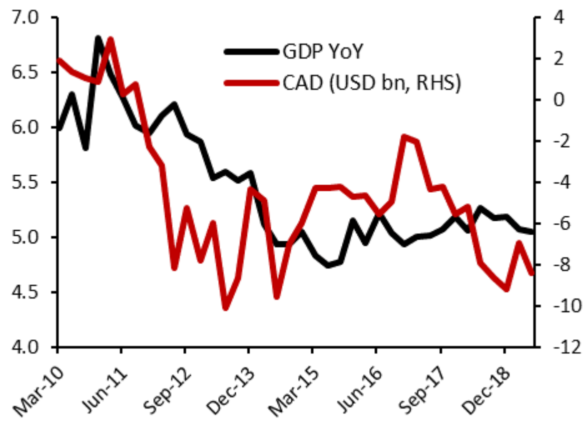
Bank Indonesia has emphasized that there is room for more accommodative monetary policy to support growth after the 25bps cut last month. Yet, the impact might not translate directly to growth this year due to the lag of monetary policy transmission. Tighter domestic liquidity and around 6 months repricing lag between lending and deposit interest rate could limit the effectiveness of the interest rate channel to credit and hence growth.

2Q19 current account deficit (CAD) worsened to 3% of GDP from 2.6% of GDP in 1Q19 due to seasonal repatriation of dividend, repayment of offshore borrowing and exports deterioration. With widening CAD and ongoing currency war tensions, BI will remain cautious on executing further rate cut. **We expect that magnitude of the cut might be kept similar to the Fed to preserve rate differential.**

After the commodity boom ended in 2013, CAD widened significantly during growth expansion. In the past 2 years, growth above 5.1% led to a deficit of -USD7.4bn (vs -USD4.7bn for growth below 5.1%) in the past three years.

In order to reduce this CAD-constrained tendency, real sector policies need to catch up with the demand side policies (both monetary and fiscal). These real sector policies include continuing the structural reform to lower logistic cost, improve ease of doing business, business-friendly labor law and development of higher value-added exports-oriented industries.

CAD-constrained growth
GDP growth and CAD (% YoY; USD bn)



Source: CEIC, DBS

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Sources: Data for all charts and tables are from CEIC, Bloomberg and DBS Group Research (forecasts and transformations).