Inside Indonesia

OCBC Bank

Fiscal Factor
Indonesia's GDP bears effects of government cutbacks

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- **At 5.02%yoy, Indonesia's Q3 GDP data comes slightly softer than the 5.08% that market pencilled in, and 5.1% we had in mind. It is also lower than the 5.18% achieved in previous quarter.**
- **The primary drag appears to be a sharp reversal in government spending in Q3, as the government shifted focus towards cutbacks to make sure that fiscal deficit would stay within the 3%-of-GDP limit.**
- **Elsewhere, all-important household consumption still chugged along at a relatively clip. Overall, the GDP number suggests that BI would continue to wait out global event risks towards year end before easing again next year.**

Soft Patch

It used to be 7% and more recently 6%, but whatever the medium-term growth target that the Indonesian government has in mind will have to contend with the current soft patch that the economy is going through now.

After a surge in GDP growth in Q2 this year to 5.18%yoy, compared to 4.91% in the quarter before, the data changed direction once more to dip south to 5.02% in the latest figure for Q3.

Source: Bloomberg, OCBC.

In a case of what the right hand gives, the left hand takes away, government spending which supported growth in Q2 turned and became a considerable drag in the latest quarter. Indeed, in year-on-year terms, support for the economy that originates from government spending grew was at -2.96% in Q3 – the lowest since at least 2011.

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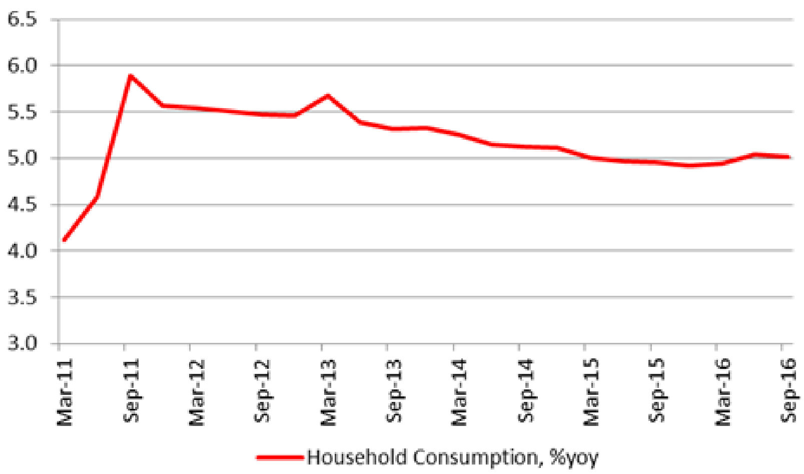
Source: Bloomberg, OCBC.

The proximate cause for the reversal in fiscal impetus was a change in thinking at the Finance Ministry after Sri Mulyani returned to her old desk in late July. She slashed what was likely an over-optimistic revenue target and took the decision to cut government spending, in order to make sure that the aggregate deficit for the year would not exceed the statutory limit of 3% of GDP.

In particular, funds transfer from the central government to municipal ones was cut by IDR68.8tn. This unfortunately caused a bit of a uneasiness among provincial and district leaders who were busy frontloading spending in the first half of the year, partly because they wanted to avoid being chastised for under-spending budget just like the year before.

The fiscal drag is likely to continue into Q4 this year, but will probably reverse itself once more early next year as the central government starts its fiscal arithmetic on a clean slate again. In addition, the 2017 budget looks to us to be one that is grounded in reality, without a hope-for-the-best optimism that carries the inherent risk of having to readjust spending downward sharply once more.

Elsewhere, it is heartening that private consumption continues to hold up well, growing at 5.01%yoy in Q3, which is pretty much the same as the 5.04% rate clocked in Q2. Despite the fact that some households would have experienced some liquidity shrinkage as they sought to pay the 2-4% penalty rates in order to participate in the tax amnesty program, it appears that the overall sector remains robust enough for us to think that it would continue to be a key support for growth in Q4 and into next year.



Source: Bloomberg, OCBC.

On this front, the fact that Bank Indonesia has slashed its policy rate repeatedly – by 6 times and 150bps – this year should help to anchor consumer sentiment, even if the slow transmission process towards lower lending rates would continue to bug policymakers. While we do continue to think that the central bank is not done easing yet, we believe that it will likely be holding a wait-and-see attitude and keep its policy rate unchanged for the remainder of the year, before we see some moves to ease rate by up to two times next year.

Overall, today's Q3 GDP print, while proving to be slightly disappointing, still suggests to us that the economy is bottoming out and would likely pick up modestly next year. We see growth averaging 5.0% this year, and for it clock 5.2% in 2017.