INDONESIA

GDP growth has been high and is set to edge up in 2017 and 2018. Government infrastructure spending continues to underpin economic activity, and both private consumption and private investment are showing signs of firming. The current account deficit is projected to be stable.

The central bank has eased rates six times since the beginning of the year. The government has released a string of reform packages over the past year to improve the business environment, streamline investment and liberalise inward investment. There should be scope for a few more interest rate cuts in the medium term, as inflation is projected to remain subdued. However, the fiscal balance is deteriorating owing to slower growth and low commodity prices. Public expenditure is being reined in to avoid breaching the legal deficit limit of 3% of GDP.

The government’s priority has been to lift spending on infrastructure and social services, notably health and education. This policy is welcome as it will raise growth and make it more inclusive. However, the deficit’s proximity to its legal ceiling has led to cuts in planned expenditure. While an ongoing tax amnesty may help ease this constraint in the short term, in the longer term tax revenues, which are very low, will have to be boosted. Policies are needed to address the narrow tax base, the low number of taxpayers and weak compliance.

Activity has started to pick up

Growth in Indonesia continues to outpace that of most other countries. Aggregate demand expansion has held up, fuelled largely by household consumption, which, in turn, has been underpinned by healthy labour market outcomes and strong real wage increases. The other components of spending have been weaker but have also been picking up. Investment was hit by weak commodity prices and regulatory uncertainty in the mining sector, but has now started to recover on the back of stabilised commodity prices and

1. 2016-18 are OECD estimates.
Source: Statistics Indonesia (BPS); Ministry of Finance of Indonesia; OECD Economic Outlook 100 database and Bank Indonesia.

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accelerated government spending on infrastructure. Exports are also beginning to recover after sharp declines due to lower external demand for commodities and a ban on exporting unprocessed ores.

After having depreciated significantly since the end of 2011, the rupiah has stabilised and even recovered somewhat over the past year. Nevertheless, the currency remains at a

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The rupiah has stabilised, and the current account deficit has fallen

Credit growth continues to decline

Source: Bank Indonesia and OECD Economic Outlook 100 database.
low level, and this has helped the current account deficit to narrow. Still, Indonesia remains in need of external funding and is thus exposed to volatile international monetary conditions.

The policy environment is supportive

Inflation has now been within Bank Indonesia’s (BI) target range of 4±1% for almost a year, and the central bank has lowered interest rates six times since the beginning of 2016. In August 2016, BI switched to a new target policy instrument, the 7-day reverse repo rate, which is expected to improve the transmission of monetary policy to the real economy. Nevertheless, real interest rates remain high, credit growth is at historic lows, and a wedge has continued to widen between the nominal and real effective exchange rates as price growth in Indonesia continues to outstrip that in other countries.

Fiscal policy had until recently been mildly expansionary, but in recent months official projections have suggested a worsening fiscal balance as higher spending on infrastructure, social security and transfers to sub-national government has outstripped the savings from the 2015 cut in fuel subsidies. Slower growth and low commodity prices have also cut into revenue. In light of these revenue shortfalls, the government has twice revised the 2016 budget, including expenditure cuts totalling over 7% of expenditure. A tax amnesty now underway is meant to help plug the hole in the budget. Public debt is low, at 27.3% of GDP in 2015, well below the 60% constitutional limit.

Going forward, the many urgent needs for government action and spending imply that increasing its size, both in terms of spending and revenue, is inevitable. This will require raising taxes by broadening the base and strengthening tax administration. In addition to improving the country’s infrastructure, more needs to be done to tackle poverty and inequality – especially in the remote regions. While impressive progress has been made in improving standards of living, the social security system needs to be further expanded and access to high quality health and education improved. Addressing the high rate of labour market and business informality would facilitate access to government services and broaden the tax base.

Growth is projected to pick up slightly

GDP growth is projected to edge up over the coming two years, with household consumption still underpinning activity and exports recovering from the recent contraction. While private investment is also set to continue to recover, public consumption and investment, which have been among the main drivers of recent growth, are both set to be curbed as fiscal pressures mount.

There are several risks to the outlook. Firstly, if revenues continue to weaken, the government could hit the maximum deficit threshold and be forced to pull back on general expenditure, including infrastructure spending. If the switch from public to private participation in infrastructure investment does not happen, activity will weaken. Secondly, if trading partner demand falls dramatically and the external balance worsens, the exchange rate may come under renewed pressure, and the monetary authorities would have to be more cautious. An increase in worldwide trade protectionism would also threaten growth in Indonesia. On the upside, commodity prices may rebound more strongly, and this would boost growth and reduce the fiscal deficit.