INDONESIA

GDP growth should firm in 2017. Private consumption is underpinning activity. Infrastructure spending is rising, notwithstanding fiscal constraints, and external demand is firming. Private investment is growing only moderately.

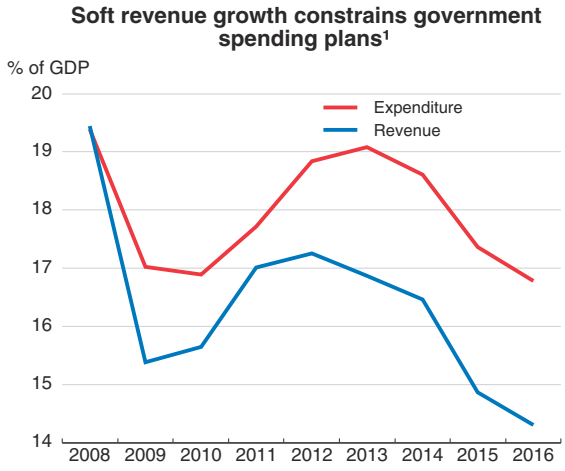
Inflation is around the 4% mid-point of the central bank's target range, and the exchange rate has been remarkably stable. Monetary policy remains on hold for now and is considered to be broadly neutral. But if the exchange rate remains stable while US monetary policy tightens, there would be scope to cut interest rates in 2018 to support activity. Fiscal outcomes will depend on the success of measures to improve tax collection.

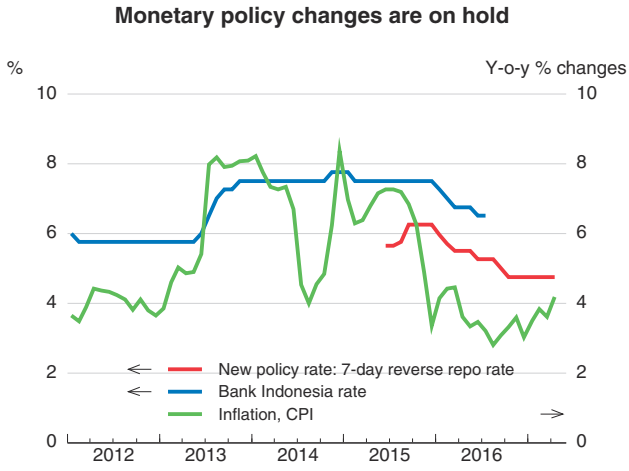
Exports of commodities such as coal, rubber and copper ore are supporting growth. Being more open to foreign trade and investment would help to diversify economic activity and exports, in particular through greater engagement in global value chains. This would create high-skill, well-paid employment and facilitate technology transfers. In turn, a larger tax base would allow the social safety net to be expanded and make growth more inclusive.

The recovery is firming

Growth in Indonesia continues to outpace that in most other countries, although it is below previous rates. Aggregate demand has held up, fuelled by government spending. However, despite healthy labour market outcomes and strong real wage increases, private consumption has failed to accelerate. Business investment was hit by weak commodity prices and regulatory concerns in the mining sector, but it has now started to recover on the back of rising commodity prices and higher government spending on infrastructure. Exports are growing because of higher commodity prices, stronger external demand and some conditional relaxation of restrictions on exports of raw materials. Motor vehicle sales are expanding rapidly, and manufacturing indicators point to fairly strong activity. Credit growth remains weak, but there are signs that it may be picking up. Nevertheless, there are still concerns about rising non-performing loans, which may also act to hamper credit extension.

Indonesia





1. General government.

Source: Statistics Indonesia (BPS); International Monetary Fund, Fiscal Monitor; and Bank Indonesia.

StatLink http://dx.doi.org/10.1787/888933503263

Indonesia: **Demand, output and prices**

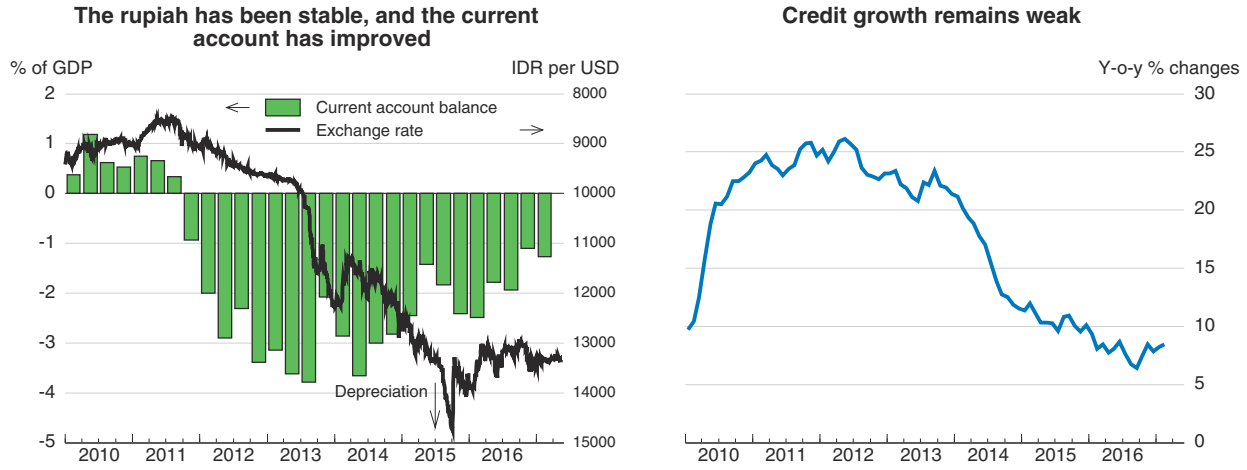
	2013	2014	2015	2016	2017	2018
	Current prices IDR trillion	Percentage changes, volume (2010 prices)				
GDP at market prices	9 546.1	5.0	4.9	5.0	5.1	5.2
Private consumption	5 425.0	5.3	4.8	5.0	5.0	5.1
Government consumption	908.6	1.2	5.3	-0.1	2.6	3.5
Gross fixed capital formation	3 051.5	4.4	5.0	4.5	5.3	5.7
Final domestic demand	9 385.1	4.6	4.9	4.3	4.9	5.1
Stockbuilding[1]	236.5	0.8	-0.9	0.6	-0.5	0.0
Total domestic demand	9 621.6	5.3	3.9	5.0	4.4	5.2
Exports of goods and services	2 283.8	1.1	-2.1	-1.7	10.7	5.6
Imports of goods and services	2 359.2	2.1	-6.4	-2.3	7.9	5.7
Net exports[1]	- 75.4	-0.2	1.0	0.1	0.7	0.1
Memorandum items						
GDP deflator	_	5.4	4.0	2.5	4.4	4.0
Consumer price index	_	6.4	6.4	3.5	4.4	4.0
Private consumption deflator	_	5.7	4.4	3.1	4.0	3.6
General government financial balance[2]	_	-2.1	-2.5	-2.5	-2.7	-2.5
Current account balance[2]	_	-3.1	-2.0	-1.8	-1.4	-1.5

1. Contributions to changes in real GDP, actual amount in the first column.
2. As a percentage of GDP.
Source: OECD Economic Outlook 101 database.

StatLink http://dx.doi.org/10.1787/888933506265

After having depreciated significantly since the end of 2011, the rupiah has been remarkably stable since November 2016. Nevertheless, the currency remains at a low level, and this has helped the current account deficit to narrow substantially. Positive perceptions about the economy have recently spurred capital inflows. Indonesia remains reliant on external funding and is thus exposed to volatile international monetary

Indonesia



Source: Bank Indonesia; and OECD Economic Outlook 101 database.

StatLink http://dx.doi.org/10.1787/888933503282

conditions. However, as of May 2017 Indonesia has an investment grade sovereign credit rating from all three major rating agencies. This should support capital inflows and lower funding costs for private and public borrowers.

The policy environment is supportive

Inflation has been inside the Bank Indonesia's target range of 4±1% for more than one year and a half, allowing the central bank to lower interest rates six times since the beginning of 2016. Inflation has edged up in 2017 due to increases in administered prices associated with reduced subsidies for electricity, but these effects are temporary. The switch to using the 7-day reverse repo rate as a policy instrument in August 2016 was expected to improve the transmission of monetary policy. But real interest rates remain high, and credit growth is low. A wedge has continued to widen between the nominal and real effective exchange rates as inflation in Indonesia has outstripped that in other countries.

The intention to boost infrastructure and social spending and to increase transfers to sub-national authorities will expand potential output and render the economy more inclusive. Achieving the planned state budget deficit of 2.4% GDP in 2017 requires strong increases in revenues, even if more moderate than the 2016 objective. Difficulties with revenue collection, together with the legal deficit ceiling of 3% of GDP, limit additional spending, despite the low level of public debt (around 28% of GDP). However, the tax amnesty that has just wound up was fairly successful, attracting almost 1 million taxpayers and raising the equivalent of 1.1% of GDP in revenue, which was 81% of its target. Nevertheless, only 14% of the assets declared offshore were repatriated.

Tax collection needs to improve to sustainably expand the provision of public services. Further measures are needed to address the narrow tax base, the still low number of taxpayers and the weak level of compliance. An effective implementation of reforms to tax administration and regulations would increase revenues and broaden the tax base. Continued efforts to reduce subsidies for energy and food would free up spending for priority areas, such as infrastructure, education and health.

Growth is projected to edge up

GDP growth is projected to rise slightly to just over 5% in 2017 and 2018, with household consumption still underpinning activity and exports rebounding from the recent contraction. While private investment is also set to continue to recover, public consumption and investment, while rising, will be curbed by the limited fiscal space.

The recent ratings upgrade to an investment grade may lower interest rates and expand the supply of capital, thereby spurring stronger private domestic demand than projected. Government revenues, and therefore spending, could also be greater than projected, if efforts to raise tax collections bear fruit, or commodity prices rise further. A stronger pick-up in demand from China or other regional partners would boost exports. On the downside, rising protectionism abroad would weigh on exports. This, or another unexpected deterioration in the external balance, would also put the exchange rate under renewed pressure, requiring the central bank to be more cautious and to delay or even reverse the recent interest rate cuts. There is also a risk that the expected switch from public to private participation in infrastructure investment does not happen as quickly as planned.