Economic Analysis

# Indonesia | GDP growth improves in Q4 2015

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Indonesia's Q4 2015 GDP growth improved to 5.0% y/y from 4.7% y/y in the previous quarter (Consensus Est.: 4.8%; BBVA Est.: 5.0%), led mainly by a pick-up in investment activity and a ramp up of government's capital expenditure disbursement, which offset the drag from weak external demand. Meanwhile, private consumption growth was flat but healthy amid rising real income levels in the wake of falling oil prices. Looking ahead for 2016, the spill-over effects of fed rate normalization, concerns over a disorderly economic deceleration of China, lingering geopolitical risks and commodity currency interplay means Indonesia's growth prospects largely depend on policy efforts towards strengthening domestic growth fundamentals.

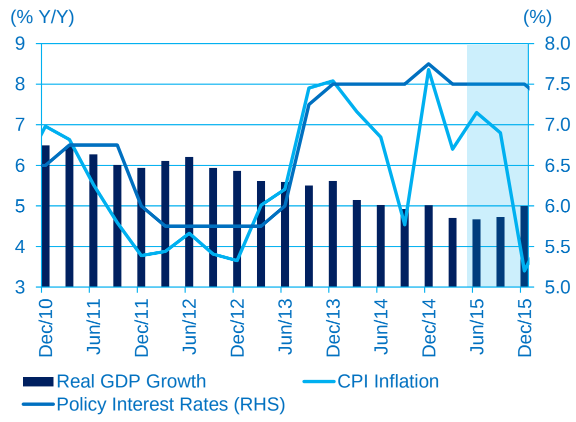
We maintain our above consensus 2016 GDP growth expectations for Indonesia at 5.3% (consensus: 4.9%), compared to 4.8% in 2015 (BBVA Est. 4.8%; slowest since the global financial crisis), driven primarily by a quicker rate of productive public spending, effective execution of recent reform measures and an improvement in domestic demand on the back of further monetary policy easing. On fiscal front, the government's progress on achieving the 2016 budgeted capex target, which is 45% higher than the realized amount last year, will be crucial. Meanwhile, following the 25 bps cut last month, we expect Bank Indonesia to cut interest rates by another 50 bps over the rest of 2016 from 7.25% currently given a favorable inflation outlook, albeit in a measured manner as it will be cognizant of depreciation pressures on the rupiah.

**Effectiveness and predictability of policy is gaining traction in Indonesia.** The past year has seen visible improvement in Indonesia's monetary and financial sector management, which has contributed to policy effectiveness. Announcement of broad-based economic measures (See our previous flash) to boost consumer purchasing power and attract investments, sound fiscal buffers and sufficient external buffers alongside Bank Indonesia's prudent monetary policy approach with a focus on anchoring inflation have augured well for Indonesia's credit matrix. The improving institutional and policy setting has aided investor confidence in Indonesia, in turn supporting the currency (the rupiah has appreciated 2.4% year to date against the USD). Encouragingly, recent investment activity indicators including foreign direct investments, cement consumption, capital goods imports and credit for investment purposes has been encouraging although it's too early to confirm a sustainable trend. Consumption demand is expected to improve ahead, as reflected by January 2016 consumer confidence index increased to a 5 month high buoyed by expectations of lower inflation pressures amid subdued energy prices and the incoming harvest season and improving economic growth prospects.

**… All said, Indonesian authorities need to step up the quality of public sector expenditure,** whose delivery remains below schedule (77% of budgeted capital expenditure disbursed in 2015), while showcasing greater commitment towards implementing difficult reforms aimed at making rigid labor laws more flexible, directly tackling red tape, and narrowing the large negative investment list that restricts foreign investments across key sectors. Besides, regulatory certainty and effective coordination amongst authorities to make land acquisition easier and enforce the new legal framework that supports public private partnerships is crucial.

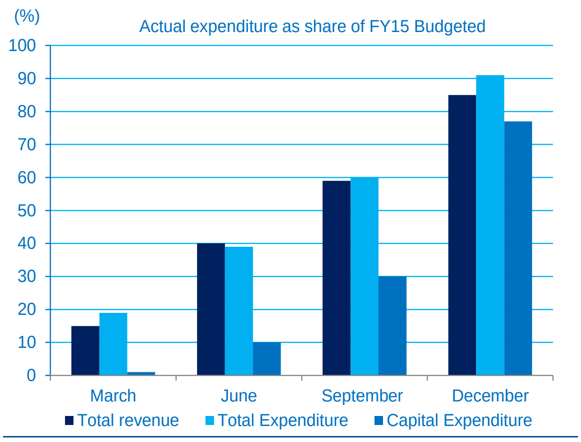
**Cautious optimism on Indonesian banking sector:** The challenging economic backdrop has raised doubts over the ability of Indonesian banks to effectively manage tail risks arising from 1) banks' exposure to foreign currency debt and 2) the presence of weak banks that can trigger a contagion. We believe that the tail risks facing Indonesian banks are manageable given 1) relatively low levels of NPL ratios, 2) high share of current and savings (CASA) deposits in their overall funding mix, 3) remarkably high profitability levels, 4) strong capital buffers, 5) on-going policy efforts towards banking sector consolidation, and 6) closer regulatory oversight to limit slippages in asset quality (See our recent ASEAN Banking Watch).

Figure 1
**Indonesia's Q4 GDP growth improves**




Source: BBVA Research, CEIC

Figure 2
**Productive public spending picked up in 2H15**




Source: BBVA Research, CEIC

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