A new look at Indonesia's growth

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- Our Indonesia Growth Tracker shows that the process of raising growth will need manufacturing reforms and gradually higher fiscal expenditure

To get a quick and reliable read on how Indonesia is growing, we have created an Indonesia Growth Tracker, which brings together a bunch of activity data and provides a monthly summary of economic activity across the key sectors of the economy.

You may ask why do we even need this tracker when we already have an official GDP series. Well, GDP may not capture turning points quickly as it is quarterly and only available with a lag. Encouragingly, our tracker has a 70% correlation with GDP in the post pandemic period, which means that important information contained in GDP gets highlighted early. What could be better?

So what is the tracker showing currently? Alas, it shows that activity has been weak in recent quarters - in fact, a shade weaker than GDP data suggests. It seems that the sharp fall in commodity prices, especially in coal, which Indonesia exports, has led to weakness in growth. Furthermore, a volatile external backdrop is coming in the way of policy rate cuts. And fiscal policy, too, hasn't been loose. Finally, the scarring from the pandemic is still likely impacting data.

What can be done to set growth back onto a rising path? This is particularly important given the new government taking over in October aims to raise growth from 5% now to 6% to start with, and eventually all the way to 8%.

To answer this more precisely, we fit a growth model to the activity tracker to understand what drives growth in the economy. We find five variables explain much of the country's growth dynamics.

Growth is positively correlated to global commodity prices given large commodity intensive exports. Government spending matters too. Here we find that, in particular, high quality capital expenditure in infrastructure, health, and education boosts growth even more than spending on current expenditure like subsidies. Growth in the near past matters too as it captures long-lasting drivers like scarring post the pandemic.

Growth is negatively correlated to policy rates. It is well known that higher rates dull activity. Finally, and most importantly, macro instability hurts growth. For instance, instability created by a sharp rise in the public debt ratio can prove counterproductive to growth aspirations.

Our model gives us some recipes for pushing growth back up.

One, the economy is still not free from commodity price shocks. In fact, most of the current weakness in growth is explained by the sharp fall in commodity prices from a year ago.

True, the economy has moved up the value added curve of manufacturing, from being an exporter of ores to an exporter of processed metals. But to be fully independent of commodity price shocks, it needs reforms to rise further up the value chain. Over time, a rising share of manufacturing in GDP will be a good indicator to track if it is indeed happening.

Two, there seems to be a sort of dual monetary policy at play.

On the one hand, policy rates are elevated in line with the objective of keeping the rupiah stable. On the other, macro prudential policies remain pro-growth. For instance, there's lower Reserve Requirement Ratios for lending to priority sectors. This has ensured that loan growth remains strong. As such, overall monetary policy is not as tight as policy rates suggest, and the drag on growth is not as large. This also suggests that policy rate cuts may not give the same boost to growth, as it did in the past.

Three, government spending helps, but within limits. Our model explains clearly that while higher government spending adds to growth, a sharp rise in spending which raises public debt ratios quickly, and questions macro stability, takes away from growth.

A truly growth enhancing way to raise government spending would be to focus on raising spending within the current fiscal limits in the short run. The fiscal deficit in 2023 came in at 1.7% of GDP, while the legislated fiscal cap is much higher at 3%.

Indeed, we find that if the fiscal deficit remains within the legislated 3% of GDP cap, expenditure can still rise from current levels, pushing up GDP growth by 0.3ppt over time, while keeping public debt at current levels of 39% of GDP. If the fiscal deficit is raised to around 4% via a legislative change, growth could be 0.5ppt higher, but so would debt. Public debt could rise to about 45%.

But if fiscal deficit rises to 6% of GDP, public debt will be closer to 50% in five years. At these levels, the overall impact on growth will be negative.

To conclude, our Indonesia Growth Tracker shows that the process of raising growth will need reforms and gradually higher fiscal expenditure. A sharp rise may prove counterproductive.

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This op-ed is based on our report: ***A new look at Indonesia's growth: Will rates, commodity prices or fiscal spending help?,*** 19 June 2024

Link to The Jakarta Post article: ***A look at Indonesia's growth under the new government| The Jakarta Post***