Taking the bitter but necessary pill?

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Summary

- The government has little option but to increase its tax revenue in 2025, with an upward adjustment to the VAT tariff offering the highest chance of success, given the bleaker outlook for other sources of tax revenue.
- The higher VAT tariff may halt the recent improvement in household consumption, as the pass-through effect on retail prices, combined with the weak outlook for wage growth, could further slow household demand growth.
- The government will need to ensure timely spending realization following the VAT hike, as higher demand from lower-income households will be crucial to offset the foregone demand from better-off households.

- The global financial market seems to be calming down of late. The nomination of a fiscal hawk to head the US Treasury Department under the next Trump administration stops the sell-off in the UST market, bringing the benchmark 10Y UST yield below the 4.2% mark as the market closed last week (albeit spiking up to 4.23% again yesterday). Lower concerns on the US' fiscal conditions and tariff measures have also cooled down the rally in the USD market, as the DXY index moves 1.08% below its YTD high of 107.6 achieved in late November 2024.
- The condition of Indonesia's financial market remains uncertain. The benchmark 10-year SBN yield has hovered between 6.87-6.90% over the past week, up from the 6.43-6.84% range observed before the USD began its post-U.S. election rally. The drivers of recent SBN market movements are unclear, partly due to delayed data updates. What is more evident is the ongoing pressure on the domestic stock market from foreign investors. Over the past week, foreign capital stock in the market declined by USD 209.6 Mn, although it rebounded early this week.
- The lack of momentum in the domestic stock market reflects the broader slowdown in the real sector. This deceleration is evident in the 4.95% YoY real GDP growth recorded in Q3 2024 and is further highlighted by the continued decline in headline CPI inflation, which dropped to 1.55% YoY in November 2024 from 1.71% YoY the previous month. Increased government spending on programmes with more profound spillover effects, such as social spending, is expected to boost the domestic aggregate demand

condition – particularly in Q4 2024 as the government seeks to accelerate the realisation of its social spending targets before the year's end.

Timing is the key

- The government has announced its intention to hit the ground running in the new year, moving away from the traditional model of slower fiscal spending realisation in the first half of the fiscal year. This fiscal ambition, of course, will only go as far as the government's ability to secure the necessary financing, explaining the planned 42.2% increase in net SBN issuance to IDR 642.6 Tn in 2025. Additionally, the government aims to raise the tax ratio to around 12% in 2025 (10.21% projected for FY2024), as the depleted excess budget balance limits the option to secure the necessary financing.
- The Ministry of Finance, as we know, have scheduled an increase to the VAT tariff by 1% to 12%, to be effective as soon as the calendar flipped into 2025. The decision to announce the VAT tariff adjustment is not surprising. **The 2025 state budget is based on a projected 12% tax ratio, but with commodity prices flatlining compared to previous super-cycles, income taxes cannot be heavily relied upon to drive higher fiscal revenue.** Consequently, the government has limited options but to adjust the VAT tariff, particularly since fiscal revenue from VAT has remained largely stable in 2024 compared to the previous year ***(see Chart 1)***.

"The limited rally in the global commodity market means that the government may not have many options to increase tax revenue but from a higher VAT tariff".

- The recent upward trend in household consumption may further strengthen the government's resolve to adjust the VAT tariff next month ***(see Chart 2)***. Despite lower annual inflation, steady and positive growth in consumer transaction data indicates an improvement in household demand in real terms, as lower goods prices and stable food supplies (particularly for staples like rice) have so far enabled consumers to add more items to their consumption baskets. **The question, then, is how significant the adjusted VAT tariff will damage the prospect for further recovery in the household demand condition**, especially for the middle-income household that is also in the crosshair amid the government's effort to enhance the accuracy of subsidy spending.
- Unfortunately, our observations of consumer transaction data in modern and traditional markets across the Jakarta metropolitan area show **little evidence of robust demand among middle-income households at present, even before the adjustment in the VAT tariff and stricter distribution of subsidised goods.** Growth in consumer transactions at Tier 1 (high-end) shopping centres has slowed sharply, in stark contrast to the steadier performance observed in Tier 2 and 3 shopping centres – indicating a down-trading trend across the household sector. With that being said**, the higher VAT tariff may reduce consumption growth to around 4.5%, while the pass-through effect on retail prices**

may add around 0.4% to the headline CPI inflation.

- We have attributed the fluctuating household demand conditions throughout the year to a declining consumption rate. Indeed, improved financial literacy and attractive coupon rates offered by retail SBNs have encouraged a shift in household behaviour toward increased investments, which also translates badly for the outlook for liquidity conditions within the banking sector.
- However, we are also increasingly confident that the improving-yet-fickle household consumption trend has something to do with the equally uncertain outlook for household income ***(see Chart 3)***. Our observations of corporate-level data reveal a sharp slowdown in annual wage growth, particularly in higher-skilled sectors such as chemical product manufacturing and industrial services. **Higher wage growth, which also indicates better employment prospects, seems to be limited to retail and consumer services sectors, meaning that the spillover effect to consumption may not be too significant given the considerably lower average income per worker in those sectors.**
- It is evident, then, that the government faces a dilemma between balancing its fiscal budget and achieving the ambitious growth target it has set for 2025. This aligns with our sentiment following the announcement of the draft 2025 state budget—that the assumptions only allow for a narrow margin of error, and the fiscal space is too constrained to accommodate the government's numerous commitments, leaving the budget posture highly vulnerable to shocks in revenue or spending realisation.
- The Indonesian government, of course, has been trying to be creative in its funding strategy, with the establishment of a new sovereign wealth fund (Danantara) aimed at undertaking off-budget public investments. Additionally, another tax amnesty program is being prepared to provide much-needed liquidity in the short term. However, we should look into these not-so-new initiatives more as a temporary shot in the arm rather than part of a permanent solution to Indonesia's narrow fiscal space, given that the cash influx due to the higher leverageable assets and cash influx from the unearthed tax subjects may not be repeated in subsequent years.
- Any plan to raise the tax revenue could be defended as a strategy to extract more contributions from the excess to provide more support for the needy. In this, timing will be the key. **It will be crucial for the Indonesian government to ensure a timely spending realisation following the VAT tariff hike, as higher spending from the middle-lower income classes will be needed to offset the declining demand from the better-off households.** Consequently, problems with the spending side of the budget realisation will damage the growth outlook, while lessons from the global bond market in recent years have shown that failure to hit the revenue target may breathe instability to the domestic bond market.

"A timely spending realisation will be needed to offset the detrimental effect of the higher VAT tariff on household consumption"

Chart 1

Doubling down on the old reliable

VAT revenue remains relatively reliable compared to other sources of fiscal revenue in 2024, a trend that seems to encourage the government to float the VAT tariff hike plan in 2025

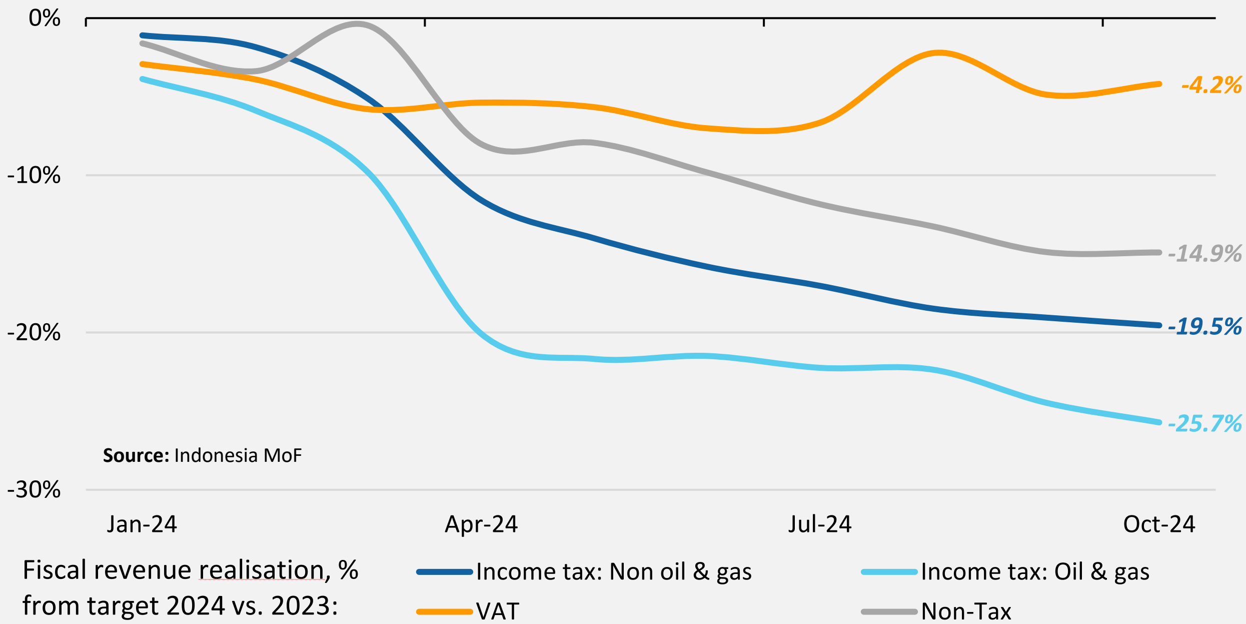


Chart 2

Another bump in the road

Despite the bottoming-up trend, higher VAT tariffs may slow down further recovery in household consumption in the upcoming period

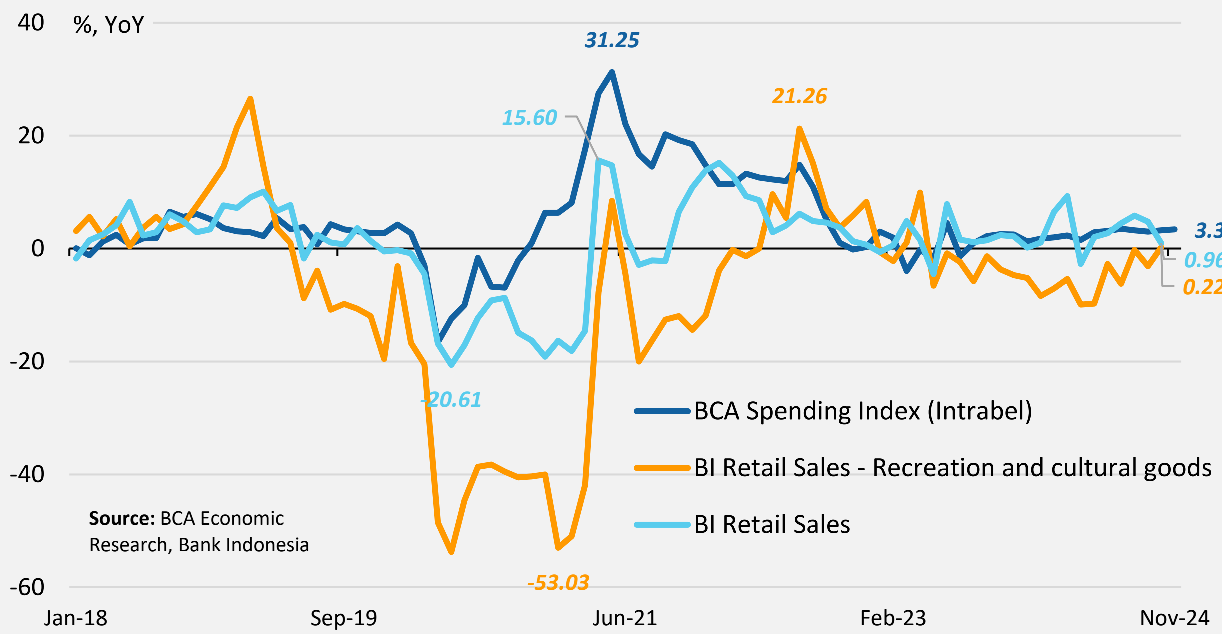
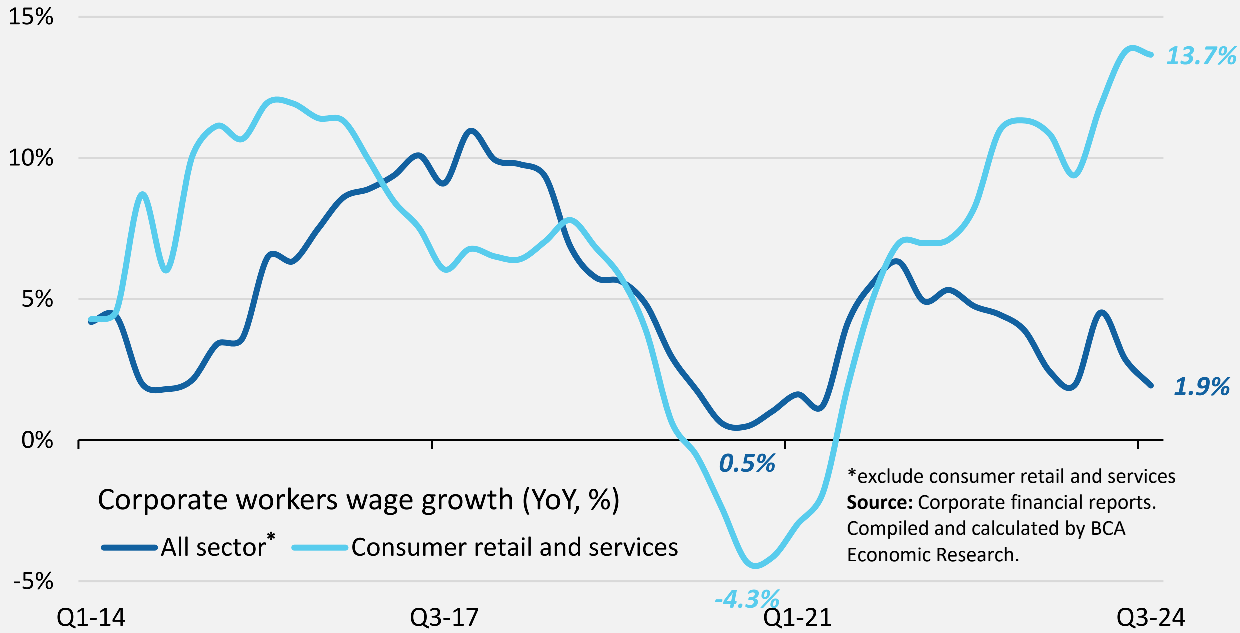


Chart 3

The payroll might not be rolling

The plan to hike the VAT tariff contrasts with the outlook on wage growth, which has been slowing down as the corporate sector thrives for efficiency rather than growth.



Economic Calendar

		Actual	Previous	Forecast*
02 December 2024				
ID	S&P Global Manufacturing PMI	49.6	49.2	49.6
ID	**Inflation Rate YoY, %**	**1.55**	**1.71**	**1.6**
US	S&P Global Manufacturing PMI	49.7	48.5	48.8
05 December 2024				
US	Balance of Trade, USD Bn		-84.4	-83
06 December 2024				
ID	**Foreign Exchange Reserves, USD Bn**		**151.2**	**152.0**
US	Non-Farm Payrolls, th		12	194.0
07 December 2024				
CN	Balance of Trade, USD Bn		95.27	89.0
09 December 2024				
CN	Inflation Rate YoY, %		0.3	0.5
ID	Consumer Confidence		121.1	121
10 December 2024				
ID	Retail Sales YoY, %		4.8	4.5
11 December 2024				
US	Inflation Rate YoY, %		2.6	2.7
16 December 2024				
CN	Retail Sales YoY, %		4.8	4.5
ID	**Balance of Trade, USD Bn**		**2.47**	**-**
17 December 2024				
EU	Balance of Trade, USD Bn		12.5	-
US	Retail Sales YoY, %		2.8	**-**
18 Desember 2024				
ID	Loan Growth YoY, %		10.92	-
ID	**Interest Rate Decision, %**		**6.0**	-
EU	Inflation Rate YoY, %		2.0	2.3
19 Desember 2024				
US	**Fed Interest Rate Decision, %**		**4.75**	**4.5**
20 December 2024				
US	PCE Price Index YoY, %		2.3	-
ID	Motorbike Sales YoY, %		5.4	-
ID	Car Sales YoY, %		-3.9	-
22 December 2024				
ID	M2 Money Supply YoY, %		6.7	-

*Forecasts of some indicators are simply based on market consensus
Bold indicates indicators covered by the BCA Monthly Economic Briefing report

Selected Macroeconomic Indicator

Key Policy Rates	Rate (%)	Last Change	Real Rate (%)
US	4.75	Nov-24	2.15
UK	4.75	Nov-24	2.45
EU	3.40	Oct-24	1.10
Japan	0.25	Jul-24	-2.40
China (lending)	2.00	Sep-24	4.05
Korea	3.00	Oct-24	1.50
India	6.50	Feb-23	0.29
Indonesia	6.00	Sep-24	4.45

Money Mkt Rates	3-Dec	-1 mth	Chg (bps)
SPN (1Y)	7.21	6.69	52.5
SUN (10Y)	6.87	6.76	10.8
INDONIA (O/N, Rp)	6.15	6.01	14.3
JIBOR 1M (Rp)	6.63	6.63	-0.8

Bank Rates (Rp)	Sep	Aug	Chg (bps)
Lending (WC)	8.87	8.78	8.91
Deposit 1M	4.81	4.79	2.01
Savings	0.67	0.65	1.33

Currency/USD	3-Dec	-1 mth	Chg (%)
UK Pound	0.789	0.774	-1.94
Euro	0.952	0.923	-3.00
Japanese Yen	149.6	153.0	2.28
Chinese RMB	7.286	7.129	-2.16
Indonesia Rupiah	15,940	15,720	-1.38

Capital Mkt	3-Dec	-1 mth	Chg (%)
JCI	7,196.0	7,505.3	-4.12
DJIA	44,705.5	42,052.2	6.31
FTSE	8,359.4	8,177.2	2.23
Nikkei 225	39,248.9	38,053.7	3.14
Hang Seng	19,746.3	20,506.4	-3.71

Foreign portfolio ownership (Rp Tn)	Nov	Oct	Chg (Rp Tn)
Stock	3,402.4	3,573.9	-171.49
Govt. Bond	872.5	885.6	-13.07
Corp. Bond	7.1	6.9	0.23

Trade & Commodities	3-Dec	-1 mth	Chg (%)
Baltic Dry Index	1,237.0	1,378.0	-10.2
S&P GSCI Index	540.0	534.8	1.0
Oil (Brent, $/brl)	73.6	73.1	0.7
Coal ($/MT)	135.2	145.7	-7.2
Gas ($/MMBtu)	2.94	1.42	107.0
Gold ($/oz.)	2,643.5	2,736.5	-3.4
Copper ($/MT)	9,010.2	9,444.8	-4.6
Nickel ($/MT)	15,791.3	15,689.5	0.6
CPO ($/MT)	1,182.8	1,116.3	6.0
Rubber ($/kg)	2.05	1.97	4.1

External Sector	Oct	Sep	Chg (%)
Export ($ bn)	24.41	22.06	10.69
Import ($ bn)	21.94	18.82	16.54
Trade bal. ($ bn)	2.48	3.23	-23.39
Central bank reserves ($ bn)*	151.2	149.9	0.87

Prompt Indicators	Oct	Sep	Aug
Consumer confidence index (CCI)	121.1	123.5	124.4
Car sales (%YoY)	-3.9	-9.1	-14.2
Motorcycle sales (%YoY)	5.4	3.7	7.4

Manufacturing PMI	Nov	Oct	Chg (bps)
USA	49.7	48.5	120
Eurozone	45.2	46.0	-80
Japan	49.0	49.2	-20
China	51.5	50.3	120
Korea	50.6	48.3	230
Indonesia	49.6	49.2	40

Source: Bloomberg, BI, BPS

Notes:

*Data from an earlier period

For changes in currency: **Black indicates appreciation against USD, **Red** otherwise

***For PMI, **>50** indicates economic expansion, **<50** otherwis

Indonesia – Economic Indicators Projection

	2020	2021	2022	2023	2024E	2025E
Gross Domestic Product (% YoY)	-2.1	3.7	5.3	5.0	5.0	4.9
GDP per Capita (US$)	3912	4350	4784	4920	4945	4980
Consumer Price Index Inflation (% YoY)	1.7	1.9	5.5	2.6	1.9	2.5
BI 7-day Repo Rate (%)	3.75	3.50	5.50	6.00	5.75	5.00
USD/IDR Exchange Rate (end of the year)**	14,050	14,262	15,568	15,397	15,947	16,393
Trade Balance (US$ billion)	21.7	35.3	54.5	37.0	29.3	26.2
Current Account Balance (% GDP)	-0.4	0.3	1.0	-0.1	-0.7	-0.9

*Estimated number

** Estimation of the Rupiah's fundamental exchange rate

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