Key Figures

- GDP Growth* (Q4 '17)
  5.1%
- GDP Growth* (FY 2018)
  5.3%
- Inflation (y.o.y. Dec '17)
  3.61%
- Credit Growth (y.o.y. Nov '17)
  7.5%
- Trade Surplus (Q4 '17)
  USD 0,95 billion
- Current Account (Q2 '17)
  -1.65%

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**) Forecast*

2018 Budget: The Need to Improve Fiscal Position

Highlights

- GDP growth of Q4 2017 at 5.1%, may rise to 5.3% in 2018;
- Manufacturing to grow faster in Q4 2017 and Q1 2018 compared to Q3 2017, supported by improving local and global demand
- Consumption growth remained stagnant, will continue current trajectory in short-term
- Growth in 2018 to be driven by investment, but disconnect between growth of loan for investments purpose and growth of gross capital formation remains puzzling
- External risks to remain manageable in short-term; risk of US recession still low, although precautions are warranted
- Improvement in fiscal condition, particularly budget deficit and speed of increase in loan, is important both to improve debt rating and better prepare for negative economic shock

Relatively disappointing performance in Q3 and very possibly Q4 means that economic growth is still on a relatively shaky ground going forward in Q1 2018. Rising commodity prices and infrastructure boost have not been translated into higher consumption (Page 8). This condition is not helped by low loan growth for investment purposes, a sign of businesses holding back increasing production capacity. The need to guard macro stability from higher budget deficit means government had to adjust its ambitious infrastructure spending to a more realistic target, thus removing any hope that fiscal stimulus could drive growth in 2017.

Table 1: LPEM FEB UI GDP Growth Forecast

Q4 2017	FY 2018
5.1%	5.3%

As price for key export commodities, particularly crude oil, rises more than expected and campaign spending preceding 2019 election will commence this year, we expect higher growth to materialize in the second half of the year. However, this growth will put more stress on government budget and export performance (Page 11). First, higher oil and coal prices and no further increase in key retail fuel prices means Pertamina's operational profit will continue to suffer and would have the same impact on budget as if government had increased fuel subsidy (i.e. higher deficit due to less revenue from dividend). Second, higher fuel prices and higher growth has increased and will continue to increase net import for oil, thus reducing net export.

With the start of new fiscal year and in light of recent developments, we reiterate the need for further improvement in fiscal positions, mainly by reducing budget deficit and controlling speed of increase in government debt. Fiscal control is largely beneficial in order to improve credit rating and perception of risk among investors, and ultimately to reduce debt servicing cost (Page 3). By gaining one or two further upgrades in credit rating, government may reduce interest cost up to half of current amount in the long-term. Furthermore, less deficit in short-term may provide more room for fiscal stimulus in case of negative external shocks, which might be needed in the medium-term.

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In Focus

Sovereign Rating Upgrade: A Worthy Pursuit?

Potential benefit of higher rating

Despite latest Indonesia sovereign debt rating upgrade to BBB by Fitch, a very welcome news, Indonesia's sovereign rating is currently still rated the lowest grade on investment grade levels by both S&P and Moody's, and still largely treated as such accordingly. at BBB- by S&P standard, an investment grade but at the lowest level of the group. S&P defines it as "… exhibits adequate protection parameters. However, adverse economic conditions or changing circumstances are more likely to lead to a weakened capacity of the obligor to meet its financial commitment on the obligation." Moody's gives Baa3, which means also the lowest notch of the investment grade ratings. Moody's defines this rating as "Acceptable ability to repay short term debt." While, it is good to be rated as an investment grade security, we have to realize that it is considered the riskiest among the group. The government will need to work hard(er) to achieve higher rating in the future.

"Like any other debt securities, higher sovereign rating means lower cost of borrowing"

Like any other debt securities, higher sovereign rating means lower cost of borrowing. But more than that, here we also discuss about what it means to have sovereign rating as it is, what could be the benefit of going up by one or two notches in the ratings scale, and how we could move up. To help with these issues, we have selected three comparable emerging economies: Thailand (BBB+), Philippines (BBB), and India (BBB-). Table B1 shows how significant the cost of borrowing differential is. The table shows the comparison between yields of local currency (LCY) government securities of the selected countries both for short-term and long-term tenors.

Table B1: Ratings and Yields of Government Securities of Selected Asian Emerging Market Economies

Country	Rating (Moody's, S&P)	Yield of 10Yr		Yield of 1Yr		Average Yield of 10Yr (2016-2017)	Average Yield of 1Yr (2016-2017)
		2016	2017	2016	2017		
Thailand	Baa1, BBB+	2.2%	2.6%	1.5%	1.5%	2.4%	1.5%
Philippines	Baa2, BBB	3.8%	2.7%	1.8%	2.8%	3.3%	2.3%
India	Baa2, BBB-	7.3%	6.9%	6.9%	6.4%	7.1%	6.7%
Indonesia	Baa3, BBB-	7.7%	7.2%	6.6%	5.8%	7.5%	6.2%

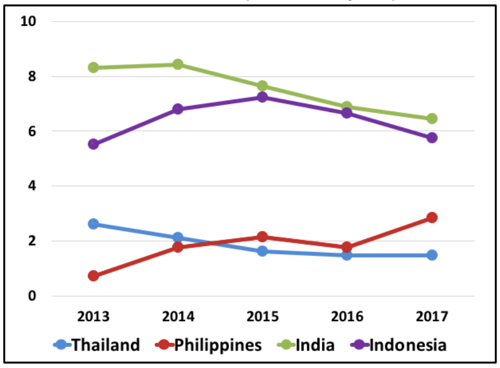
Source: CEIC, Moody's, S&P, LPEM Calculation

Based on the latest data (February 2018), Thailand is rated the highest among the four selected countries above, with Baa1 and BBB+ ratings by Moody's and S&P respectively. Philippines is one notch below, with Baa2 and BBB ratings. India and Indonesia are rated at the same notch by S&P. On the other hand, based on Moody's, India is one notch above Indonesia.

For both 1-Yr and 10-Yr tenors, there is a clear negative relationship between the rating and the yield. Philippines' yields, albeit only one notch above, are noticeably much lower than those of India's and Indonesia's.[1] Figure B1 and Figure B2 below show the contrast of yields between Thailand and Philippines on one hand with India and Indonesia on the other.

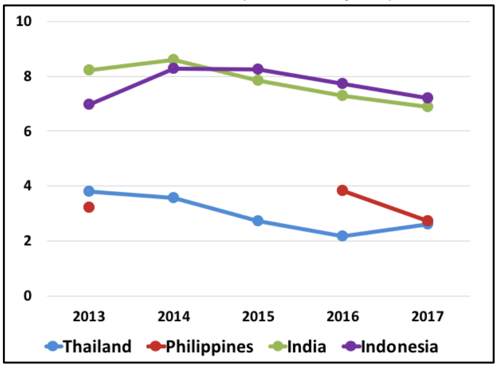
[1] Fairly, this is a rough comparison. To reach a more definitive comparison, one could calculate the average yields for all of BBB-rated countries instead.

Figure B1: Yields of 1-Yr LCY Government Securities of Selected Asian Emerging Economies (Percent p.a.)



Source: CEIC

Figure B2: Yields of 10-Yr LCY Government Securities of Selected Asian Emerging Economies (Percent p.a.)



Source: CEIC
Note: Some data for Philippines are missing

"Since the GFC, fiscal strength is now more important than ever. Every 10 percentage points increase in debt burden (public debt to GDP) lowers the rating by 0.3 notches"

Just to give a perspective on the consequence of the yield differentials on the budget of the Government of Indonesia (GoI), there are about IDR174 trillion and IDR202 trillion interest payments made by GoI on LCY debts in 2016 and 2017 respectively. Based on the rough comparisons above, GoI could have save half of those amount, had Indonesian rating been BBB instead of BBB-. Clearly, further study is needed to produce a more precise number.

Broader study is also needed for identifying other potential benefits and also costs of achieving higher sovereign rating. Among others, higher rating means more capital inflow both portfolio and foreign direct investments. This will in turn result in higher GDP growth rate as well. During period of 2010-2011, there was about USD25 billion short term capital inflow to IDR bonds market. Coupled with the commodity boom, this resulted in above 20% annual growth of lending by commercial banks and above 6% GDP growth rates during 2012-2013 period.

Determinants of sovereign rating

Vast literature has been available for finding the potential variables that are believed to have determined why and when the rating agencies change their views on creditworthiness of a government. Cantor and Parker (1996) is among the most cited studies. Recently, Amstad, M and F Packer (2015), conducted the same study with focus in showing the recent trends after the 2008 Great Financial Crisis (GFC). Our discussion in the next parts is going to be based on this paper.

In general, ratings are now explained by less than 10 variables. *GDP growth* and potential have been always one of the best predictors of ratings. At the same time, per capita GDP maintains its high statistical significance: a 10% increase in the level of per capita GDP adds 0.15 notches in 2015.

Flexible exchange rate regime and *reserve currency status* would tend to result in higher ratings. Moving from fixed exchange rate to a flexible exchange rate regime, given everything else is the same, is associated with an increase in the sovereign rating of 2.5 notches.

Since the GFC, fiscal strength is now more important than ever. Every 10 percentage point increase in debt burden (public debt to GDP) lowers the rating by 0.3 notches. On the other hand, every 10 percentage point increase in interest-to-revenue lowers the rating by 1.2 notches.

"Indonesia, on the other hand, suffered the highest depreciation rate of its currency…This is one of the reasons for S&P's hesitation until it finally decided to upgrade Indonesian LCY bonds to BBB- back in May 2017"

Since GFC, default history has gained in importance in determining the rating. Countries with a history of default on average get penalized by 2.5 notches. Interestingly, foreign currency denomination of debt appears to have lost its relevance. This may reflect the increased ability of EMEs to borrow in LCY.

A 10 percentage point increase in the ratio of foreign exchange reserves to GDP strengthens the rating by 0.4 notches. Institutional strength, as measured by the corruption perception index, is still significant. By contrast, inflation is not statistically significant.

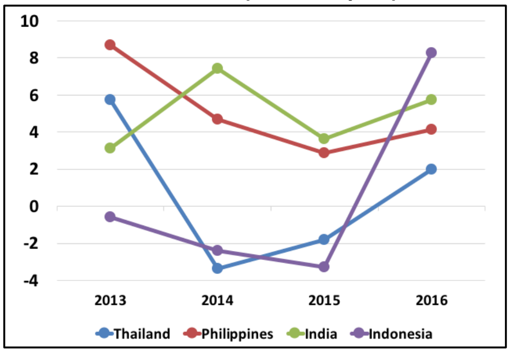
Table B2: Selected Factors Affecting Sovereign Ratings of Selected Countries

Country	Rating (Moody's, S&P)	GDP (USD billions)	Average USD-GDP growth (2013-2016)	Average Depreciation Rate (2013-2016)	Average Budget Surplus/GDP (2013-2016)	Tax/GDP Ratio 2016	Tax/GDP Ratio 2017	Country Risk Premium
Thailand	Baa1, BBB+	407	0.6%	3.3%	0.1%	12.3%	11.9%	1.8%
Philippines	Baa2, BBB	305	5.1%	3.0%	0.3%	11.7%	12.1%	2.2%
India	Baa2, BBB-	2,264	5.0%	5.9%	-7.0%	7.3%	7.7%	2.2%
Indonesia	Baa3, BBB-	932	0.5%	9.3%	-2.3%	10.4%	10.9%	2.5%

Source: CEIC, LPEM Calculations, Country Risk calculation is based on http://pages.stern.nyu.edu/~adamodar/New_Home_Page/datafile/ctryprem.html

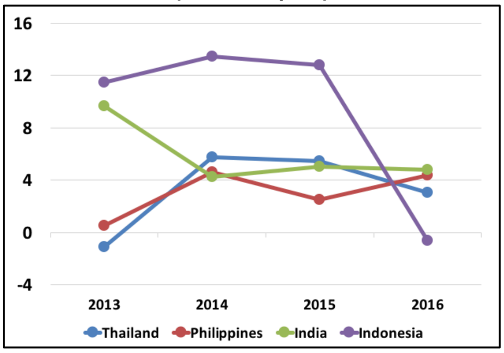
In light of the results above, Table B2 put some of those variables in perspective with the context of our selected countries to compare. Converting the GDP figure of each country into its USD value and take the annual growth of it shows how important a stable exchange rate is. Compare Figure B3 and Figure B4 below. Philippines and India enjoyed high growth of USD-denominated GDP in 2013-2016. India achieved high GDP growth, despite high depreciation rate of INR. Indonesia, on the other hand, suffered the highest depreciation rate of its currency. As a result, its GDP growth rate reached only 0.5% during the same period. This is one of the reasons for S&P's hesitation until it finally decided to upgrade Indonesian LCY bonds to BBB- back in May 2017.

Figure B3: Annual Growth Rate of GDP (in USD) of Selected Asian Emerging Economies (Percent p.a.)



Source: CEIC

Figure B4: Annual Depreciation Rate of Selected Asian Emerging Economies (Percent p.a.)



Source: CEIC

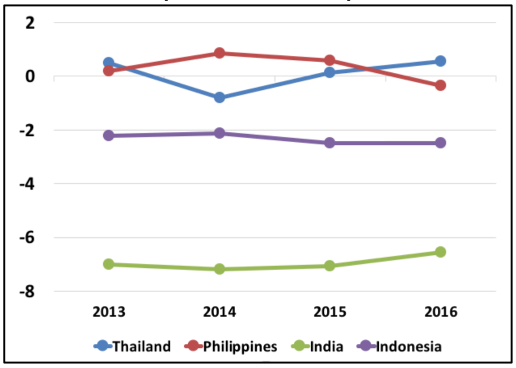
The government's credit worthiness is now more important than ever. This is also evident from the comparison between our four selected countries. In terms of managing its budget deficit (relative to GDP), Thailand and Philippines again appear to be in one category. Indonesia is below these two countries, albeit "not too far". India, on the other hand, is quite far below everyone else (Figure B5)

"Despite GoI's performance in improving its budget credibility…Indonesia does need to improve its budget deficit, maybe closer to Thailand's and Philippines' level, to gain a rating upgrade"

Tax Revenue is clearly a big factor; it directly affects the size of a government's budget surplus. Philippines is currently leading the pack with slightly above 12% Tax-to-GDP ratio while managing its budget deficit well. Thailand is showing a steep decline in the tax ratio as a result of weak GDP in 2014 and 2015 but accompanied by strict fiscal discipline that resulted in even a budget surplus in 2016.

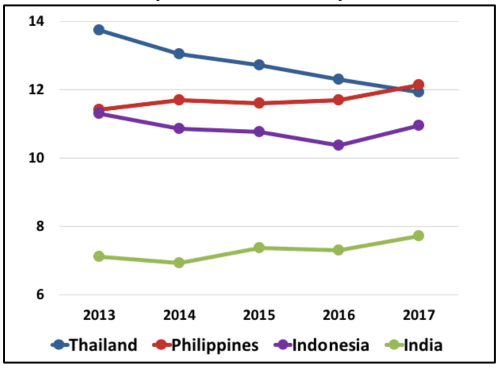
Indonesia has done a comparably good job as well. After suffering negative GDP growths in 2013-2015 – hence worsening tax ratios until 2016 – Indonesia enjoyed a huge jump in GDP performance in 2016, mainly due to stabilized IDR. Its tax ratio increased significantly in 2017.

Figure B5: Budget Surplus of Selected Asian Emerging Economies (Percent of GDP)



Source: CEIC

Figure B6: Government Tax Revenue of Selected Asian Emerging Economies (Percent of GDP)



Source: CEIC, Note: 2017 Figures are LPEM projections

What's next?

Rating agencies, especially Moody's and S&P, are going to do their annual evaluation of its ratings on Indonesia's sovereign debt securities. Despite GoI's performance in improving its budget credibility, especially by keeping its budget deficit below 3%, i.e. following Maastricht criteria, Indonesia does need to improve its budget deficit, maybe closer to Thailand's and Philippines' level, to gain a rating upgrade. Despite the successful Tax Amnesty program, tax reform is still needed to broaden the tax base and improve tax obedience.

Bank of Indonesia is on the right track in keeping the IDR stable and predictable. Bigger size of international reserves is still needed since the 40% of IDR3,200 trillion bonds are held by foreign investors. This number is still in increasing trend. GoI needs to watch debt-to-GDP ratio closely. At approximately 28.9%, it is still relatively low by international standard. But GoI needs to watch the speed of its increase in the medium-term to maintain sustainability.

References

Amstad, M and F Packer (2015): "Sovereign Ratings of Advanced and Emerging Economies after the Crisis", BIS Quarterly Review, December 2015.

Cantor, R and F Packer (1996): "Determinants and impact of sovereign credit ratings", *Economic Policy Review*, vol 2(2), pp 37-54.

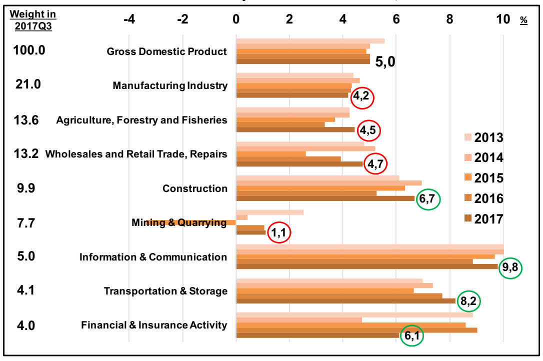
Broad-Based Growth Ahead

Manufacturing industry may deliver more good news ahead, as Q3 (4.84% y.o.y) and soon-to-be-released Q4 figures suggests that manufacturing growth may cross 5% level in 2018. Production of Food and Beverages is still leading this sector with strong growth of demand in Q3, as more manufacturing subsectors exhibit higher y.o.y growth in Q3 compared to Q2. Manufacturing industry as a whole is helped by rising consumption growth domestically and increased global growth, which has increased export in USD, IDR, and volume terms and generally improving global economic mood going forward.

Food and beverage manufacturing continues to be the leading subsector of manufacturing industry, with impressive growth of 9.46% (y.o.y) in Q3 2017. The dynamics of food and beverages from the expenditure side of GDP matches this, which indicates that food and beverage manufacturing largely caters to domestic market and seem pretty immune to fluctuation in global and Indonesian economy. Strong growth in food and beverage manufacturing owes to long-term trend of steady increase of new middle class and urban populations, who values convenience of pre-packaged foods and drinks.

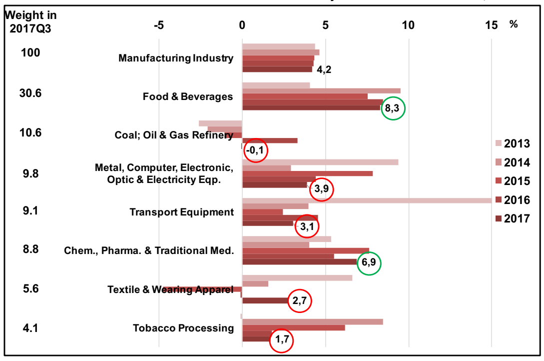
"Manufacturing industry as a whole is helped by rising consumption growth domestically and increased global growth, which has increased export..."

Figure 1: Growth rate of GDP and the Main Industries, 2013-2017Q3



Source: CEIC

Figure 2: Growth rate of Manufacturing Sector and Its Subsectors, 2013-2017Q3



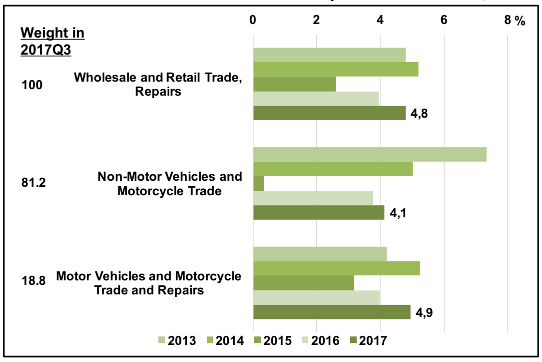
Source: CEIC

Q3 also saw more broad-based improvement across of manufacturing subsectors, a trend we expect to be seen in Q4 figure and to continue in Q1 2018 figure. Take textile and wearing apparel subsector, which saw its y.o.y growth increase in Q3 2017 to 4.4% from 3.65%. Another example is furniture subsector and transport equipment subsector, the growth of which accelerated from 0.9% and 0.5% in Q2 2017 to 5.47% and 5.63% in Q3 2017.

Rise in consumer confidence, both domestically and globally, has also benefited other sectors of the economy, albeit rather unevenly. For example, Wholesale and Retail Trade, which decelerated in Q2, started to accelerate back in Q3, with growth of 5.50% y.o.y. This trend is unsurprisingly coincided with rather steep rate cut of BI Reverse Repo Rate, from 4.75% at the start of Q3 to 4.25% by the end of Q3. As expected, vehicle-related trades are most benefited by BI rate cut, as growth of Motor Vehicle and Motorcycle Trade and Repairs subsector accelerated from 3.14% to 6.12% in Q3.

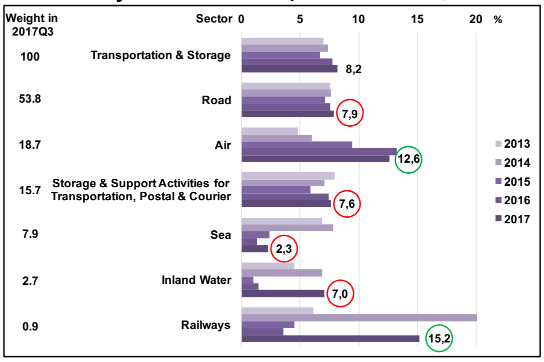
As we expected in our previous report, the weakness in non-vehicle-related trade is not the product of decline in retail sector, but rather a consequence of rather weak consumption. Non-Motor Vehicle and Motorcycle Trade subsector growth accelerated to 5.5% in Q3 2017 after it previously decelerated to 3.85% in Q2 2017, closely following the trend of its corresponding manufacturing subsector like textile and wearing apparel manufacturing or furniture manufacturing subsectors. This confirms that at least for now, apparent retail trade weakness in Indonesia is temporary in nature, not due to structural headwind presented by competition from e-commerce trade. We maintain our prediction that wholesale and retail trade will moderately accelerate in Q1 2018, as interest rate will continue to go down following rate cuts by Bank Indonesia back in September.

Figure 3: Growth rate of Wholesale and Retail Trade and Its Sub-sectors, 2013-2017Q3



Source: CEIC

Figure 4: Growth rate of Transport and Its Major Sub-sectors, 2013-2017Q3



Source: CEIC

"We also expect construction sector, which grew by 7.13% in Q3 2017, to grow faster in Q4 2017 and Q1 2018, benefiting from at least four positive factors"

Transportation and storage services remain strong and accelerated further in Q3 (see Figure 4) and may stabilize in Q4, thanks to completion of several major infrastructure projects and further investments by Government of Indonesia in infrastructure, particularly outside Java. The acceleration of growth in transportation services will stabilize or moderately increase in Q1 2018 as market for transportation services, both by conventional providers or online providers, expand in secondary and tertiary cities, which rapidly urbanize and still underserved by public transportation. Onerous traffic in primary cities will further drives demand for delivery services for wider range of goods and experiences, as demonstrated by comprehensive delivery offerings by Go-Jek (from food to massage services), and long-overdue investments in public transport by municipal government. This is shown by growth in storage and support activities for transport (9.71% in Q3 2017) and railways (22.32% in Q3 2017).

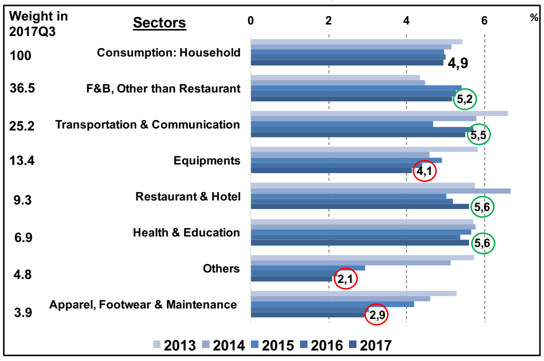
We also expect construction sector, which grew by 7.13% in Q3 2017, to grow faster in Q4 2017 and Q1 2018, benefiting from at least four positive factors. First, there are more infrastructure projects are now either in tendering process or construction sector, which drives demand for construction-related businesses. Second, relatively stable inflation in the last few years have induced banks to cut down interest rate and lengthen maturity for fixed rate mortgages, inducing more potential homebuyers to purchase homes. Third, demographic structure indicates that there are more potential homebuyers now than ever, particularly as more Gen-Y Indonesians now have entered working age. Finally, somewhat related to first factor, the coming election in 2019 will only further bring more infrastructure and affordable housing elections, given that Jokowi administration put infrastructure building as centerpiece of his first-term legacy.

Consumption Still Within 4.9-5.0% range in Q4 2017, Slightly Higher in Q1 2018

It is noteworthy that consumption growth is stuck at around 4.9% in throughout Q1-Q3, thus leading us to expect slightly increasing consumption to just below 5.0% in Q4 2017 and slightly above 5.0% in Q1 2018. Several rate cuts by Bank Indonesia throughout last year should have eventually induced consumers to spend more, but improvement in consumption has not materialized. This can be attributed to stagnating consumer confidence in Q3 and Q4 2017, which is shown by stagnant reading of BI's Consumer Confidence Index in Q3 and Q4 at 123.0 (Q3 average) and 123.1 (average Q4 average). One of the most concerning factor that contributes to stagnating consumer confidence is relatively pessimistic perception of job availability, even as consumer tend to be more optimistic about their current earning.

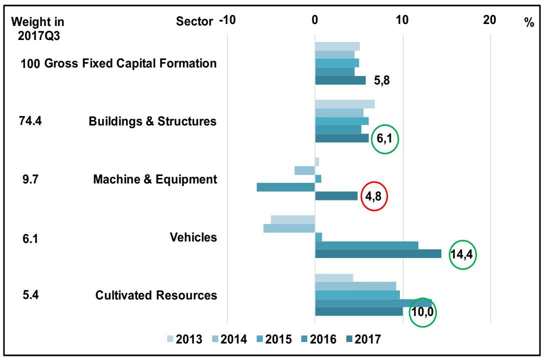
"One of the most concerning factor that contributes to stagnating consumer confidence is relatively pessimistic perception of job availability, even as consumer tend to be more optimistic about their current earning"

Figure 5: Growth rate of Household's Consumption and its Components, 2013-2017Q2



Source: CEIC

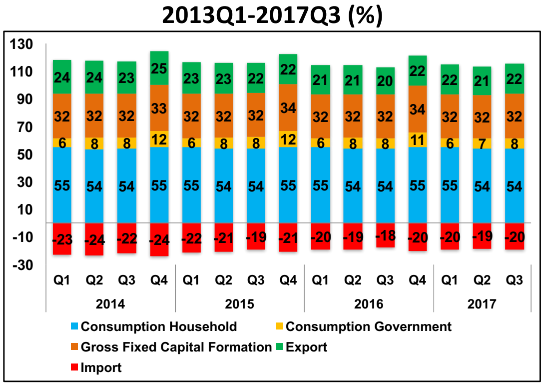
Figure 6: Growth rate of Investment and its Main Components, 2013-2017Q1



Source: CEIC

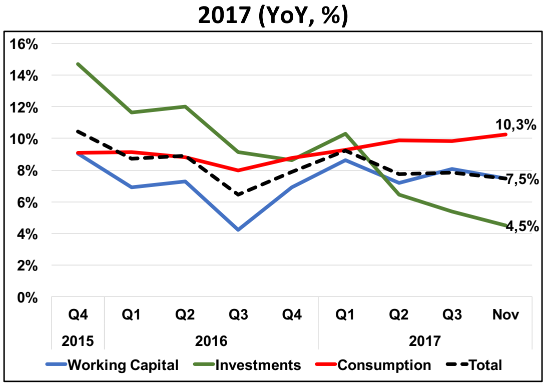
Most of the components that constitute household consumptions growth (see Figure 5) stay relatively stable since Q1, with notable exception of transportation and communication (accelerating to 5.86% from 5.32%). Lower interest rate may explain increase in growth for transportation and communication consumptions, as consumption-related credit has crossed 10% growth in November (Figure 8). Nevertheless, consumers are also still postponing their purchase of non-vehicle durable goods or less urgent spending; growth of equipment consumptions for households in Q2 is reported at only 4.14% and restaurant and hotel consumption slowed down to 5.52% in Q3. With no significant increase in loan disbursement for consumption purpose, we do not see consumption growth to cross 5.1% anytime soon.

Figure 7: Shares of GDP Components, 2013Q1-2017Q3 (%)



Source: CEIC

Figure 8: Credit Growth by Purposes, 2015-Nov 2017 (YoY, %)

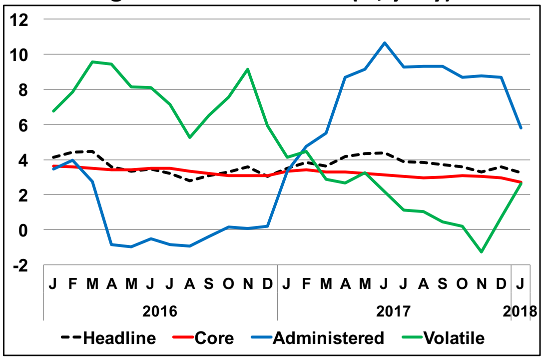


Source: CEIC

Unchanged growth rate of domestic consumption and reluctance of consumers to spend is also manifested by exceptionally low inflation throughout 2017, despite major increase in electricity throughout first half of 2017 and creeping rise in non-subsidized fuel price in the second half of 2017. Headline inflation and core inflation stands at 3,61% and 2.95% respectively. We do not see oil price to rise significantly much further, allowing government to continue with their current fuel price policy. January inflation, however, may point out to a rather muted outlook for Q1 2018, as core inflation has hit another low at 2.69% y.o.y. If February core inflation stay far below 3.0% y.o.y level, there is cause for genuine concern about consumers' purchasing power going forward.

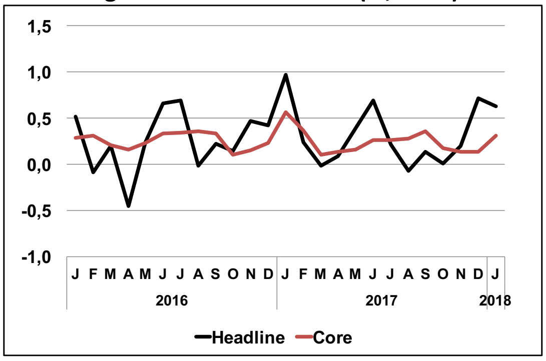
"If February core inflation stay far below 3.0% y.o.y level, there is cause for genuine concern about consumers' purchasing power going forward"

Figure 9: Inflation Rate (%, y.o.y)



Source: CEIC

Figure 10: Inflation Rate (%, mtm)

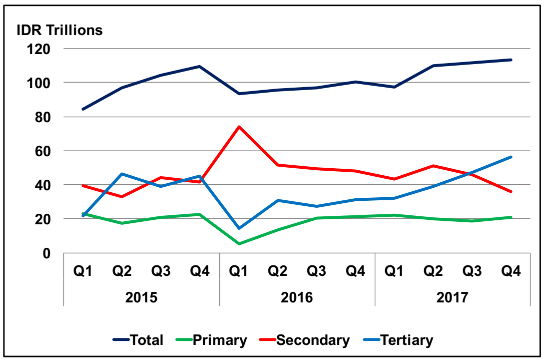


Source: CEIC

Investment and Export: Key Growth Drivers for 2018

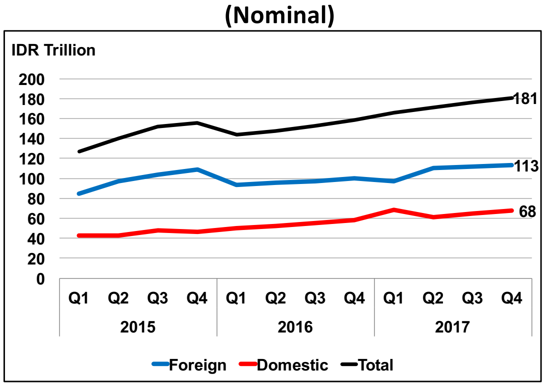
We cautiously expect further acceleration in investment in 2018, particularly driven by increased investment in properties and vehicles. Gross fixed capital formation, the measure of investment in GDP, grows significantly faster than the economy in Q3 (7.11 % y.o.y) with construction boom and rebound in vehicle sales that surrounds large-scale infrastructure projects. Investments by both foreign and local enterprises also continue to increase in Q3 and Q4, as shown by increase in foreign direct investment and domestic direct investment by 14.95% and 16.82% (y.o.y.) respectively in nominal Rupiah term.

Figure 11: FDI Realization (Nominal)



Source: CEIC

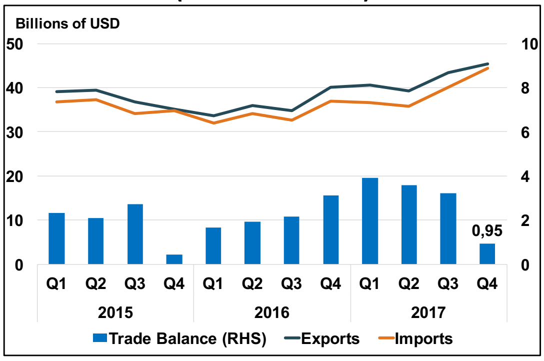
Figure 12: Foreign and Domestic Investment (Nominal)



Source: CEIC

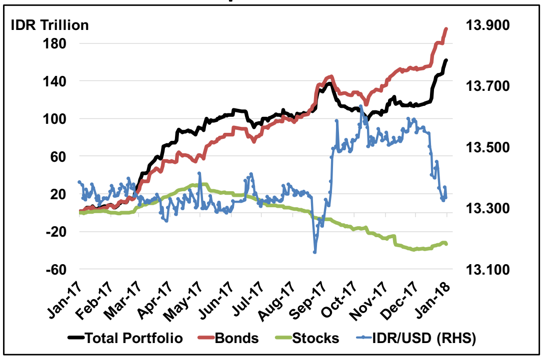
Strong investment growth in Q3 is very surprising when we look at loan growth for investment purposes. In Q3 2017 and in November 2017, loan for investment purposes grew at 5.39% and 4.50% y.o.y, hardly a sign that points toward higher productive investment. There are several plausible hypotheses that explain reduction in investment-related loans. First, as corporate profitability rose, businesses might find internal financing for business investment more appealing than tapping into relatively more expensive bank financing. Corporations, sitting on large cash piles[2], may find investing their money to increase production more lucrative than parking their money in bank deposits or short-term securities. A less rosy hypothesis is that loans for investments in a given quarter may have been disbursed in the previous several quarters, which may indicate less investments in the economy in coming quarters. Testing such hypothesis may take another one or two quarters before we get some clues.

Figure 13: Trade Balance (Nominal) (2015Q1-2017Q4)



Source: CEIC

Figure 14: Exchange Rate and Short-Term Capital Inflow



Source: CEIC

"Booming commodity prices serves as double-edged sword; increase in commodity prices may boost coal, gas, and CPO export, but increase in commodity prices also lead to increase in imports of oil, given Indonesia's status as net oil importing nation"

Another source of growth in first half of 2017, net export, started to worsen in Q4 2017 and may perhaps start to turn into trade deficit in Q1 2018. Booming commodity prices serves as double-edged sword; increase in commodity prices may boost coal, gas, and CPO export, but increase in commodity prices also lead to increase in imports of oil, given Indonesia's status as net oil importing nation. Furthermore, export profile of Indonesia is currently not diversified enough to find new growth centers for exports to increase net export; exports are still dominated by raw materials while most of Indonesia's imports are for capital goods and input materials for production.

We still expect export to improve somewhat, largely due to higher demand from China, Japan, and Eurozone, rebound in commodity prices, and implicit commitment of Bank Indonesia to keep Rupiah from appreciating further. We however change our view on imports growth in light of recent development and higher oil prices. Total current account deficit is however projected to still be below 2.0% in Q4 2017 and Q1 2018, reflecting strong capital inflow in recent months into bonds market (Figure 14).

Lower-than-Budgeted Budget Deficit, Tax Collection Still Below Target

By end of December, cumulative tax receipts increased by around 4.0% (y.o.y) to IDR 1,151.1 trillion (89.7% of 2017 revised target), which represents improvement in tax realization compared to 2016 budget realization. A rather welcome news also came from the fact that excluding receipt from tax amnesty in 2016, total tax revenue increased by 15.85%. Increases in

[2] This notion is supported by increase in gross domestic savings to 35% GDP in 2016 from less than 33% in 2013 despite worsening budget deficit. Increase in gross domestic savings most likely come from significant increase in corporate or household savings.

tax revenue is largely driven by more-than-targeted increase in VAT revenue (100.6% of 2017 revised target) and improving tax revenue from oil and gas sector.

While overall revenue has been closer to target compared to 2016 budget, 2017 budget still leaves much to be desired, particularly from non-oil-and-gas income taxes and the fact that tax revenue is still 10% below target. The problem with non-oil-and-gas income tax receipts is less about decrease of its nominal amount to Rp595.3 trillion from Rp630.1 trillion but more about almost 20% shortfall of this item from its target. First, as Rp630.1 trillion of non-oil-and-gas income tax in 2016 includes one-off items such as revenue from tax amnesty, government may want to set a more realistic target in the future to increase budget credibility. Second, the tax amnesty program was touted as a way for government to better target wealthy taxpayers to pay more, but the fact that, subtracting revenue from tax amnesty, non-oil-and-gas income tax receipts only increased by around less than 13% gave signs that tax amnesty may not live up to its promises.

"Current retail fuel price policy is not only disappointing…but also dangerous, as higher crude oil prices will…further reduce non-tax revenue when government needs more money for other spending"

We also see some promising signs about the direction of spending pattern by the central government, with some notable exceptions. For example, we see that more allocation of spending towards infrastructure, universal healthcare program (JKN), and education represents a much better way to spend government budget. However, it becomes increasingly apparent that government now have effectively broken its own pledge to leave gasoline price to market mechanism and limit fuel subsidies by letting Pertamina bear the losses of not increasing price in higher oil price environment. Current fuel price policy is not only disappointing, as it represents a step back at creating more market-based economy and more pro-poor budget, but also dangerous, as higher crude oil prices will be translated into higher losses for Pertamina, which in turn will further reduce non-tax revenue when government needs more money for other spending.

External Risks: How Long Can the Good Times Last?

2018 started with news about improving global economy and sanguine outlook of most businesses and global investors. For example, January non-farm payroll in US is better than expected and tight labor market (unemployment now at 4.1%) has pushed up wages, indicating strong US GDP in the next few quarters. Economic strength in developed economies indicates firmer path towards higher interest rate in forward, particularly in US, Eurozone, UK, and possibly Japan. We also see that market participants are also comfortable with China's more sustainable, if somewhat lower, GDP growth. This broad-based optimism also induces more risk-taking behaviors by market participants, thus explaining lofty valuation in many equity markets that we see today.

However, strong global economy and record-low unemployment rate in US, and to some extent economies like Germany and Japan, bear some uncanny resemblance with the peak of economic cycles that happened before. As of now, US unemployment rate is at 17-year low and almost touching 4% level, and stock market valuation has been elevated for quite some time. The last time US unemployment rate sustained below-4% level for extended period of time was between 1966 and 1969, right after the start of Vietnam War and at the peak of Keynesian-driven economic policies. While systemic risk in financial market is lower than it was before 2008 crisis, there are growing alarm of repeat of 2002-like recession in the US.

Before we hastily conclude that recession is coming in the US and will negatively affect global economy, there are some key differences compared to previous peaks of economic cycle. For example, China, the second largest economy, is now increasingly reliant on domestic consumption and may insulate much of Asia from possible US recession. Wage growth in US and the rest of developed economies have been somewhat muted, indicating more room for businesses to hire more people before wage increase kicks in and increase inflation. Third, current yield curves in most developed countries still suggest higher interest rate in the future, indicating expectation from market participants that the economy is just running normally. We also central banks to closely monitor developments in the economy, thus reducing risk of unexpected surprises that may trigger recession. There is a good chance that 2018 will pass without any signs of global economy heading towards another recession. Nevertheless, the risk may increase considerably beyond 2018.

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As the risk of recession is rather low in the short-term and the next US recession may not last for long period of time, we see that increased vigilance among policymakers and business community and incorporation of US recession risk in stress test scenario are sufficient in the context of Indonesia for now. In any case, the effect of sudden US recession to Indonesian economy should be considerably less than the effect of 2008 crisis, thus limiting negative risks towards Indonesian economy. Additionally, government and Bank Indonesia still have sufficient means to support the economy and reduce exchange rate volatility in cases of sudden recession, with record-high foreign reserves, low inflation, and sufficient fiscal capacity.