LPEM FEB UI

LPEM
Economic Quarterly Outlook

Highlights

- **GDP in Q3 to grow at 4.7% (y-o-y) due to weak domestic consumption.**
- **Inflation rate to revert to its lower trend to finish at around 4% this year.**
- **Current account to show improvement due to higher decline in imports than exports.**
- **Rupiah to move within the range of 13,500-14,000 until end of the year.**

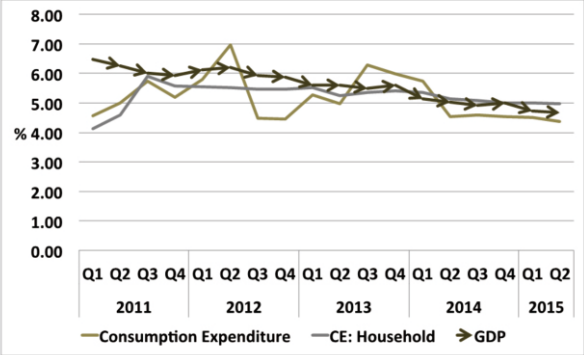
After years of high commodity prices since mid-2000s and, subsequently, quantitative easing policies in developed economies on an unprecedented scale, Indonesia—along with the rest of emerging markets—became complacent and failed to enact badly-needed structural reforms.

It is therefore unsurprising when simultaneous episodes of China's decelerating growth, early signs of monetary policy tightening in the US, and commodity price slump hurt exports significantly and put strains on Rupiah. BI's mandate to stabilize exchange rate limit policy tools to maintain growth during episode of global slowdown leaves Indonesia with little room to support economic growth. The series of policy shocks by People's Bank of China—culminated in Q3 2015—that exacerbate global turmoil kicked the post-boom hangover into full swing, marked by Rupiah depreciation to 14,800 in October

Flagging Consumption

At **4.7%**, our estimate of Q3 GDP growth data reflects the adjustments that Indonesia face today. Persistently slow growth can be largely explained by weak domestic consumption. Despite the fact that Ramadhan—traditionally a period of above-average consumption—fell in Q3 2015, evidence of muted spending in Q3 reflects deteriorating consumer confidence, as confirmed by September 2015 Consumer Confidence Index that fell to 97.5, lowest level in the last 5 years and indicates generally pessimistic mood amongst consumers. .

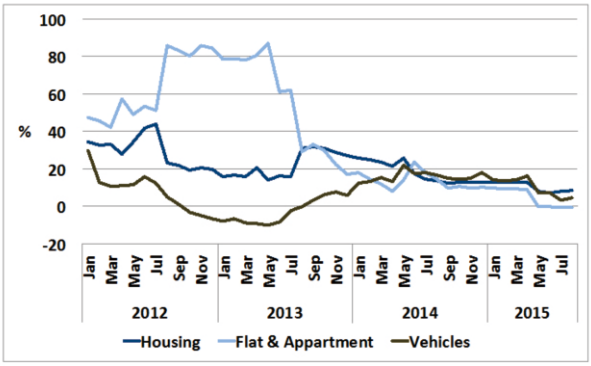
Figure 1: GDP Growth



Source: CEIC

Increasing reluctance to spend amongst Indonesian consumers is particularly evident in durable goods consumptions, which also experience additional downward pressure by BI's decision to continue its tight-bias monetary policy. Auto sales for January-September 2015 reached 764,683 units, down 18% from 932,677 units during the same period last year.

Figure 2: Household Loans Growth

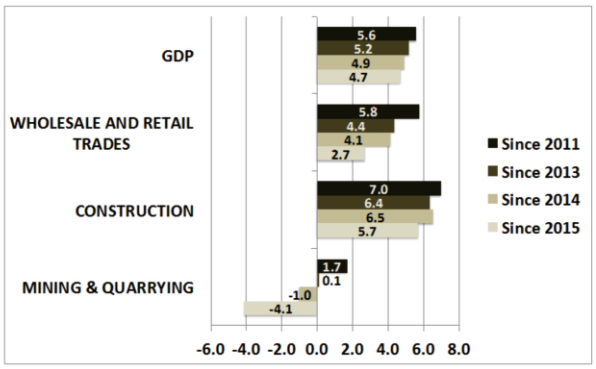


Source: CEIC

Residential sales, which experienced high growth during the last few years, are also hit by tight monetary policy. Average price growth of new homes in Q2 decelerated to 5.95% y.o.y., while sales growth in Q2 decelerated to 10.84% q.t.q, well below average quarterly sales growth of 23.38% for the last three years. Another measure, using growth in residential mortgages, shows steady decline since mid-2013, which mirrors general slowdown in the economy.

General decline in growth across sectors that limited expectation of wage increase and disposable income, might account for decline in consumption growth, which in turn creates negative feedback loop in the economy. Mining, construction, and trading activities are particularly hit hard by recent slowdown. Real growth in mining has turned negative since earlier this year due to excess supply in international markets for coal and iron ore. Increasingly austere consumers cut spending in non-essential goods, which hit hospitality and retail sectors hard.

Figure 3: Average GDP Growth By Sector



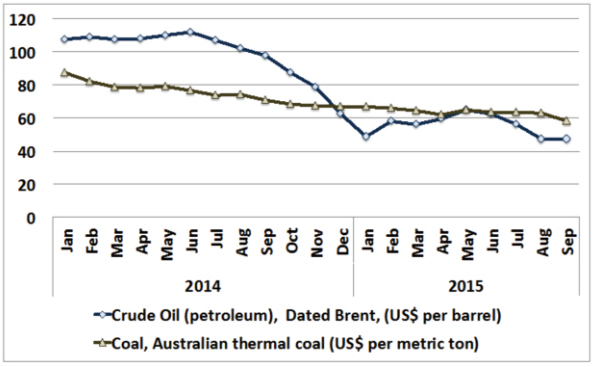
Source: CEIC

Better Current Account Due to Fall in Import

While domestic factors, such as tight-bias monetary policy to stem capital flight and deteriorating confidence due to steep Rupiah depreciation, account for current economic slowdown, the transmission of global economic slowdown to Indonesia is primarily explained by declining exports. Lackluster exports performance has not responded to the steep Rupiah depreciation. A 15.43% y.o.y decline in export value (USD) for Q3 2015 period is also followed by 5.16% y.o.y decline in weight of exported goods for July-August period. Feeble growth in Indonesia's primary export markets, such as China, United States, and Japan, reduced demand for export goods.

Coal exports, which accounts for more than 12% of Indonesian exports, is hit particularly hard. The combination of more affordable price of unsubsidized renewable energy, slowdown in China, and stricter environmental regulations sapped demand for Indonesian coal. Indonesia coal export to China alone is down by 49% y.o.y for the first half of 2015. This trend is confirmed by further 23% y.o.y decline for total coal export in July-August 2015 period.

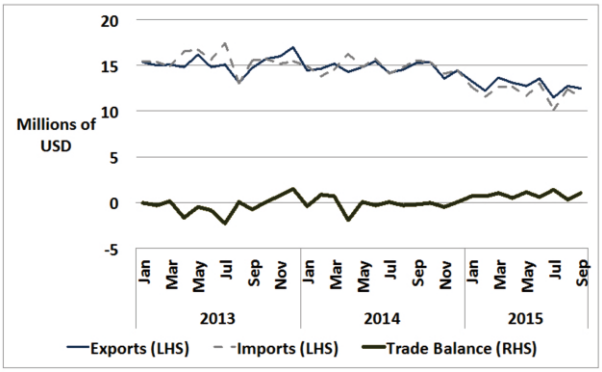
Figure 4: Commodity Price



Source: CEIC

Weak exports performance, however, is compensated by steeper decline in imports, which explains the improvement in current account. Decline in energy prices reduce needs for oil and gas imports by 41.21% y.o.y for the first 9 months of 2015. Weaker rupiah also reduced demand for non-oil-and-gas imports by 12.65% y.o.y for the first 9 month of 2015. We predict that these factors help reduce Q3 current account deficit to **2% of GDP**, in spite of aforementioned decline in exports.

Figure 5: Trade Balance (Millions of USD)



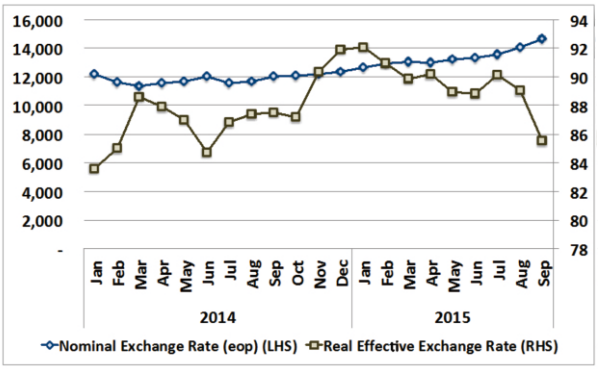
Source: CEIC

Rupiah: Ready for the Next Storm?

Given the improvement in current account and relatively sound fundamental, we view that recent upheaval in financial market, which drove USD/IDR to more than 14,800 and Jakarta Composite down to 4,000 level, is little more than massive overreaction. From actions by Chinese government to encourage bubble in domestic equity market, failure to orderly burst the resulting bubble, China's abrupt move to float its currency, concerns about global growth, to prospect of US rate hike in October meeting, these series of events that dramatically increased volatility in global (and Indonesia) financial market had little to do with fundamental.

We predict that Rupiah will move within the range of **13,500-14,000** until end of the year, given the steady improvement of current account and thin trading as the market approach Christmas and year-end holiday season. While further depreciation of Rupiah is possible should BI decide to ease monetary policy in November meeting, we view BI easing as unlikely given the increased probability of December rate hike by the Fed after the October FOMC press release wording.

Figure 6: Exchange rate



Source: CEIC

Going Forward

Despite our generally subdued outlook for Q3 2015, we are of the view that current economic slowdown is bottoming out in Q3 and Q4, and will accelerate in the following quarters. Generally low and stable energy price throughout 2015 and the return of relative stability in foreign exchange market may provide boost to domestic businesses that now have the advantage of weak Rupiah to increase export competitiveness.

With good execution, the release of economic packages by the government may provide additional boost to the economy. Of all economic packages that have been released by the government so far, we view that the results from implementation of third and fourth economic packages may be the most immediate and thus deserve high priority from related ministries. Reduction of energy prices may immediately lower production costs, while implementation of

transparent minimum wage formula that is based on productivity growth and inflation can improve investment climate significantly, given that uncertainties over minimum wage law have reduced competitiveness and hampered growth of manufacturing sector.

Uncertainties from external factors, however, still loom large and may affect growth trajectory in the near-and-medium-term. While unemployment data shows that US has almost reached full employment, there still are risks that December hike—a real possibility as of today—may be premature and negatively affect US' feeble recovery. This scenario carries additional downside risk for global market and can be easily transmitted to Indonesia.

The state of China's economy may present another downside risk to future growth outlook. As President Xi Jinping repeatedly stressed out that his government will tolerate lower growth as the price of transition to a more sustainable consumer economy, further deceleration in economic growth will dim growth outlook for Indonesia, particularly as Indonesia heavily rely on China to be its export market for commodities, particularly for coal and palm oil. China's close economic ties with Indonesia's major trading partners, such as Japan and ASEAN nations, means that China's slowdown may be transmitted to Indonesia through other economies.

As global economic growth remains subdued throughout next year, we expect various commodities to continue trading at its currently low price. Oil price, in particular, may remain well below $50 threshold should OPEC members continue to exceed its production quota and/or oil supply is significantly increased once international sanctions on Iran are lifted. Coal price may also be depressed further should China adopt even more stringent environmental following Paris climate talks this December, a real possibility given its recent climate accord with US.

In light of these external risks, we view that key assumptions for recently-approved 2016 State Budget to be generally realistic. At 5.3%, growth target for next year is more feasible to achieve than the original target of 5.5%. Exchange rate is also reasonably targeted at around Rp 13,900/USD, although Rupiah can easily appreciate beyond that level if growth and current account improve as expected next year. On the other hand, target ICP is still quite high despite significant cut to USD 50/barrel, although we admit that such pricing may be justified should oil output drop significantly due to higher-than-expected closure of money-losing unconventional oil fields in US and Canada. All being said, we are of the view that economic improvements for upcoming quarters is aligned with government assumptions, which may make implementation of fiscal policy for next year more effective.

Contact:
Febrio Kacaribu, PhD (febrio.kacaribu@lpem-feui.org)
Research Assistants:
Alvin Ulido Lumbanraja
Faradina Alifia Maizar