LPEM
ECONOMIC QUARTERLY OUTLOOK
2016 Q1

Highlights

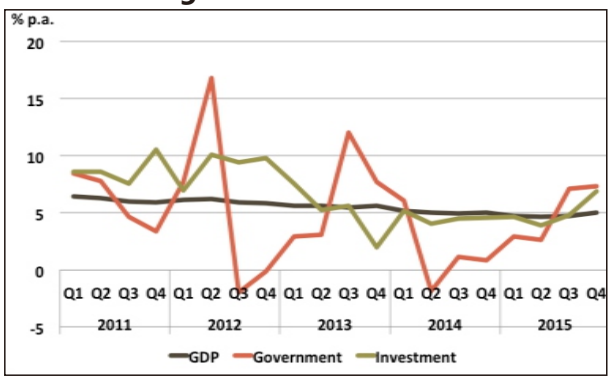
- **2016 Q1 GDP to grow at about 5.2% (yoy) and 2016 GDP to grow at 5.2-5.4% (yoy)**
- **Foreign investments led 2016 Q1 growth, consumption growth to continue at a moderate pace**
- **Current account deficit will be higher than 2015**
- **2016 inflation to be within BI's target, higher than 2015**

Improvements of global sentiment and unconventional policy easing in developed economies have benefitted Indonesian economy considerably; there is now less pressure on Bank Indonesia to reduce excess Rupiah volatility as capital outflow from Rupiah-denominated securities has slowed, and persistently low commodity prices have held down inflationary pressure. These two factors have allowed Bank Indonesia to start reducing target interest rates at current pace.

Simultaneously, the effects of structural reforms by Jokowi administration, particularly in area of deregulation and infrastructure investments, may also help boost confidence of investors. This combination of favorable external conditions and government efforts are behind the recent increase in growth of gross fixed capital formation, a promising sign for the outlook of 2016 as a whole.

Despite the good policy direction, however, we remain cautious of several key external risks that may pose challenges for Indonesia macroeconomic stability. Recent unexpected drop in global oil inventory may signal eventual rise in oil prices, which may affect the consumer price dynamics, even if the chance of $50/barrel oil price is still remote in near term. On the other hand, the inability of developed economies' central banks to increase inflation expectation and growth would affect the world's GDP growth rate in the next several years. This would worsen the global economic uncertainty longer until it finds the so-called new normal.

Figure 1: GDP Growth



Source: CEIC

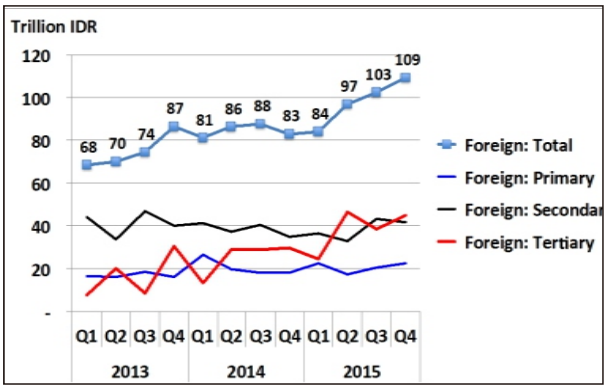
Sustained Growth Acceleration

Supported by rising government spending, particularly on infrastructure projects and strengthening business confidence, we estimate Q1 2016 GDP growth to be at 5.2% level. Private investments are expected to increase considerably in second half of 2016 following the groundbreaking of key infrastructure projects. On the other hand, consumption is expected to still grow at a moderate pace due to low inflation and improvement in domestic demand. Exports, along with imports, will continue to decline in 2016 due to global economic slowdown and sustained trend of low commodity prices in the near- and medium-term.

Investments to Grow Faster than The Economy

Current trend of capital inflows, which have resulted in significant Rupiah appreciation, may be argued by some to be the result of negative interest rate policy by major central banks. We, however, believe that despite the fact that majority of capital inflow is attributable to portfolio investment (USD 4.82 billion in Q4 2015), healthy positive growth in FDI realization indicates that investors' confidence in long-term prospect of Indonesia is relatively strong.

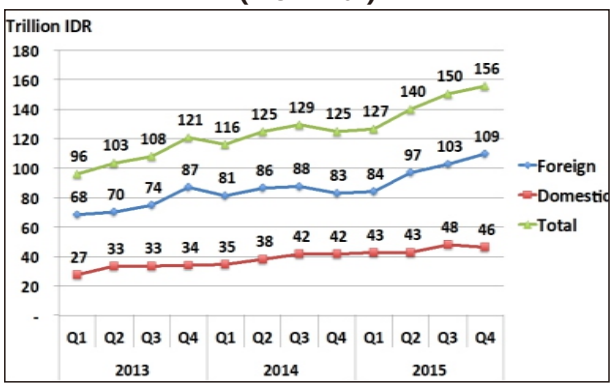
Figure 2: FDI Realization (Nominal)



Source: CEIC

Despite challenging year in 2015 for direct investments, as shown by stalling growth of investments by domestic corporations, we identify several key factors that will continue to support the acceleration of investment realizations. The most important one is the pro-investments stance by Jokowi administration, especially structural reform efforts, infrastructure projects, and relaxation of Negative Investments Lists that are designed specifically to promote investments. Reduced Rupiah and commodity prices volatility due to improved global sentiment, coupled with BI's move to gradually cut interest rate may also increase direct investments in 2016. **Reflecting this trend, we predict that investments (gross fixed capital formation) will continue to grow at higher rate than the economy in 2016.**

Figure 3: Foreign and Domestic Investment (Nominal)



Source: CEIC

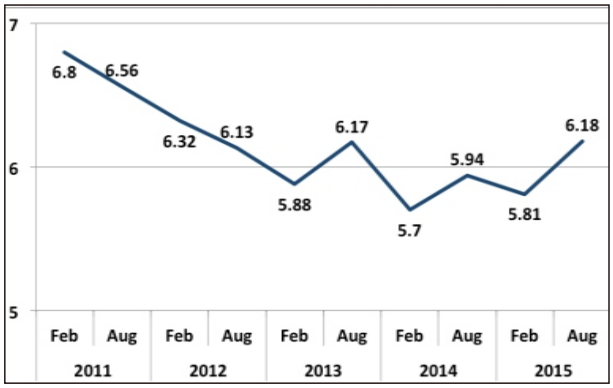
Infrastructure spending to boost economy in 2016

We expect infrastructure spending, the main pillar of Jokowi campaign, to become one of the key growth drivers in 2016. This is made possible by the record budget of Rp 313.5 trillion for infrastructure and accelerated government procurements, which has enabled ministries and government agencies to spend faster even in Q1, such as Public Works and Public Housing Ministries (PUPR), which has quadrupled its Q1 spending from the same period last year. Should this pattern of accelerated spending continue, we expect that infrastructure spending realization may be on line with the trend of >90% budget of overall State Budget.

The government is currently focusing on 30 priority infrastructure projects and will make sure the projects finish by the end of 2019. The projects include the development of eight segments of Trans-Sumatra toll road Kuala Tanjung Port, Jakarta Mass Rapit Transit (MRT) north-south line, and Bontang oil refinery.

The positive impacts of 2016 Budget, particularly infrastructure spending, may nevertheless become limited if the government tax target is not achieved. This concern is warranted as the government tax revenue in Q1 2016 is actually less than Q1 2015. While we do not expect government to cut infrastructure budget in the case of low to moderate budget cut, possibility of failure of tax amnesty program, increase in non-taxable income, and proposed tax rate decrease may force government to curtail infrastructure spending.

Figure 4: Unemployment Rate



Source: BPS

Subdued Consumption Growth

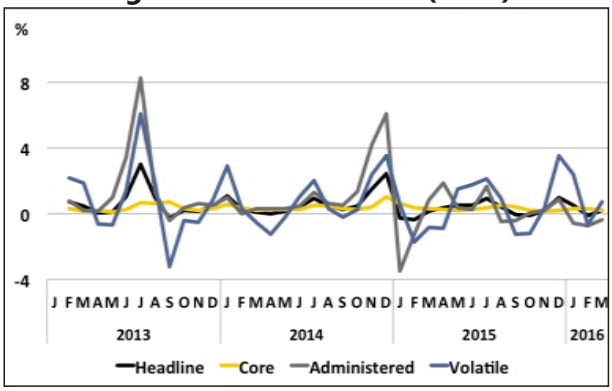
We predict household consumption to post a modest growth in 2016 Q1 at 5.0-5.1% level. This modest growth can be attributed to slow pass-through of BI rate cut and increase in unemployment rate. Slow pass-through of interest rate cut is evident in the persistently high lending rates for all types of loans (working capital, investment, and consumption rates in January 2016 are 12.57%, 11.91%, and 13.44%, respectively).

We expect unemployment rate to decrease to around 6% in February 2016 mainly due the seasonal effect. The figure will be still higher than the February 2015 number which was at 5.81%, reflecting the lagging effect from the slower economic growth last year. Faster GDP growth rate that started last quarter would lower the unemployment rate but the impact would be lagged. If the rebound of the GDP growth rate is here to stay, we could see around 5.9% unemployment rate in August 2016.

One factor that may drive down the unemployment figure is the reduction of size of labor force in August 2015, mainly due to decision by people between the age of 15 and 24 to go to school. However, compared to previous year. This, however, may only affect the figure marginally and actually have adverse effect to consumption growth (due to shrinking potential consumer base).

Going forward, we expect that consumption will grow at faster pace, particularly in the medium-term. The decision by government to increase non-taxable income by 50% from IDR36 million per year to IDR54 million per year may increase domestic demand and boost consumption growth, but the effect may be somewhat limited due to relatively small current tax base. Further rate cut and the pass-through of previous cuts will also help to boost durable goods consumption.

Figure 5: Inflation Rate (mtm)



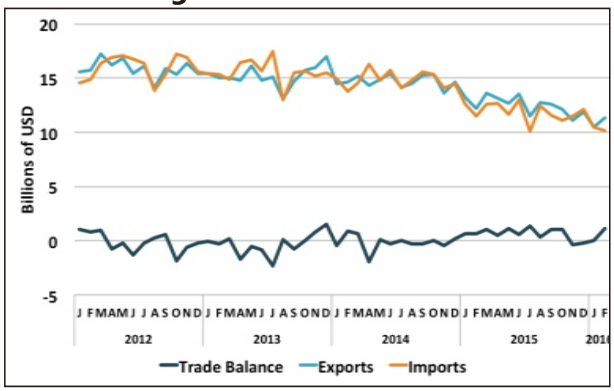
Source: CEIC

We expect inflation to be above 4.5% level for 2016, above 2015 inflation but still within BI's target. Higher inflation in the near term is attributable to El Nino and other climate-related factors, which cause delayed harvest season and elevated risks of harvest failures. We also expect core inflation to remain at current trajectory of sub-4% level. Slack in the labor market, as shown by higher unemployment rate, and predicted single-digit minimum wage increase (due to newly-implemented minimum wage formula) this year will also help to control inflation expectation in 2016.

While we largely believe the risk to be remote, sudden and significant oil price increase may pose risks to 2016 inflation target. As local prices tend to be sticky during episode of gasoline price decrease yet highly responsive to gasoline price increase, any hint of sustained increase of oil price may compel businesses to front-load the price hike and drive inflations higher. The risk of higher inflation is elevated should oil price cross $50-60/barrel thresholds. If the oil price rebound significantly in 2016, BI's indicated plan to further cut interest rate, considering that non-durable goods constitute a significant part of inflation basket, could actually cause the inflation to overshoot the upper-bound of the inflation target.

Oil Price and Global Macro to Dominate External Risks

Figure 6: Trade Balance



Source: BPS

As China's economic growth is expected to be slightly above 6% and commodity prices to remain relatively low in near-term, we expect exports to continue to fall slightly in 2016. On the other hand, imports will start to increase in 2016 due to enormous infrastructure projects,. Current account deficit in 2016 will consequently be higher than 2015.

Nevertheless, we still expect Rupiah to remain within the range of 13,000 – 13,500, given that search for yield will make capital inflow to emerging market assets continue in the near term amid unprecedented monetary policy easing by major central banks. We also expect that increase in Fed rate later this year has largely been priced in since last year and will not affect the movement of Rupiah significantly in 2016

As global market have discounted much of negative events since last year, particularly the scenario of China slowdown, Fed rate hike in early 2016, stagnant growth in developed economies, there are now rather limited room for downside risk to the economy. One of the key risks that remain is oil price surge, which will have mixed effects for Indonesian economy. Should OPEC somehow find ways to

credibly freeze supply after Sunday OPEC meeting, it will provide much-needed boost to the State Budget at the expense of supply-side driven inflation and higher-than-expected current account deficit.

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