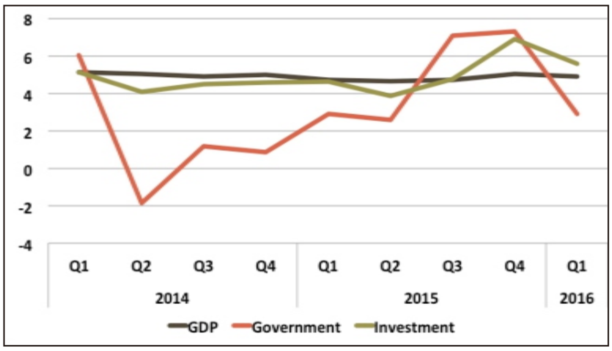
LPEM
ECONOMIC QUARTERLY OUTLOOK
2016 Q2

Highlights

- **2016 Q2 GDP to grow at about 5.0% (yoy) and 2016 GDP to grow at 5.0-5.3% (yoy) level**
- **Investments led 2016 Q2 growth, to be further supported in the rest of 2016 by passage of tax amnesty and further expected rate cuts**
- **Consumption growth to continue at a moderate pace**
- **2016 inflation to stay within BI's target**

Figure 1: GDP Growth



Source: CEIC

The main themes for Indonesian economy in the second quarter of 2016 revolve around subdued global growth, struggle to accelerate growth, and challenges for export diversification. As commodities oversupply, particularly for steel, oil, and coal, continued for the first half of this year, we do not expect prices to be high enough to actually help export and growth in the near future. Without any indication for the return to pre-2008, or even pre-2014 commodities prices in the near future, this should put renewed sense of urgency on the part of government to diversify exports and strengthen Indonesia's position in global value chain.

The Q1 economic growth has demonstrated that significantly more efforts are needed to achieve government's growth target of 7%. We expect the challenge of growth acceleration will also be highlighted by Q2 economic data that are to be released. We expect modest improvement in overall growth to **5.0%**.

We expect investments to grow faster than general economy in Q2 and for the rest of 2016, despite reduced gross capital formation growth and FDI in Q1. We maintain such view, given that 100bps rate cut since the end of 2015 should have influenced businesses to undertake investments. Growth in investments may be further supported by expected rate cuts in the rest of 2016, capital inflows following continued monetary easing in advanced economies, and assets repatriation following passage of tax amnesty program.

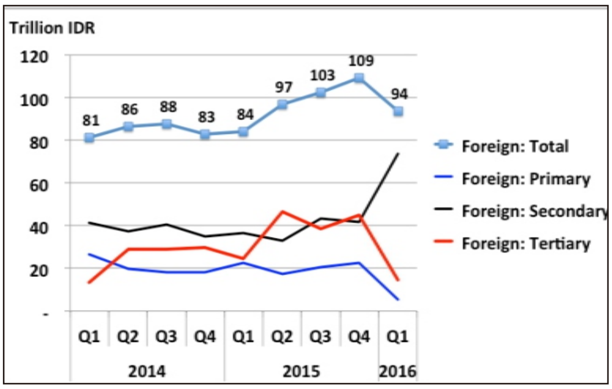
We also expect consumption growth to remain aligned with general trend of economic growth in Q2 and the rest of 2016. While there are signs from BI's consumer surveys that consumers are becoming more confident to spend money, trend of slow growth in the last several quarters and recent budget cuts that hinder pay raises will constrain room for consumption and import growth for the rest of 2016, particularly if BI remains comfortable with current exchange rate level.

Investments to still grow faster than the economy

The slowing growth in gross fixed capital formation and FDI in Q1 2016 and most probably in Q2 2016, which normally is source of alarm, should be discounted for the cyclical trend that tend to concentrate capital expenditure in second half of the year and appreciation of Rupiah from last year. This sign of increase in investment activities are shown by report of easier access to credit by businesses, increased utilization of production capacity, and gain in investment activities in BI survey.

Another trend that leads us to remain sanguine on investments despite the slowdown is the considerable shift of investment compositions, particularly for FDI. In Q1, foreign investments in secondary sectors (i.e. manufacturing) increased significantly, even as investments in primary (i.e. agriculture and extractions) and tertiary (services) sectors. Such trend should also be retained in Q2, although we expect to see some rebound in tertiary sector investments.

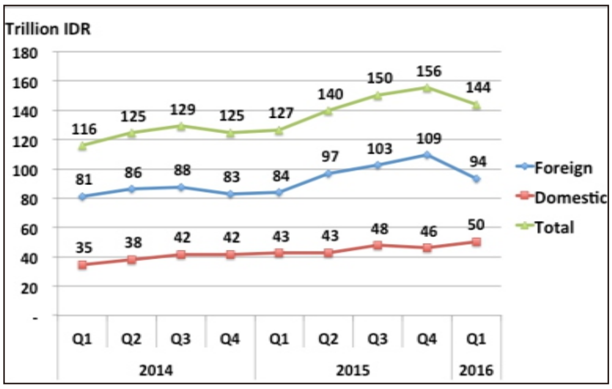
Figure 2: FDI Realization (Nominal)



Source: CEIC

While it is too soon to determine any particular trend in the economy, current shift of FDI compositions in Indonesia is particularly encouraging in light of the need to diversify the export bases. We noted that FDI in Q1 were largely concentrated in paper and printing industry, chemical and pharmaceutical industry, and transport equipment industry, which reverses the notable decline in FDI for those sectors in 2014 and 2015. Should this trend be sustained in the second half of 2016 and beyond, it signals that governments' effort to encourage investments, such as minimum wage certainty and easier permits, have yielded some results.

Figure 3: Foreign and Domestic Investment (Nominal)



Source: CEIC

Public spending to depend on tax amnesty

One of the key concerns for the revised 2016 budget and the reason that we do not expect government spending to be a growth driver for 2016 is the concern about tax receipts. With persistently low commodities prices, revised 2016 budget is critically dependent on tax amnesty receipt, projected at Rp 165 trillion, to maintain deficit level below the statutory 3% maximum.

The risk to 2016 budget is centered on the actual value of assets to be declared under tax amnesty program. With industry estimates that are lower than official estimate, it is possible that the tax revenue will be far short of Rp 165 trillion; assuming that other items in the budget to achieve 100%

target, our calculation shows that tax amnesty receipt below Rp 100 trillion will make the budget to breach 3% GDP budget deficit statutory limit and force significant spending cut by the end of year. Ministry of Finance may have to expend extraordinary amount of efforts to ensure the success of tax amnesty program, or more realistically, prepare a contingency plan for budget cut if it becomes apparent that tax amnesty target is impossible to achieve.

The more reassuring aspect of revised 2016 budget is the pledge by government not to cut infrastructure spending. This indicates high level of commitment by current administration to address infrastructure shortage and will not in any way jeopardize medium-term prospect. We however see that any potential budget cut may negatively affect services industry in the short term, as government has indicated that cut in spending will be made on non-essential spending, such as meetings, business travels, advertising, and other items that are not critical to departmental functions.

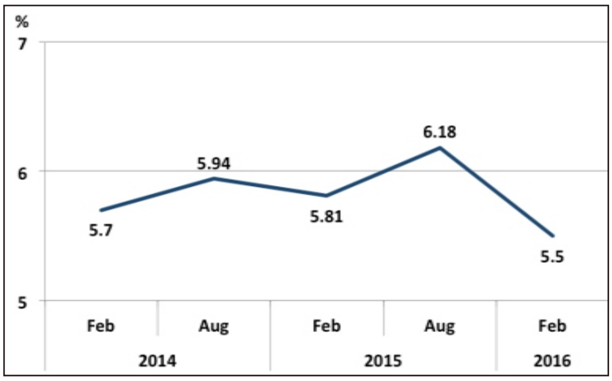
Subdued consumption growth

Supported by slightly increasing consumer confidence from Q1, we expect consumption in Q2 to post a modest growth at 4.8-4.9% level. On quarterly basis, BI survey shows that consumer confidence index is up by less than 0.8% on quarterly basis, influenced by mixed perception of consumer on the state of the economy. On one hand, consumers have noticeably better expectation on employment conditions and business activities in Q2 compared to Q1. Consumers are also more confident to buy durable goods in Q2, while still generally pessimistic due to slow pass-through effect of interest rate cuts.

Consumers, however, are less optimistic on their current income, expectation of future income, and expectation of business condition. This is in line with our view that pay raises will be more restrained in the rest of 2016 as pay raise tend to lag the economic growth and minimum wage formula effectively eliminate the possibility of drastic pay raises that occur in previous years.

Restrained wage outlook and more predictable minimum wage, however, may have induced companies to be less hesitant to increase headcount. Consumers and businesses alike indicate that employment opportunities are quite robust in Q2. Businesses in particular report increases in general labor utilization level in Q2 and Q3 (projected), which points to higher level of employment, seasonally adjusted. **We therefore expect unemployment rate to be around 5.6-5.8% (non-seasonally adjusted) for August 2016.**

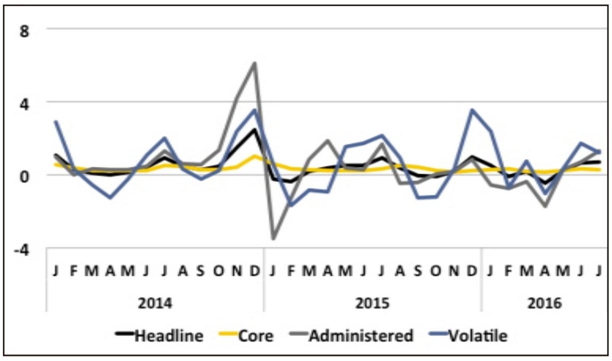
Figure 4: Unemployment Rate



Source: BPS

Slight increase in consumption due to relatively restrained wage raise reduce the possibility of inflation to cross the upper boundary of BI's 2016 inflation target of 4% ± 1%, revising our position in previous outlook. With inflation at 3.45% (yoy) and 1.06% throughout first half of 2016, the risks for inflation to miss the lower bound target is now higher than the risk of overshooting the upper bound target.

Figure 5: Inflation Rate (mtm)



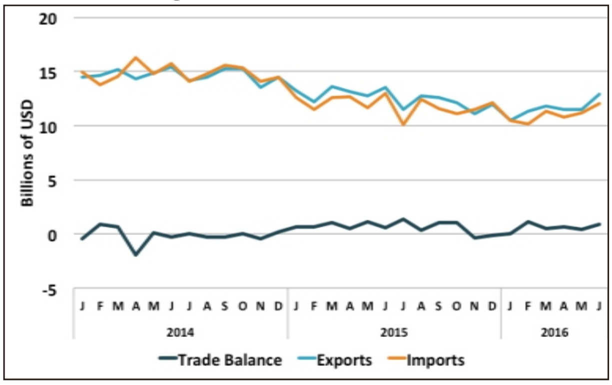
Source: CEIC

We therefore expect inflation to hover at 3.0-3.5% for 2016. The factor that we identify as key upward risk for inflation, commodities prices, appears to remain low for the rest of the year and will not affect inflation substantially. Crude oil price, which traditionally is the commodity that affect inflation rate disproportionately, has high probability to remain below $50/barrel level for the rest of 2016 and thus will not drive gasoline price and inflation higher. While coal prices have increased by around 20% since January, we do not expect the price to increase further and force PLN to increase electricity tariff, mainly because China, the largest importer and one of key coal producer, has the interest not to increase electricity tariff in slowing growth environment, even as it has curbed domestic coal oversupply.

Political-related global risks in H2 2016

The push to contain Indonesia's current account deficit to sustainable level, or even surplus, currently rests on the ability of government to simultaneously promote investment in export-oriented manufacturing and global demand for Indonesian exports. Global demand remains tepid, particularly after the effect of China slowdown is compounded by global uncertainties due to Brexit. There are signs, however, that downward trend in monthly exports and imports may have bottomed out earlier this year and start to increase again since then.

Figure 6: Trade Balance



Source: BPS

Early signs of increasing trade surplus, combined with search for yield to emerging market and assets repatriation, convince us to retain our target for Rupiah to remain within the range of 13,000 – 13,500. While we expect the Fed to postpone the timeline of rate increase for this year, we do not expect much in the way of further Rupiah appreciation. This is largely due to words and actions of Bank Indonesia through recent increases in foreign reserves that imply their preference for Rupiah to remain at current level in order to support exports.

As global market have priced in much of negative macro events since last year, such as the scenario of China slowdown, Fed rate hike in 2016, and stagnant growth in developed economies, the room for downside market-related and macro risks are currently limited. The risks that have been largely discounted by the market and may have significant negative repercussions to global economy, however, are political in nature.

We are concerned that the market and policymakers around the world, including Indonesia, may have underestimated the significant negative impacts of political events in major economies. Brexit, for example, was largely dismissed by market participants in UK and the rest of the world as unlikely until it actually happened and then put UK into the brink of recession by the end of 2016 and threatens the feeble recovery of the Eurozone.

The presidential and congressional election process in the United States this November presents another potential risks for the global economy, including Indonesia, with potentially far worse impacts than Brexit. As one of the leading presidential candidate, which currently lead the poll, openly accused China of stealing US jobs (sic), threatened to make US leave TPP, proposed increase of tariffs to countries that treat US unfairly (sic), and planned to aggressively pursue budget surplus and debt reduction while reducing tax rate (through massive spending cut), the risks of global recession and trade war are currently elevated, given the rise in global wave of populism. While we are not in the position to participate in the politics of another country, we do not see any way to dismiss US political events as a non-risk for the global economy and Indonesia, particularly as many events that were previously deemed to be unlikely actually happened in 2016.

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