

# LPEM ECONOMIC QUARTERLY OUTLOOK 2016 Q3

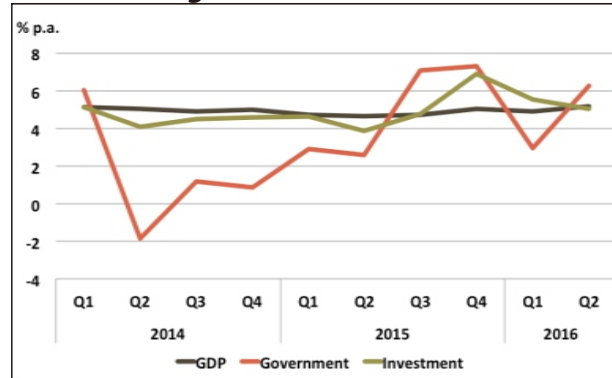
## Highlights

- **2016 Q3 GDP to grow at about 5.0% (y.o.y.) and 2016 GDP to grow at 5.1-5.2% (y.o.y.) level**
- **Success of Tax Amnesty program, appointment of Sri Mulyani, and commitment to deregulation to boost credibility of overall macro and fiscal policy, boost investments**
- **Consumption growth to modestly accelerate**
- **International trade's relative contribution to economy to shrink further**
- **2016 inflation to be slightly above 3.0%.**

The overall sentiment in Q3 and going forward is leaning toward cautious optimism across the board. While external environment remains challenging for Indonesian economy as a whole, most of the headwinds in global macroeconomic outlook have been priced in. Several key domestic developments, such as significant improvements in Ease of Doing Business ranking, consistent business-friendly reform packages, successful Tax Amnesty program, and more realistic 2017 budget, have improved business confidence. Furthermore, global tail risks, such as risk from US election and drastic oil supply cut, have subsided considerably.

**We expect Q3 GDP growth to be at 5.0% level. We also expect FY2016 GDP to grow at 5.1-5.2% level and FY2017 to grow at 5.2-5.4% level,** reflecting the slight pick-up of growth amidst challenging environment. **We expect output from government spending in Q3 and Q4 2016 to stagnate,** due to combination of significant budget cut in August and stagnant nominal spending realization in Q3 2016 compared to Q3 2015.

Figure 1: GDP Growth



Source: CEIC

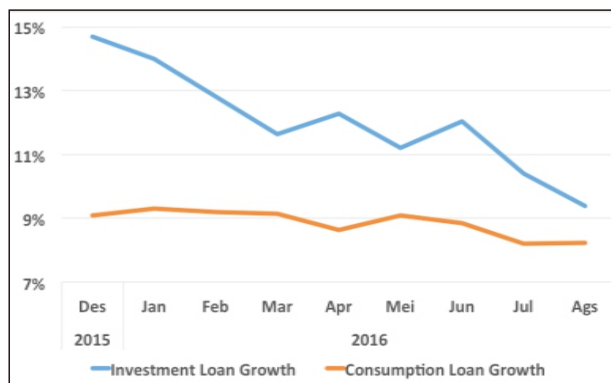
**We expect investments to grow slower than the economy in Q3 and Q4 2016.** This trend can be attributed to previously low utilization of production capacity, particularly in manufacturing industry. Slower investment growth may also be caused by expectation of several rate cuts in Q3 and Q4 and uncertainties about Fed rate hike, which may put businesses to defer capital expenditures to Q4 and next year, even if domestic demand remains robust.

**We also expect consumption growth to modestly accelerate,** consistent with general trend of economic growth, in Q3 and Q4 of 2016. This is in line with increasing consumer confidence and manageable inflation in recent months, which should support consumption going forward.

**Investments to grow slower than the economy**  
After growing faster than economy in Q4 2015 and Q1 2016, we expect the slowing trend of investment growth that was evident in Q2 2016 to continue in Q3 and Q4, before resuming accelerating in 2017. Gauges that serves as proxy to investment outlays,

such as growth of investment loans, have consistently declined in the last several months; y.o.y. growth of investment loans in August stood at 9.38%, compared to 14.69% in December.

**Figure 2: Nominal Credit Growth (y.o.y.)**

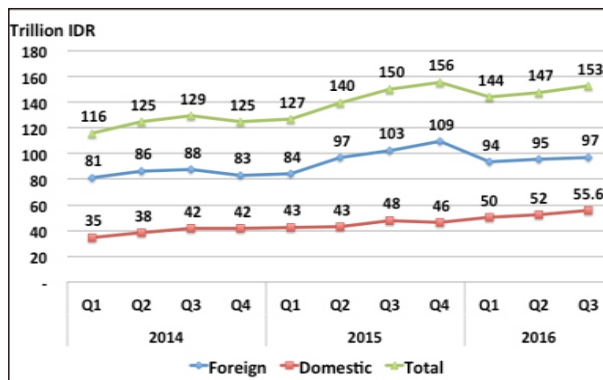


Source: Financial Services Authority

At face value, this trend of decreasing disbursement of loan for investment purposes should raise concern. However, we see this decrease in loan disbursement to non-financial firms more as prudential measures rather than slow demand. A clear sign of banks' prudential measure is the considerable increase in system-wide CAR to 23.26% in August from 20.73% a year earlier. Non-bank sources of corporate funding also stem the decline in credit growth; funding from capital market, both debt and equity, for the first 8 months of 2016 is recorded at IDR 43.93 trillion, up from IDR 31.89 trillion in the same period in 2015.

Other factors that contribute to lower investment are trend to increase utilization of production capacity by businesses and uncertainties surrounding Fed rate hike. Capacity utilization by overall businesses and manufacturing industry in Q3 2016 is reported at 76.21% and 73.15% respectively, up from 75.36% and 68.46% in Q3 2015. We expect investment to increase in Q4, particularly for domestic-oriented businesses, to anticipate increasing domestic demand in 2017.

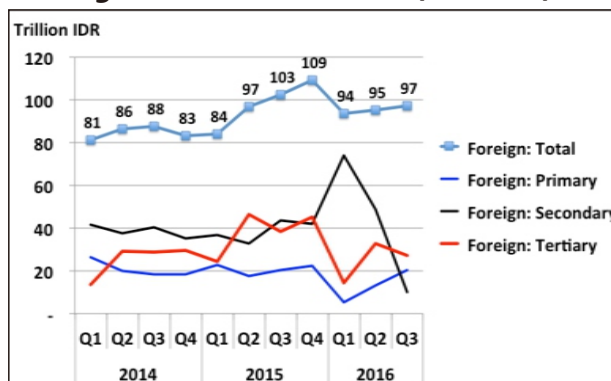
**Figure 3: Foreign and Domestic Investment (Nominal)**



Source: CEIC

While investments in real sectors are less susceptible to volatility in financial market, uncertainties surrounding the key macro events, such as Fed rate hike decision, concern over Chinese economy, and Brexit, has caused foreign investors to be more cautious in significant capital spending. However, increased share of direct investment by local businesses, which have more stable and higher growth path, has made direct investments more aligned with overall higher growth path. Cumulative investment realization in Indonesia in the first nine months of 2016 is around IDR 444 trillion, about 75% of Indonesia's Investment Coordinating Board (BKPM) 2016 target. We expect this target will be achieved by the end of this year.

**Figure 4: FDI Realization (Nominal)**



Source: CEIC

### More Credible Budget Going Forward

In previous outlook, our key concerns and reasons that we do not expect government spending to be a growth driver for 2016 is the concern about tax receipts and the fact that level of budget deficit is hinged on tax amnesty program, the success of which is questioned ex ante. We cautioned that assuming 100% revenue and budget realization, tax amnesty receipt below IDR 100 trillion will make the budget to breach 3% statutory limit.

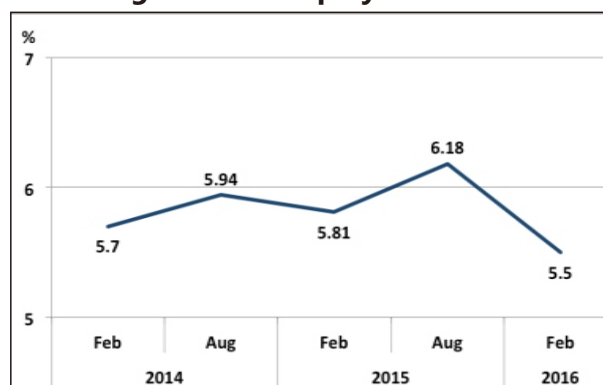
Our concern about government spending as growth laggard may have materialized as we expect government expenditure in Q3 GDP to stagnate. Government spending in July-September 2016 is recorded at IDR 479.5 trillion, compared to IDR 475 trillion in the same period in 2015, or a nominal increase of 1%. Accounting for inflation at 3.07% y.o.y. indicates that real government spending may have been in negative territory. Small increase in Q3 spending is attributed to lower budget realization (62.7% of pre-revised target for first 9 month of 2016, compared to 62.9% of pre-revised target in 2015) and higher budget realization in Q1 and Q2, which translated to fewer project backlogs in Q3.

We however commended Ministry of Finance for pre-emptively cutting the budget again by IDR 133 trillion without cutting budget for major infrastructure programs and working to exceed expectations in their tax amnesty program. With over IDR 3,880 trillion of assets declared and IDR 97.9 trillion in receipt by end of October, government's tax amnesty program is a success that cannot be overlooked. Another important steps in improving credibility of government budget is the more realistic posture of 2017 budget, which has smaller revenue target than even the revised 2015 budget and smaller spending target than revised 2016 budget.

Increase in budget credibility and our expectation of increased tax ratio going forward is also attributable to the appointment of Sri Mulyani as the new Minister of Finance. While previous minister has also done a good job, especially for initiating tax amnesty program, given the constraints of slowing economic growth in 2014-2015, the appointment of Sri Mulyani as a new finance minister and her previous record of chasing after large corporations and significant reforms in first Susilo B. Yudhoyono administration presents credible threats to would-be tax dodgers. We expect these factors, in addition to increase in tax information and 2017 timeline for OECD automatic mutual exchange of information, to improve compliance and tax ratio by the end of her term.

### Modest Uptake in Consumption Growth

Figure 5: Unemployment Rate



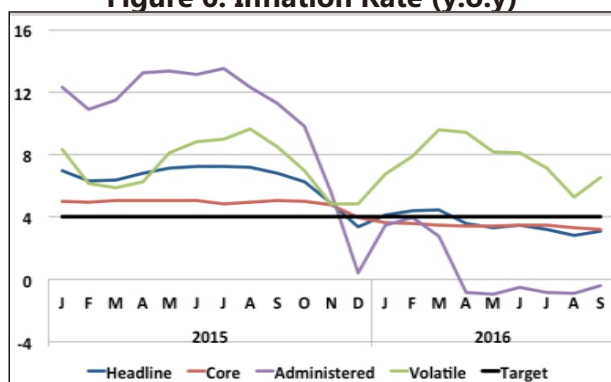
Source: Statistics Indonesia

Supported by increasing consumer confidence, we expect consumption to post a modest growth at 5.0% level. On quarterly basis, BI survey shows that consumer confidence index is up by more than 0.8% on quarterly basis, influenced by mixed perception of consumer on the state of the economy. On one hand, consumers have slightly better expectation on business activities, current income, and expected income in Q3 compared to Q2. Consumers

are also slightly more confident to buy durable goods in Q2, while still generally pessimistic (below 100) due to slow pass-through effect of interest rate cuts. Consumers, however, are less optimistic on expected availability of job openings. **We still expect unemployment rate to be around 5.6-5.8% (non-seasonally adjusted) for August 2016.**

Slight increase in consumption due to relatively restrained wage raise and manageable increase in energy prices make the possibility of inflation to be above 4% target virtually impossible. With inflation at 3.07% (y.o.y) and 1.97% throughout first nine months of 2016, the risks for inflation to miss the lower bound target is still high.

**Figure 6: Inflation Rate (y.o.y)**



Source: CEIC

**We expect inflation to be slightly above 3.0% for 2016.** With subdued key upward risk for much of Q3 and, according to our expectation, for Q4. The factor that we identify as key upward risk for inflation, particularly energy prices, appears to remain manageable 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 remained within close range of \$50/barrel level, even as OPEC has continuously talked about supply cut. Such talks ironically have only achieved reduction in its supply threat credibility and its relevance.

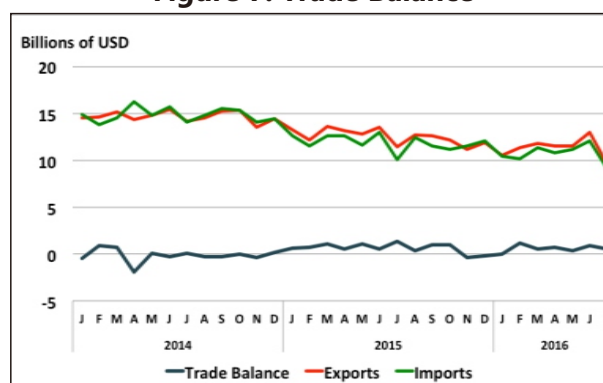
While coal prices have increased considerably since January, we still do not expect the price to increase further and force PLN to increase electricity tariff, mainly because China, the largest importer and one of key coal producer, has the interest not to increase electricity tariff in slowing growth environment, even as it has curbed domestic coal oversupply.

The recent move to lower BI's Reverse Repo Rate from 5.0% to 4.75% might save the inflation rate from missing BI's lower bound target. Albeit small, there is a chance that BI will lower its policy rate before the expected Fed Funds rate hike in Dec 2016.

**Shrinking Trade: Tepid Global Growth and Return to Protectionism?**

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. While trade balance has been in positive territory for 2016, downward trend in monthly exports and imports seem to be more resilient than we initially expect.

**Figure 7: Trade Balance**



Source: CEIC

Consistent trade surplus, combined with search for yield to emerging market and assets repatriation, convince us to tighten our target for Rupiah for end of 2016 to the range of 13,000 – 13,300. We expect that Fed's possibility to increase rate in December meeting to have been priced in by market participants and do not expect much in the way of high volatility of Rupiah. 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 populist uprising, as evidenced by Brexit, the eleventh-hour surprise holdout by Wallon region for Canada-EU Trade Agreement, and increasingly hostile tone of both major US presidential candidates on free trade. Feeble global demand, coupled with creeping protectionism throughout regions that have traditionally espoused free trade, may further

reduce the relative share of international trade to global economy.

While we do not expect return to high-tariff regime and spike in trade barriers, both tariff and non-tariff, in the near future, anti-globalization and anti-trade sentiments may impact the volume of trade in the medium-term and long-term through reduced political will to facilitate more free-trade agreements and public backlash on job outsourcing to developing countries. The presidential and congressional election process in the United States this November clearly embodies this risk of creeping protectionism. As one of the leading presidential candidate 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 another major candidate's gradual opinion shift to disfavor the TPP, we do not see any way to dismiss the waves of increased nationalism and populism as credible threats to global trade and Indonesia's effort to engage more in global supply chain.

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