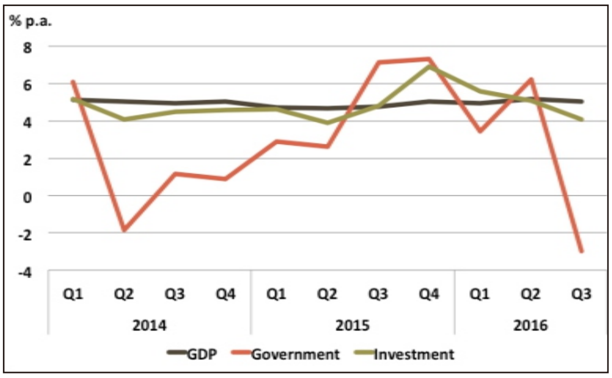
LPEM
ECONOMIC QUARTERLY OUTLOOK
2016 Q4

Highlights

- **2016 GDP to grow at 5.1 %(y.o.y.) level;**
- **2017 GDP to grow at 5.2-5.3% (y.o.y.);**
- **Consumption to grow at a moderate pace;**
- **Rupiah to continue its stable performance amid global uncertainties, supported by stronger domestic market.**

Still consistent with our previous outlook, we expect 2016 GDP to grow at around 5.1% level, higher than the preceding year. This is attributable to more robust consumption growth amid low inflation. **However, this growth is most probably lower than the potential amid stagnating government spending in 2016** due to two budget cuts in the second semester of 2016 and less-than-target tax revenue.

Figure 1: GDP Growth



Source: CEIC

We still expect investments to grow slower than the economy in Q4 2016, mainly caused by high-degree of global uncertainty. China's slow economic growth, surprising Brexit, and Donald Trump's unexpected win in the 2016 US presidential election may cause investors to delay any investment decision. Apart from external factors, increasing religious and ethnic-related tensions may put business to hold capital expenditures.

We also expect consumption to grow at a moderate pace at around 5.0%, continuing its robust growth. Consumer confidence in 2016 Q4 was at 116.0, up 12.5 point compared to the same period last year.

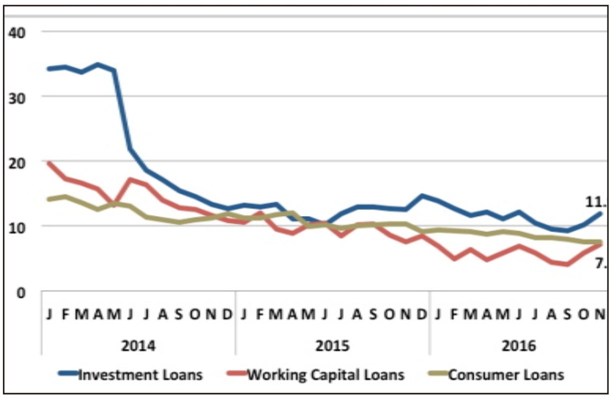
Going forward, we expect the 2017 GDP to grow at a slightly higher pace at 5.2.-5.3%. Domestic factors will continue to be more sanguine than external factors. Rising external uncertainties and threat of reduced global trade, led by increasingly unhinged Trump administration, can potentially dampen confidence by business communities to invest in emerging economies, which reduce our growth expectation in 2017.

Investment to still grow slower than the economy

Since 2015 Q4, gross fixed capital formation shows decreasing growth trend from 6.9% (2015 Q4) to 4.06% (2016 Q3). While the government has made some progress in creating more business-friendly environment through 14 economic stimulus packages and removal of several industries from negative investment list, we expect this downward growth trend will continue in 2016 Q4, due to high-degree of global uncertainty.

Uncertainties around the world, including slowing China's economy, Brexit, and Donald Trump's surprise victory, have prompted businesses to be more reluctant in committing large-scale capital expenditure. This is evident in 9.1% (y.o.y.) decrease, in Rupiah term, in FDI realization in 2016 Q4. On the other hand, domestic investment realization shows slight increase of 0.26% (y.o.y.) in 2016 Q4, indicating stable growth since 2014 Q1. Total investment in 2016 was recorded at IDR 601.6 trillion, 1.2% above Indonesia's Investment Coordinating Board (BKPM) 2016 target.

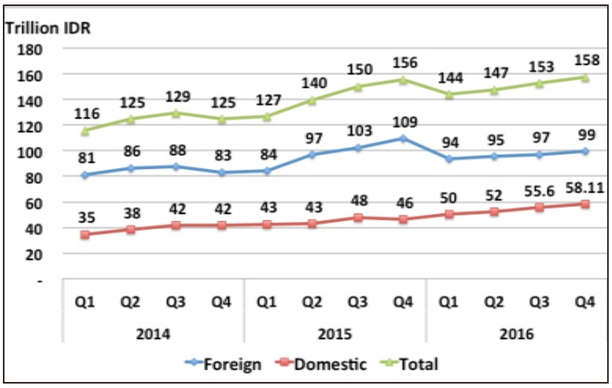
Figure 2: Nominal Credit Growth (y.o.y.)



Source: CEIC

Continuing the positive trend from September 2016, the annual loan growth was reported at 8.5% in November 2016. This, however, is still lower compared to the same period last year (+9.6% y.o.y.). The highest growth was reported by investment loans (+11.9% y.o.y.) while working capital loans and consumer loans lag the increase by (+7.2% and +7.5% y.o.y., respectively). We expect the moderate improvement in domestic business investments will lift the loan growth in 2017. This will cancel out the negative impact from the expected unstable interest rate in 2017.

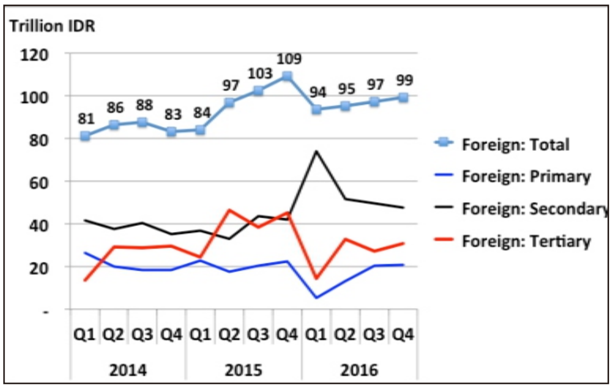
Figure 3: Foreign and Domestic Investment (Nominal)



Source: CEIC

Despite overall negative FDI realization growth, foreign investment realization in secondary sector recorded a positive growth of 13.9% (y.o.y.) in 2016 Q4, a good sign for the government that prefer a shift from exploiting natural resourced into formal to more productive and labor-intensive sectors, such as metal, machinery, and electronic, chemical and pharmaceutical industry, paper and printing industry, and automotive industries. FDI realization in both primary and tertiary sector indicates negative growth at 6.6% (y.o.y.) and 31.7% (y.o.y), respectively.

Figure 4: FDI Realization (Nominal)



Source: CEIC

Stagnant Government Spending, More Realistic 2017 Budget

Continuing our view from previous outlook, government spending will not be a growth driver in 2016. With budget cuts following the appointment of Sri Mulyani as the new Minister of Finance, government spending is expected to slightly dampen economic growth in 2016 and in 2017. The budget cut, which amounts to IDR 133.8 trillion (around USD 10.3 billion), was taken to comply with 3% deficit rule. Government spending in January to November 2016 was recorded at IDR 1,636.5

trillion, 78.6% of the revised 2016 state budget, compared to IDR 1548.8 trillion in the same period in 2015 or a nominal increase of 5.7%.

Despite lower-than-target tax revenue realization, which has been the case for years, we lauded the Ministry of Finance for successfully executing tax amnesty program. By the end of January 2017, over IDR 4,340 trillion of assets declared and IDR 103.7 additional tax revenue, around 62% of tax amnesty program target. We expect tax amnesty program target will be achieved by the end of the program in March 2017.

However, the actual government tax revenue excluding tax amnesty receipts, which was lower than in 2015, warrants concern about the state of the economy. While it is possible that reduced overall tax revenue this year is mainly caused by tax directorate efforts to book some of this year's receipt in 2015 in order to achieve 2015 target, it is also possible that tax amnesty program diverted the resources allocated to normal tax allocation, which offset the tax amnesty revenue. It also shows the desperate need for the government to improve overall tax compliance.

On another positive note for the fiscal management, the government set a more realistic state budget in 2017, which has smaller revenue target than even the revised 2015 state budget and smaller spending target than revised 2016 budget. More credible target will improve the credibility of Budget Law (UU APBN) and setting the correct, feasible target for tax directorate employees.

Infrastructure Developments Require More than Good Intentions

Based on the Government Work Plan (Rencana Kerja Pemerintah (RKP)), the theme for 2016 was accelerating infrastructure development, which was divided into three components: economic infrastructure, social infrastructure, and support infrastructure. According to Ministry of Finance data, infrastructure budget in revised 2016 state budget was IDR 317 trillion (economic infrastructure, social infrastructure, and support infrastructure budget were IDR 307.1 trillion, IDR 5.7 trillion, and IDR 4.2 trillion, respectively). This infrastructure budget increased by 13.1% from revised 2015 state budget.

The Ministry of Public Works and Housing has several tasks, including developing infrastructure related to food and water security, domestic connectivity, and residential area. In 2016, The Ministry of Public Works and Housing has completed development of seven water-related infrastructure, started eight dam constructions, completed 68 km additional highway, more than 9,000 m additional bridge, and around 800 thousand new houses to achieve 1 million houses program (*Program Satu Juta Rumah*).

However, even with continuous major increase in infrastructure budget for following years and ability to achieve 100% budget realization, the budget for infrastructure is severely inadequate. Using government's 2015-2019 medium-term plan target of Rp 2,215 trillion national budget for infrastructure and Rp 5,519 trillion total infrastructure expenditures. The medium-term target looks unrealistic.

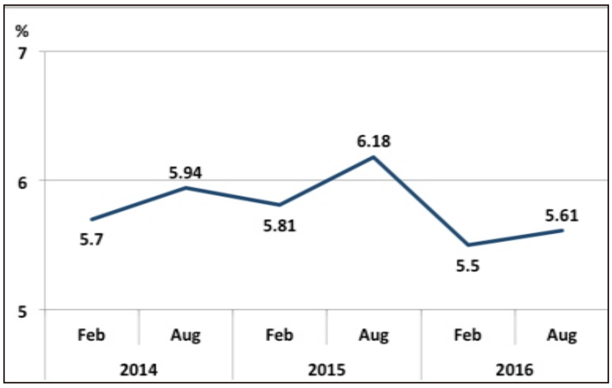
We also deem current infrastructure regulations for private sectors, which are expected to support significant amount of capital to kick start infrastructure projects, to be counterproductive. While we laud Joko Widodo administration for introducing regulations that allows higher private sector participation in funding infrastructure projects through PPP scheme, such sentiments are not shared by other governmental institutions that are critical to.

The most high-profile recent case on counterproductive regulatory regime is the Constitutional Court ruling which, on surface, prohibits the private ownership of power plant. While Joko Widodo administration and PLN have reassured IPPs that the ruling should be interpreted only as prohibition of direct distribution by IPPs to consumers, the ruling will undoubtedly add more regulatory uncertainties for IPPs in particular and. Combined with limited role of market mechanism in setting the user cost of infrastructure projects.

Moderate Growth in Consumption

Amid low inflation throughout the year, we expect consumption to still grow at a moderate pace at around 5.0% level. BI survey shows quarterly consumer confidence index (CCI) was at 116.0 in 2016 Q4, up 12.1% from the same period last year. Increasing CCI was supported by increase in all 6 components forming CCI, which consist of current economy and expectation of the future. On quarterly basis, consumers are most optimistic with job availability in the next six months and have better expectation on business activities and expected income. Although consumers are more optimistic about job openings, unemployment rate in August 2016 was at 5.61%, down from 6.18% in August 2015. This is consistent with our previous outlook. Beside the seasonality effect, the decrease in unemployment rate is attributable to increase in female worker, higher number of workers in informal sectors, and the effect of e-commerce. The unemployment rate figure should be lower than 5.5% in Feb 2017 data release.

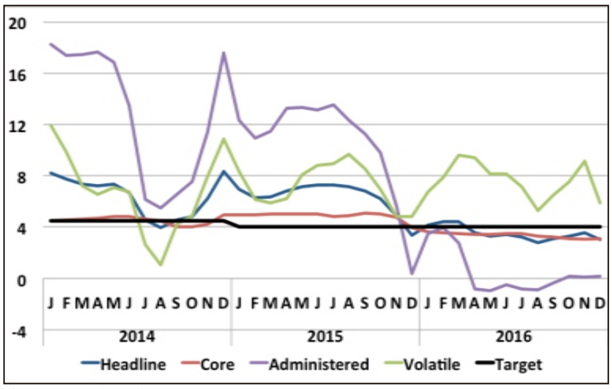
Figure 5: Unemployment Rate



Source: Statistics Indonesia

Beside the relatively weak aggregate demand in 2016, low annual inflation rate in 2016 at 3.02% (y.o.y.) was due to low administered inflation at 0.21% (y.o.y), caused by low global oil price, which translated into low fuel and electricity prices throughout 2016. In addition, the government was relatively successful in maintaining food supply throughout the year, evident in moderate inflation during Lebaran and Christmas period.

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



Source: CEIC

Looking forward, **we expect inflation will be higher in 2017, at around 4.0% (y.o.y.)**. Climate-change-related extreme weathers, which affect food prices, combined with fuel and electricity price adjustment will push inflation upward. In January 2017, the government raised electricity tariff for 900 VA households and fees for vehicle registration.

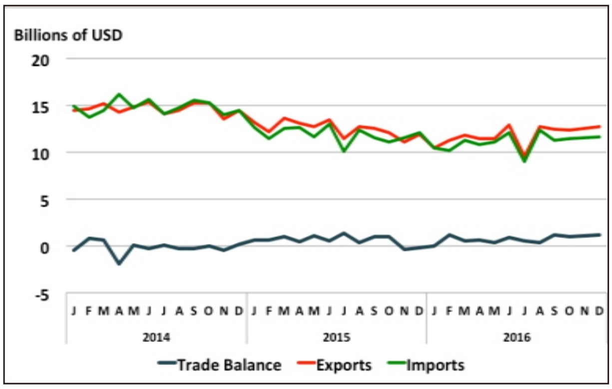
Another potential risk for inflation volatility is the November 2016 decision of OPEC countries agreed to cut oil productions to clear global oil glut and to raise oil price. OPEC members, who normally failed to comply with the agreement, shows 82% compliance rate in January 2017 with around 950,000 bpd oil production cut from around 1.2 million bpd cut target. OPEC members also coordinate with non-OPEC members, including Russia, to jointly cut oil production of 1.8 million bpd. While it remains to be seen whether this agreement can actually have any credibility, we see that global market still has some faith in OPEC agreement, which can sustain the upward price movements.

On the other hand, as crude oil price increases, the US shale industry may increase its production adding more oil supply. Trump administration's plan to approve Keystone XL project and moves by U.S. Republicans to allow drilling in national parks may also put further downward pressure to oil prices. Based on the speed and flexibility of shale industry players, we expect crude oil price to average between USD 50 – 60/barrel, while never hitting more than USD 70, barring some surprising developments in the market.

Elevated Global Risks

Despite weak global demand, Indonesia's trade balance in 2016 Q4 showed a surplus of USD 3.1 trillion. Higher growth in exports of 13.8% (y.o.y.), due to strengthening commodity prices, compared to 6.5% (y.o.y.) growth in imports in 2016 Q4 contributed to higher trade surplus. Looking into 2016 data, both exports and imports decreased by 3.9% (y.o.y.) and 4.9% (y.o.y.), respectively. This decline is better compared to 14.6% (y.o.y.) decline in exports and 19.9%% (y.o.y.) decline in imports in 2015. Bank Indonesia recorder current account deficit (CAD) eased to 1.83% GDP in 2016 Q3 due to increase in non-oil and gas trade surplus and decrease in oil and gas trade surplus. Looking into trade balance surplus in 2016 Q4, we expect CAD in 2016 Q4 to be at around 1.80% GDP

Figure 7: Trade Balance



Source: CEIC

Positive domestic economic performance supported relatively stable Rupiah during 2016, which moves between IDR 13,100 to IDR 13,900 per USD. The highest pressure on Rupiah was apparent when Donald Trump won the US presidential election after beating market favorite, Hillary Clinton. Rupiah depreciated by 0.32% on 9 November 2016. With increasing global uncertainty, including the probablee Fed rate hike, we expect Rupiah to fluctuate around IDR 13,500-14,000 per USD.

Trump administration, in less than 2 weeks after inauguration, has elevated risk to global economic recovery rapidly. Confirming our previous assessment on Trump, recently issued executive orders should raise alarm on the possibility of global recession. On his first days as president, Donald Trump formally withdrew The US from Trans-Pacific Partnership, fulfilling his campaign promise. Not long after that, he signed an executive order ordering the construction of The US – Mexico border, 'The Wall', which is still unclear who should pay for it. The most recent controversial policy was to ban people from Sudan, Syria, Iraq, Iran, Somalia, Yemen, and Libya, Muslim-majority countries, from travelling to the US. While President Trump's current policies have little impact on Indonesia, more agressive future policy direction, such as assertive stance on China-US tariff or reckless geopolitical engagements, can have more direct impact on Indonesia and must be treated with caution.

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