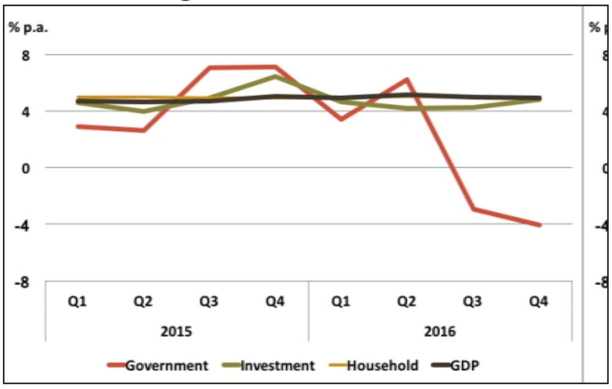
LPEM
ECONOMIC QUARTERLY OUTLOOK
2017 Q1

Highlights

- **Q1 2017 GDP to grow at 5.0% (y.o.y.) level, 2017 GDP to grow at 5.1-5.3% (y.o.y.);**
- **Domestic consumption growth to remain flat;**
- **2017 inflation to be around 4.0% (y.o.y.);**
- **Investments led Q1 2017 and overall 2017 growth, to be supported by improving investment climate.**

2017 presents both good news and bad news for Indonesia, which we expect to be evident in Q1 2017 economic data. On one hand, Indonesia has successfully weathered structural adjustment for the last 5 years and is now in relatively healthier posture. Investment climate has improved considerably due to the success of tax amnesty programs, the fact that the government made good on its national infrastructure spending pledge and more realistic 2017 budget.

Figure 1: GDP Growth



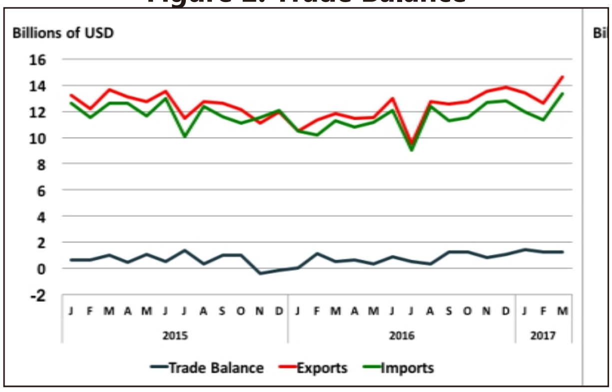
Source: CEIC

Some external variables have also worked in Indonesia's favor. Higher commodity prices, such as for crude palm oil and coal, is expected to help improve export performance. Tepid US GDP growth has eased concern about more Fed rate hike, while consumption-driven acceleration of China GDP growth may further boost Indonesia's export. Increasingly diversified energy market, particularly with shale boom in US and increasingly affordable renewable energy, has kept oil price stable despite faster global growth and keep near-term inflation manageable.

On the other hand, **weak consumer confidence, reduced government spending, and geopolitical risks still pose major risks for the prospect of faster GDP growth**. Domestic consumption is expected to stagnate, even decelerate, given higher electricity tariff and lower wage growth. Increasingly erratic and unreliable US foreign policies, inability of Trump administration to pass major legislation despite controlling both houses of Congress, and uncertainties in Europe may drag global GDP growth lower in 2017. We expect quarterly growth to remain at 5.0% (y.o.y) during the first quarter of 2017, with overall 2017 growth to slightly accelerate to 5.1-5.3% for Fy2017.

Exports Boost from Commodity Prices

Figure 2: Trade Balance



Source: CEIC

Crude palm oil and coal prices are slightly below USD50 per barrel USD 80 per ton, respectively, recovering substantially from its 2015 low. We expect the contribution of coal export to be diminished as the decline in use of coal may be irreversible in the long-term, due to increasingly abundant cheaper and cleaner alternatives such as natural gas and alternative energy. CPO may have much better prospect as increase in global processed food consumption, recovery of Chinese consumption, and rising middle class in Africa would help sustain the positive trend for its demand. This trend is evident in exports and imports figure, which increased in Q1 2017 by 20.8% (y.o.y.) and 14.8% (y.o.y.), respectively, suggesting further boost to net export.

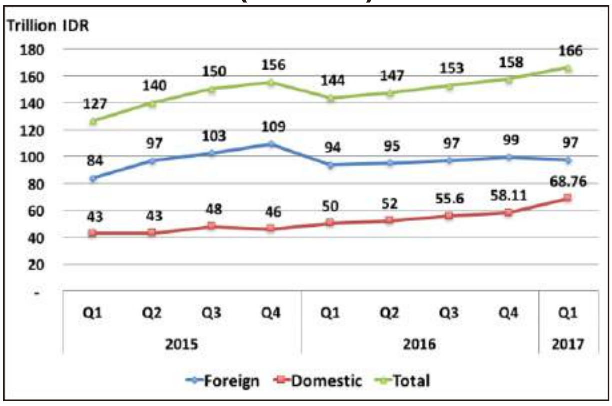
During the start of the year, it is a normal phenomenon to see government spending lower than expectation. Until 31 March 2017, it is reported that the state revenue was IDR 294.6 trillion, 16.8% of state budget, while the spending was IDR 400 trillion, 19.2% of state budget. We expect government spending growth rate to be lower than the economy's during the first quarter.

Investment to Be the Growth Driver in Q1 2017 and beyond

Continuing its positive trend since Q4 2016, gross fixed capital formation will be the key driver in Q1 2017. Economic stimuli package, Governments' effort to create a better investment climate through 14 economic stimulus and structural reforms have resulted in some increase in investors' confidence. In addition, while there were major concerns regarding sectarian conflicts that might result from racially and religiously charged Jakarta gubernatorial election, such risk has largely eased when Governor Basuki Tjahaja Purnama quickly conceded defeat to his rival, former minister of education Anies Baswedan.

Sanguine domestic factors translate into increase of 4.0% (y.o.y), in nominal Rupiah term, in foreign domestic investment (FDI) realization in Q1 2017. On the other hand, domestic investment realization shows significant increase by 36.6% (y.o.y), the fastest pace during 2014 – 2016. Total investment realization for Q1 2017 was recorded at IDR 166.1 trillion, 24.5% of Indonesia's Investment Coordinating Board (BKPM) 2017 target. Looking into domestic and external factors, we expect BKPM to achieve their overall 2017 target.

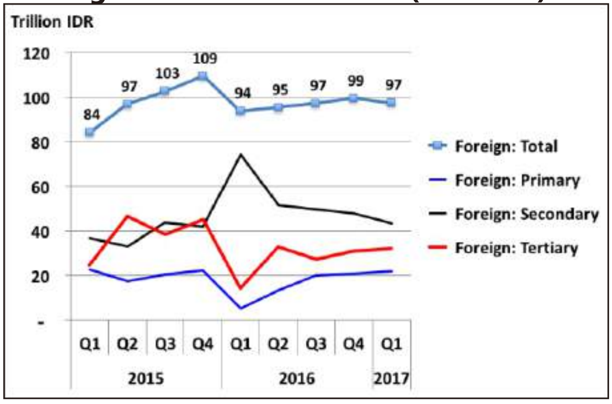
Figure 3: Foreign and Domestic Investment (Nominal)



Source: CEIC

Although overall FDI realization recorded positive growth, FDI realization in secondary sector (manufacturing) decline by 41.6% (y.o.y. in Q1 2017. FDI realization in both primary and tertiary sector indicated positive growth at 6.6% (y.o.y.) and 31.7% (y.o.y), respectively. This decline is attributed to a combination of abnormally high level of manufacturing FDI and significant IDR appreciation compared to Q1 2016 level.

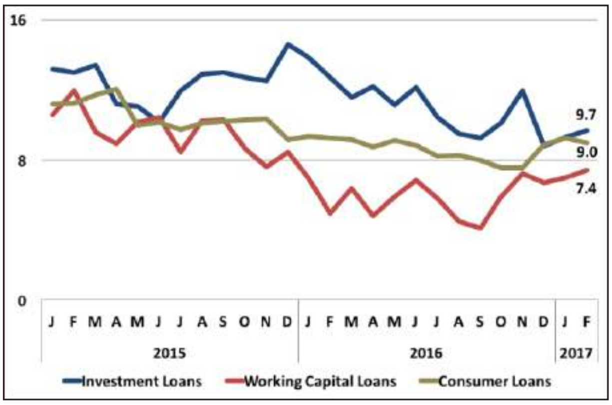
Figure 4: FDI Realization (Nominal)



Source: CEIC

Loan growth indicated stable growth since November 2016 at around 8% (y.o.y.) with the latest growth in February 2017 was reported at 8.4% (y.o.y.). All three types of loans experienced growth with the highest growth was reported by investment loans (9.7% (y.o.y.)), followed by consumer loans and working capital loans by 9.0% (y.o.y.) and 7.4% (y.o.y.), respectively. Acceleration is particularly evident for working capital loan from the same period in 2016. We expect that, with increasing trend of direct investments realization in 2017, outstanding investment loans and working capital loans growth will accelerate slightly.

Figure 5: Nominal Credit Growth (y.o.y.)



Source: CEIC

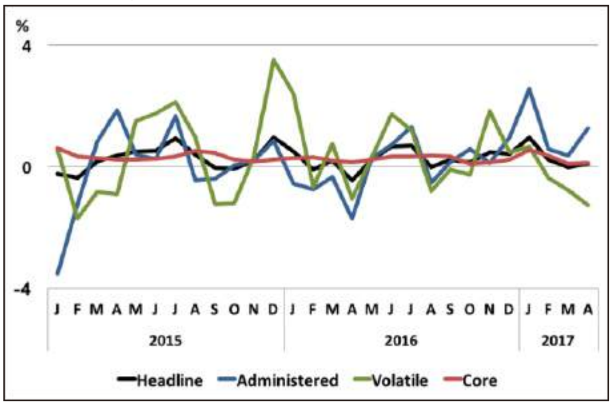
Muted Government Spending

Reduced 2017 budget and slow big-ticket government spending during the first months of the year should be translated into lower-than-expected government spending growth for Q1 2017 and for the rest of 2017. State revenue during Q1 2017 was IDR 294.6 trillion, 16.8% of state budget, while the spending was IDR 400 trillion, 19.2% of state budget. We expect government spending to increase in the following quarters, although. However, given only 2.5% increase in nominal government spending realization, and more than 4% inflation, we expect government expenditure to record slight negative growth.

The government set tax revenue target for 2017 at IDR 1,498.9 trillion, up 16.8% from the previous year tax revenue realization of IDR 1,283.6 trillion in 2016. Until March 2017, tax revenue and total revenue amounted to IDR 237.2 trillion (15.8% target) and 294.6 trillion (16.8% target). This is major improvement of total revenue and tax realization for 2016, which amounts to 13.0% and 13.6% target respectively. The tax collection progress was partly supported by the last round of tax amnesty receipts. Looking into current trend and improved tax enforcement quality, we see that tax revenue collection to only be slightly below target in 2017.

Stagnant Domestic Consumption Growth

Figure 6: Inflation Rate (mtm)

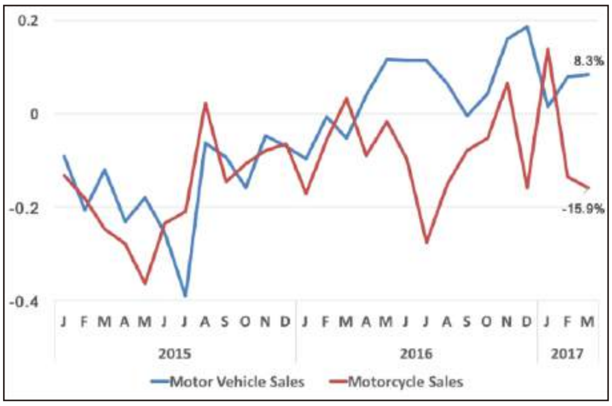


Source: CEIC

Relatively manageable inflation during in the first three months of 2017 is most likely to be caused by flat or decelerating (below 5% y.o.y.) domestic consumption growth. The government continues to curtail energy subsidy, particularly electricity, which cause weak consumer demand. There are three rounds of subsidy cuts in 2017, January-February 2017, March-April 2017, and May-June 2017, in each step will be 30% price increase. By July 2017, consumers of R-1 900 VA electricity will not receive subsidy. Higher electricity tariff is expected to put pressure on inflation, which nevertheless will be offset by subdued domestic demand. During Ramadhan season, inflation is likely to increase, but still manageable. **We expect inflation to hover around 4% (y.o.y.) in 2017.**

Another contributor to soft domestic consumption growth is weak wage growth, which was partially driven by new government policy to peg minimum wage increase to nominal GDP growth. Slow pass-through of policy rate decrease of the last several quarters to consumer credit interest rate is also to blame for anemic growth in durable goods consumption. This is evident in decelerating motorcycle sales, which declined by -6.8% (y.o.y.) in Q1 2017. We only expect consumer confidence to rebound in the second half of this year, when liquidity in financial system increase and consumer credit rate eventually converge to decrease in monetary policy rate.

Figure 7: Motor Vehicle and Motorcycle Sales Growth (y.o.y.)



Source: CEIC

Continuing External Risks

An unexpected direct external risk to Indonesia economy is posed by President Trump's Executive Order 13786, which ordered investigation into severe trade imbalance between the US and 16 countries, including Indonesia. Under normal circumstances, we are confident that this should not result in any significant action that hurt Indonesia's position. However, given the erratic nature of Trump's administration policy so far, we do not want to discount adverse future effect from any protectionist measure from United States, no matter how specious the claim of Indonesia's unfair trade practices is.

Broader trend of Trump's administration incompetence may have unique and significant repercussion for global economy in 2017 and for the rest of his administration. Inability to pass significant major legislation in Republican-controlled Congress may signal lower chance to pass tax reform and infrastructure package bills, which may reduce confidence of US consumers and businesses. Combined with unusually high vacancies for key Cabinet appointments and Trump's threat to repeat 2013 government shutdown after being unable to pass any significant legislation make prospect of US economic stagnation and 2018 recession not entirely impossible. US mishandling of situation in North Korea is also not helpful to increase stability in Asia-Pacific.

Even as businesses in Europe and around the world expect Macron to win French presidency, prospect of Le Pen victory and increased far-right control of French parliament may significantly lower global GDP due to pledged Frexit (exit of France from European Union) and possible protectionist measures, which are strongly advocated by Le Pen and Front Nationale. Failure of UK to reach free trade deals with EU in post-Brexit era may negatively lower both UK and Eurozone GDP considerably. With EU accounting for around 20% of global GDP, more negative risks to already fragile European economies will inevitably affect

Indonesia.

A surprising phenomenon is that these geopolitical risks, while real, are not reflected in current asset prices. This may show that businesses and investors to expect extremist politicians to eventually normalize and common sense will prevail. However, even as these risks may be low, the negative effects to global economy, particularly for export-import and cross-border investments. Some degree of caution is warranted with respect to these global risks.

Researchers

Febrio Kacaribu, Ph.D.
Head of Research
Macro and Financial Market Studies
febrio.kacaribu@lpem-feui.org

Alvin Ulido Lumbanraja, S.E.
Faradina Alifia Maizar, S.E.
Research Assistant