

Key Figures

- GDP Growth* (Q1 '18)
5.2%
- GDP Growth* (FY 2018)
5.3%
- Inflation (y.o.y. Mar '18)
3.40%
- Credit Growth (y.o.y. Feb '18)
8.22%
- Trade Surplus (Q1 '18)
USD 0,28 billion
- Current Account (FY 2017)
-1.70%

*) Forecast

Challenges of Economic Reform and External Risks

Highlights

- GDP to grow 5.2% in Q1 2018, overall 2018 forecast remains unchanged at 5.3%
- Manufacturing sector has steadily grown faster through Q4 2017, should probably sustain acceleration for 2018 as direct investments accelerate
- Consumption growth still lags investment growth, but may cross 5% level this year
- Growth in 2018 to be driven by investment, particularly foreign direct investments
- External risks to remain manageable in short-term; risk of large-scale trade wars between major economies have receded
- Fiscal management is sound and current debt position is still healthy, but creeping increase in energy subsidies, price control, reliance on SOEs balance sheet for infrastructure spending, and inconsistent regulatory regime are concerning

Higher commodity prices and infrastructure spending have not been followed by increase in household consumption. This condition is also exacerbated by low growth of outstanding investment loans. The need to ensure macro stability by managing budget deficit means government should adjust its infrastructure spending plan to a more realistic target. Fiscal stimulus should not be expected to be a growth driver in 2018.

Table 1: LPEM FEB UI GDP Growth Forecast

Q1 2018	FY 2018
5.2%	5.3%

Trend of price reversal for key export commodities in recent months, particularly coal and palm oil, may poses some headwind for growth for the rest of this year. With CPO down by 5% and Indonesia Coal Reference Price (Harga Batubara Acuan) practically unchanged compared to 6 months ago, net export and consumption growth in key provinces may be relatively flat, especially if the stagnant price continues. On the other hand, household consumption in general may start to increase considerably, as indicated by 11.2% growth in consumption credit in February. We expect consumption growth to exceed 5% starting from Q1 2018 and to increase slightly further by the end of 2018.

As we are now currently less than one year away from 2019 General Election, it is interesting to note how the issue of government's fiscal policy starts to take center stage again. While most of the attentions were brought to perennial and unwarranted hysteria that surrounds nominal debt, some of the overlooked issues warrant genuine concerns and call into question the commitment for reform by current administration. We are increasingly concerned with recent decision to quietly increase effective fuel subsidies by leaving RON 88 gasoline price (Premium) and diesel fuel (Solar) price unchanged and how it may increase fiscal and current account deficit. Deteriorating balance sheet of SOEs also highlights how unsustainable SOEs-dependent infrastructure financing is and underscores the urgent need for government to actually take PPP scheme seriously.

Macroeconomic & Financial Sector Policy Research

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Inconsistent, Anti-Import Regulatory Regime Hurts Industrial Growth

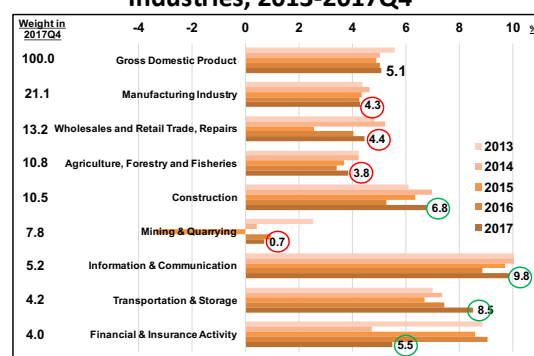
One of the most remarkable aspect of current policy stance of government is that while President Joko Widodo has vowed to do everything in his power to deregulate and make regulatory regime more business-friendly, some of regulations signed by his ministers tend to be rather protectionist and anti-business. While protectionist regulations are ostensibly promoted by ministers as measures to protect local businesses and livelihood of Indonesian workers, such measures will in fact do significantly more harm than good. Over the long term, increased protections may have and will continue to hurt our import-dependent exporters, consumer spending, and broader economic growth.

One of the victim of government's protectionist bent may be Indonesia's manufacturing industry, since vast majority of our imports are raw materials (input goods), intermediate goods, and capital goods that are primarily used by local manufacturers. As much as 91% of our imports are raw materials, intermediate goods, and capital goods, with only 9% of total imports are consumer goods. Rather than accelerating in Q4, manufacturing industry growth slowed to 4.38% (y.o.y), bringing 2017 manufacturing growth to 4.3%. The slowdown in manufacturing growth as a whole is glaring when compared to rising consumption growth domestically and robust global growth.

Salt import is just one of perennial example of how government's good intention in protecting domestic industry may do more harm than good for economic activities. With estimated industrial demand of more than 65% of total Indonesia's salt demand in 2016, unstable salt supply might hit manufacturing processes that require large amount of salt hardest. Several manufacturing subsectors that require the largest amount of industrial salt and most vulnerable to salt shortage are, according to Indonesia Industrial Salt User Association (AIPGI), petrochemicals (47.2%), pulp and paper (18.8%), food processing (14.2%), and fish salting (12.2%).

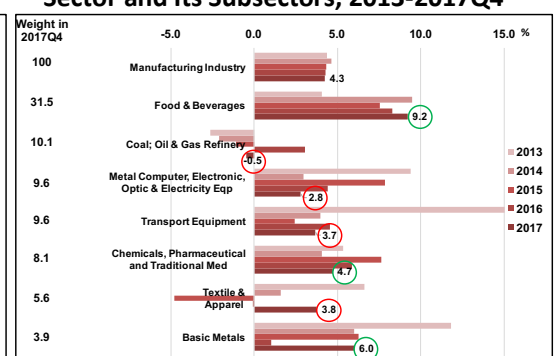
"Over the long term, increased protections may have and will continue to hurt our import-dependent exporters, consumer spending, and broader economic growth"

Figure 1: Growth rate of GDP and the Main Industries, 2013-2017Q4



Source: CEIC

Figure 2: Growth rate of Manufacturing Sector and Its Subsectors, 2013-2017Q4



Source: CEIC

Indeed, we saw several indications that government's inconsistent salt policy affects chemicals manufacturing, as growth of chemicals manufacturing has slowed down for the last two consecutive years, with Q4 growth recorded at -4.19% (y.o.y). Also, while food and beverage manufacturing grow by 13.2% (y.o.y) in Q4 2017 due to steady increase of new middle class and urban populations, continued salt shortage might show up in reduced growth of food and beverage manufacturing in Q1 2018. Only when industrial users started to complain did the government issued Government Regulation (PP) No. 9/2018 and shifted the purview of industrial

salt import quota from Ministry of Maritime Affairs and Fisheries to Ministry of Industry, which is more attuned to the input goods need from industrial users.

The case of salt import quota and the necessity of government to backtrack its decision is far from isolated. Marks (2017) highlighted that effective rate of protections, which shows the degree of tariff and non-tariff (e.g. import quota), had increased considerably across almost all range of goods from 2008 to 2015. This finding indicates that previous administration's tendency to restrict import was continued by current administration and, judging by recent decisions by policymakers, shows no sign of reversal.

Such policy direction is counterproductive to Jokowi administration's efforts to be more pro-business and, as highlighted by the example of salt import, may harm businesses in various ways. Inadequate import quota may constrain supply and raise prices of input goods for industrial users, thus putting local manufacturers at disadvantage, both in their ability to supply goods consistently to buyers and reduce cost competitiveness. This in turn will undermine the business case of setting up or retaining manufacturing base for export-oriented industries in Indonesia and, from business perspective, increase the relative appeal of Indonesia's more business-friendly neighbors such as Vietnam.

Persistent sub-5% manufacturing growth in Indonesia shows how Indonesia missed the opportunity of courting Chinese manufacturers that started to relocate from China due to rising labor costs. Indonesia cede the opportunities of attracting export-oriented FDI to Vietnam, Thailand, the Philippines, Cambodia, or even African countries. Several export-oriented subsectors that should have attracted businesses that relocate from China, such as textile and wearing apparel and electronic/electrical equipment subsectors, recorded annual growth of only 3.8% and 2.8%. Transport equipment manufacturing, which tends to be higher value-added and higher-paying, also recorded growth of only 3.7% for 2017.

Service Sectors Growth: Towards Experience Goods?

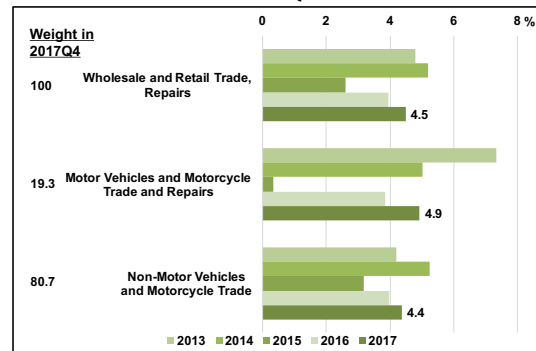
Recent improvement of service sectors growth seems to highlight changing consumption pattern within Indonesian society. Slight increase in domestic consumption affect various sectors rather unequally, with sectors that are associated with consumer experience tend to fare better than retail trade. For example, back in 2011, when GDP growth was recorded at 6.2%, Wholesale and Retail Trade grew by 9.66%, compared to Transportation and Sector, which grew by 8.31% and Accommodation, Food, and Beverages, which grew by 6.86%. In FY2017, when GDP growth was recorded at 5.07%, the figures for those three sectors are 4.44%, 8.49%, and 5.55% respectively.

Relative drop in consumption of consumer goods is a secular trend that has happened for quite a while but less recognizable in 2014-2016, largely due to low economic growth. This is particularly apparent in Non-Motor Vehicle and Motorcycle Trade subsector, which grew by only 3.80% in Q4 2017. Aside from increased competition from e-commerce sellers, which depressed profit margin for retailers, consumer goods may have relatively less appeal for urban middle-class consumers. They are more attracted to consume their disposable income for experience goods, such as dining out and vacations. This trend may not be as apparent in motor vehicles trade and repairs, which recorded 5.74% (y.o.y) growth in Q4 2017, given the inadequacy of urban public transport systems, especially in secondary and tertiary cities, to accommodate rising mobility needs of increasingly affluent new urban middle class.

“Persistent sub-5% manufacturing growth in Indonesia shows how Indonesia missed the opportunity of courting Chinese manufacturers that started to relocate from China due to rising labor costs”

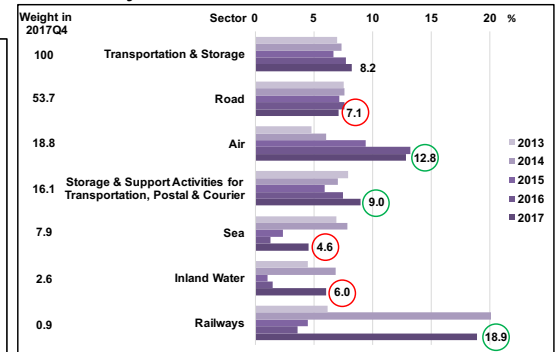


Figure 3: Growth rate of Wholesale and Retail Trade and Its Subsectors, 2013-2017Q4



Source: CEIC

Figure 4: Growth rate of Transport and Its Major Subsectors, 2013-2017Q4



Source: CEIC

“Construction sector posted fastest growth in the last 3 years at 7.67% in Q4 2017. We see various reasons why construction sector will still experience rapid growth in 2018”

At 7.84% in Q4 2017 and overall 2017 growth of 8.32%, Transportation and storage services growth remains strong, although slightly lower than in Q3 (see Figure 4). Air transport continues to be the source of fastest growth in transport subsectors, thanks to large boom in tourism. Road transport, which accounted for more than 53.7% value added created by transportation sector, also posted robust growth of 7.55% in Q4 2017, partly due to rapid increase in usage of expedition services for e-commerce.

Tourism-related boom is also consistent with growth in Accommodation, Food and Beverages Activities sector growth, which grew by 5.49% in Q4 2017. This boom in tourism trend is in no small part due to increase in the use of visual-heavy social media, such as Facebook and Instagram, which facilitates sharing of holiday experiences to wider social circle. Additionally, the use of social media also prompts the creation of more visually appealing dining experiences, which command higher price and higher value-added for restaurant and café industry. The use of social media is therefore related to relative rise experience goods in overall share of household consumptions.

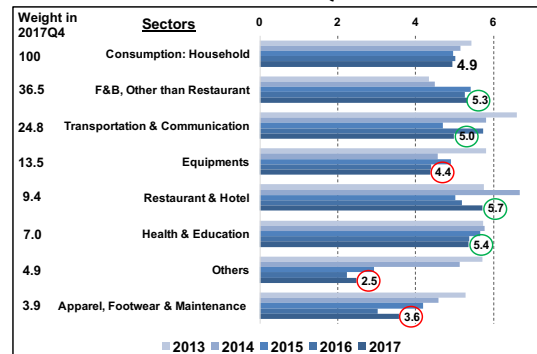
Construction sector posted fastest growth in the last 3 years at 7.67% in Q4 2017. We see various reasons why construction sector will still experience rapid growth in 2018. First, as 2019 election is now less than a year away, there will be increased pressure on Jokowi administration to speed up and complete unfinished major infrastructure projects in his bid for reelection. Second, nominal mortgage rate has gone down by 1.02% even as inflation remains relatively stable, thus creating more incentives for households to take residential mortgages. Also related to infrastructure projects, we expect communication sub-sector, which grew by 8.99%, to still grow by around 8-9% in 2018 as more consumers are becoming connected and increasingly rely on online transactions, thus creating more demand for IT infrastructure for both consumers and businesses.

Consumption to Grow at 5.0-5.1% in 2018

The glacial pace at which household consumption grew throughout 2017 suggests that households' consumption pattern tend to lag the overall economic growth and is less sensitive to changes in overall GDP. While outstanding consumption credit growth is relatively high at 11.04% (y.o.y) on December 2017, actual household consumption in Q4 2017 only grew by 4.96%. Looking at credit growth in February that stands at 11.16% y.o.y. and better market sentiments,

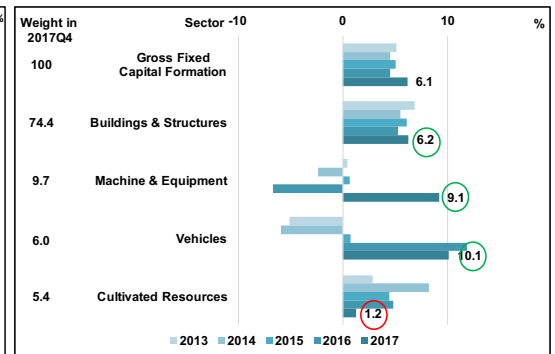
we expect consumption to grow at or just slightly above 5% in Q1 2018. While we do not expect interest rate to go down any further, higher inflation should also prompt consumer spending throughout the rest of 2018 to grow slightly faster at 5.0-5.1% level.

Figure 5: Growth rate of Household's Consumption and its Components, 2013-2017Q4



Source: CEIC

Figure 6: Growth rate of Investment and its Main Components, 2013-2017Q4

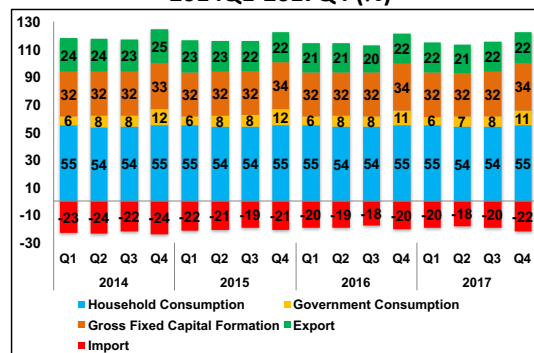


Source: CEIC

“Most of the components that constitute household consumptions growth (see Figure 5) stay relatively stable since Q1...”

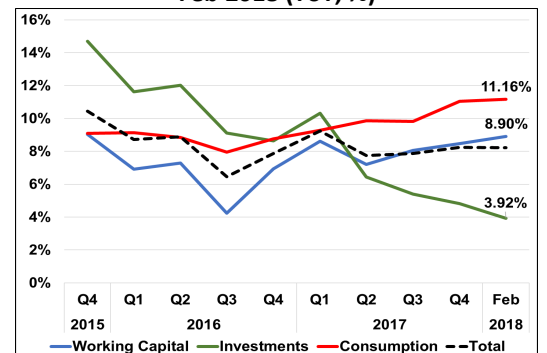
Most of the components that constitute household consumptions growth (see Figure 5) stay relatively stable since Q1, with notable exception of transportation and communication (decelerating to 4.45% from 5.01%). Another sign of relatively more sanguine household expectation, consumption on restaurant and hotel continues to grow significantly faster than overall consumption, growing at 5.71% in Q4 2017; restaurant and hotel tends to grow faster than the economy as a whole when consumer tend to have higher disposable income and the first to be cut when purchasing power is eroded. Spending on non-restaurant food and beverages also grew faster than overall economy in 2017, consistent with the fast growth of processed food and beverages industry.

Figure 7: Shares of GDP Components, 2014Q1-2017Q4 (%)



Source: CEIC

Figure 8: Credit Growth by Purposes, 2015Q4-Feb 2018 (YoY, %)

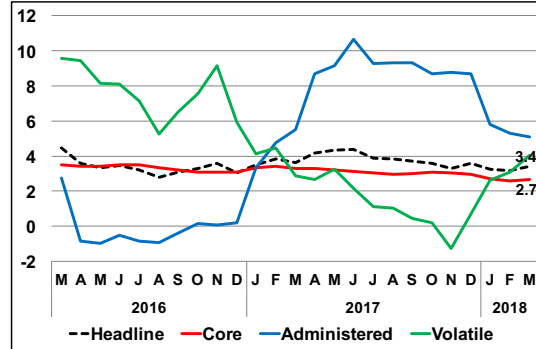


Source: CEIC

Slightly higher domestic consumption may not be readily apparent when we are looking at core inflation, which stood at 2.67% (y.o.y) in March. This may be due to the fact that core inflation has stabilized at around 2.5-3.5%, conveniently within the lower bound of Bank Indonesia's inflation target. At current trend of GDP growth rate, we do not expect core inflation to accelerate much further. Recent multiyear high of international crude oil price at USD74/barrel may also have little impact on domestic inflation throughout 2018 and possibly well into 2019, as government has implicitly indicated that they were backtracking their pledge to float the price

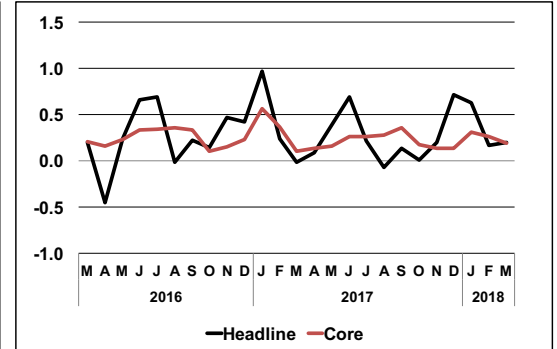
of subsidized fuel price, particularly as 2019 General Election nears. As such, the upward risk to inflation comes mostly from exchange rate risks, which have depreciated by more than 4% from the start of this year.

Figure 9: Inflation Rate (% , y.o.y)



Source: CEIC

Figure 10: Inflation Rate (% , mtm)



Source: CEIC

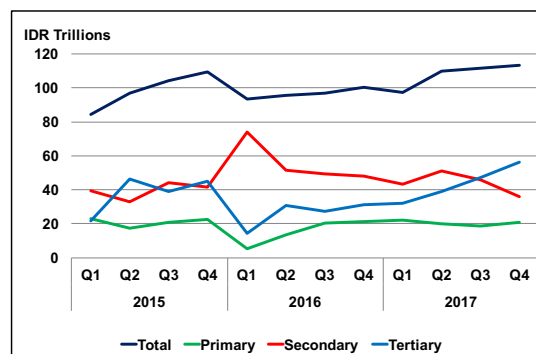
“We expect investments to accelerate considerably in 2018, continuing the trend in 2017”

Investment to Still Grow Above 6% in 2018

We expect investments to accelerate considerably in 2018, continuing the trend in 2017. Gross fixed capital formation, the measure of investment in GDP, still grew significantly faster than the economy in Q4 at 7.25 % y.o.y, bringing overall 2018 real investment growth at 6.12% y.o.y. Key drivers of investment growth in Q4 are machine and equipment investments. This type of investment grew by 22.27% in Q4 and 9.54% throughout 2017. This growth trend is last seen in 2011, when quarterly GDP growth was consistently above 6%.

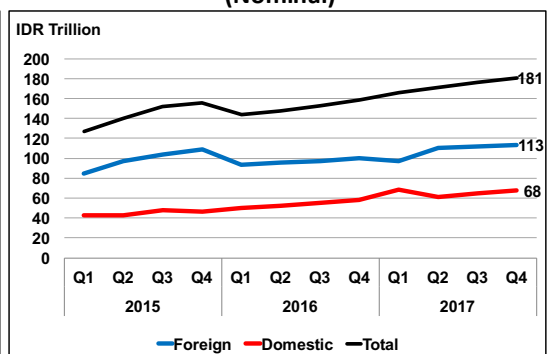
Reversing the trend in Q3, investment in vehicles experienced negative growth in Q4, which is partially explained by cyclical trend and the fact that several previous quarters already saw high level of growth. Consistent with stellar growth of construction sectors, investment in building continues to be strong in Q4. Investments by both foreign and local enterprises also continue to increase in Q3 and Q4, as shown by increase in foreign direct investment and domestic direct investment by 14.95% and 16.82% (y.o.y.) respectively in nominal Rupiah term.

Figure 11: FDI Realization (Nominal)



Source: CEIC

Figure 12: Foreign and Domestic Investment (Nominal)



Source: CEIC

Strong investment growth in Q4 continued to be accompanied by record-low growth banking sector loans for investment purposes. In Q4 2017 and in February 2018, loan for investment purposes grew at 1.82% and 1.11% respectively in real term (4.82% and 3.92% y.o.y in nominal term, subtracted by core inflation), despite the fact that gross capital formation grew by 7.25% in Q4. This can be explained by the fact that investors apparently deploy more equity-based investment, or in several cases, investors may opt to tap into capital market for long-term investment financing. One of the hint for more equity-based investment financing can be seen by looking at total direct investment growth in real term, which in Q4 amounted to 10.97%. Another hint is the fact that corporate bond issuance in 2017 grew by 31.02% in real term, albeit with total corporate bond issuance in 2017 of only Rp156.71 trillion. Higher reliance on equity investment, foreign capital, and capital market financing is ultimately good for the corporations and the economy, as real investments become less vulnerable to market cycle, 2018 trend of higher interest rate worldwide, and higher interest rate charged by banks.

“A key problem of this year’s fiscal policy is government’s tendency to ignore the fixed fuel subsidy and floating fuel price system”

Slightly Better Tax Collection, Subsidies to Increase Considerably in 2018

A key problem of this year’s fiscal policy is government’s tendency to ignore the fixed fuel subsidy and floating fuel price system. From political economy standpoint, such change of heart makes sense, given that issue of living costs, which fuel price have outsized influence on, can influence reelection chance of current administration in 2019 General Election. On the other hand, the issue of fiscal deficit and government debt prompt Government to pledge the return to zero or positive primary balance. At the same time, key export commodities like CPO or coal have seen reduction in price, which poses risks of below-target tax and non-tax revenues from extractive sectors. In the medium term, this means government has to choose between cutting expenses from other posts or raising tax revenues from other sources.

The risk of more expensive bill for fuel subsidies is not trivial, particularly given that OPEC members seem to remain committed to production cut and raising prices to their target price of \$80-\$100/barrel. Government’s Financial Notes (Nota Keuangan) has explicitly outlined Ministry of Finance’s assumption of fixed fuel subsidy, while in practice this is not the case, as gasoline price has remained constant even as oil price has risen by more than 30% on year-on-year basis. Government has also essentially forced Pertamina to shoulder the losses that they may incur for selling gasoline at government-mandated price, which jeopardize the health of Pertamina’s balance sheet and its sustainability as a company.

Following Ministry of Energy and Mineral Resources’ formula to calculate economical price for RON88 gasoline and gasoil, government’s decision to keep RON88 gasoline price at Rp6,450/liter (Rp6,550/liter in Java) and Diesel at Rp5,150/liter can easily raise cost of subsidy far above RAPBN’s target of only Rp10.39 trillion. At \$76/barrel RON92 and \$81/barrel Gasoil MOPS price, we estimate that total fuel subsidy amounts to Rp83 trillion¹. Pertamina cannot shoulder the cost of fuel subsidies by itself.

Letting Pertamina shoulder the losses of current oil price may hurt Pertamina’s ability of doing business by forcing them to operate with deteriorating cash flow. In the short term, this will reduce remaining Pertamina’s dividend or retained earnings, which will show up in reduced non-

¹ Based on our projection of average price for MOPS Gasoline 92 and MOPS Gasoil throughout 2018



tax revenues. In the long term, production capacity and competitiveness of Pertamina will deteriorate due to shortage of capital for investment.

In our opinion, the risk of keeping retail fuel price at current level is quite high. Government will eventually have to adjust fuel price. However, the longer government delay the adjustment, the harder will such adjustment be implemented. Government should start to adjust retail fuel price gradually.

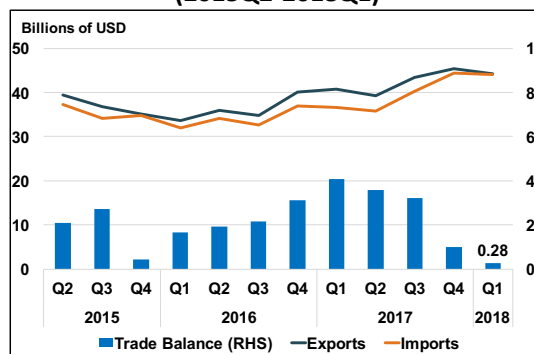
If government succeed in adjusting retail fuel price gradually, we see that government revenue target of 2018 is realistic enough. However, slightly lower coal price and CPO price may slightly affect tax and non-tax revenue. 2018 revenue target is just around 13.5% higher than 2017 realization. Combination of higher crude oil price, better economic growth, and increased tax compliance should suffice in achieving 2018 revenue target. If government can address the problem of fuel subsidies in time, government target of achieving positive primary balance by 2020 should be within reach.

“However, the longer government delay the adjustment, the harder will such adjustment be implemented. Government should start to adjust retail fuel price gradually.”

Trade Balance May Be Negative in 2018, External Risks to be Manageable

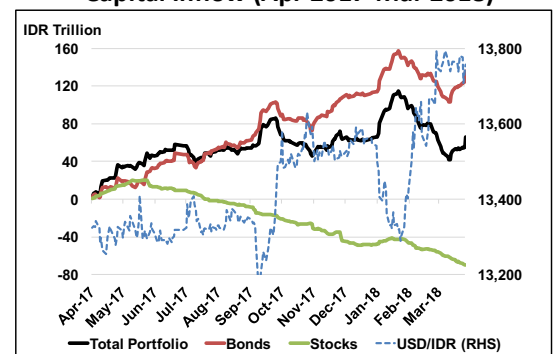
Another source of growth in 2016 and 2017, net goods export, started to worsen in Q4 2017. Depending on the direction of crude oil, CPO, and coal prices, net export may be negative for 2020. As Indonesia is heavily reliant of export of these three commodities and other raw materials (see Figure 15), commodities prices are very important in shaping Indonesia’s trade balance. As of recently, crude oil has risen by more than 30% (y.o.y), compared to gain in coal prices of 14.8% and CPO of around 10%. The extent of impact of new regulation about domestic market obligation of 25% total production at discounted price, which was implemented to help PLN and to keep electricity subsidy expenditure low, on coal exports is still uncertain, given that the government pledge to increase production quota for coal.

Figure 13: Quarterly Trade Balance (Nominal) (2015Q2-2018Q1)



Source: CEIC

Figure 14: Exchange Rate and Short-Term Capital Inflow (Apr 2017-Mar 2018)

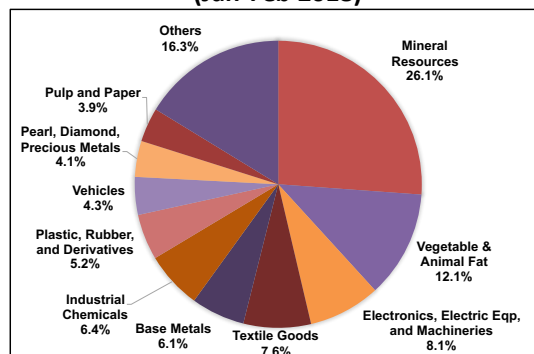


Source: CEIC

Adding to the problem of commodities price volatility is the contrast between export profile and import profile of Indonesia. In total value, Indonesian export is still highly dependent on export of raw materials, particularly mineral resources, vegetable fat/CPO, and precious metals. Together these three categories account for 42.3% of total exports, which explains the vulnerability of Indonesian exports to changes in global commodity prices, even until now. In contrast, Indonesia tends to import higher value-added goods, such as electric equipment,

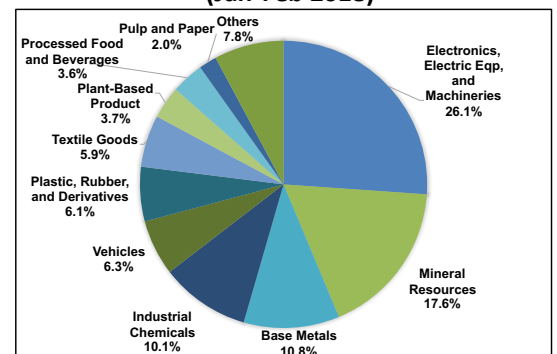
industrial chemicals, and vehicles, which are much less vulnerable to commodity prices fluctuations. As the result, recent improvements in domestic investments have net negative impact on Indonesia's trade balance. We expect trade balance in 2018 to be slightly negative, unless prices of key export commodities like CPO and coal start to rise again. The trade deficit will also slightly worsen Indonesia's current account position in 2018, possibly in the range of 1.8-2.0% for FY2018.

**Figure 15: Indonesia Export Profile
(Jan-Feb 2018)**



Source: CEIC

**Figure 16: Indonesia Import Profile
(Jan-Feb 2018)**



Source: CEIC

"We expect trade balance in 2018 to be slightly negative, unless prices of key export commodities like CPO and coal start to rise again"

Improvement in global economy seems to become more robust in most developed countries and key emerging markets, with mixed impacts on Indonesian economy. On one hand, higher-than-expected global demand for the rest of 2018 will help raise commodities prices and demand for Indonesian manufactured goods. This will in turn improves Indonesian export performance from the baseline scenario and strengthen current account position. On the other hand, economic strength in developed economies makes higher interest rate world an inevitability at this point. Higher-than-expected US growth in particular will create impetus for The Fed to raise interest rate even faster. This will create additional downward pressure on already-depreciating Rupiah.

Even if global equity market, with its already lofty valuation, will eventually experience significant correction, we do not expect such correction to have large impact on global growth like how interest rate increase from 2005-2007 in US induced Global Financial Crisis in 2008. First, strict financial regulations that were introduced in post-2008 financial market means that significant market corrections will poses much less risks to financial system. Second, increasing reliance on domestic consumption in China, compared to 2008, may insulate global economy from possible US recession. Third, pace of interest rate increase in US is also much more gradual when compared to interest rate increases around 2005-2006. Finally, major central banks, having learned the lesson of 2008 crisis, have signaled that they monitor developments in the economy much more closely and are readier to intervene when there are signs of economic downturn, thus reducing risk of unexpected surprises that may trigger recession. We still stand by our projection that is a good chance that the external risks in 2018 will be rather limited to downward pressure on Rupiah and will be relatively manageable.