LPEM FEB UI
UNIVERSITAS INDONESIA

MACROECONOMIC ANALYSIS SERIES

Indonesia Economic Outlook

Q1-2019

Key Figures

- GDP Growth* (Q4 '18)
  5.1%
- GDP Growth* (FY 2018)
  5.1-5.2%
- GDP Growth* (FY 2019)
  5.2-5.3%
- Inflation (y.o.y. Dec '18)
  3.13%
- Credit Growth (y.o.y. Dec '18)
  16,2%
- Trade Balance (2018)
  USD -8.57 billion
- Current Account (Q3 '18)
  -3.37%

**) Forecast*

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Lower External Pressure: Unforeseen Breathing Space

Highlights

- GDP to grow by 5.1% in Q4 2018, 5.1-5.2% in FY2018, and slightly accelerate to 5.2-5.3% in FY2019
- Growth of the manufacturing sector is still below 5% for 2018; slightly affected by Rupiah depreciation
- Consumption growth rate to exceed 5% for the whole 2018 and accelerate in 2019 if inflation remains under control; this will face a challenge if government hikes retail fuel price
- Widened current account deficit is predicted to continue in Q4 2018 and slightly improve in Q1 2019
- FDI is likely to be better due to perceived higher potential in emerging market investment and the government's effort to step up the game
- GoI's debt is low and managed prudently. Some risks related to high share of foreign ownership of GoI's debt warrant an improved negative Tobin tax

Following previous expectation, we see that the economy in Q1 2019 will be slightly improved. A series of unexpected trends since November, such as the reversal of capital flow to emerging markets, lower crude oil prices, and negotiations between US and China, has brought positive sentiment to the domestic market. The effect of the influx of foreign portfolio investment in the last three months has improved Rupiah to be among the most improved currencies together with the currencies of Thailand, the Philippines, and Malaysia, with Rupiah in these past two months trading at around Rp14,000 per US dollar. The trend of declining crude oil price in the next two quarters due to overflow in oil production may give more breathing space for the government; it is likely to improve the trade balance and also reduce pressure on the government's challenging decision to hold fuel price at the same level until the general election.

Table 1: LPEM FEB UI GDP Growth Forecast

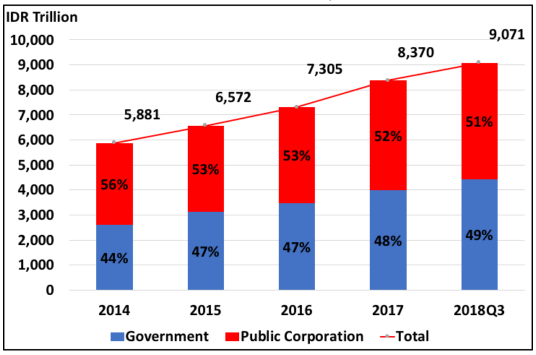
Q4 2018	FY 2018	FY 2019
5.1%	5.1-5.2%	5.2-5.3%

We are keeping our projection that GDP will grow by 5.2-5.3% in 2019. Despite lower commodity prices, deficit in current account will slowly improve and remain within manageable level as the government efforts to curb imports of consumption goods and lower crude oil price alleviate the trade imbalance. On the other hand, FDI would be the main concern of the government due to its declining trend since last year. We see that a set of effective structural and regulatory reforms is much needed to improve exports as well as FDI.

Indonesia Raising Debt: Too Much Noise over Substance

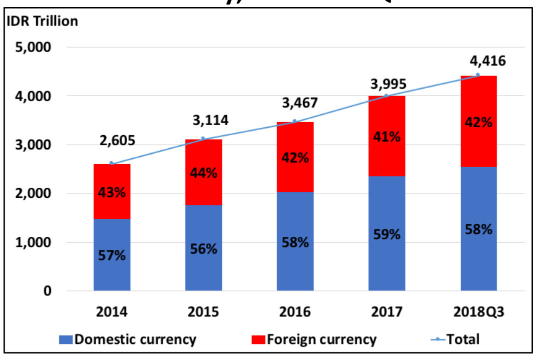
Government of Indonesia (GoI)'s debt has increased relatively faster over the past four years, with the amount of debt in Rupiah today is about 1.7 times larger than it was in 2014. This soaring trend of government debt has provoked public unease and triggered heated debate. At first glance, the rise in government debt appears exceedingly high and adverse to prudent debt management. Though it seems to be increasing fast, we view that the government's debt remains benign and under control.

Figure B1: Total Public Debt, 2014-2018Q3



Source: *Public Sector Debt Statistics of Indonesia, 2018Q3*

Figure B2: Central Government Debt by Currency, 2014-2018Q3



Source: *Public Sector Debt Statistics of Indonesia, 2018Q3*

Firstly, most of the debt is in domestic currency. By Q3 2018, foreign currency denominated debt amounted to IDR1,873 trillion, while Rupiah-denominated debt stood at IDR2,544 billion or equivalent to 58% of total debt. Nevertheless, compared to 2014, the share of foreign currency denominated debt has slightly decreased from 43% to 42%. Given that Rupiah has depreciated by about 20% since the end of 2014, the relatively constant share of foreign currency denominated debt is impressive. This implies that Indonesia's debt management is resilient to currency fluctuations; it represents a strong discipline in mitigating exchange-rate risk and reducing vulnerability to global shocks associated with external debt.

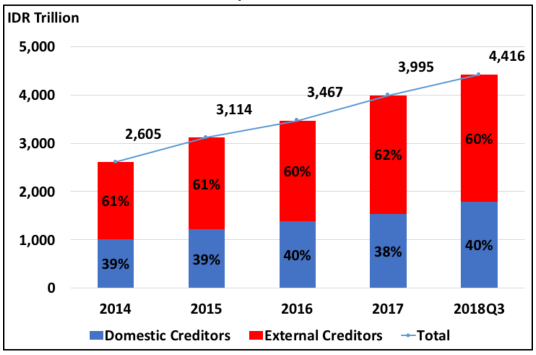
Related to the first point above, the **second** aspect we look into is the comparison between domestic versus foreign lenders. GoI depends more on external lenders rather than domestic lenders. See Figure B3. This is quite a concern since 57.6% of GoI's debt is in the form of IDR securities, and about 40% (about Rp850 trillion) of these is held by foreigners. A sudden reversal of portfolio capital flow would pose a serious threat to the exchange rate; just like the 2018 and 2013-2015 periods.[1] However, similar to the story of foreign currency denominated debt above, compared to 2014, albeit still high, the share of foreign lenders in GoI's debt has been more or less constant. Notably, the GoI's discipline in 2018 managed to bring the ratio down from 62% in 2017 to 60% in 2018.

The **third** aspect we look into is the standard debt-to-GDP ratio. Even though Indonesia's debt-to-GDP ratio has become increasingly visible over the past five years, it is still much lower than 15 years ago. See Figure B6. It should also be noted that the majority parts of the additional GoI's debt is used for the "productive" investment, especially on the infrastructure projects, which should stimulate future GDP streams, rather than for consumption (e.g. financing subsidy for the energy sector). Therefore, there should be less worry about the increasing debt-to-GDP ratio. Visibly, in the last three years, despite the big push for infrastructure project financing, GoI has managed to significantly slow down the increase of the ratio and

[1] After a sharp increase from 18.6% by end of 2009 to around 38% by the end of 2014, the ratio of foreigners held Rupiah bonds to total Rupiah tradable bonds has been fairly constant in the last four years. See Figure B4.

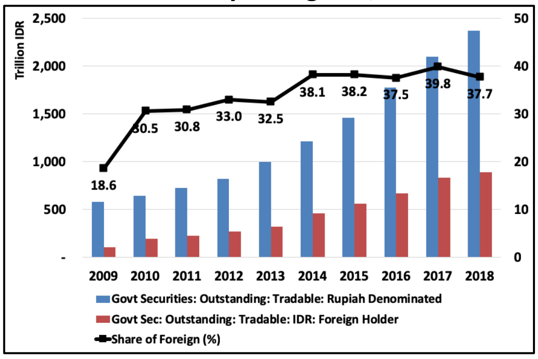
to restrain the ratio below 30%.[2] Additionally, this ratio is relatively very low compared to emerging market peers such as Thailand (42%), Malaysia (55%), Vietnam (58%), or Brazil (88%). See Figure B5.

Figure B3: Central Government Debt by Creditors, 2014-2018Q3



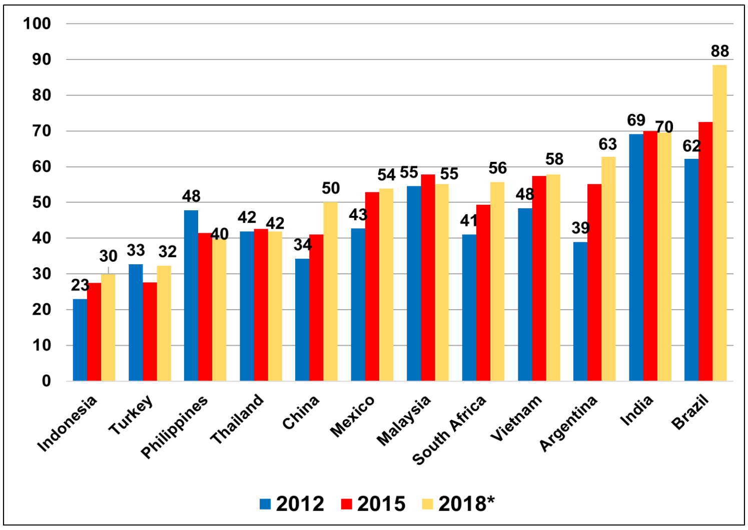
Source: Public Sector Debt Statistics of Indonesia, 2018

Figure B4: Rupiah Denominated Government Securities Held by Foreigners, 2009-2018



Source: CEIC

Figure B5: Total Debt-to-GDP Ratio Comparison



Source: IMF World Economic Outlook, 2018Q3

The **fourth** aspect we look into is whether GoI is increasingly borrowing short term over long term. This aspect is crucial in determining the sustainability of the debt management. GoI owes almost all in the long term debt compared to debt that matures in the short run. Government borrowing is desirable when potential GDP growth rate is promising because [productive] debt will further enhance the growth of the economy through targeted improvement in both infrastructure and human capital. Therefore, borrowing in a sustainable fashion will generate a sustainable long-term growth with an increase in standard of living resulting from productivity increases while the debt burden is manageable. In this regard, we view that the current mix of GoI's debt is sustainable.

On the more sanguine side, the government has demonstrated commitment to sustain its debt by extending the dominance of long-term maturity debt at least in the last 6 years. The latest data in Q3 2018

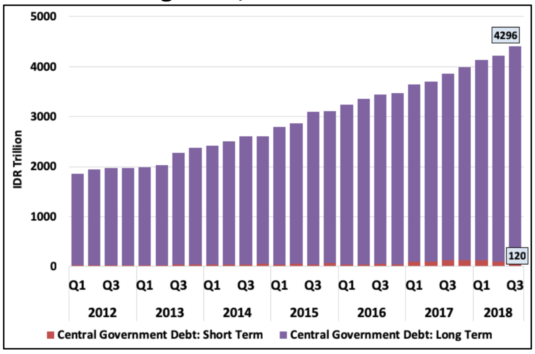
[2] This is well below 60% maximum limit prescribed by Maastricht Treaty that was adopted Indonesian parliament in Law 17 of 2003 on State Finances.

shows that the government's cumulative debt is at IDR4,416 trillion or grew by 14.2% (y.o.y), in line with financing needs for infrastructure development and other productive activities. More specifically, based on maturity, the debt was dominated by long-term debt, which stood at about IDR4,296 trillion or 97% of the total government debt and grew by 14.7% (y.o.y), while short-term debt stood at IDR120 Trillion or 2.7% of the total and fell from previous year by 2% (y.o.y). This is indicating that debt payments will decline in the national budget together with an increase in the medium and long-term debt. Therefore, debt payments will burden the annual budget less in the future.

Figure B6: Indonesia Debt-to-GDP Ratio, 2005-2018

Source: Public Sector Debt Statistics of Indonesia, 2018

Figure B7: Government Debt: Short-term vs Long-term, 2014-2018Q3[3]



Source: External Debt Statistics of Indonesia, 2018

The **fifth** aspect that we scrutinize is the interest payment burden of the debt. The bigger the debt, the bigger is the interest payment. Apart from the increase in nominal outstanding debt, a higher interest payment could be also due to the increase in the government bonds yields, which depends on the market conditions for the government bonds itself. The decreasing trend of interest payment relative to the budget prior to 2013 is due to both decreasing debt to GDP ratio and the decreasing yields. After 2013, the yields of government bonds are fairly stable at average of 7%; the increase in the interest payment burden is therefore mainly due to the increase of the size of the debt.

Notably, the interest payment burden remains constant at 10.8% in the last two years. We view that the increase of the interest payment burden is a legitimate concern. Nevertheless, we see that GoI has done enough in the last two years in terms of increasing the efficiency of its budget; budget deficit is very manageable and decreasing while productive spending is still high. It remains to be seen if GoI can continue this discipline and keep the increasing trend of the tax ratio. On the other hand, as the portfolio investment capital inflow has started again since October 2018, yields of government bonds will decrease again. We project the interest payment burden will decrease in 2019.

Lastly, the **sixth** aspect we look into is the seemingly overly dominance of securities in GoI's debt. The share has increased from 68% of total debt in Q3 2012 to 81% in Q3 2018. Related to the fifth point above, this fact is responsible for the relatively high interest payment burden, particularly when the market condition is unfavorable for the government bonds. Unfortunately, the voices against the dominance of the securities over loans usually refer back to the era when GoI's debt was dominated by loans from multilateral

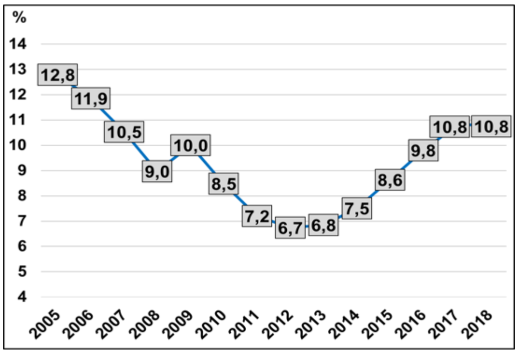
[3] *Total external debt payments in Tier 1 include payment of principal and interest on long-term debt and interest payments on short-term debt*

organizations like the World Bank; a situation when Indonesia was still a poor country, hence be eligible for these funds.

There are at least two good reasons why the dominance of the securities over loans is actually a good thing. The first is that GoI will be forced to keep a high level of fiscal discipline every year. Any signs of mismanagement will be automatically punished by the market by higher yields; government bonds holders will tend to sell the bonds. Given the fact that GoI is still so eager to go up by one notch in the sovereign rating, fiscal discipline will be the main theme of GoI for the next several years. If successful, GoI will be rewarded with higher rating and lower yields, hence lower interest payment burden in the future. The second reason is that the government can use its bonds as the catalyst for financial market deepening to encourage more saving by providing a safe instrument.

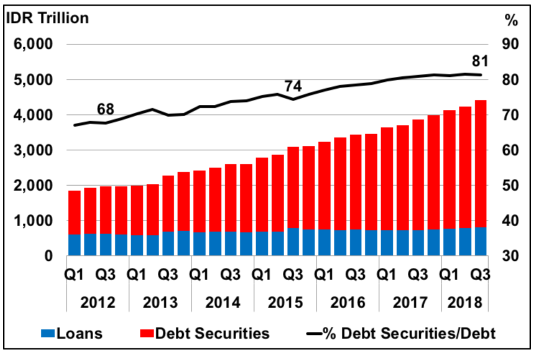
However, the fact that the big majority of the debt is in the form of securities poses the risk discussed in the second point above, i.e. it is prone to global market shocks. Anytime a global shock happens, investors tend to sell emerging economies assets - Indonesian government bonds included – and move their money to the safe-haven assets. After events like 2009, 2013-2015, and 2018, GoI should really put more attention to this imminent risk. Bank of Indonesia has done its part by deepening the foreign exchange market in the short run by introducing several short-term hedging instruments. On the other hand, GoI also introduced an incentive for exporters to convert their USD export proceeds into Rupiah; for example, holding it in Rupiah for six months in a Rupiah time deposit will get them zero tax on the interest. We view this kind of incentive – which is called negative Tobin Tax – should be implemented to more types of assets, in particular the Rupiah bonds, in order to attract investors to keep their Rupiah-denominated money for a longer period, even if there is a global shock.

Figure B8: Interest Payment (% Budget Realization) 2005-2018Q



Source: CEIC

Figure B9: Central Government Debt in Loans and Debt Securities, 2012Q1-2018Q3



Source: CEIC

In conclusion, Indonesian government debt is low and managed prudently. It is among the lowest debt-to GDP ratio among the emerging economies. Overwhelmingly, it is in the form of long-term debts instead of short-term debts. Interest payment burden has increased in the last several years, but good fiscal discipline is in place to curb and even bring it down in the near future. High risks exist due to relatively high share of foreign currency denominated debt and also relatively high share of foreign ownership of GoI's debt, for which Bank of Indonesia and GoI will need to improve their policies.

Structural Reforms Needed to Boost Sluggish Manufacturing Sector

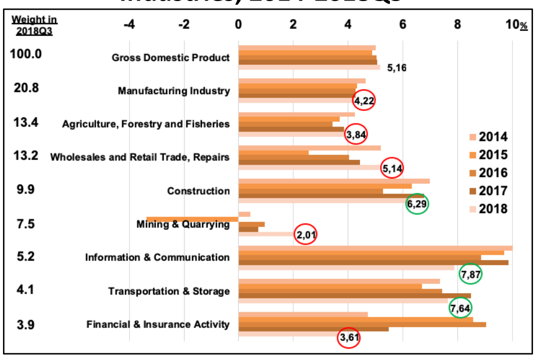
Indonesia's global competitiveness index in 2018 increased to 64.95 with a slightly higher ranking of 45th compared to 47th in 2017. On the other hand, the latest data shows that Indonesia's ranking in the global manufacturing competitiveness in 2016 was 19th; still lower than its close peers: Thailand, Malaysia, and Vietnam. With current trend, Indonesia's ranking is projected to increase to 15th in 2020, but still below Thailand, Malaysia, and Vietnam.

"….we project that the food and beverage industry will recover to increase in Q4 2018 along with Christmas and New Year celebrations and continue to be the leading sector in supporting Indonesia's manufacturing industry and economic growth in Q1 2019"

The growth of the manufacturing industry increased from the previous quarter from 3.84% to 4.33% in Q3 2018. However, when we see its average yearly trend in 2018, it declined slightly to 4.22% from 4.27% in 2017. The food and beverage subsector continued to be the largest and fastest growth driver in the manufacturing industry, with the overall growth of 9.82% (y.o.y) in 2018. Nevertheless, although there was a slight decline in Q3 2018 (8.10%) from Q2 2018 (8.67%), we project that the food and beverage industry will recover to increase in Q4 2018 along with Christmas and New Year celebrations and continue to be the leading sector in supporting Indonesia's manufacturing industry and economic growth in Q1 2019.

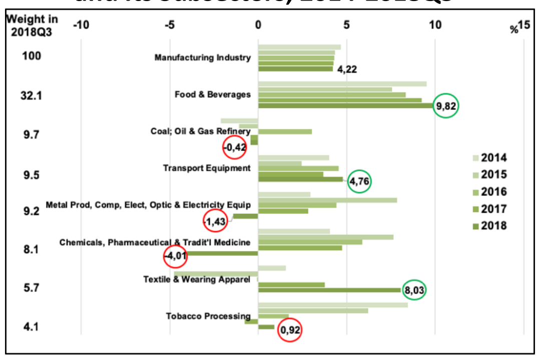
Meanwhile, transport equipment and textile & wearing apparel industries overall enjoyed rapid growth, from 3.67% in 2017 to 4.76% in 2018 for transport equipment subsector, and from 3.76% in 2017 to 8.03% in 2018 for textile & wearing apparel subsector. Similarly, the growth of the tobacco processing industry in the manufacturing subsector also increased even though with a small number, recording a positive growth of 0.92% from its negative trend in 2017. Rising exports of the tobacco processing industry were the underlying cause of growth increase in this subsector.

Figure 1: Growth of GDP and the Main Industries, 2014-2018Q3



Source: CEIC

Figure 2: Growth of Manufacturing Sector and Its Subsectors, 2014-2018Q3



Source: CEIC

On the other hand, there was a discernible decline (contraction of growth) in the metal, computer, electronic, and electricity equipment subsector, dipped by -1.84% in Q3 2018 from 0.47% in Q2 2018, making the overall growth of this subsector detrimental to -1.43% (y.o.y) in 2018. Likewise, the growth of coal, oil, and gas refinery declined significantly to -1.63% in Q3 2018 after previously growing positive by 0.23% in Q2 2018, making the overall growth of this subsector negative to -0.42% (y.o.y) in 2018. The main culprit of the downward trend was high global crude oil prices. Meanwhile, the chemical and pharmaceutical subsector remained in a negative growth trend, with a growth of -2.80% in Q3 2018. Observing more specifically, the average growth of the chemical and pharmaceutical subsector dropped substantially to -4.01% in 2018 from 4.71% in 2017. Rupiah's depreciation is the main culprit.

Subsequently, growth in the agricultural sector has moderated to 3.84% in 2018, partly due to the base effect of last year's bumper harvest season and lower production of food crops and commodities such as palm oil and rubber. The mining and quarrying sector also continued to grow from 2.60% in Q2 to 2.68% in Q3, making the overall growth higher to 2.01% in 2018 as a result of strong global commodity prices. Still supported by strong investment activity on infrastructure projects, especially in buildings and structures, the growth of the construction sector slightly up from 5.73% in Q2 to 5.79% in Q3.

There is a clear urgency for Indonesia to shift from a commodity-dependent economy into a manufacturing-based economy to achieve sustained economic growth. The manufacturing industry can provide a broader effect on the increase in value added, employment, additional taxes and duties, as well as foreign exchange revenues from exports. Considering that the contribution of the manufacturing sector in the last five years has experienced a slowdown and remained under GDP growth (4.22%), Indonesia should immediately undertake structural reform to the industry nationwide. The importance of improving the economic structure, particularly industrialization, is essential to avoid the middle-income trap.

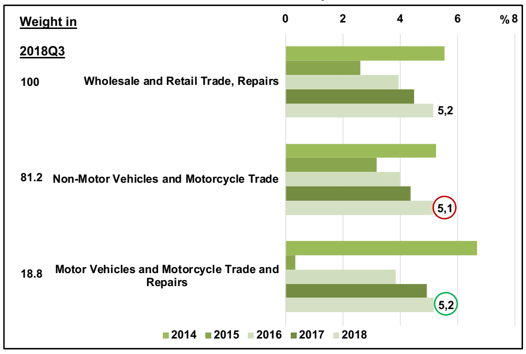
"We view that GoI needs to implement the kind of structural reforms that boost export-oriented manufacturing industries."

We view that GoI needs to implement the kind of structural reforms that boosts export-oriented manufacturing industries. Supposing that the reform is successful, it can alleviate Indonesia's widening current account deficit (-3.37% of GDP). Looking at the strategy of neighboring countries such as Thailand, Malaysia, and Vietnam, they have successfully integrated their economy into the global value chain and do not have a problem with importing input goods for production purposes. Thus, we view that the obstacle comes not from the import side, but from how a country can utilize the imports of capital goods and essential goods to build its industries so that there is a production surplus. Therefore, Indonesia must take advantage and contribute to the global value chain in order not to be left behind by more business-friendly neighboring countries such as Vietnam and Thailand. Fiscal incentives for the upstream sectors need to be broaden and implemented fast.

Another important aspect that drives the growth of the manufacturing industry in Q4 2018 and Q1 2019 is the momentum of the 2019 General Election. If the economic and political conditions can be maintained steadily throughout this political year, it can boost the growth of the manufacturing industry, especially the food and beverage processing industry and the textile and apparel industry due to increased demand for these commodities during the campaign season.

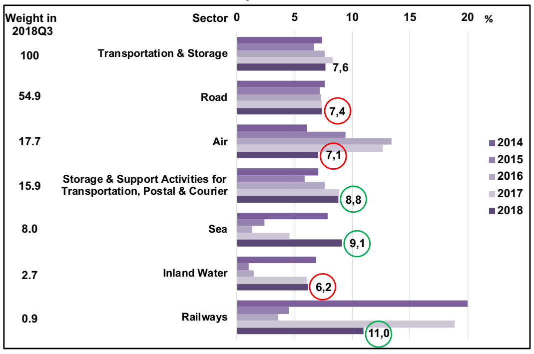
Retail Industry Recovers Amid Growth of Services Sectors

Figure 3: Growth of Wholesale and Retail Trade and Its Subsectors, 2014-2018Q3



Source: CEIC

Figure 4: Growth of Transport and Its Major Subsectors, 2014-2018Q3



Source: CEIC

Indonesia's retail sector remains one of the most promising in Asia with higher household purchasing power and increasingly modern spending habits, thanks to its large population and growing middle class. The retail industry is now recovered from the lowest point in 2015. The sector grew by 5.26% in Q3 2018, driven by increases in motor vehicle sales, albeit only a slight increase from 5.24% in Q2 2018, making it accelerates to 5.2% in the overall 2018. Meanwhile, the growth of non-motor vehicle retail trade had a minor decrease to 5.32% from 5.44% (y.o.y) in Q2 2018 despite still being relatively high and having an upward trend for the past five years. The momentum of Asian Games 2018, which started in Q3 2018, gave a boost to the retail industry, contributing mainly through the increase in consumption of non-motor vehicles and motorcycle subsector with the overall growth of 5.1% in 2018.

Following business reforms and commitments to infrastructure development, some of the world's largest retailers in Indonesia have increased their presence. At the same time, continued sector liberalization has led to lower risk levels and greater market penetration. Nowadays, Indonesia is home to a mix of traditional and modern retail outlets that are boosting their e-commerce activity, bolstering the growth of modern retail and creating new business opportunities. The wholesale and retail trade outlook for Q1 2019 will start with optimism, albeit still with a modest increase. Nonetheless, retail businesses should carefully monitor if there is a sudden future deterioration in consumer expenditure.

"Nowadays, Indonesia is home to a mix of traditional and modern retail outlets that are boosting their e-commerce activity, bolstering the growth of modern retail and creating new business opportunities."

Government and businesses are currently seeking to amplify the role of Indonesia's service sector to manage the country's current account and balance of payment in the face of dwindling commodity prices and stagnant manufacturing industry. Indonesia's services sector grew strongly at an average of 7% per year, with the growth of ICT, transportation & storage, and financial & insurance sector reaching 7.8%, 7.6%, and 3.6% respectively, much higher than the manufacturing and agricultural sectors. The more advanced a country becomes, the greater the role its services sector plays, which is especially crucial for Indonesia as it is keen to implement the fourth industrial revolution.

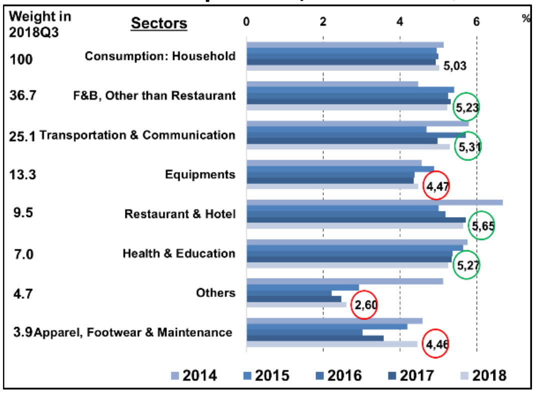
Nevertheless, according to OECD 2017 Services Trade Restrictiveness Index, Indonesia was found to be the most restrictive in legal distribution, insurance, telecommunications and maritime transport services, compared to 43 other countries. The absorption of service workers is now partly moving more toward informal sectors and menial jobs in trade and construction, whereas there are fewer workers in the more modern, high-skilled services sectors. Furthermore, the development of the service sector could be delayed in the near future due to the lack of Indonesian participation in the global value chain, which requires human resources to bring more added value to physical goods.

Despite the growth of the transportation and storage sector in Q3 2018 declining by 3.06%, from 8.7% in Q2 2018 to 5.64% due to subsided increase experienced by all subsectors, the industry overall still promises to grow fairly high above economic growth in Q1 2019. The freight transport market in Indonesia is expected to continue growing as government efforts to improve the economic situation in Indonesia also increase. The growth of the storage and freight market in Indonesia is supported by the rising growth rate of the domestic segment. Growing demand from the country's e-commerce market has fueled the domestic freight and logistics market. Another factor is the Indonesian government's heavy focus on developing national road networks to catalyze the country's road freight market. Besides, the government also has made considerable progress in closing Indonesia's infrastructure gaps, thus raising demand for land, maritime, and aviation transport services and helping the sector maintain strong momentum as the country moves into 2019.

Consumption to grow above 5% in 2018, could get better in Q1 2019

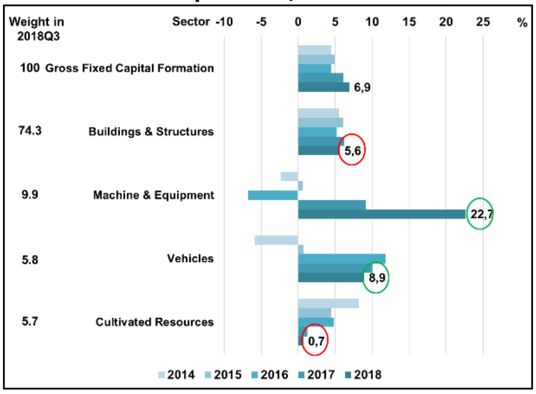
The household consumption growth in 2018 had been marked by a slowdown to 5.01% (y.o.y), bringing the average of the first three quarters in 2018 to be at 5.03%. This condition was caused by the instability of the global economy along with the implementation of policy normalization by the Fed, which raised its benchmark interest rate for the fourth time in 2018. It is exacerbated by concerns over the US-China trade war. Bank Indonesia's resistance to further increasing interest rate in the last two months has been able to considerably encourage another rise in consumption in Q4 2018 and further in Q1 2019. However, consumption growth in Q4 is expected to be flatter, aligning with the stagnation of BI consumer confidence at 123 in Q4 2018, similar to 122.9 in Q3 2018.

Figure 5: Growth of Household Consumption and its Components, 2014-2018Q3



Source: CEIC

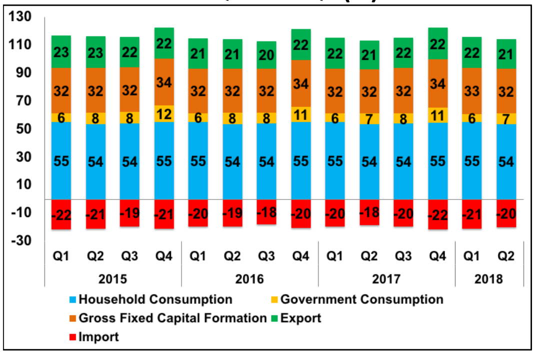
Figure 6: Growth rate of Investment and its Main Components, 2014-2018Q3



Source: CEIC

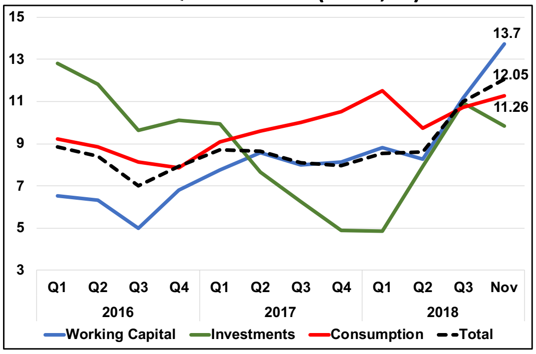
Most of the components that constitute household consumption growth grew in the range of 5% in Q3 2018 despite a slowdown in growth compared to the previous quarter, during which Ramadan and Eid al-Fitr were held. Faster consumption growth in Q3 took place in transportation and communication (rising to 5.68% in Q3 2018 from 5.32% in Q2 2018) and clothing, footwear and maintenance (rising to 4.45 % in Q3 2018 from 2.86% in Q2 2018). Overall, consumption growth in 2018 has experienced the highest growth for the past four years.

Figure 7: Shares of GDP Components, 2015Q1-2018Q3 (%)



Source: CEIC

Figure 8: Credit Growth by Purposes, 2016Q1-Nov 2018 (Y.o.Y, %)



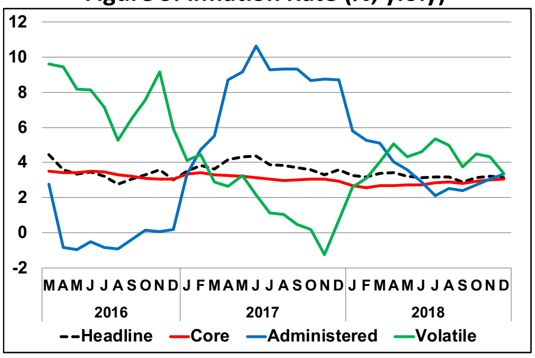
Source: CEIC

"The steady consumption growth was supported by the subdued inflation rate and the series of events towards the hype of the 2019 legislative and presidential electios."

The steady consumption growth was supported by the subdued inflation rate. Consumption performance was also triggered by the increase in the performance of the non-profit institutions serving households (LNPRT) expenditure component of 8.54%, which rose due to the large number of social activities related to the earthquake and tsunami in Donggala and the series of events towards the hype of the 2019 legislative and presidential elections.

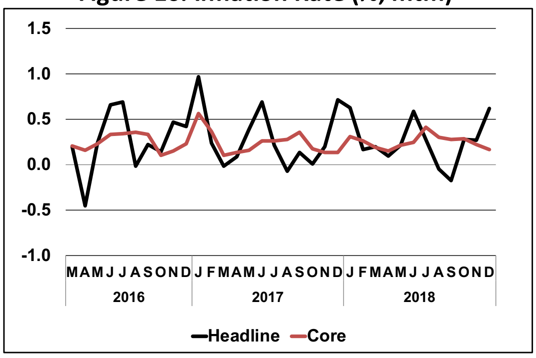
Headline and core inflation in 2018, which respectively reached 3.13% and 3.07% (y.o.y), are relatively stable. Headline inflation in the Q4 2018 scored a better performance in line with the stable recovery of prices after deflation in the previous quarter. Core inflation has continued to decline since Q3 until the year-end at 0.17%. The low level of public demand in the second semester was primarily causing deflation in the core inflation. Cumulatively, inflation in 2018 emerged from volatile food inflation, which experienced pressure at the beginning and end of the year.

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



Source: CEIC

Figure 10: Inflation Rate (%, mtm)

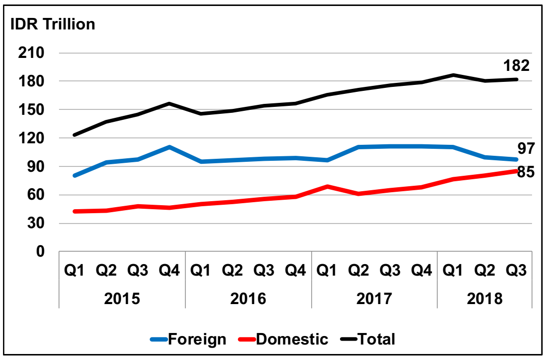


Source: CEIC

We see a slight upward trend for consumption in 2019, accompanied by slightly higher inflation at around 3.2-3.5% level in 2019. We see that consumption growth is potentially to accelerate in Q1 2019. Although the risk of a global downturn still looms and trade tensions may rise further, sentiments from the political year up to the April election will still be able to boost Indonesia's economic activity.

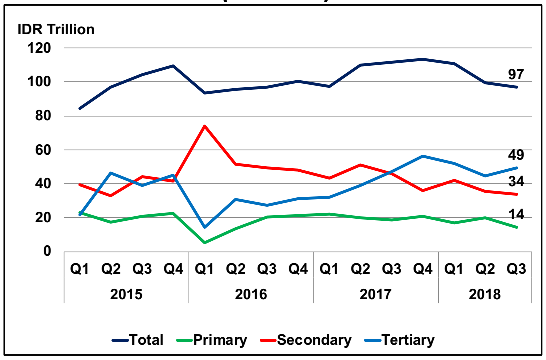
Slightly Improved Investment in Q4; Will be Better in 2019

Figure 11: FDI Realization (Nominal)



Source: CEIC

Figure 12: Foreign and Domestic Investment (Nominal)



Source: CEIC

After slowing down, partly due to the government's decision to postpone key infrastructure projects in previous quarter, investments continued to rise in Q3 2018 with the growth soaring up to 6.9% from 5.9% (y.o.y). Key contributions in Q3 are still buildings and structure, the proportion of which amounted to 74% of gross fixed capital formation. The growth of this type of investment has increased to 5.66%. On the other hand, investment of machine and equipment relatively unchanged at 22.13% in Q3. Following previous trend, we see that double-digit investment in machines and equipment have yet to translate to manufacturing growth, given Q3 growth for this sector is still below 5% level. We expect that this puzzling combination will remain in the near future due to the probability that these machine and equipment investments are not fully absorbed by manufacturers, but more by businesses in other sectors, especially construction. Recent data also shows that growth in construction sector is above 5% level and has slightly risen to 5.79% in Q3.

"…that the introduction of the 94 newly opened sectors for foreign investment will attract more investors only if the government also try to remove unnecessary bureaucratic processes"

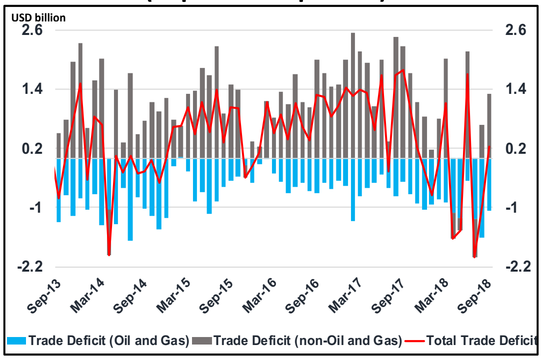
Persistent Rupiah volatility and the trend of global monetary tightening continue to bring negative effect to the value of foreign investment in Q3 2018. The events are captured in the second consecutive drop of foreign direct investment realization to below Rp100 trillion throughout 2018. However, total investment has decreased only slightly compared to last year's sharp drop in FDI, thanks to 30% growth (y.o.y) in domestic investment. Following the previous trend, rising domestic investment in this quarter is also in line with the robust growth for loan of investment and working capital purposes. Other than that, direct investment data by the Indonesian Investment Coordinating Board (BKPM) show that transportation and telecommunications as well as electricity business sectors still gained the most compared to the rest industries.

Although Rupiah has improved since October 2018, thanks to lower external pressure, we see that FDI will not change significantly in Q4 2018 and the total investment is expected to be less than US$20 billion for the whole year. However, we believe that the declining trend of FDI will not continue in 2019 following some steps that have been undertaken by the government in the 16th Economic Policy Package. A combination of three key policies, (1) the revision of negative investment list, (2) the expansion of tax holidays, and (3) the development of tax incentives for exports proceeds, is predicted to stimulate investment in the near future. It should be noted, however, that the introduction of the 94 newly opened sectors for foreign investment will attract more investors only if the government also try to remove unnecessary bureaucratic processes.

Thus, Indonesia could increase its competitiveness compared to its counterparts and improve its currently stagnating ranking in the Ease of Doing Business Index.

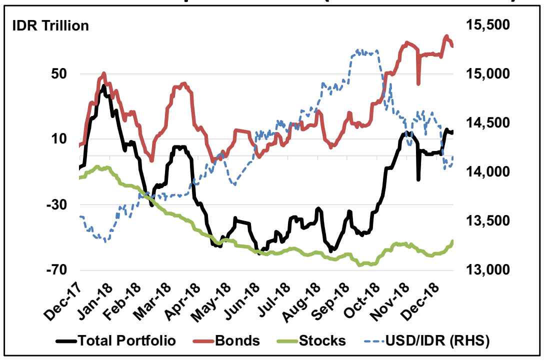
Deteriorating Current Account Position Amid Better External Risks

Figure 13: Monthly Trade Balance (Nominal) (Sept2013-Sept2018)



Source: CEIC

Figure 14: Exchange Rate and Accumulated Short-Term Capital Inflow (Dec '17-Dec '18)



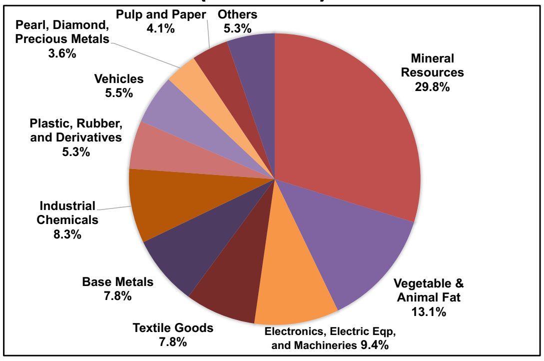
Source: CEIC

"...better oil and gas account in the two upcoming quarters as oil price has significantly dropped after the peak in early October."

At US$8.8 billion, current account deficit in Q3 2018 hit its highest nominal level in the last decade and was equivalent to 3.4% of GDP. Indonesia trade imbalance has widened slightly on the back of stronger domestic demand compared to Q2 2018, which recorded a deficit of US$ 8 billion (3.02% of GDP). Weaker trade performance coupled with increased service account deficit was the main driver of the worsening current account deficit. Rising oil and gas trade deficit along with limited non-oil and gas surplus has led to the reversal of goods trade account into deficit balance. Persistent oil and gas trade deficit can be explained by the increase of crude oil price, along with the limited national production capacity; falling short of servicing the increasing domestic demand. However, we predict better oil and gas account in the two upcoming quarters as oil price has significantly dropped after the peak in early October. As a result of the sudden drop in crude price, pressure on the government's challenging decision to hold fuel price at the same level could be slightly eased at least until after the national election on April.

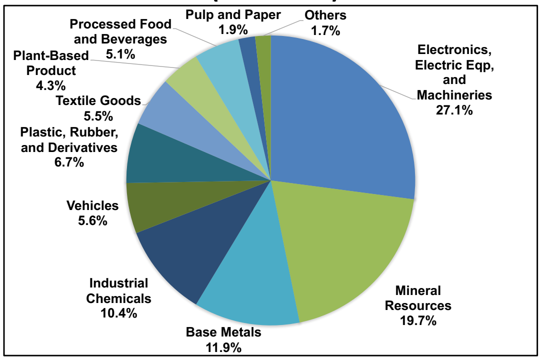
While the oil and gas sector were mainly driven by global fuel prices, the widened current account deficit in Q3 2018 was also contributed by significantly lower non-oil and gas trade surplus, which stood at US$3.1 billion compared to US$6.5 billion in the same quarter last year. The pressure from China's coal imports restriction and the gradual downturn in global CPO prices have weakened the export of non-oil and gas. The growth of consumption goods imports in Q3 2018 has also significantly accelerated to 36% (y.o.y) amid Rupiah depreciation. Soaring demand of consumption goods imports has been driven by households' earlier purchases in anticipation of the implementation of higher import tax in mid-September. On the other hand, import growth of inputs and capital goods flattened to 17.2% (y.o.y) from 21% in Q1 2018. However, it was still higher than last year's growth. It should be noted that the jump in import growth for 2018 overall was driven by the sudden purchase of machinery and equipment, which are related to the construction and completion of major infrastructure and development projects throughout 2018.

Figure 15: Indonesia Export Profile (Nov-2018)



Source: CEIC

Figure 16: Indonesia Import Profile (Nov-2018)



Source: CEIC

"… expect Rupiah to be among the biggest beneficiaries of this trend in 2019 due to improvement in financial market confidence"

Looking deeper, Indonesia's worsened trade balance in Q3 2018 was explained by the unchanged structure of Indonesia's export and imports. Exports are still heavily dependent on the export of raw materials, particularly mineral resources, vegetable fat and precious metals with these three categories accounting for 50.7% of total export value. A combination of large commodity goods exports and lower CPO price has reduced the benefits from export activities. On the other hand, the government's push to complete infrastructure projects before 2019 has further driven imports of input and capital goods such as machineries to rise last year. Not only capital goods, our imports were also dominated by mineral resources, particularly oil, at least in these past five years. Hence, the increase in heavy machineries imports and the rise in crude oil prices volatility, coupled with steady upward trend in consumption amid lower exports, have driven the widening imbalance in the third quarter last year.

The trend of worsening current account position is predicted to continue in Q4 2018 as December export import data shows the third consecutive monthly trade deficit, which has driven the overall trade balance into negative nominal value of US$8.57 billion. Swirling global trade tension and falling commodity prices have disrupted overall export performance in 2018 by around 6.7% y-o-y loss to US$180.1 billion. Meanwhile, double-digit import growth due to relentless domestic demand has stoked total imports to US$188.6 billion. As the high uncertainty last year prompted the government to play a more active role in managing stability, we see that the trade balance should be better at least in 1H 2019 following some mitigations that have been undertaken by the government, such as postponing several infrastructure projects and implementing the B20 mandatory requirements. In addition, government efforts to curb imports by imposing higher tax up to 10% on 1,147 consumer goods in mid-September last year have started to take effect since December and are expected to further curb imports in 2019.

On a more positive note, Rupiah against US dollar has enjoyed robust appreciation in the last two months after depreciating heavily throughout 2018 with its highest year-to-date depreciation rate at around 12% in October. The improvement cannot be separated from the combination of external factors and domestic economic sentiment. US midterm election results in November, a decline in global oil prices, and a potential truce in the US-China trade war are among the positive shocks to Rupiah. Meanwhile, strong domestic indicators driven by better-than-expected Q3-2018 growth, the ahead of the curve action, and several direct and indirect interventions by Bank Indonesia also contributed to Rupiah appreciation. Improvements in domestic indicators amid the slowdown in the global economy prompted foreign investors to reallocate their assets to Indonesia more compared to its emerging market peers. The influx of foreign portfolio investment flowing into the domestic market has thus made Rupiah among the least fragile currencies together with the currencies of Thailand, the Philippines, and Malaysia at least in the last few months, with the currency trading at slightly over Rp14,000 per US dollar.

Should the reversal of capital to the emerging economies continue, we may expect Rupiah to be among the biggest beneficiaries of this trend in 2019 due to improvement in financial market confidence. Several measures by Bank Indonesia such as Domestic Non-Deliverables Fund (DNDF) and special deposit accounts for export proceeds (DHE) have helped investors to trust the market. The contribution of DNDF to the deepening of the domestic foreign exchange market has showed since the first week of its establishment, in which total transaction volume amounted to US$115 million. Meanwhile, efforts to lessen the possibility of sudden reversal by imposing negative Tobin Tax for export proceeds converted from dollar to rupiah have also started since Jan 1. The impact will start to show up in Q1 2019, but we expect it to have a more significant impact after the general elections as exporters may still take a wait-and-see stance for stocking their export proceeds in or more than 6 months.