Indonesia Economic Outlook

2020

Key Figures

- GDP Growth (Q2 '19)
  5.05%
- Inflation (y.o.y. Sept '19)
  3.39%
- Credit Growth (y.o.y. Agst '19)
  9.58%
- BI Repo Rate (7-day, Sep '19)
- **5.25%**
- Current Account Deficit (CAD) (Q2 '19)
  -3.04%
- IDR/USD (Oct '19)
  IDR14,164

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Macroeconomic & Financial Sector Policy Research

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Further Slow-Down in The Midst of Heightened Global Risks

Highlights

- Global slowdown for trade and GDP growth will persist with the additional risk of crisis or further slowdown in advanced economies in 2020. While export will still grow negatively this year, the sign of rising in commodity prices, particularly palm oil, offers a potential non-negative growth for Indonesian exports in 2020.
- Investment will be subdued in 2020 as barriers to trade and investment remain high in Indonesia. Any significant reform that improves the investment climate could help economic activity in 2020.
- Manufacturing sector continues to underperform due to dampened global demand and rather limited improvement in the industry's competitiveness.
- The ongoing monetary easing will provide some support for credit growth in 2020.
- We predict GDP to grow slower at 4.9% in Q3 2019. We also revise our projection for 2019 to 5.0-5.1%.
- We forecast GDP to grow by 5.0-5.2% for 2020 based on several scenarios. If not mitigated well, the risks of recession in advanced countries could aggravate the growth of Indonesia's GDP in 2021.

Since March 2019, the US bonds market has recorded an inverted yield curve, meaning that the yields of short-term bonds have surpassed those of long-term bonds. This condition indicates a negative perception of the US's economic performance as the inverted slope of the yield curve is very frequently correct in predicting the occurrence of recession in the near future. Even though the transmission channel of the potential global shocks to the domestic economy by capital flow channel would not yet clearly materialize in 2020, the rising concern of recession that would take place in US may spark speculative attacks in the foreign exchange and capital market. The speculative attack will notably affect Indonesia's financial system by triggering capital outflows, giving substantial pressure to Rupiah. However, if the government and Bank of Indonesia (BI) could manage expectations of the market, it will drive capital to flow back to Indonesia after the turbulence period ends. We expect BI might, at least, lower the policy rates one more time and then hold it in 2020 until the volatility of Rupiah requires hikes in 2020. The currently ongoing monetary easing will provide some support for the credit growth in 2020.

Table 1: LPEM FEB UI Forecasts

Indicators	Q3 2019	FY 2019	FY 2020
GDP	4.9%	5.0-5.1%	5.0-5.2%
Inflation	3.4%	3.3-3.5%	3.3-3.6%
Credit Growth	9.6%	10-11%	10-12%
BI Repo Rate (end of period)	5.25%	5.00%	4.75%
CAD	2.1%	2.5-2.7%	2.5-3.0%
IDR/USD	14,100	14,000-14,200	14,000-14,300

Domestic GDP growth rate is reported at 5.05% (yoy) in Q2 2019, while the manufacturing sector, the biggest sector, grew at 3.59% (yoy). Other than still robust domestic consumption spending and manageable inflation, the macroeconomic data are not painting a good picture of the Indonesian economy at the moment and for the rest of 2019. Relatively weak export performance due to overreliance on raw commodity export, palm oil and coal in particular, and still weak manufacturing sector that is also dependent on imported input and capital goods, have sustained the trade deficit into 1H 2019. Escalation of the trade war and fears of future recession might stifle the growth in trade at least until 2020. Along with that, there is no definite sign of improvement in FDI, which is subdued to 5.02% (yoy) in 1H 2019. All in all, we see GDP to grow by 5.0-5.2% in 2020.

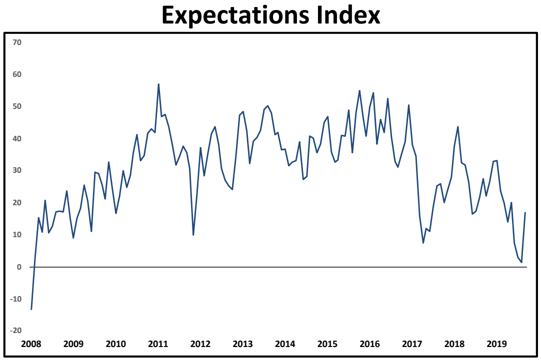
RISK OF A GLOBAL CRISIS

Bleak Growth Ahead

"The inversion of the yield curve in the US this year has provided a stronger signal that an economic crisis in the US would happen sometime in mid of next year.."

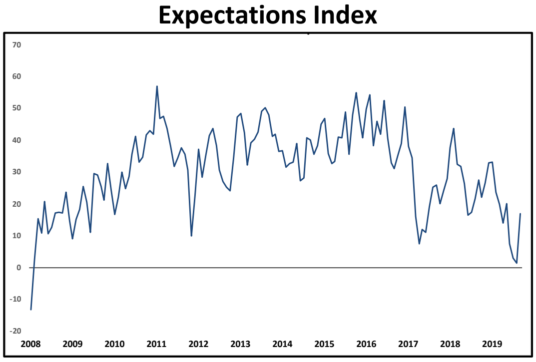
Global economic slowdown is happening. Global growth has decelerated in the past two consecutive quarters, while the market expectations in the advanced economies has reached its lowest level since 2008 Global Financial Crisis (GFC) (Figure 1 & Figure 2), in addition to the drop of world trade volume growth, which also reached its lowest level since GFC. Overall world output growth in 2019 is expected to be lower than in 2018 and there is still no clear sign whether the growth will pickup in the next year as the uncertainty is at its peak. Additionally, the output growth of four systemic countries, including US, China, Euro Area, and Japan is expected to moderate in 2020. This bleak outlook of subdued growth is a consequence of rising trade barriers; elevated uncertainty surrounding trade and geopolitics; idiosyncratic factors causing growth halt in several emerging market economies; and structural factors, such as low productivity growth and aging demographics in advanced economies.

Figure 1: ZEW US DOW Jones Market Expectations Index



Source: Bloomberg

Figure 2: ZEW Eurozone Stoxx 50 Market Expectations Index

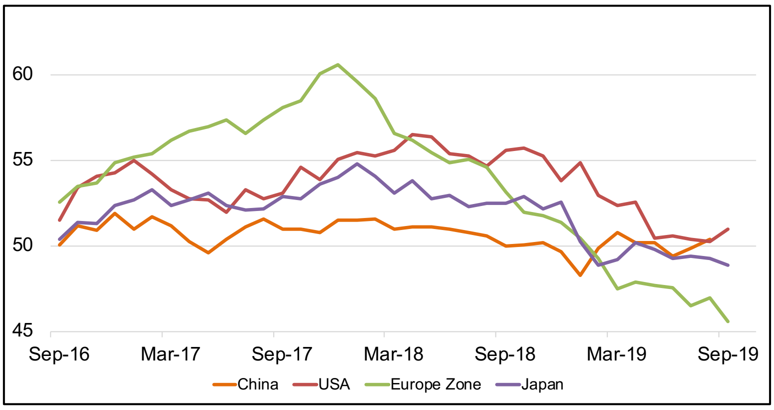


Source: Bloomberg

Probability of crisis in 2020 is rising as a crucial indicator raised a flag. One indicator of recession is marked by an inverted US yield curve, which occurs when the yield of short-term bonds surpass those of long-term bonds. It is widely accepted that the slope of government bonds' yield curve, when it is inverted, serves as an early warning of future economic recession in the advanced economies, and already occurred in the US during this year. Thus, the inversion of the yield curve in the US this year provides a stronger signal that an economic recession in the US would happen sometime in mid of next year.

Moreover, manufacturing sector provide an alternatives presentation of the dwindling global trade. Globally, especially in advanced and systemic economies, manufacturing continues to deteriorate (Figure 3). Observing the Euro Area, export-driven core of the Eurozone has been badly affected by weak world trade. Germany posted negative GDP growth in 2Q 2019 as the weakness of its manufacturing industry more than outweighed its robust domestic economy. This might, in turn, put more pressure on ECB to increase the pace of Quantitative Easing in 2020. The similar condition is also occuring in Japan. Slowing manufacturing performance, coupled with constrained monetary policy and aging population put Japan in a position where economic growth pickup is unforeseeable in the near future. While China is badly hurt by the trade tension with the US, its domestic economy also not in a favor of supporting growth. While their manufacturing index may perform rather better than developed economies' manufacturing sector, their latest economic data begs to differ. China's real GDP only grew 6% in Q3 2019, recorded as the lowest growth in 27 years.

Figure 3: PMI Manufacturing Index



Source: Bloomberg

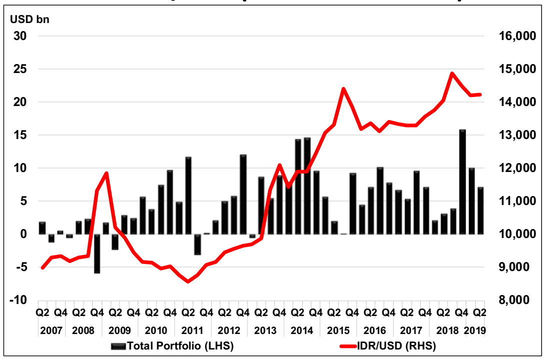
Generally, economic data is painting a bleak picture of current global situation. Uncertainty triggered by the trade tension, as well as Brexit, is mounting. This situation worsen by declining performance of manufacturing in advanced economies. Limited room for fiscal and monetary expansion in several developed economies also make a shortage of tools for policymakers to rebound the economy. Numerous factors causing macroeconomic strain, such as fluctuation in commodity prices and slow progress of structural reforms, make the developing countries are simply not strong enough to cushion the upcoming slowdown of the global economy.

CAPITAL FLOWS

How much is the capital inflow needed to weather the 2020 crisis?

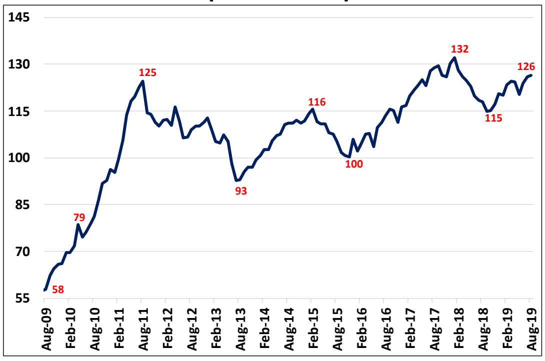
Indonesia has gained estimable experience in handling the global financial crisis in 2008. During the crisis, Indonesia's financial account dropped to -USD2.12 billion (-0.41% to GDP). It was mainly influenced by the deteriorating position of Indonesia's portfolio investment which was hit by massive capital outflows of -USD5.94 billion in Q4 2008. This resulted in rupiah weakening to higher than IDR11,800, depreciated by 29% (ytd). Since then, policymakers took several effective and sustainable monetary and fiscal measures, which became potent medicine in quickly mitigating the crisis. Bank Indonesia eased its monetary stance by cutting the benchmark interest rate, thus triggering the flow of portfolio back to Indonesia. From mid-2009 until August 2011, the total accumulated capital flow was USD21.3 billion; substantially muting the depreciation and helping Rupiah to strengthen to around IDR8,500. Despite the rate cut, BI also managed to accumulate its foreign exchange reserves along with continuing capital inflow. The reserves are needed as a buffer to withstand the risk of external shocks. Figure 5 shows that BI managed to accumulate around additional USD67 billion of reserves until August 2011 to stabilize the currency at IDR9,000-8,000.

Figure 4: Accumulated Portfolio Net-Inflow and IDR/USD (June-2007 to date)



Source: CEIC

Figure 5: Foreign Exchange Reserves (USD Billion)



Source: CEIC

"We predict that dovish views from both the Fed and other central banks will continue in 2020. Bank Indonesia currently also pledges for more easing to come as it shifts focus to support growth."

The upcoming global economic slowdown will undoubtedly affect the movement of Rupiah. Even though in 2020 the transmission channel of global shocks to the domestic economy by capital flow channel is not clearly visible yet, uncertainty can spark speculative attacks in the foreign exchange and capital market. This may influence public expectations, which eventually will facilitate the shock to transmit into the domestic market. Indonesia could use some valuable insights from the 2008 global financial crisis to overcome the external impact on the domestic economy. The global financial crisis started to give a negative impact on Indonesia's capital market in mid-2008, the crisis then substantially reduced stock and bond inflows afterwards at the end of 2008. As observed from the GFC, there was a one-year lag from when the crisis started in the US in the mid-2007 until capital flow started to reverse from Indonesia (Figure 4). Meanwhile, transmission from the portfolio to the real sector was delayed by half a year. Thus, it took at least one and a half years for the global crisis to fully affect the economy. If that mechanism prevails, Indonesia might need to take preventive action to deal with the spillover effect from the potential recession in the US next year as this might shock the domestic economy in 2021.

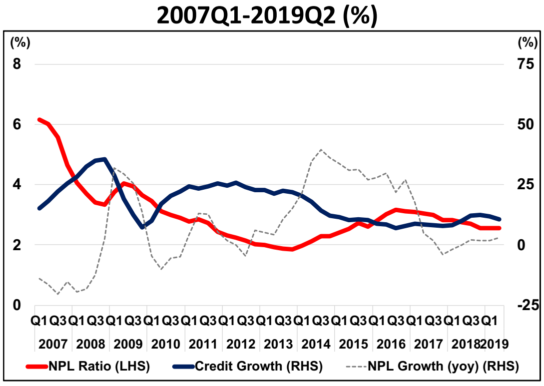
The projected 2020 recession is approaching and the Fed keeps intensifying its dovish policy stance, with the probability of a rate cut by the Fed this month until the end of 2019 increasing. We predict that dovish views from both the Fed and other central banks will continue in 2020. Bank Indonesia currently also pledges for more easing to come as it shifts focus to support growth. We expect BI to at least hold interest rate in 2020 until there is volatility in Rupiah. There may also be room for a further cut by 25bps in 2020 if Rupiah depreciates deeper or to adjust to the Fed rate movement. We see that once the crisis occurs, it will notably affect Indonesia's financial system by triggering capital outflows, giving substantial pressure to Rupiah. However, if BI can mitigate the risk, it will drive capital to flow back to Indonesia after the turbulence period ends. Reflecting on what happened during the GFC, with the continuing foreign fund inflows after the crisis, BI accumulated at least half of its international reserves during the aftermath period of the global financial crisis until mid-2011. If the current global economic slowdown is getting worse in the near future then BI would need to accumulate its international reserves to around IDR34 billion, according to the accumulation of international reserves needed in the aftermath of the 2008 GFC. To counter the weakening of Rupiah during 2018, BI released USD17 billion of its FX reserves, from USD132 billion to USD115 billion. Since then, BI has continued to collect foreign exchange reserves until now. We predict FX reserves in 2020 to reach around IDR150 billion, at which the reserves will be enough to stabilize Rupiah at around IDR14,000-14,200.

CREDIT AND NON-PERFORMING LOANS

Cautious Credit Versus Weak Demand

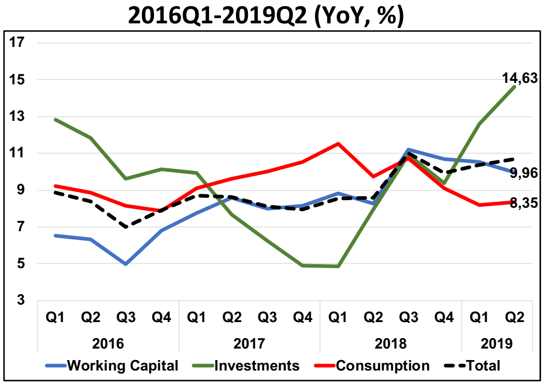
Considering the post-GFC condition of the domestic banking sector, credit proliferated to its highest point of 35% in Q4 2008. At the same time, the NPL ratio plummeted from 6,1% in Q1 2007 to 3.3% in Q4 2008, suggesting that credit grew quicker than bad loans. NPL ratio then gradually declined until the end of the commodity boom era. Since then, economic slowdown, widening trade deficit, currency fluctuation, and a series of tightening monetary policy in 2013-2016 put pressure on banking sector performance as banks' NPL ratio slowly increased to as high as 3.2% in September 2016, with the growth of around 30% per year in the period of 2014-2016. Meanwhile, loan growth slumped from 25.9% in Q2 2012 to only 7% in Q3 2016, indicating massive bad loans growth along with weakening credit growth during 2013-2016. Since then, we have not seen much improvement in the banks' asset quality until Q2 2019. Although NPL ratio has started to decrease and credit growth is slowly recovering, NPL growth indicates that there is an increase in bad loans growth.

Figure 6: Credit Growth and NPL, 2007Q1-2019Q2 (%)



Source: CEIC

Figure 7: Credit Growth by Purposes, 2016Q1-2019Q2 (YoY, %)



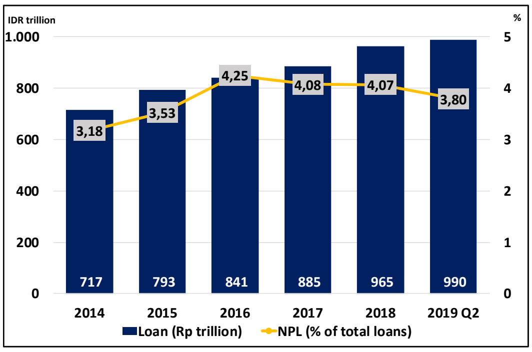
Source: CEIC

Sluggish GDP growth in Q2 2019 (5.05%) and relatively low inflationary pressure have induced Bank Indonesia to continue its supporting activity with accommodative monetary policy and a more dovish policy stance. The ongoing easing cycle stimulated credit growth to climb to 10.67% (yoy) in Q2 2019 compared to 10.37% in the previous quarter. Moreover, investment loan growth remained strong, rising to 14.63% (yoy) from 12.58% in Q1 2019. However, we do not see similar trends in both working capital and consumption credit growth as consumption credit grew only moderately by 8.35% (yoy) (8.19% in Q1 2019) while working capital credit growth decelerated to 9.96% (yoy) in Q2 2019 from 10.53% (yoy) in Q1 2019. With the easing of monetary policy and the declining interest rates in the last three consecutive months, we expect a rise in credit growth in Q3 2019.

"...the NPL ratio should be carefully managed by maintaining a stable yet low growth to stun excessive future bad loans."

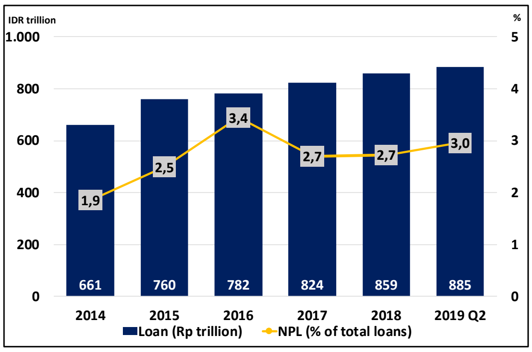
Observing NPL throughout economic sectors in Q2 2019, NPL ratio decreased across sectors except for manufacturing. Muted NPL ratio materialized in several sectors such as wholesale & retail trade, agriculture, construction, in which the ratio dropped to 3.8%, 1.39%, and 3.7% of total loans respectively as per Q2 2019. Relatively low interest rate in the upcoming periods is expected to help NPL trend in those sectors stay manageable despite weak demand and low commodity prices as the repercussions of global turmoil.

Figure 8: Wholesale and Retail Trade Sector Loans and NPL



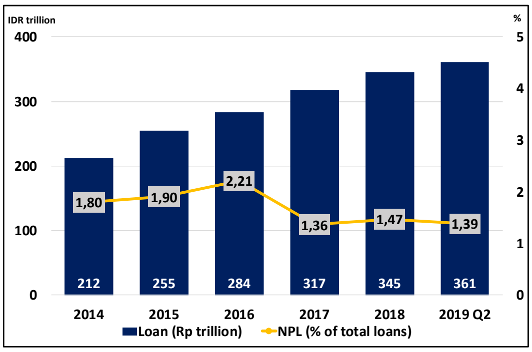
Source: CEIC

Figure 9: Manufacturing Industry Sector Loans and NPL



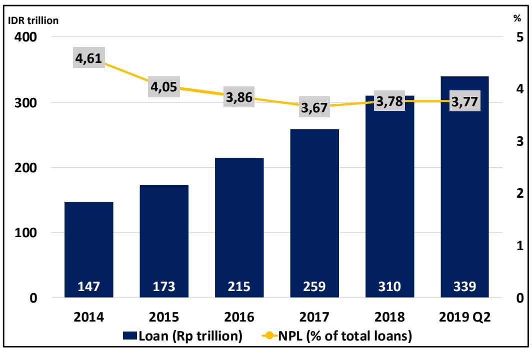
Source: CEIC

Figure 10: Agricultures, Hunting and Forestry Sector Loans and NPL



Source: CEIC

Figure 11: Construction Sector Loans and NPL



Source: CEIC

Considering the potential recession in 2020, the NPL ratio should be carefully managed by maintaining a stable yet low growth to stun excessive future bad loans. We believe that the recovery of loan demand, coupled with low-interest-rate level, will support credit growth in 2020. We see that banks could expand their loans more in the next year, supported by the government's policy initiatives for financial markets, such as credit for SMEs or KUR (Kredit Usaha Rakyat).

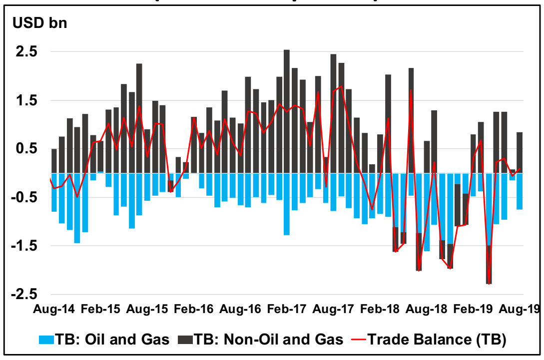
TRADE TENSIONS

External Risks Continue to Retard Economic Growth

The signal of recession has also raised concerns of potential shock stemming from trade tensions, which escalated in these past few months as the US administration threatened additional tariffs on China's exports and new tariffs on EU's exports. In the past, Indonesia's exports slumped by 15% (yoy) in 2009, impacted by the global financial crisis, while economic growth slowed down to 4.7%. This pattern shows that the transmission channel of global shocks into real domestic sector lagged by around six quarters from the first kick-off of the US financial crisis in Q2 2008. Hence, if the crisis occurs in the near future, we predict that it will take a while to transmit into Indonesia's trade aspects.

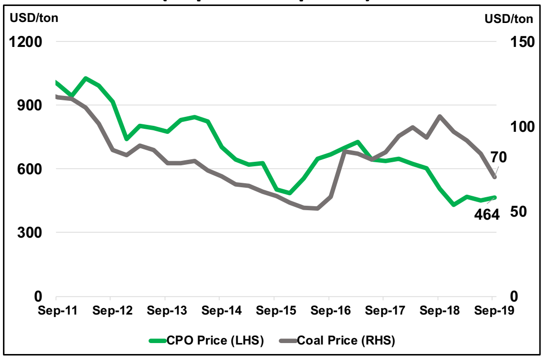
From January to August 2019, Indonesia's exports declined by 8% compared to the same period last year. This translates to widening current account deficit in Q2 2019, which stands at 3.04% of GDP (USD8.4 billion) from 2.6% (USD6.9 billion) in Q1 2019. Amid the seasonal pattern of the foreign loan payment and the repatriation of dividends in the second quarter, trade of oil and gas in Q2 2019 dropped into USD3.2 billion deficit, significantly deeper than USD2.2 billion deficit in a quarter earlier, showing us that the improvement of CAD in Q1 2019 might be an anomaly. Relatively higher crude oil price, along with increasing domestic demand has led to persistent oil and gas trade deficit since 2013, and we predict it to continue through 2020. Taking into account that changes in global fuel prices will significantly influence the trade balance; thus, maintaining domestic demand is necessary. However, as oil and gas trade balance has remained in deficit for the last five years and has only fluctuated along with crude oil price dynamics, imported oil is not the main culprit for the widening of current account deficit. Instead, the narrowed non-oil and gas trade balance as a result of disappointing export performance is one of the drags that widened the trade deficit.

Figure 12: Monthly Trade Balance (Nominal) (Jan2013-Sept2018)



Source: CEIC

Figure 13: CPO and Coal Price (USD/ton) (Sept '11-Sept '19)

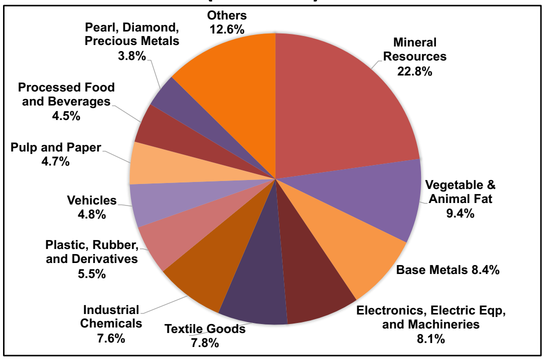


Source: CEIC

Considering non-oil and gas aspect, given that Indonesia's export is dominated by commodity and raw materials, falling commodity prices have decelerated exports at least in the last three quarters. Lower demand for palm oil due to trade uncertainty and the EU ban towards unsustainable palm oil production has translated into lower CPO price at USD464 per ton in Q2 2019 compared to USD602 in the same period last year. Even worse, starting from 2019, Indonesia has failed to maintain its most significant market of refined palm oil, RBD, in India due to lower tariff on Malaysian RBD exports that have been agreed in a bilateral trade agreement between India and Malaysia. This caused a significant drop in the quantity of Indonesia's RBD export to only 0.2 million ton in Q1 2019 from 2.3 million ton in Q4 2018. At the same time, RBD from Malaysia was exported to India in double amount (0.5 million ton) than their business as usual. Along with that, lower coal prices from USD93 in Q2 2018 into USD70 in Q2 2019 also lowered exports, hence widening the current account deficit.

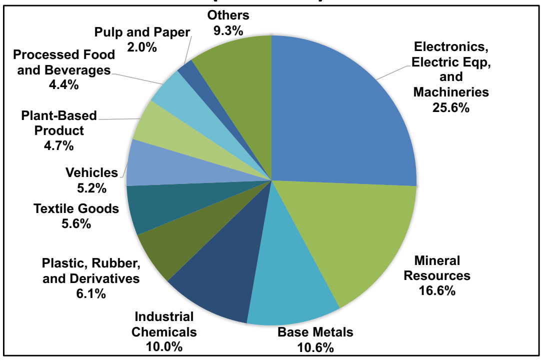
In addition, the surge in non-oil and gas imports since 2018 has also contributed to widening trade deficit. It should be mentioned, however, that the increase in imports activities was mainly influenced by a sudden surge in the purchase of machinery and equipment, due to the completion of major infrastructure and development projects. We predict that the demand for this kind of imports will remain high until 2020, along with the increasing trend of the government's infrastructure budget.

Figure 14: Indonesia Export Profile (Q2-2019)



Source: CEIC

Figure 15: Indonesia Import Profile (Q2-2019)



Source: CEIC

"Looking forward, we see that non-oil exports performance will not be significantly improved in 2020, due to the ongoing US-China trade war and the sign of the global economic slowdown."

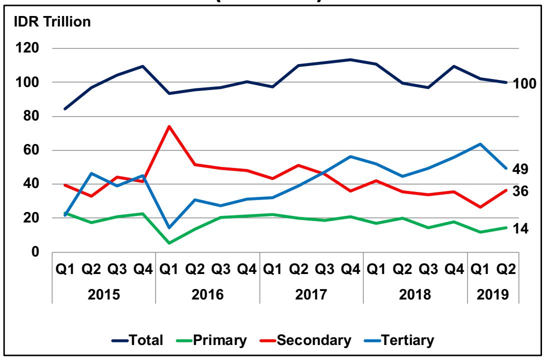
To get a better picture of the overall trade balance, we also have to see the specific compositions of exports and imports. As pointed out earlier, our exports are still dominated by raw goods, such as mineral resources, vegetable and animal fat as well as base metals, which represent 40.6% of the total export value. Enormous contribution of these commodities to GDP has led to a high dependency on key commodity prices, CPO in particular. On the other hand, input goods and capital goods tend to have higher price stability and continue to rise in demand, tracking overall GDP growth. Stagnating trend in exports, coupled with rising demand for imported goods, has reversed the usual trade surplus into deficit since 2018. Looking forward, we see that non-oil exports performance will not be significantly improved in 2020, due to the ongoing US-China trade war and the sign of the global economic slowdown However, the current improvement in commodity prices, particularly CPO, might give a slight breathing space for our exports. The projection of persistent oil and gas deficit, slightly better performance of non-oil and gas exports, and continuation of infrastructure projects will cause minor changes in trade balance at least until 2020. Moreover, the lagged transmission effect from global shocks into Indonesia's real domestic economy will keep trade from falling apart in the near future.

INVESTMENT

Subdued Investment in 2020

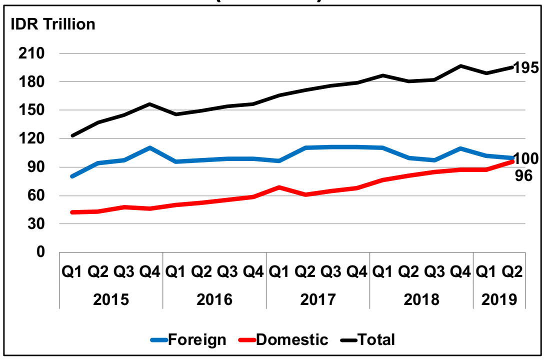
The measure of investment component in GDP, gross fixed capital formation, only grew at 5.01% (yoy) in Q2 2019, bringing real investment growth to 5.02% in 1H 2019. It also decelerated from the investment growth of 6.9% in the same period last year. The risk of wider current account deficit being addressed by postponing infrastructure projects might be one of the culprits. Around 75% of gross fixed capital formation is for buildings and structures and growth for this type of investment slightly dropped from 5.6% in 1H 2018 to 5.5% in 1H 2019. Moreover, the second-highest contributor to gross fixed capital formation, machinery and equipment, only grew at 9.2% in 1H 2019, significantly lower than the rate of 23% in 1H 2018. The government's decision to curb the current account deficit by holding back imports might have contributed to the lower growth of machinery and equipment investment.

Figure 16: FDI Realization (Nominal)



Source: CEIC

Figure 17: Foreign and Domestic Investment (Nominal)



Source: CEIC

"If the government wants to step up the game and prioritize long-term revolution to achieve a friendly investment climate, the government needs to strictly maintain the system by continuing economic reforms..."

We can see a similar trend of investment between direct investment data by the Indonesia Investment Coordinating Board (BKPM) and gross fixed capital formation. The amount of total investment realization in 1H 2019 has decelerated by 14% (yoy) from the previous year. 4% (yoy) slowdown of foreign investment realization might have contributed to the decline in investment, while domestic investment realization increased up to 19% (yoy). Looking at the trend of last year's investment realization, the current drop in FDI realization might be explained by the combination of tighter monetary policy worldwide, which increases long-term borrowing cost for firms globally, and Rupiah volatility, which might negatively affect the value of investments by foreign firms.

Furthermore, higher domestic investment is supported by robust loan growth for investment purposes and working capital purposes, which grew by 14.6% and 9.9% in Q2 2019, respectively. On the other hand, lagging performance of Indonesia's domestic industries continues to hold back potential foreign investment into the country. The relatively slow movement of Indonesia's efforts in taking advantage of the US-China trade war has shifted prospective foreign investment to other countries, such as Vietnam. Improvement in foreign investment has helped Vietnam to maintain its exports as well as economic growth, which is estimated to reach 6.6% this year.

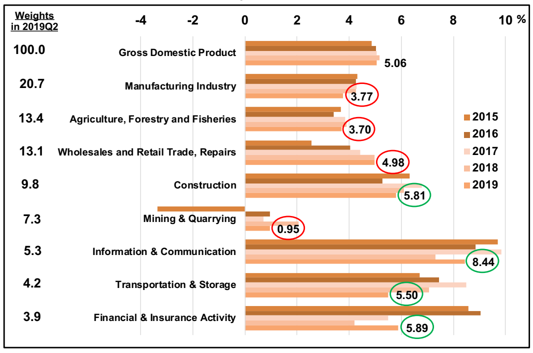
The slight drop of Indonesia's Ease of Doing Business Index to 73rd position in 2019, from 72nd in 2018, shows that this country is slower in reforming the investment climate compared to other rival countries. The complexity of bureaucratic issues is still one of the biggest pulls for Indonesia's investment. Too many regulations and different mindsets as well as investment awareness between government bodies have lowered the appetite of foreign investors in joining the long-term investment game in Indonesia. Looking at the current condition, we see that investment might be still subdued in the near future.

If the government wants to step up the game and prioritize long-term revolution to achieve a friendly investment climate, the government needs to strictly maintain the system by continuing economic reforms such as the 16th economic policy package, which entails relaxation of foreign ownership restriction, better implementation of Online Single Submission (OSS), and higher intensification of investment facilities by relevant government agencies both at the central and regional levels.

DOMESTIC CONDITIONS: GDP

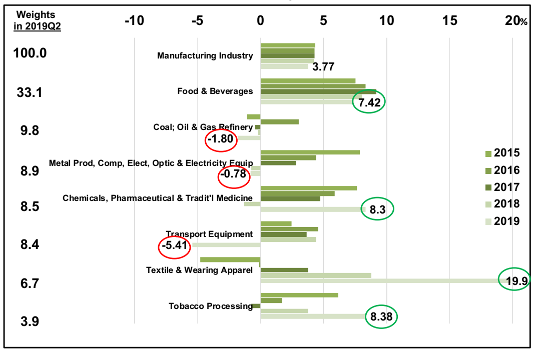
Winter is Coming

Figure 18: Growth of GDP and the Main Industries, 2014-2019Q2



Source: CEIC

Figure 19: Growth of Manufacturing Sector and Its Subsectors, 2014-2019Q2



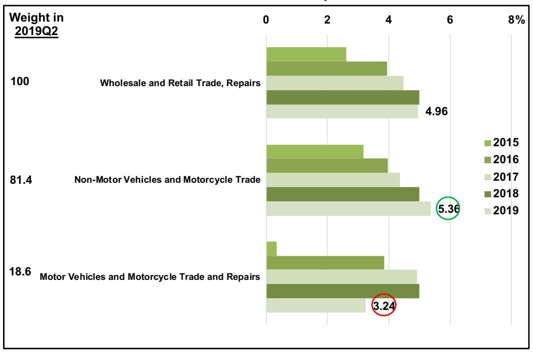
Source: CEIC

As the global economy marches towards the end of 2019, a worrying pattern is emerging as GDP growth slows down for two quarters in a row. The latest economic data has shown an economic slowdown as GDP growth is recorded at 5.06% (yoy) in Q2 2019, slightly lower than 5.07% (yoy) in the preceding quarter; making overall growth in 1H 2019 to 5.06% (yoy) (Figure 18). Various external pressures such as reemerging geopolitical tensions and plummeting commodity prices, compounded by rather weak domestic conditions, could mean that this economic slowdown is an early sign of further decline in 2020 and 2021. The manufacturing industry, as the most contributing sector in GDP, is telling the same story, if not worse. The manufacturing industry recorded the fourth consecutive quarter of lower growth at 3.59% (yoy) in Q2 2019, which is considerably lower than 3.96% (yoy) in Q1 2019 and bringing the growth for 1H 2019 at 3.77% (yoy) (Figure 19). Comprehensively, the data is not painting a good picture of the Indonesian economy currently and for the rest of 2019, suggesting a bleak future ahead.

Slower manufacturing growth on its fourth consecutive quarter should be a source of concern for the Indonesian economy. The latest data on exports and imports show a decline, which serves as a bad signal for the manufacturing industry as lower exports gestures a lower productivity and lower imports also hurt the industry due to the sector considerably relying on imported inputs. While food and beverages as the most significant subsector recorded a notable growth of 7.42% (yoy) in 1H 2019 (higher than the previous quarter of 6.84%), several vital subsectors for the economy has negative growth, such as coal, oil, and gas refinery (-1.80%) and metal production, computer and electricity equipment (-0.78%, yoy). The transport equipments subsector also recorded a negative growth of 5.41% (yoy) as the repercussion of skyrocketing airfares, which started in early 2019.

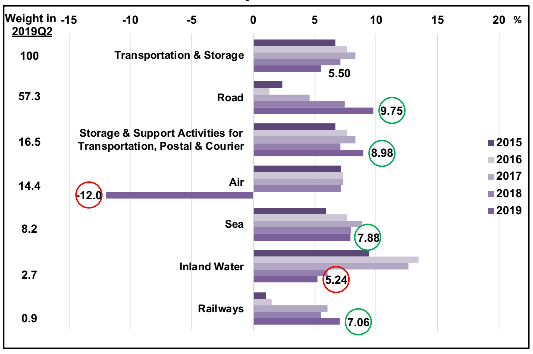
We see the assemblage of short-term and long-term factors to drive the weakness in manufacturing sector growth in Q2 and the second half of 2019. Short-term manufacturing growth was and is still likely to be dampened by weak demand, both globally and domestically. Furthermore, Indonesia's exporters rely heavily on imported materials and capital goods to process their goods, and as such, lower flows of import are likely to damage the manufacturing sector's productivity.

Figure 20: Growth of Wholesale and Retail Trade and Its Subsectors, 2014-2019Q2



Source: CEIC

Figure 21: Growth of Transport and Its Major Subsectors, 2014-2019Q2



Source: CEIC

"While the pickup of growth was starting to materialize, the repercussion of substantially higher airline ticket prices remained as sectoral growth has not reached the "normal" growth level before the airfare hike…"

The wholesale and retail trade sector only grew by 4.62% (yoy) in Q2 2019 from 5.29% (yoy) in Q1 2019, making overall growth for 1H 2019 at 4.96% (yoy) (Figure 20). Weaker growth in the second quarter of 2019 is mainly attributed to seasonal trends; retails sales declined as private consumption returned to normal after the end of the 2019 general elections and Eid-ul-Fitr festive period. Each subsector also uniformly recorded a decline in 1H 2019 compared to the first quarter, as non-motor vehicles and motorcycle trade subsectors only grew 5.36%, lower than 5.77% in Q1 2019 and motor vehicles and motorcycle trade subsectors grew 3.24%, compared to 3.29% in Q1 2019.

The transportation and storage sector rebounded in Q2 2019 with growth at 5.78% (yoy), relatively higher than in Q1 2019 which grew only 5.23%, thus, bringing overall growth for 1H 2019 at 5.50% (yoy) (Figure 21). While the pickup of growth was starting to materialize, the repercussion of substantially higher airline ticket prices remained as sectoral growth has not reached the "normal" growth level before the airfare hike of around 7%. Furthermore, the air transport subsector is still hurt as it recorded the second consecutive negative double-digit growth of 12% (yoy) in 1H 2019. Whilst most of the other subsectors recorded increasing growth in Q2 2019 compared to Q1 2019, thanks to the benefit of large ongoing infrastructure projects, the sizable decline in air transport growth is worrying as the subsector contributes rather significantly to total country's GDP and might add to the risk of Indonesia's GDP growth level not reaching 5% in 2019.

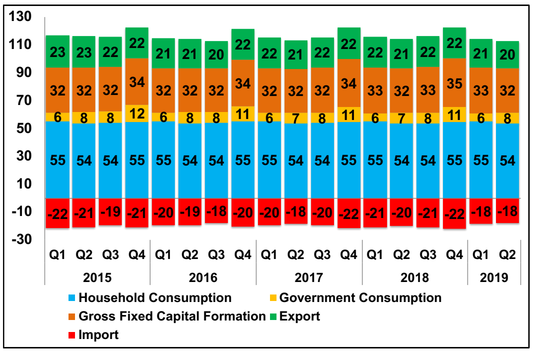
CONSUMPTION AND INFLATION

The Moderately Adequate Rise in Consumption is Projected to Continue

From the expenditure side, household consumption growth accelerated to 5.23% in Q2 2019 compared to 5.02% in Q1 2019 due to stronger retail sales growth, bringing 1H 2019 growth up to 5.12% (yoy). Accelerated consumption drivers include sales of clothing, household equipment, and other goods. It can be seen that most of the components that constitute household consumption growth bolstered considerably in Q2, with the notable exception of transportation and communication decelerating by 4.86% in Q2 2019 from 4.94% in Q1 2019. Slower consumption growth in transportation and communication was due to the massive reduction in the number of air transport passengers as the price of airfare remained relatively high.

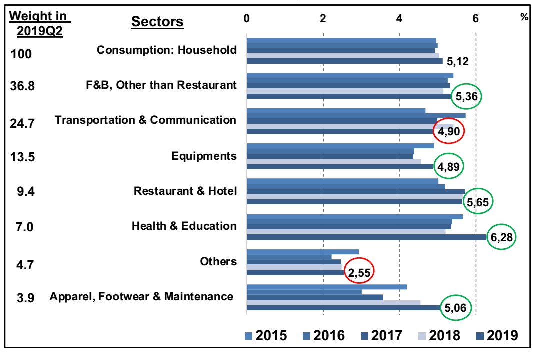
"As an effort to mitigate the crisis, GoI should undertake expenditure policies by injecting fiscal stimulus which can create a higher multiplier effect on the consumption level."

Figure 22: Shares of GDP Components, 2015Q1-2019Q2 (%)



Source: CEIC

Figure 23: Growth of Household Consumption and its Components, 2015-2019Q2



Source: CEIC

Within household consumption, consumption of food and beverages as the most significant contributor to the growth of consumption increased by 5.39% (yoy) in Q2 2019, making overall growth in 1H 2019 to 5.36%. Furthermore, expenditure on equipments as well as on apparel, footwear, and maintenance also picked up to 5.05% and 5.22% in Q2 2019, from 4.72% and 4.91% in the previous quarter, bringing the subsectors' growth for 1H 2019 to 4.89% and 5.06%, respectively. Likewise, health and education consumption continued to be robust amid government social and subsidy spending, growing faster to reach 6.28% growth in 1H 2019.

Amid global uncertainty triggering a slowdown in Indonesia's economic growth, we believe that Indonesia's macroeconomic condition will remain stable in 2H-2019 and 2020. The priority of GoI currently and in the near future should be on stability while maintaining the momentum of growth. Nevertheless, it will be challenging for the economy to improve investment growth beyond the high 2H18 base of 6.48%. It is also noteworthy that, if we want to maintain economic growth level above 5%, then boosting consumption is essential as it accounts for 56% of Indonesia's GDP pie. Meanwhile, there is a possibility of a slowdown in consumption next year due to fears of a recession, which will cause people to delay spending, especially on durable goods, and divert consumption to savings. As an effort to mitigate the crisis, GoI should undertake expenditure policies by injecting fiscal stimulus, which can create a higher multiplier effect on the consumption level. Notably, the outcome might be more significant if government spending could trickle down to the middle to low income class, as this category comprises a large share of private consumption. We see that private consumption will remain robust and continue to be the main driver of growth in 2020. Besides being triggered by projected stable-low inflation in the next year, consumption boost should be supported by government-driven consumption, such as social expenditure, and this is reflected in the 2020 budget.

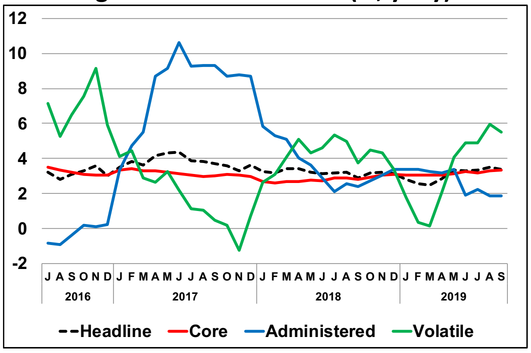
Inflation Outlook: Manageable for The Next Year

Acceleration in consumption growth was also fueled by better consumer optimism level, which was reflected in higher consumer tendency index in Q2 2019 (125.6) than the previous quarter (104.3). Nevertheless, it may not be apparent when we are looking at the monthly trend of core inflation. Sluggish domestic demand and consumption have driven down core inflation. As we can see in Figure 25, monthly core inflation dropped to 0.29% after picking up to its highest point this year at 0.43% (mtm). On an annual basis, both core and headline inflation in September 2019 were still manageable at 3.32% and 3.39% (yoy), conveniently within Bank Indonesia's inflation target.

We view that inflation remains under control in 2H 2019 but with a slight potential disruption from food price volatility due to harvest season, though there will be a lower probability of El-Nino during the wet season. On the flip side, if the government commits not to increase government-regulated assistance such as subsidized fuel prices and basic tariffs on electricity, it will also help to stabilize inflation. We see the possibility of a significant increase in administered price to be slight next year, due to the need to support purchasing power. Inflation is therefore estimated to remain at a manageable level for the rest of 2H 2019 and 2020.

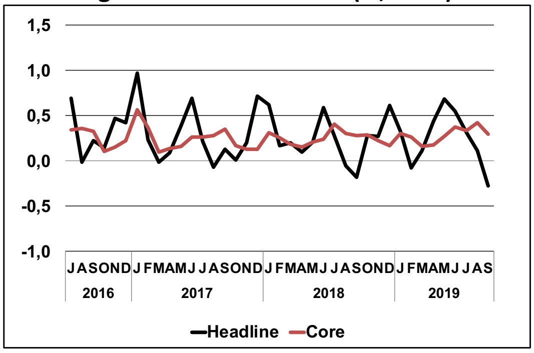
"We would like to see another improvement in a prudent fiscal management framework that controls both the fiscal deficit and debt ratio."

Figure 24: Inflation Rate (%, y.o.y)



Source: CEIC

Figure 25: Inflation Rate (%, mtm)



Source: CEIC

AGENDA IN MITIGATING THE RISKS UPCOMING GLOBAL SHOCKS

Considering the potential upcoming recession in the near future, BI still have a room to ease its policy rate before the "flight to safety" of portfolio takes place. Fiscal policymakers should also be preparing a similar short-term response. To prevent the recession from becoming too severe, countercyclical fiscal measures are needed to manage the potential decline in economic growth and aggregate demand. Nevertheless, fiscal stimulus also needs to be implemented in a prudent manner. Excessive stimulus would eventually lead to rising inflation above central banks' targets as well as unsustainable fiscal deficits and public debt accumulation.

"…. The concrete act of structural reform is of utmost importance in order to grow the manufacturing sector and boost our trade competitiveness."

We view that robust fiscal policy is critical as the primary policy instrument to counter future risks. Aside from expanding tax-base through reforms and reallocating budget to infrastructure, now it is also the time to start resolving the structural issues, such as unproductive subsidies. The gain from the reduction of unproductive subsidies could be used to add more social spending.

The government has to develop a more equal spending pattern. As a strategy to boost household demand, government expenditure should be directed to overcome inequality as to create extra multiplier effects on growth, such as by prioritizing on the social spending, e.g. education and health, and strengthening the quality of fiscal decentralization including village funds. However, the fiscal policy should be constantly managed carefully. Government bonds holders would like to see another improvement in a prudent fiscal management framework that controls both the fiscal deficit and debt ratio.

From the credit risks, the recovery of loan demand coupled with low-interest-rate level will support future credit growth. We see that banks could expand their loans more in the next year on the back of the government's policy support for financial markets such as credit for SMEs or KUR (Kredit Usaha Rakyat).

Moreover, given the weak performance of trade and investment, we still see the possibility of more pressure on the current account deficit, which requires the government to take several concrete actions. GoI should put attention on fixing the economic structure. Persistent efforts in supporting selected domestic industries, particularly import-substitution industries, will generate a better quality for future economic growth. Along with that, the government's effort to simplify investment regulations will create a more attractive investment climate; hence, positive investment growth in future.

In the domestic sectors, manufacturing sector as the highest contributor to GDP has long-term problems that have not been adequately addressed by the government, mainly in terms of business climate and business certainty perceived by investors. The fact that Indonesia is nowhere near any strategic position in global value chains is telling. One factor that plays a significant role in contributing to the low degree of Indonesia's investment attractiveness is relatively hostile policies and practices toward foreign investment and workers. The bill to improve the labor law in Indonesia is showing no significant progress yet. Also, several contradictory policies on the regional level may reduce the attractiveness of investment in manufacturing sector in Indonesia.

Even though the current administration has vowed to open more industries to foreign investments by removing negative lists, without concrete and measurable actions of structural reform, no improvement will be made on investment attractiveness. The concrete act of structural reform is of utmost importance in order to grow the manufacturing sector and boost our trade competitiveness.