LPEM FEB UI
UNIVERSITAS INDONESIA

MACROECONOMIC ANALYSIS SERIES

Indonesia Economic Outlook

Q1-2020

Key Figures

- GDP Growth (Q3 '19)
  5.0%
- Inflation (y.o.y. Dec '19)
  2.7%
- Credit Growth (y.o.y. Oct '19)
  6.5%
- BI Repo Rate (7-day, Dec '19)
  5.0%
- Current Account Deficit (CAD) (Q3 '19)
  -2,7%
- IDR/USD (Dec '19)
  IDR13,901

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2020 Fiscal Position: Another Rally for Fiscal Discipline

Highlights

- GDP growth rate of Q4-2019 estimated at 4.9%, bringing overall 2019 forecast at 5.0%. We see a potential for a better GDP growth rate at 5.0%-5.2% in 2020.
- 2020 budget needs a prudent fiscal policy, particularly in maintaining a healthy deficit.
- A very welcome news came from the manufacturing growth that has increased from 3.59% in Q2 to 4.15% in Q3-2019.
- Consumption growth eased to 5.01% in Q3-2019.
- Sluggish investment in Q3-2019 (overall 4.21%) happened in almost all sectors.
- The CAD improvement has not translated in economic growth as exports fail to pick up.
- B20 mandatory starts to bear fruits as it is projected to save USD1.7 billions cost of importing fuels, particularly diesel imports.
- External risks to remain relatively manageable in short-term; the precautions are still needed in medium-term.

The economy continues to grow more slowly from 5.07% (y.o.y) in Q2-2019 to 5.02% (y.o.y) in Q3-2019. It is likely to be followed by similar performance in Q4-2019. Despite the ongoing global economic slowdown, manufacturing sector rebounds in Q3-2019 (4.15%) after two consecutive slower growth in 1H-2019. It could be a promising sign of further acceleration in 2020. On the other hand, consumption has declined as a consequence of rather weak spending due to rising global uncertainty.

By starting the new fiscal year, the administration needs to further improve fiscal positions, mainly by maintaining a healthy budget deficit. Manageable fiscal figure has significant benefits in boosting Indonesian sovereign credit rating and in reducing the interest rate costs. With current stable and prudent fiscal policy settings, we believe IDR government bonds are in a good trajectory to get a one-notch upgrade in the sovereign credit rating in 2020. With relatively good fundamentals and GoI continuing priority on stability, Indonesia is well-positioned to weather most of the incoming global shocks.

Table 1: LPEM FEB UI GDP Growth Forecast

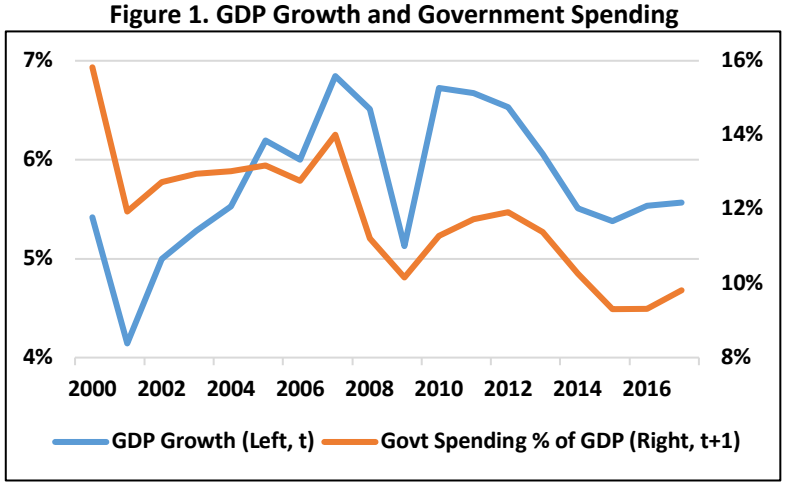
Q4-2019	FY 2019	FY 2020
4.9%	5.0%	5.0-5.2%

Trade deficit has amounted to USD-3.2 billion in December 2019, improving from USD-8.6 billion in the same period last year. However, the improvement of trade balance was not attributable to faster GDP growth as exports fail to pick up; deeper drop in imports (-10% y.o.y growth) has accompanied the slowdown in export (-7% y.o.y growth). Rising uncertainty in business activities hold back the demand for expansion, hence, lower imports of capital and raw material goods. We see that overall Q4-2019 trade balance most likely will follow this trend. On the other hand, our trade remains vulnerable to the commodity prices, particularly crude oil, as Indonesia's status as net importer of oil at least since 2013. Besides lessen the net exports, any jumps in oil prices will also put more stress on government budget, but it might be slightly manageable if we follow the mandatory obligations of B20 that projected can save the cost of importing fuels, particularly diesels. More cut in diesel imports are expected due to the expansion of B20 mandatory to B30 this year. From external sectors, prudent policy by the government as well as Bank Indonesia is highly needed to prepare for the case of negative external shocks in the medium-term.

Government Will Go the Extra Mile to Manage 2020 Fiscal Position

As the economy marches into the new year, the economic outlook of 2020 is not so bright. Global economic slowdown has put pressures on the governments and policymakers to take actions, no exceptions to Indonesia's. However, such needed response is a tricky matter. Standard macroeconomic textbook theory might suggest implementing countercyclical policy in order to support growth might not be as simple as not every country could afford to carry out a countercyclical policy. In emerging countries, procyclical fiscal impulse existence is rather frequent, including in Indonesia (Figure 1). As we can see in Figure 1, the general pattern is that movement of Indonesia's GDP growth in a specific year is followed by the movement of the share of central government spending to GDP in the following year with the same direction of movement. Hence, Figure 1 shows the procyclicality behavior of fiscal policy in Indonesia; when the economy performs well, the government increased its spending in the following year and vice versa. This procyclicality behavior might not be the product of choice since the fiscal policy in emerging countries, including Indonesia, due to the nature of the economy whose business cycle is highly relying on capital flows and commodity exports.

Figure 1. GDP Growth and Government Spending



Source: CEIC

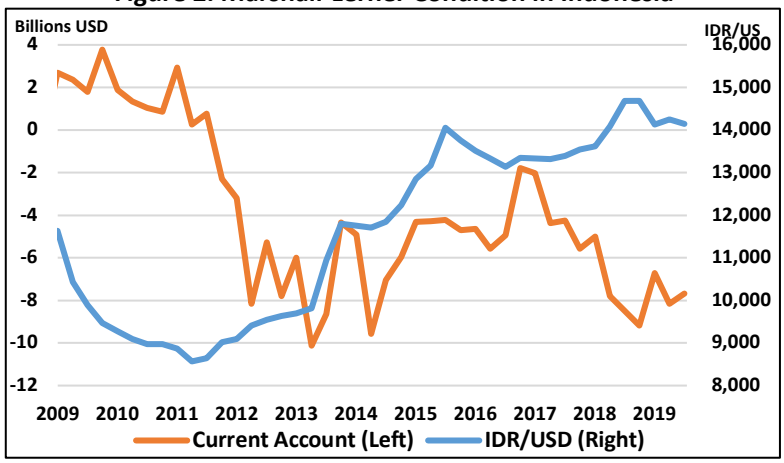
How effective fiscal stimulus can be?

The dispute regarding the effectiveness of fiscal stimulus is usually revolving around the composition of fiscal stimulus and the concern about fiscal space. In the case of Indonesia, the discussion about the composition of fiscal stimulus might not be relevant as the more important question is whether countercyclical fiscal impulse could be implemented in Indonesia. The answer to this question determined by several key factors such as the fiscal space, growth driver, risk perception, uncertainty, among others. Generally, fiscal policy in emerging economies tends to be procyclical because the driver of the business cycle in these countries are capital flows and commodity exports. Thus, in times of capital flows dry up and commodity prices plunge, financing an expansionary fiscal policy became increasingly difficult.

Furthermore, the idea of fiscal stimulus might not be ideal to be implemented for the economic slowdown in Indonesia is due to several reasons. Fiscal stimulus causes a worsening budget deficit and coupled with the continuing the deficit of current account in Indonesia which leads to a twin deficit and twin deficit, as shown by many examples throughout history, is the highway to a potential economic crisis. In addition, as the business cycle in Indonesia is driven mainly by capital flows and commodity exports, economic slowdown causes a depreciation of its currency. This depreciation might even worsen the current account deficit as "Marshall-Lerner condition" does not hold in Indonesia. As seen in Figure 2, the depreciation of IDR is associated with deeper current account deficit. The nature of export-import component of Indonesia might explain this phenomenon. As most of the import components of Indonesia are imported

inputs, relatively more expensive foreign currency would decrease the amount of import, which are the input components of Indonesia's exported goods. Hence, worsening import would almost surely be translated into declining exports.

Figure 2. Marshall-Lerner Condition in Indonesia

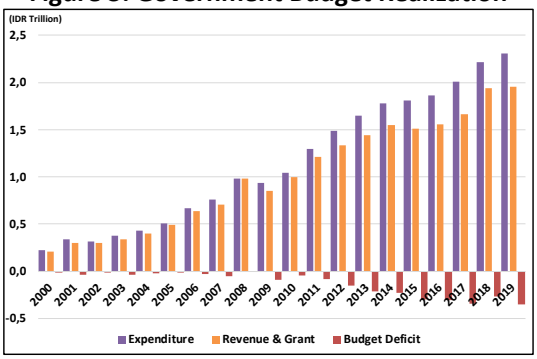


Source: CEIC

Fiscal policy dependence on financial market

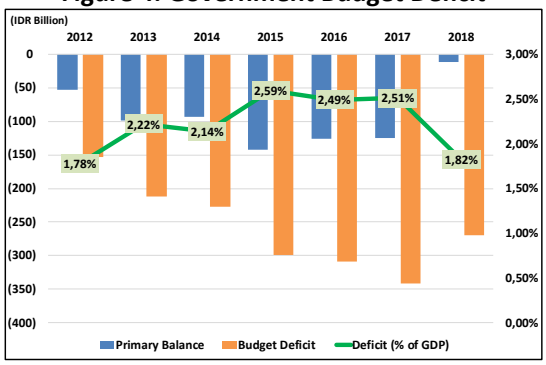
Another potential repercussion of fiscal stimulus in Indonesia is it might give an upward pressure to the interest rate and crowd out investment. The government spending has been expanding massively, particularly since 2015 under the first administration of President Joko Widodo, in order to finance infrastructure projects. Meanwhile, the revenue side of the budget is left far behind the spending side; thus creating a big fiscal gap in which spending increase is not fully supported by the increase of tax revenues. As a result, the fiscal deficit rises significantly (Figure 3). In 2019, Indonesia recorded a budget deficit of IDR-353 trillion or -2.2% of GDP as the government revenue has taken a hit as economic growth weakened, exports slumped, and oil and gas production missed targets.

Figure 3: Government Budget Realization



Source: APBN Realization, Ministry of Finance

Figure 4: Government Budget Deficit



Source: APBN Realization, Ministry of Finance

Theoretically, crowding-out happens when government spending expansion pushing for higher interest rate in the market, due to higher demand for money given a relatively fixed supply of money[1]. When the government plan to implement fiscal stimulus by increasing capital spending, the government usually try to finance the spending by issuing government bonds. The issuance of government bonds would drive interest rate up; thus would cause a contraction to the economy which is the exact opposite of what fiscal

[1] Monadjemi, M.S. (1993), Fiscal policy and private investment expenditure: a study of Australia and the United States, Applied Economics, 25, 143-148

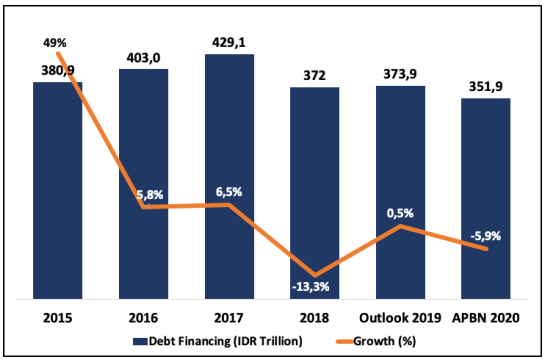
stimulus is intended to achieve. In this kind of environment, the liquidity goes to government sector from the private sector, meaning that the private sector will suffer from less investment because the money goes to the public sector. At the same time, the government bond yield may be higher because more demand for money coming from the government sector, generating a higher interest rate.

As a commodity-dependent country, Indonesia has enough FX reserves which could act as a cushion during the heightened risk and uncertainty that may affect commodity prices and IDR stability. The current position of reserves, stood at USD129 billion[2], remains adequate to finance 7.6 months of imports or 7.3 months of imports and servicing government's external debt, which is well above the international adequacy standard of three months imports. Foreign exchange reserves availability provides room for accommodating monetary policy, easing domestic financing constraints, reducing the risk perception, and countering fire sales during a potential flight-to-safety event. Furthermore, reserves adequacy would improve credit rating, dampening the risk premium on external financing. Nevertheless, albeit adequate reserves condition in Indonesia, implementing fiscal stimulus during the slowdown will put another risk to the economy since it erodes the availability of the reserves. As a consequence, this may, in turn, will worsen the current account deficit as "Marshall-Lerner condition" does not hold in Indonesia as mentioned earlier. Without enough reserves, it will trigger speculative attacks in the currency. Moreover, the availability of sufficient reserves does not alter the neutral effect of fiscal stimulus on growth in the long-run.

Balancing between stability and growth; more fiscal prudent needed

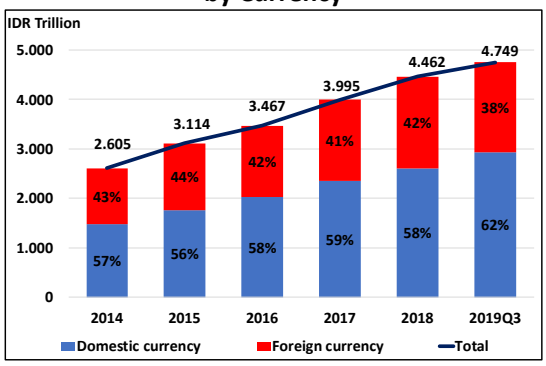
Overall Indonesia's fiscal stance remains prudent thanks to the Government Regulation No.23/2003, which caps the fiscal deficit at -3% of GDP and debt at 60% of GDP, and for GoI that has been operating at the highest discipline. The debt ratio relative to GDP is fairly low and stable at 29,8% in Q2-2019 with debt financing shows a decreasing trend. In the current lackluster growth, the challenge is the need to preserve stability even though the growth has been unable to chase its potential. Therefore, maintaining debt financing that is supported by good governance and risk management systems is urgently needed. GoI has slowly shifted the debt (including loans and government securities) which becomes the primary financing instruments for the budget deficit to IDR denominated debt from foreign currency denominated to control the Rupiah stability. As seen in Figure 6, from IDR4,749 trillion, 62% debt in IDR while foreign currency-denominated debt has trended downwards and now reaching only 38%.

Figure 5: Debt Financing (IDR Trillion)



Source: MoF, APBN 2020

Figure 6: Composition of Goverment Debt by Currency



Source: CEIC

[2] Bank Indonesia

2020 could become the year full of uncertainty with additional unfavorable external risks that give persistent pressure on domestic growth prospect. Fiscal policy should then be implemented in a prudent manner with revenue optimization and increasing quality of expenditure.

To optimize the budget revenue, tax receipts are clearly a big factor; it directly affects the size of a government's budget surplus. Despite a very welcome news came from the government's high efforts in giving several incentives (e.g. tax allowance, tax holiday, super deduction) for the taxpayers in 2019, the overall tax revenue has not lifted yet. By end of December, cumulative tax receipts only increased by around 1.7% (y.o.y) to IDR1,545 trillion (87% of 2019 budget target), which represents a phasedown in tax realization compared to last year realization. In 2018, the overall tax revenue escalated by 13% (y.o.y) to around IDR1,519 trillion or stand for 94% of 2019 budget target. In line with the tax receipts, fiscal deficit is much lower in previous year at -1.8% of GDP compared to the outlook deficit for 2019 of -2.3%.

Even though the details of tax realization have not published yet, tax receipts figure in 2019 is likely to follow the slowdown in GDP. After enjoying huge jump in GDP performance starting from 2016, which in turn significantly increase the tax ratio to 10.7% and 11.4% for 2017 and 2018, Indonesia GDP growth is recently slackening. With the forecasted economic growth at 5% for overall 2019, the outlook of the tax ratio is now expected to be lower than 11%. If this trend continues, we see a potential shortfall of tax receipts in 2020. However, to meet the tax receipts target of IDR1,643 trillion next year, we have to expand tax revenue by 6.3% (y.o.y). The number might look too impractical, but it is achievable as long as the government can pull out the last year sluggish business activities into a more productive economy in 2020.

Omnibus Law Could Support the Tax Reforms

For his second term, Jokowi has introduced a number of policy innovations starting from internal system matters to the strategy of the country's external relations. One of the substantial progress is their efforts in attracting more investment by implementing omnibus law. The government has realized that there are numbers of overlapping regulations and authorities, which in turn interrupt the economy to run effectively. To attract investments, omnibus law implementation is aimed to reduce the complexity in investment licensing, labour, as well as tax regulations.

The Minister of Finance has announced that the administration would include some relaxation treatments on tax collection system as a part of the initiative on improving the investment climate. The planned tax reforms would ease the corporate income tax both for Indonesian and foreign expatriates, eliminate dividend tax, lessen individual income tax, lower tax penalties, and prepare new digital economy tax regulations. The business will bear a lower rate of corporate income tax at 20% by 2023 from the current 25% tax rate. Specific remedy of 3% additional reduction on corporate income tax would also be given to the new go-public company.

Besides easing the tax rate, the government would axe some articles on tax regulations, such as the exclusion of dividend tax to the entities with less than 25% shares in a company. The overseas dividends will also be removed from the law. The other noteworthy headway is the relaxation of individual income tax particularly the plan to change the tax regime into a territorial system. This would mean that foreigners will be taxed only on the income they earn in the country, while Indonesians working abroad will be exempt from paying income tax in Indonesia. To create a fairer tax collection mechanism, the 2% tax penalty rate per month for the late payment would also be converted into the market interest rate. Despite the incentives of lower tax rates, these long list of tax relaxations is expected to generate higher investment, which in turn will broaden Indonesia's tax revenue in the future. However, this scenario will only be achieved if we see larger business activities as the impact of a wider investment.

On the other hand, the government would also develop a new regulation for taxing multinational digital firms that have no physical presence in Indonesia yet benefit financially from their activity in the country's enormous market. Collecting tax from digital companies in Indonesia is likely to be an additional major source of the potential tax revenue as the size of Indonesia's economy has amounted to USD40 billions in 2019 (Temasek, 2019). Even though the planned tax reforms are still being reviewed, we see some promising signs about the direction of investment climate in Indonesia, thus, the tax revenue.

Given the fiscal policymaker's stance in maintaining the macroeconomic stability through a prudent fiscal setting, we see this as a relatively good initiative within the ongoing trajectory of a better sovereign credit rating in the near future. Indonesian economy should be still in a relatively good position to weather the global shocks in 2020.

Keep Pushing for Structural Shifts

2019 was not a pleasant year for the economy as the data has shown general slowdown across the globe. World trade volume contraction, rising trade barriers, and elevated uncertainty are several critical drivers of the 2019 grim economic overview, and this certainly have implications to Indonesia. Following a uniform global pattern of subdued output, Indonesia's GDP growth realized at 5.02% in Q3-2019, continuing the trend of decreasing growth since the last quarter of 2018. Several major sectors in the economy such as manufacturing, wholesale and retail trade, repairs, agriculture, and mining & quarrying, which together contributes almost 50% of the economic activity, recorded a declining growth in Q3-2019. However, several potential sectors like construction, ICT, and financial & insurance activity experienced higher growth in Q3-2019 compared to the previous quarter. The distribution of sectoral growth might serve as an early indication for GoI to put more focus on those potential sectors as Indonesia needs to lessen its dependency towards the sectors which heavily impacted by external pressures, not to mention that those sectors also produce lower value-added and have a limited room for growth improvement.

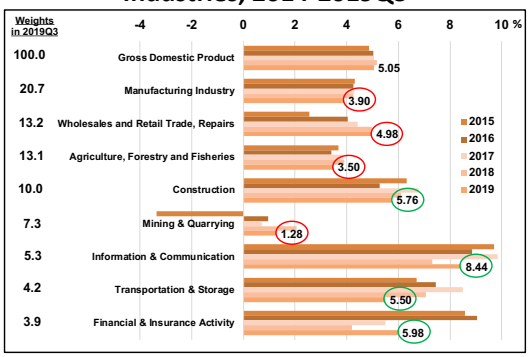
"2019 was not a pleasant year for the economy…."

Manufacturing industry as the biggest sector to contribute to GDP recorded a relatively significant growth increase from 3.59% in Q2 to 4.15% in Q3-2019. Despite the ongoing global economic slowdown, a somewhat favourable performance of the manufacturing sector as it rebounds in Q3-2019 after two consecutive slower growth in the first half of the year. Nonetheless, when we see its average annual trend in 2019, it declined considerably to 3.90% from 4.22% in 2018, confirming a global trend of the sluggish period for the economy. On the other hand, food and beverage subsector continued to be the most significant patron while still recording a substantial quarterly growth of 8.33% (y.o.y) in Q3-2019 - the highest growth rate in the last five quarters - making an overall growth of 7.72% (y.o.y) in 2019. Furthermore, textile & wearing apparel subsector continued a trend of the double-digit quarterly growth for its five-consecutive quarter, with the increase of 15.08% (y.o.y) in Q3-2019, even though we predict a declining growth pattern as the general election period has ended.

Meanwhile, coal, oil & gas refinery, and transport equipment subsectors overall grew negatively, from -0.42% in 2018 to -1.44% in 2019 for coal, oil & gas refinery, and from 4.76% in 2018 to -4.00% in 2019 for transport equipment. While transport equipment always recorded negative growth in each quarter of 2019, the growth of -1.23% (y.o.y) in Q3-2019 is better compared to -7.09% (y.o.y) in Q1 and -3.73% (y.o.y) in Q2 of 2019. We expect this subsector to maintain its

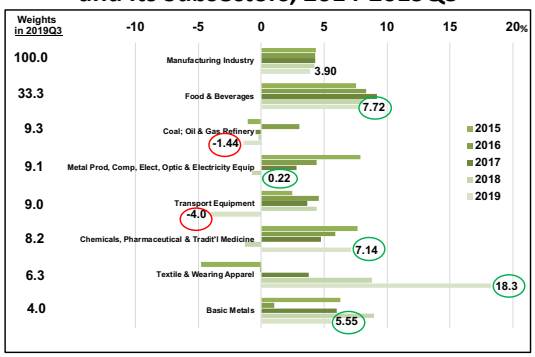
progress in the last quarter of 2019. Similar to another commodity-based subsector, while still enjoying a positive growth, the overall growth of basic metal subsector declined from 8.98% in 2018 to 5.55% in 2019 due to sluggish global demand during 2019. However, in Q3-2019, basic metal subsector recorded a higher growth of 4.62% (y.o.y) compared to the preceding quarter. Similar with its basic subsector, metal products, electronic, optic & electricity equipment subsector also enjoyed a rapid growth of 2.21% (y.o.y) in Q3-2019, compared to a growth decline of -2.52% (y.o.y) in Q2-2019. A different growth condition showed by chemical, pharmaceutical & traditional medicine subsector which recorded a weaker growth of 4.76% (y.o.y) in Q3 from 5.05% (y.o.y) in Q2-2019. Yet, that subsector performed excellent in overall than the previous year, with growth reported of 9.46% in 2019 from only 1.64% in 2018.

Figure 1: Growth of GDP and the Main Industries, 2014-2019Q3



Source: CEIC

Figure 2: Growth of Manufacturing Sector and Its Subsectors, 2014-2019Q3



Source: CEIC

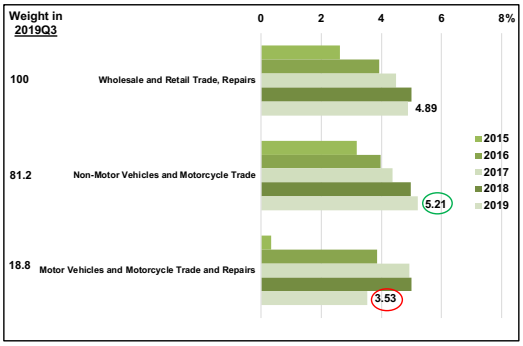
"The real challenge is, however, not to do some popular expansionary policy to compensate temporary deceleration in the economy but to implement a strategy in which could generate structural and sustainable growth."

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 4.75% (y.o.y) in Q3-2019, higher than of 4.62% (y.o.y) in the previous quarter, thanks to motor vehicles sales and repairs. However, the two components of wholesale and retail trade & repairs sector have an instead mirroring performance, both for Q3-2019 and overall. While accumulatively motor vehicles & repairs subsector performed considerably worse, only recorded a growth of 3.53% in 2019 compared to 5.00% in 2018, its growth increased to 4.11% in Q3-2019 from 3.20% in Q2-2019. On the other hand, non-motor vehicles subsector performed better overall, with the growth level of 5.21% in 2019, compared to 4.99% in 2018. However, it grew slightly slower in Q3-2019, from 4.95% (y.o.y) in the previous quarter to 4.90% (y.o.y), despite still being relatively high and having an upward trend for the past five years.

The transportation and storage sector continued the increasing growth trend for the second consecutive quarter. The sector grew substantially of 6.63% (y.o.y) in Q3-2019, from 5.78% in Q2-2019. This hefty level of increased growth, however, is not derived from the excellent performance of the sector; hence does not perceive a growing of quality. Instead, this level of growth came from the materialization of the normalized airline ticket price, which skyrocketed in the early of 2019. Furthermore, while it is a good thing that the rebound is taking place, the transportation and storage sector has not reached its normal quarter growth level before the airfare hike of above 7%. We predict even when the effect of an airfare hike already wears off, the transportation and storage sector could still grow higher than 8% and might reach a double-digit level. The ample room for sectoral growth of transportation and storage is mainly attributed

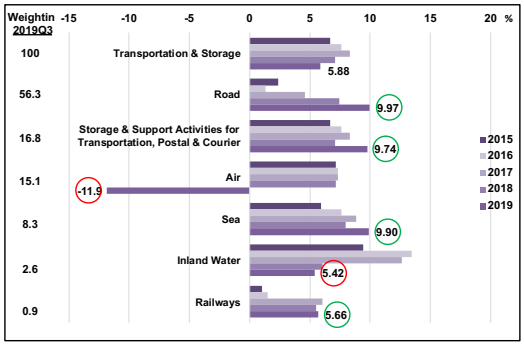
by a vast extension of "industry 4.0"-led industry (e-commerce and ride-hailing) and government infrastructure projects, both in central and regional level.

Figure 3: Growth of Wholesale and Retail Trade and Its Subsectors, 2014-2019Q3



Source: CEIC

Figure 4: Growth of Transport and Its Major Subsectors, 2014-2019Q3



Source: CEIC

While in third-quarter manufacturing sector recorded the first sector's growth increase in 2019 and several potential industries (construction, ICT, and financial services) is gaining a growth momentum, GoI still needs to increase its focus and take more concrete and strategic actions through policy reform to strengthen Indonesia's competitiveness in the global market as now the country's competitiveness is considered relatively weak, even compared to its peers. Nevertheless, the potential of economic contraction in 2020 shall also not to be taken lightly by the GoI. The real challenge is, however, not to do some popular expansionary policy to compensate temporary deceleration in the economy but to implement a strategy in which could generate structural and sustainable growth. In order to achieve this, GoI needs to focus on the investment component in GDP as the investment is a good indicator of how the market and the global economy perceive Indonesia's economic performance. Creating a friendly investment climate is essential to push the economy forward, both qualitatively and quantitively, as the inherent benefit of increased investment would be a key driver of sustainable growth for the society. Higher direct investment to Indonesia means attracting durable engine of growth through knowledge and technology transfer to locals which will be translated into a better positioning for Indonesia in the global value chain and might level up Indonesia in the global competition.

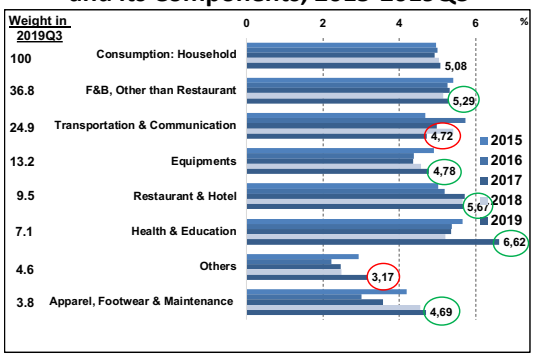
"In 2020, we expect consumption to rise in case inflation can be controlled. Otherwise, consumer confidence continues to ease along with increasing commodity prices as escalating global tensions pose additional downside risk and uncertainty."

Consumption Has Been Losing Its Heat

After posting its highest growth in the whole year at 5.22% (y.o.y) in the previous quarter, the growth rate of consumption eased to 5.01% in Q3-2019, making the overall growth of consumption in 2019 to 5.08% (y.o.y). The weakness in domestic demand is fully reflected by the dropped in almost all subsectors in consumption, except consumption in health and education which climbed up from 6.76% in Q2-2019 to 7.34%, making the overall growth in 2019 to 6.62%; being the highest growth during the past five years. The slowing down of private consumption is reasonable following the seasonal pattern after significant spending for the Moslem festive season and general election. In 2020, we expect consumption to rise in case inflation can be controlled. Otherwise, consumer confidence continues to ease along with increasing commodity prices as escalating global tensions pose additional downside risk and uncertainty.

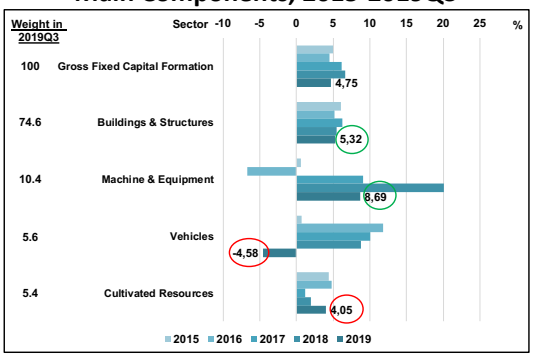
Investment slowed to 4.21% in Q3-2019 from 5.01% (y.o.y) in Q2 (Figure 6), which was the lowest figure since Q2 2016. Similar to the consumption trend, sluggish investment was captured by the dropped in most of subsectors except cultivated resources. Going forward, lower commodity prices and both external and domestic uncertainty partly contributed to weakening public investment. Growth of buildings & structures that dominates investment pie at about 75% slowed to 5.03% in Q3-2019 from 5.46% in the previous quarter, making the overall growth in 2019 to 5.32%. Likewise, growth of machine & equipment and vehicles are remaining subdued. In Q1-2020 we forecast only a modest improvement in investment from this year, partly because the 2020 budget envisages a smaller fiscal deficit and hence negative fiscal impulses on growth. Amid new unfavorable external conditions, the government should immediately find ways to cushion the impact of the US-Iran conflict, especially in maintaining investors' appetite by boosting global competitiveness to reap the opportunities.

Figure 5: Growth of Household Consumption and its Components, 2015-2019Q3



Source: CEIC

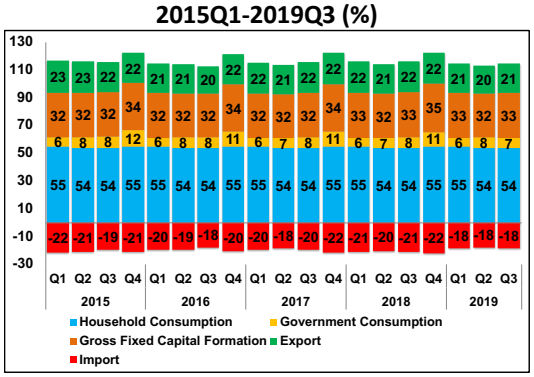
Figure 6: Growth rate of Investment and its Main Components, 2015-2019Q3



Source: CEIC

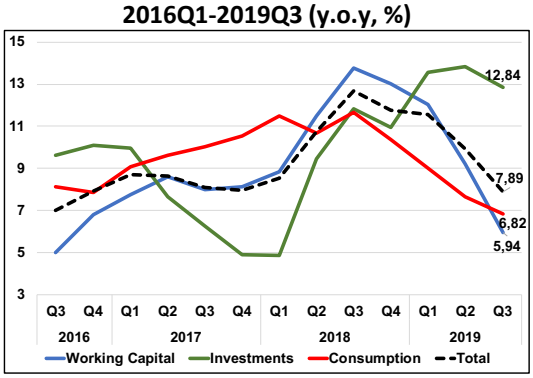
Looking closer to the credit growth (Figure 8), total credit growth continued its downtrend to 7.89% in Q3-2019, from 9.92% (y.o.y) from Q2-2019. The overall component of credit recorded a declining trend, with the deepest fall happened in the working capital credit, declined to 5.94% from 9.22% (y.o.y). Loan on consumption also recorded its lowest point since 2016, stood at 6.82% (y.o.y). Moreover, investment credit declined to 12.84% (y.o.y) in Q3-2019 from 13.85% (y.o.y) in the previous quarter due to the economic slowdown and political uncertainty of election result, making investors are more willing to run into wait-and-see mode. Amid the lackluster growth, the four consecutive rates cut by Bank Indonesia since July 2019 should stimulate liquidity and might help to recover credit growth in 2020; nevertheless, we see banks will remain cautious and demand for credit still subdued.

Figure 7: Shares of GDP Components, 2015Q1-2019Q3 (%)



Source: CEIC

Figure 8: Credit Growth by Purposes, 2016Q1-2019Q3 (y.o.y, %)

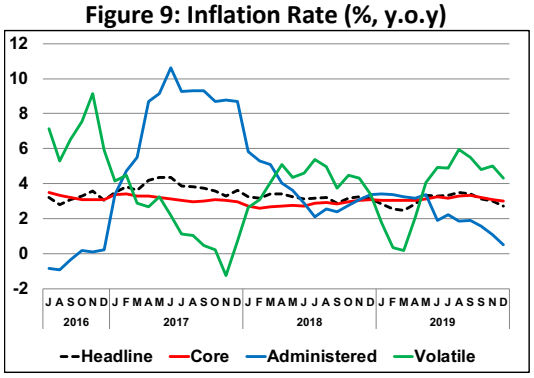


Source: CEIC

Headline inflation in Q3-2019 slightly upward from the average inflation in Q2-2019 (3.14%, y.o.y), but stable within BI's target corridor of 3.5%±1%, with the average of 3.40% (y.o.y). Meanwhile, 2019 inflation in December has been relatively low almost reaching the lower limit of BI threshold, stood at 2,72% (y.o.y), making the overall inflation in Q4-2019 to 2.95% (y.o.y). High raw food prices translate to the increasing trend of volatile food inflation in Q3-2019 to an average of 5.45% (y.o.y) from 3.68% (y.o.y) in Q2-2019 partly due to the adverse effects of the unusually longer El Nino drought season. On the other hand, administered price inflation declined from an average of 2.8% (y.o.y) to 2% (y.o.y) since the government intervention to lower the airfare during the off-peak season. Benign administered price inflation has also been tamed by deflation in energy prices at -0.12% (y.o.y).

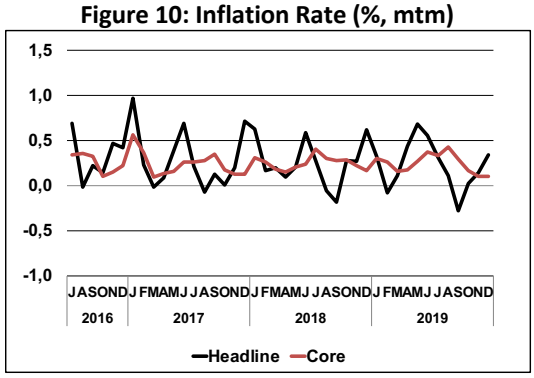
Not only headline but also core inflation is partly affected by food prices' dynamics pinned by the rose of an average core inflation during Q3-2019 to 3.27% (y.o.y) from 3.14% (y.o.y). However, sluggish domestic demand and consumption, have driven down core inflation in Q4-2019 to 3.10% (y.o.y).

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



Source: CEIC

Figure 10: Inflation Rate (%, mtm)



Source: CEIC

"..we expect Bank Indonesia to step up its intervention this year in order to stabilize inflation within its new target corridor of 3.00%±1% from any potential unexpected hike of administered prices.."

All in all, we forecast inflation still manageable for the beginning of this year, remain inside the target margins, backed by BI's prudent monetary policy. However, there are several potential headwinds that might have considerable impact to inflation, especially in 2020. The recent conflict between US-Iran which cause climbing oil price would be one of the potential risks to inflation. The domino effect of rising oil prices might affect domestic fuel prices which will ultimately have an impact on logistics and transportation costs, not to mentioned, prices of basic commodities also be likely to hike. Going forward, the significant hike of tobacco excise, the 50-116% adjustment on the national healthcare (BPJS) insurance premia, and the government policy to reform electricity subsidies from non-poor 900VA households are expected to affect consumer price inflation to inch up in Q1-2020. Therefore, we expect Bank Indonesia to step up its intervention this year in order to stabilize inflation within its new target corridor of 3.00%±1% from any potential unexpected hike of administered prices.

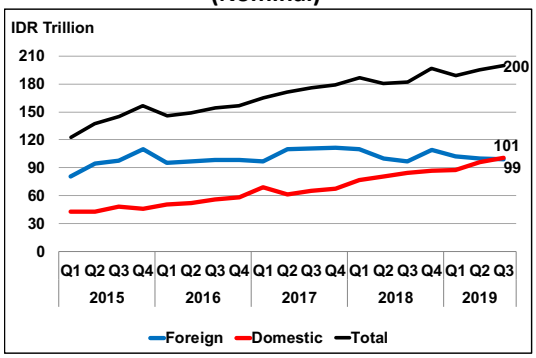
Investment Starts to Catch Up

Overall investment as measured by gross fixed capital formation continue to fall into 4.2% (y.o.y) in Q3, bringing the estimated 2019 real investment growth to 4.8%. This posture is much lower compared to 6.7% investment growth in 2018. The drop might be contributed by the sluggish trend of business activities as well as the extension break in infrastructure projects. As we know

that 74% of the gross fixed capital formation are for buildings and structures and its growth has slowed down to 5.03% in Q3 from 5.46% in Q2.

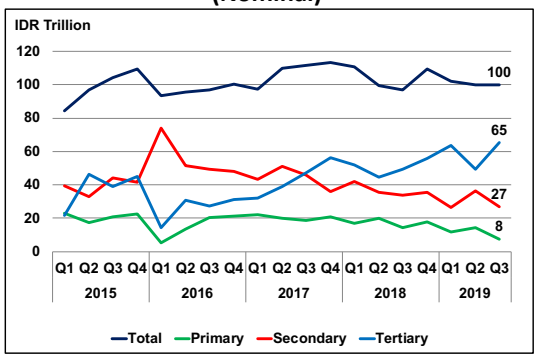
On the other hand, the direct investment data by Indonesian Investment Coordinating Board (BKPM), that represents 22% of gross fixed capital formation, shows that investment by both foreign and local enterprises slightly increase in Q3. The FDI and DDI realization grew at 1.9% and 18.8% (y.o.y) respectively in nominal Rupiah term, bringing total direct investment growth to 9.8% (y.o.y). Despite the high growth of domestic direct investment, the revival of positive growth in foreign direct investment has accelerated total direct investment into IDR200 trillion for Q3-2019; it signs a promising trend in the future.

Figure 11: FDI Realization (Nominal)



Source: CEIC

Figure 12: Foreign and Domestic Investment (Nominal)



Source: CEIC

"As one of the crucial drivers of economic growth, the trend in investment is likely to be translated into the sectoral growth."

Looking further, the improvement in direct investment figure was mostly contributed by the investment in tertiary (service) sector, while the primary and secondary sectors experienced a slight slowdown. Besides construction, the services activity running in transportation, warehouse, and communication sectors have also attracted investors the most in Q3-2019. From the foreign direct investment realization, the total amount of investment on this sector has multiplied twice larger than its amount in the previous quarter. It can be explained by the entrance of foreign investors, such as Japan's large telecommunication company, SoftBank, that has invested in Indonesia's ride-hailing startup company on July 2019. As one of the crucial drivers of economic growth, the trend in investment is likely to be translated into the sectoral growth. Just to give a perspective as the impact of higher investment to economic activity, the prompter growth of logistics and communication related investment that has reached into 76% (y.o.y) was in line with the real growth of transportation and storage and ICT sectors at 6.6% and 9.2% (y.o.y) respectively in Q3-2019.

Even though the growth of investment indicator in GDP, gross fixed capital formation, is still declining, we see that the investment will be slightly better in Q4-2019 as the promising signs from direct investment data by BKPM. Moreover, we might also see additional significant investments in 2020 if all of the government's efforts in maintaining investment climate, particularly omnibus law, can be accomplished in the near future.

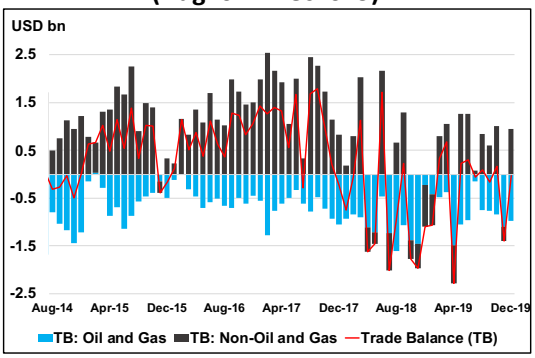
Economy Needs Higher Exports to Spur Growth

Current account deficit figure slightly worsened from -2.6% in Q2 to -2.7% of GDP or equivalent with USD-7.7 billion in Q3-2019. However, the number is much lower than the last year deficit that has amounted to USD-8.5 billion. The upturn in current account deficit has significantly contributed by the shift in trade balance over the last one year. Amidst the persistent oil and gas trade deficit, the eight times trade surpluses in non-oil and gas balance have generated several monthly trade surpluses throughout 2019. Total trade deficit is only accounted for USD-3.2 billion in December 2019, improving from the USD-8.6 billion in the same period last year.

Even though the trade balance showing a significant improvement, it has not translated into the economic growth yet as the economy is estimated to grow only at around 5% (y.o.y) in 2019. The distortion might be coming because the recent improvement in trade balance was not attributable with higher export, but the deeper drop in import than its slowdown in export. Total export in 2019 has declined by -7% (y.o.y). Meanwhile, the import has plunged to -10% (y.o.y). The international trade disruption has caused the trend of slowing down in export-oriented business expansion, which in turns hold back the demand for capital and input materials goods that mostly came from abroad.

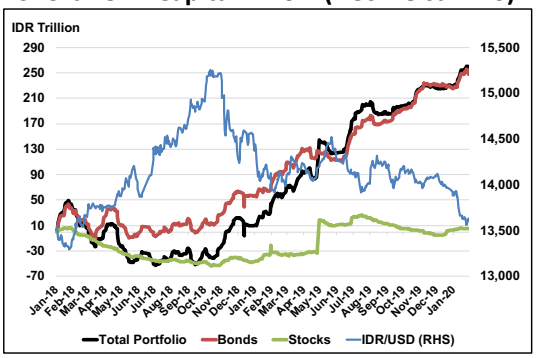
"Even though the trade balance showing a significant improvement, it has not translated into the economic growth yet as the economy estimated will grow only at around 5% (y.o.y) in 2019"

Figure 13: Monthly Trade Balance (Nominal) (Aug2014-Dec2019)



Source: CEIC

Figure 14: Exchange Rate and Accumulated Short-Term Capital Inflow (Dec '18-Jan '20)

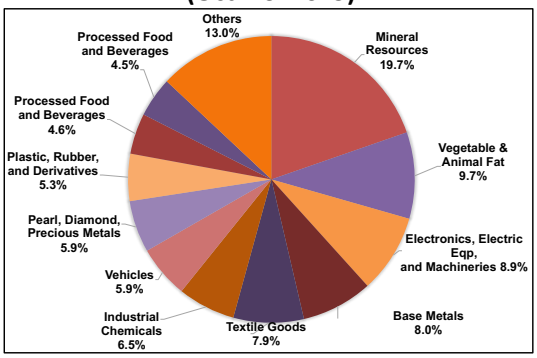


Source: CEIC

Indonesia's export profile is currently not varied enough to find new growth centers for exports to increase trade balance. Our exports are still dominated by raw materials, particularly mineral resources, vegetable fat, and precious metals whose value amounted to 37% of total export (Figure 15). Meanwhile, most of Indonesia's imports are for capital goods and input materials for production, such as electronics and machinery sector (27.6%). However, we can see from figure 16 that imports are also dominated by mineral resources (15.2%), particularly oil. The high reliance of commodity goods, both in exports and imports, gives the high risk to our trade posture as they have a high volatility prices compared to the manufacturing goods. Moreover, any increases in commodity prices might be serves as double-edged sword, where the higher commodity prices may boost CPO, coal, and gas export, but rise in commodity prices will also lead to increase in imports of oil, given Indonesia's status as net oil importing nation at least since 2013. If there are no changes in the exports and imports structure, our trade would remain vulnerable to the swing in global prices. Given the heavy number of commodity-based trade, the government needs to step up and start the structural reforms; unlikely to be achieved shortly. Therefore, the government needs to strictly maintain the export and import flows, particularly

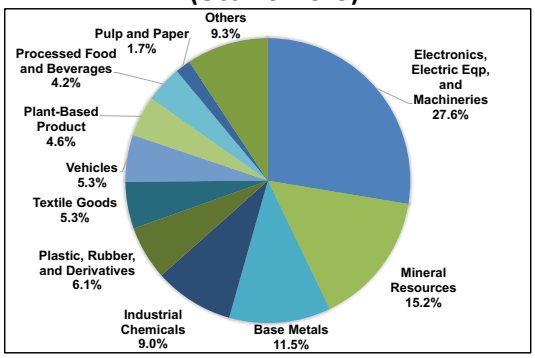
the toughness of the market. It will be achieved somehow by the larger and closer bilateral relations with our current and new potential trade partners.

Figure 15: Indonesia Export Profile (Oct-Nov2019)



Source: CEIC

Figure 16: Indonesia Import Profile (Oct-Nov2019)



Source: CEIC

For Q4 and overall 2019, we still see that CAD remains between -2.5 to -3.0%. It might be slightly better than the last year position due to the lower trade deficit throughout 2019; deeper drop in import than its slowdown in export. However, we see export to slightly improve in 2020 largely due to the commitment of the new administration to maintain the trade flows and boost the investment. The imports are also predicted to be manageable even if there is a hike in oil prices like the recent higher oil prices due to the geo-political tensions between US and Iran.

"With the recent expansion of the B20 rules into B30, Indonesia is projected to expand its biodiesel production and continue to slash the diesel imports"

We believe that the biodiesel mandate starts to bear fruit as the latest data shows the declining trend of oil imports by -27% (y.o.y) in 2019. The obligation to utilize biodiesel into B20 phase since September 2018 has projected to reduce the cost of importing fuels, particularly diesels at around USD1.7 billions. This reduction is equivalent with 3.5 million kilolitres cuts in diesel imports, meanwhile, the production of palm oil mix, Fatty Acid Methyl Esters (FAME), has amounted to 6.2 million kilolitres from 2014 until the end of 2018. With the recent expansion of the B20 rules into B30, Indonesia is projected to expand its biodiesel production and continue to slash the diesel imports. Likewise, this effort will also potentially help the fiscal budget in minimizing oil subsidy in the future.

As the risk of global economic slowdown is getting undeniable, captured by the lower projected global growth for 2020, we see that the government still have enough means to support the economy for now as the manageable amount of current account and fiscal deficit. Bank Indonesia has also maintained its pre-emptive move to push economic growth momentum by cutting the policy rates fourth times in 2019. In cases of sudden capital shocks, BI has collected sufficient amount of foreign reserves to reduce the exchange rate volatility. However, Rupiah is kept stable and even appreciated at 3.3% (ytd) against the dollar in December 2019, it also briefly touching IDR13.800 recently. The temporary break in US-China trade war will also prompt another capital inflow into emerging economies at least until the Q1-2020, thus, support the monetary authority to collect more reserves in the near future.