Indonesia Economic Outlook
Q3-2020

Key Figures

- GDP Growth (Q1 '20)
  2.97%
- Inflation (y.o.y. Jun '20)
  1.96%
- Credit Growth (y.o.y. Apr '20)
  5.7%
- BI Reverse Repo Rate (7-day, Jul '20)
  4.0%
- Current Account Deficit (CAD) (Q1 '20)
  -1.4%
- IDR/USD (Jul '20)
  IDR14,473

Macroeconomic & Financial Sector Policy Research

Jahen F. Rezki, Ph.D.
jahen@lpem-feui.org

Syahda Sabrina
syahda.sabrina@lpem-feui.org

Nauli A. Desdiani
nauli.desdiani@lpem-feui.org

Teuku Riefky
teuku.riefky@lpem-feui.org

Amalia Cesarina
amalia.cesarina@lpem-feui.org

Meila Husna
meila.husna@lpem-feui.org

Sailing Through the Perfect Storm

Highlights

- As the peak of the pandemic is still uncertain and the end seems nowhere in the near future, GDP growth in Q2-2020 is expected to reach -4.2% to -5.3%; around 0.0% to -1.5% for overall 2020.
- The burden-sharing between BI and MoF in financing the Covid-19 responses will give no significant harm to economic stability as long as they still maintain their credibility, and thus increasing investor confidence in the market.
- Maintaining credibility of BI and MoF will crucially depend on the implementation of the burden-sharing mechanism and the clarity of future "exit strategy" from the mechanism.
- The Covid-19 pandemic has brought nearly all economic sectors to experience contraction in Q1-2020; same or even worse pattern predicted to appear in the Q2-2020.
- Sluggish domestic demand and an increase in precautionary saving are expected to shrink household consumption in 2020.
- Lower credit growth in Q2 and Q3-2020 is expected since banks still cautious and demand for credit still subdued.
- Significant disruption in global trade and investment flows is undeniable since the production and consumption are scaled back all over the world.
- The trade surplus does not represent a better economic growth as exports fail to pick up and low import signals low industrial activity.

It has been five months since the first announcement of Covid-19's confirmed case in Indonesia on the early March. The massive widespread of the virus has brought a catastrophic impact, not only on human health but also on economic consequences. The set of measurements, such as global travel restrictions and social distancing, affect nearly all economic sectors. Unsurprisingly, the disruption was reflected by the lower-than-expected economic growth in Q1-2020 at 2.97% compared to the traditional consensus of 3.5-4%. The main contributors to the GDP, such as manufacturing, wholesale and retail trade, construction, and mining and quarrying sectors, which accumulatively accounted for more than half of the GDP, experienced a contraction in Q1-2020. At the same time, household consumption slumped to 2.84%, far below 5.01% growth recorded in the same period last year. The disruption in domestic demand is reflected by the drop in almost all subsectors in consumption.

Table 1: LPEM FEB UI GDP Growth Forecast

Q2-2020	FY 2020
-4.2% to -5.3%	0.0% to -1.5%

On the other hand, the trend of sluggish demand and consumption has brought inflation into fifth consecutive drops since February. We see that the trend of low inflation might persist, at least, until the consumer's confidence increased. For the external factors, the significant disruption in global trade and investment is undeniable since the production and consumption are cut down all over the world. Indonesia's overall investment continues to fall to its lowest growth since 2006. Moreover, the muted demand has created a trade surplus, which narrowed the current account deficit to US$2.9 billion or equal to 1.4% of GDP in Q1-2020. However, we have to keep in mind that the improvement does not represent a better economic condition as the surplus was a result of decreasing imports, rather than improving exports. The similar trend was recorded at Apr-Jun 2020 trade balance data; we see that lower CAD will remain between 1.2-1.5% of GDP in Q2-2020. Since the pandemic peak and settlement is still uncertain, GDP in

Q2-2020 is expected to contract significantly. The economic growth is estimated to reach as low as -4.2% to -5.3%; making the growth for FY2020 at around 0.0% to -1.5%.

Extraordinary Times Call for Extraordinary Measures

The Covid-19 has put many countries into a vulnerable position, including Indonesia. Since the first case announcement in early March, the Government of Indonesia (GoI) has put many efforts to combat the virus. To prevent its transmission, several policies to limit mobilization and activities have been carried out, including the implementation of large-scale social restrictions (PSBB). Ultimately, the goal of fiscal expansion employed by the GoI is to preserve the health of the population and to cushion the economy from any potential permanent damage due to the pandemic. This means that besides funding for any health aspect costs to preserve lives, the stimulus has to be able to boost the economy and to decline any rise of unemployment due to pandemic during the recovery process.

For all these objectives to be achieved, the cost is by no means cheap. Covid-19 related financing increases the total government spending by approximately 8% based on recent state budget revision stated on Presidential Regulation Number 72 of 2020. On the other hand, government revenue is decreasing due to the economic contraction caused by the Covid-19 and several tax-related benefits during the pandemic. Furthermore, the GoI has also executed many reallocation plans both in the central and local government budget. However, the condition is still considered as unfavourable for the government as the deficit is expected to drown to 6.34% of GDP.

Burden-Sharing Scheme to Support Economic Recovery

In order to finance the additional spending, the GoI (represented by Ministry of Finance/MoF) has planned to issue the additional government bonds with the total amount of IDR903.46 trillion (equivalent to 6% of GDP). The amount of burden arising from the additional issuance of bonds has made Bank Indonesia (BI) and the Ministry of Finance (MoF) agreed to split the burden with the burden-sharing mechanism. The one-off policy of burden-sharing mechanism distinguishes government spending into three posts, i.e. public goods, non-public goods, and other spending. The public goods post includes spending on health, social safety net, and sectoral spending. Assuming the reverse repo rate at 4.3% and market-rate 7.36%, BI will bear the full burden of public goods and a few of non-public goods (Table A). BI will also purchase government bonds for public goods through a private placement mechanism. Other than public goods, the government bonds for non-public goods and other spending will be offered through the market mechanism.

Table A. BI and MoF with and without The Burden-Sharing Mechanism

BI and MoF with Burden-Sharing Mechanism

Bonds Offer (IDR Tn)		Coupon	OM	Burden Sharing (%)		Total Interest Expense (IDR Tn)		Notes
				BI	MoF	BI	MoF	
Public Goods	397.56	4.30%	4.30%	8.60%	-	34.2	-	*private placement*
Non-Public Goods	177.03	7.36%		4.06%	3.30%	7.2	5.8	*market mechanism*
Other	328.87	7.36%			7.36%	-	24.2	*market mechanism*
*OM: Cost for Monetary Operation						**41.4**	**30.0**	

BI and MoF without Burden-Sharing Mechanism

Bonds Offer (IDR Tr)		Coupon	OM	Burden Sharing (%)		Total Interest Expense (IDR Tr)		Notes
				BI	MoF	BI	MoF	
Public Goods	397.56	7.36%	-	-	-	-	29.3	*market mechanism*
Non-Public Goods	177.03	7.36%	-	-	-	-	13.0	*market mechanism*
Other	328.87	7.36%	-	-	-	-	24.2	*market mechanism*
*OM: Cost for Monetary Operation						**-**	**66.5**	

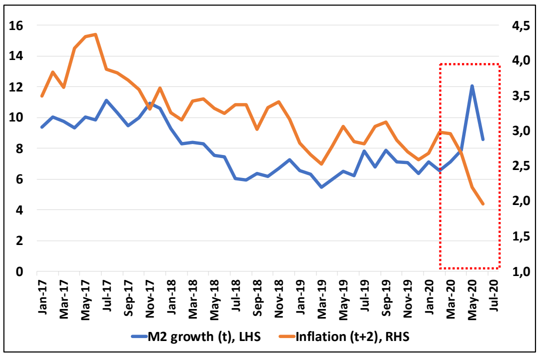
Source: Bank Indonesia and Ministry of Finance

Generally, the implementation of burden-sharing scenario is predicted to have a positive impact on the economy. From the fiscal side, the operation of such mechanism is expected to broaden the fiscal space in the medium and long-term. Therefore, the GoI can slowly resume the fiscal discipline by 2023. The burden-sharing mechanism would also be conducted with full consideration to the credibility of Bank Indonesia as the central bank. Giving the pros and cons that may follow the scheme, both BI and MoF seem well-aware and will begin the process in early August 2020.

Risks of Inflation and Exchange Rate

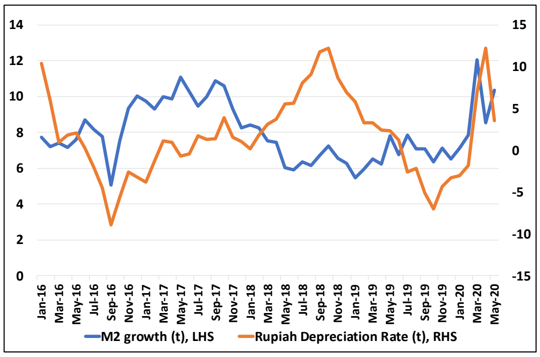
Monetizing state debt has long been perceived as taboo. Many concerns on the risks it would pose on macroeconomic stability, notably on inflation and exchange rate. According to Friedman's theory of money, if a central bank increases its money supply through directly financing the fiscal expansion or known as "debt monetization", it could trigger a high rise in inflation and severely can lead to stagflation, in which the economic slowdown is accompanied by high inflation. This theory can be depicted from the historical trend in figure A, where an increase in the money supply will drive inflation, which usually materializes within two months lags.

Figure A: Money Supply (M2) and Inflation Rate (%)



Source: Bank Indonesia

Figure B: Money Supply (M2) and Depreciation Rate (%)



Source: Bank Indonesia, CEIC

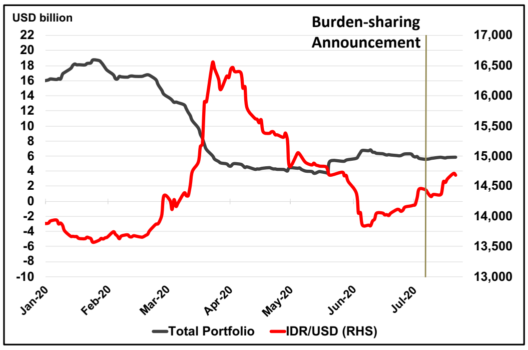
However, the Friedman's theory does not fully apply to the current economic situation. The debt monetization will not be able to leverage domestic demand because the current level of private consumption remains weak. The subdued demand occurs as a result of social distancing and lockdown policy, as well as a rise in precautionary savings. It is fully reflected in the low trend of inflation and even threatened with deflation in the upcoming months. In addition, the consumption patterns have not improved as well. People tend to take precautionary measures by saving instead of consuming, as indicated by a significant drop of Consumer Confidence Index (CCI) from the average of 117 in Q1-2020 to 82 in Q2-2020 after pandemic hit. Nevertheless, even if the debt monetization will raise the inflation rate once demand has recovered, the inflation is expected to pick up to hover around the upper bound of BI's target range this year. With a relatively well-anchored inflation trend, such an unconventional quantitative easing move by BI must be implemented immediately even if it raises inflation a little. This move may be desirable to offset the current low inflation conditions by the amount of currency in circulation and further prevent a deeper economic slowdown in Q3-2020.

On the other hand, the implication of debt monetization on the exchange rate is expected to be moderate, but it is only in a short-run. According to Dornbusch's theory of exchange rate overshooting, changes in the money supply have an immediate effect on the interest rates and exchange rates. The volatility of the exchange rate is due to a faster adjustment of expectations and market responses compared to the price level. Thus, an increase in the money supply will be compensated by a lower interest rate, reducing the expected return on Indonesia's assets. This reduction in yields leads to Rupiah depreciation. However, a temporary pressure on the exchange rate as a result of debt monetization might be partially mitigated by constant capital inflows due to stable expectation of foreign investors.

Risk of Central Bank Independence

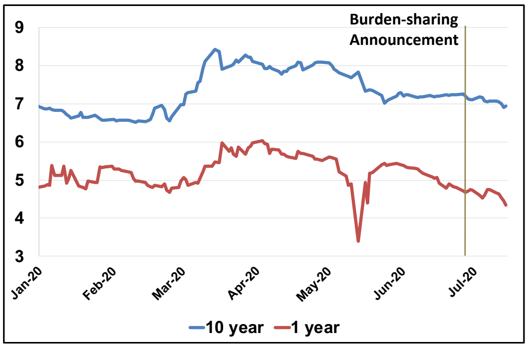
The burden-sharing scenario operated by BI and MoF in its simplest form is a conduct of debt monetization of the central government by the central bank. While it is necessary to fund the stimulus to fight the pandemic, this act comes with costs, especially on the central bank's side. Sacrificing some degree of its independence is the price BI has to pay for this monetization, among other costs such as inflationary pressure and higher cost of open market operation, shall the debt monetized by this scheme be used as a tool for future monetary policy. Traditionally, the idea of central bank funding government's debt seems heretical as the political exposure to the central bank will set its independence, hence credibility, in jeopardy. As the higher independence of central banks promotes price stability (Alesina & Summers, 1993), a less independent one is associated with a higher level of inflation and its volatility and would consequently risk the macroeconomic stability. Moreover, the standard textbook theory of "impossible trinity" also suggests that less independency of central banks also erodes its capacity of maintaining exchange rate stability. As mandated by law, BI's main tasks include maintaining the price and exchange rate stability and a lower degree of independence makes BI's duty to achieve those all more difficult.

Figure C: IDR/USD and Accumulated Portfolio Capital Inflow (Last 24 Months)



Source: CEIC

Figure D: Government Bonds Yield (% pa)



Source: Investing.com

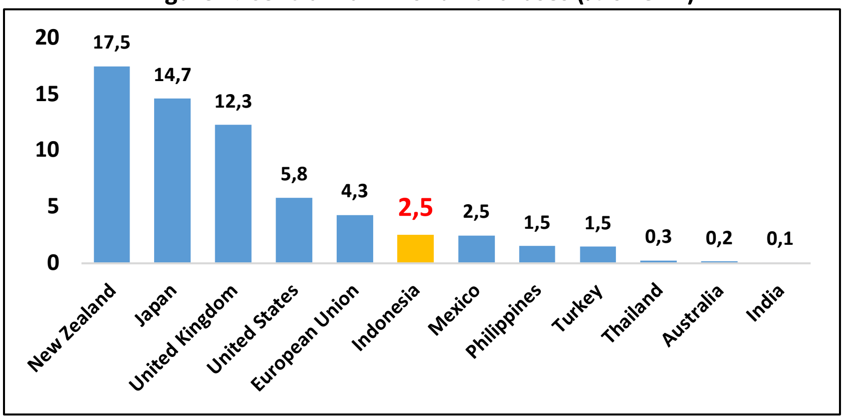
Regardless, extraordinary times call for extraordinary measures, and this ongoing pandemic is one of those very rare times in history. The promulgation of Law No.2 of 2020 gives a legal basis for the fiscal and monetary authority to take such measures and act in the manner of "whatever it takes" to weather the ongoing crisis; debt monetization is among those measures. As unorthodox as it would have been in normal times, this unconventional monetary policy is rather a common practice by central banks around the world these days. Considering the reputation of its prudence that has been built over the years, coupled with an ample amount active of communication to the public, BI and MoF have set a precedent regarding debt monetization. Further assurance by the fiscal and monetary authority that the deal is “one-off” also save the central bank some of its independence perceived by investors.

Keeping touch with reality, since the announcement of the burden-sharing act, investors seem to give BI and MoF the benefit of the doubt. While Rupiah has experienced a mild depreciation, its movement is rather stable compared to a few weeks ago when uncertainty was higher (Figure C). Furthermore, no episode of capital outflow and no spike in government bond yield imply the burden-sharing announcement has not deterred investors’ confidence toward Indonesia’s macroeconomic prospect. If anything, a pattern of decreasing 1-year government bond yield after the announcement implies a more positive sentiment of the market (Figure D). These signs of a favourable tendency towards Indonesia are also validated by the rating agencies (Moody’s and S&P) who said that the debt monetization would not affect Indonesia’s credit rating in the short term. This suggests that policymakers are currently able to maintain their credibility while BI is sacrificing some of its independence. However, the loss of some degree of independency due to crisis has to be restored sometime in the future, lest policymakers would put permanent damage to its credibility.

The Implementation of Burden-Sharing Scheme in Other Countries

The burden-sharing scheme is considered as a significant change in Asia’s bond markets, but Indonesia is not the only one among the emerging market economies (EMEs); there are also Thailand, Philippines, India, Chile, Columbia, Hungary, Turkey, Poland, South Africa, and Mexico. Meanwhile, the developed countries are also doing QE and monetization of debts in a more sophisticated way. This burden-sharing scheme is something new for some countries mentioned above, especially for the EMEs. However, this unconventional monetary tool offers new hope to help them ride out the crisis caused by Covid-19 pandemic. There are still worries about the independency of the central bank in some countries along with the potential impact on the bond yields and exchange rate. However, the BIS found that the bond purchase announcement impact to the market varied widely between countries (BIS Bulletin No. 20, June 2020), and some of them fell prior to the announcement. For example, South Africa with its 10-year bond yields dropped by 100 basis point; while Indian and South Korean yields fell by 15 and 7 basis point respectively, which are smaller yet still considerable in implying a positive sentiment of the market. This indicates that the initial conditions, along with how the measures were designed and communicated, are crucial.

Figure E. Central Bank Bond Purchases (% of GDP)



Source: Reuters; The World Bank Database

As a comparison, New Zealand’s central bank, RBNZ, purchased bonds accounted for 17.5% of their GDP to provide financing for the economy. Followed by Japan, United Kingdom, United States, EU, and the other countries. Indonesia with its debt-to-GDP ratio that relatively lower than other countries and has an excellent track record of its prudence in maintaining fiscal deficit within the cap of 3%, is believed to be in a good position with BI's bond purchases for 2.5% of GDP, especially among the EMEs. The government debts are predicted to increase from 30% to 35% this year, but it is still much lower than the 60% threshold. However, we should be cautious because there have not been any clear mechanism regarding the BI's strategy to end the partial deficit financing which is feared will have further implications on the central bank's credibility and political independence in the long term.

More Clarity on Mechanism and "Exit Strategy" are Needed to Maintain Market Confidence

Amidst all the side-effects of the burden-sharing scenario, the essential part that is crucially needed by BI and MoF is managing bonds market participation during the potential bonds' sell-off. BI and MoF need effective measures to minimize the broader risks of capital outflows. There are a number of ways to maintain investor confidence during the debt monetization; one of them is giving the clarity of the mechanism and the safeguard of the burden-sharing scheme. The market participants need the details on how this burden-sharing will be implemented, and the most important part is how long the mechanism will be applied. Once the investors see this scheme as a "one-off" policy that is expected to be only implemented for this year, they get the certainty of Indonesia's market outlook.

Further, BI and MoF also need to maintain market confidence over the looming fear of moral hazard between fiscal policy and central bank independence. They require to minimize the massive potential perception of declining monetary independence due to the increasing fiscal dominance by promoting the equal burden between the two macroeconomic actors. This attempt will also help to lower the political cost of the current government that might arise during the burden-sharing implementation.

The other vital component to save market confidence is the clarity of the monetary exit strategy by BI. Although BI had mentioned that they have a robust exit strategy, the market still needs certainty of these plans. Some of the planned exit strategy measures, such as higher banks' reserve requirement ratio will fundamentally affect investors' perception of the market. Thus, BI requires to create an exit strategy that is still prioritizing their primary role, which is Rupiah stabilization. A vigilant exit strategy is highly needed to keep BI from both external risks and domestic pressures. Nevertheless, shall BI and MoF are capable of managing the market confidence towards the burden-sharing implementation, this plan will give no harm to macroeconomic stability and might support economic growth.

Big Losers and Small Winners

As we marched into the crisis of Covid-19, the pandemic has wreaked havoc almost all aspects of life across the globe. The rapid escalation of its spread has affected not only the health of the population but also has overarching consequences. While the first confirmed case of Covid-19 in Indonesia is in early March, considered as relatively delayed compared to other countries, the impact is nevertheless as damaging. Several factors came into play during the few first weeks of the spread in Indonesia which caused the casualty spurred massively, including the government's inadvertency of the virus manifestation domestically, low awareness by the population, and inadequate capability and capacity of current public health and medical infrastructure to contain the virus. Unsurprisingly, looking back at our response during those days, the realization of GDP figure in the first quarter of 2020 was significantly worse than expected. Besides, since the first outbreak in Indonesia was near the end of the first quarter period, many expected the economy would experience a contraction of GDP between 3.5% to around 4%. However, the realization was far lower than the consensus, which is 2.97%, and this came as a shock to many.

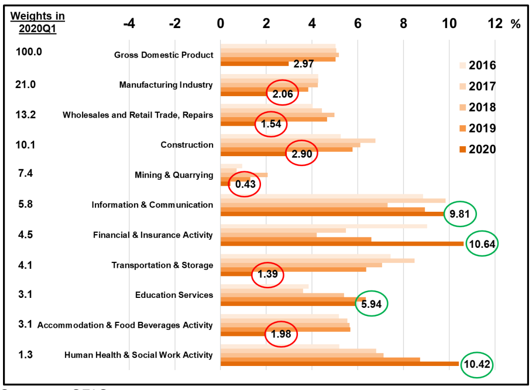
"Several factors came into play during the few first week of the spread in Indonesia which caused the casualty spurred massively, including the government's denial of the virus manifestation domestically, low awareness by the population, and inadequate capability and capacity of current public health and medical infrastructure to contain the virus."

The main contributors to the GDP (e.g. manufacturing, wholesale & retail trade, construction, and mining & quarrying sectors) which accumulatively accounted for more than half of the GDP, all experienced a contraction in Q1 2020. Manufacturing industry grew only 2.06% (y.o.y) in Q1 2020, significantly lower compared to the previous quarter of 3.66% (y.o.y) and also the lowest quarterly growth rate of the industry for more than 20 years. Other main contributors also told the same story in their growth figure, though with different magnitudes. A more significant drop was experienced by wholesale & retail sector in which it declined to 1.54% (y.o.y) compared to 4.27% (y.o.y) in Q4 2019. For the last ten years at least, GoI always pushed forward infrastructure development agenda on their spending, and it was reflected in the quarterly growth rate of construction sector which always reached above 4% until Q1 2020. Construction sector growth rate recorded at 2.90% (y.o.y) compared to the previous quarter of 5.79% (y.o.y). These grim performances of several biggest sectors in the economy tell the same story of weakening demand and purchasing power, disrupted supply chain, and halted economic activity due to the pandemic. As severe as it could be, the impact of Covid-19 on the economy caused the biggest five sectors to be considered as “loser” sector as they experienced a slowdown.

“Despite the majority of the sectors came out as “losers” by the hit of the pandemic, several sectors actually enjoyed higher growth in Q1 2020.”

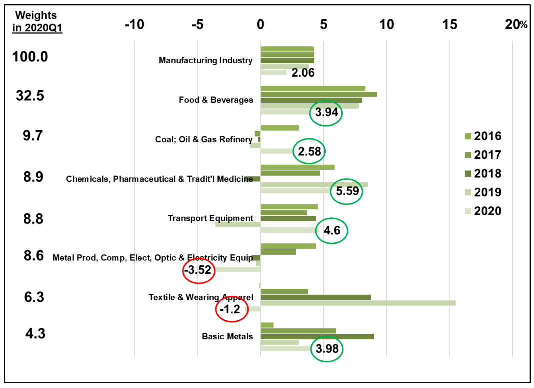
Looking deeper, almost all of the subsectors within the manufacturing industry had a declining growth compared to the last quarter of 2019. Food and beverages subsector, accounted for around a third of manufacturing industry output, grew only 3.94% (y.o.y) in Q1 2020 from 7.95% (y.o.y) in Q4 2019. This is rather expected as daily business activities were restricted by the implementation of large-scale social restriction (PSBB) and disrupted supply chain, which in consequence decrease the demand for food and beverage products rather drastically. Furthermore, chemical, pharmaceutical, rubber, leather and wood subsectors experienced a negative growth as the weak demand materialized, both from domestic and international markets. Paradoxically, after suffering a long trend of low quarterly growth rate (sometimes even negative), coal, oil & gas refinery subsector experienced a growth of 2.58% (y.o.y) in Q1 2020, higher than of 1.06% (y.o.y) in Q4 2019 and also its highest growth since mid-2016. Furthermore, while it was catastrophic, we view that the manufacturing sector will experience a harder hit in Q2 2020 as the materialization of halted economic activity is lengthier during April until June 2020.

Figure 1: Growth of GDP and the Main Industries, 2016-2020Q1



Source: CEIC

Figure 2: Growth of Manufacturing Sector and Its Subsectors, 2016-2020Q1



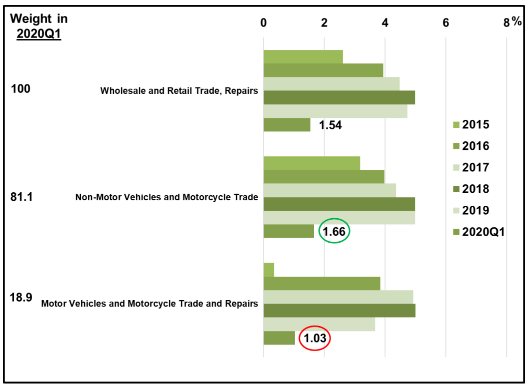
Source: CEIC

Among all sectors, the wholesale and retail sector is considered as one of the sectors with the hardest hit. The impact of the Covid-19 outbreak instantly knocked on the wholesale and retail sector as the considerably high population chose to retain their consumption. As the demand slumped, the sector grew only 1.54% (y.o.y) in Q1-2020, declining 2.73 points from the previous quarter that grew 4.27% (y.o.y). The growth in Q1-2020 might be recorded as another lowest point of the wholesale and retail sector since the last decline was back in the second and third quarters of 2015. Looking deeper, the two components of wholesale and retail also reflecting the same pattern as both motor and non-motor subsector not performing any better role to maintain the growth of the overall sector. With the notable proportion of 81.1%, the non-motor vehicle and motorcycle trade grew only 1.66% (y.o.y) in Q1-2020 compared to 4.31% (y.o.y) in Q4-2019. Showing also a somewhat worse performance marked by the lowest slide, the motor vehicles and motorcycles trade, and repair growth recorded only 1.03% (y.o.y) compared to 4.09% (y.o.y) in Q4-2019.

Similar to the wholesale and retail sector, the transportation and storage sector also recorded a rather unfavorable growth. The sector grew only 1.39% (y.o.y) in Q1-2020, 6.3 points lower than the growth in the preceding quarter that recorded at 7.7% (y.o.y). The first outbreak of Covid-19 started in China and several foreign countries, and the confirmation of Indonesia's first cases in early 2020 frightened the people and affect their travel decision. Looking further, the people's concern upon their travel decisions is reflected by the considerable level of decreased growth in railway and air transport components that respectively declined to -6.93% (y.o.y) and -12.81% (y.o.y). Particularly air transport, the negative growth is considerably worse than the low level of growth caused by the rising of the airline ticket back in early 2019. Moving to the other components, a substantial yet still favorable decline presented by road and sea transport that grew 5.15% (y.o.y) and 5.93% (y.o.y). However, a considerably better decline of the two components was indeed driven by the demand of the logistic sector. Last, another negative growth also performed by the storage and support activities, recorded at -0.48% (y.o.y) compared to 11.54% (y.o.y) in Q4-2019. The storage and support activities component considered to have a significant role in dragging the growth of the transportation and storage sector as the proportion of the component is quite significant (15.9% from the overall transportation and storage sector). The same or even worse pattern predicted to appear in the Q2-2020 as several regions in Indonesia have started to implement the large-scale social restriction (PSBB) policy.

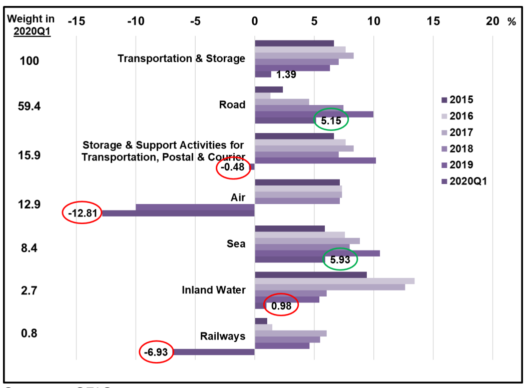
"Among all sectors, the wholesale and retail sector is considered as one of the sectors with the hardest hit."

Figure 3: Growth of Wholesale and Retail Trade and Its Subsectors, 2015-2020Q1



Source: CEIC

Figure 4: Growth of Transport and Its Major Subsectors, 2015-2020Q1



Source: CEIC

Despite the majority of the sectors came out as "losers" by the hit of the pandemic, several sectors actually enjoyed higher growth in Q1 2020. While the population are forced to stay at home, several sectors reaped the benefit from this opportunity. Among them includes ICT, financial & insurance activity, education services, and human health & social work activity. As most workers are forced to work from home and students to study not in the class, usual physical face-to-face interaction was replaced by online interaction and this increased the growth of ICT sector to 9.81% (y.o.y) in Q1 2020 compared to 9.62% (y.o.y) in the previous quarter. Furthermore, another implication by this crisis is that people tend to increase their savings as uncertainty increases and shift the risk appetite of the population towards risk-aversion as the pandemic gives a bleak perspective of the near future situation. This drives a boost in the financial and insurance sector as they grew to 10.64% (y.o.y) in the first quarter of 2020 – its first double-digit growth rate since 2013. While these sectors are considered as the "winner" or champion sectors during the pandemic, their contributions to overall Indonesia's GDP are relatively low. However, looking at the current condition, these sectors are potential and might worth considering to be supported by the GoI as they are having an ample room of growth.

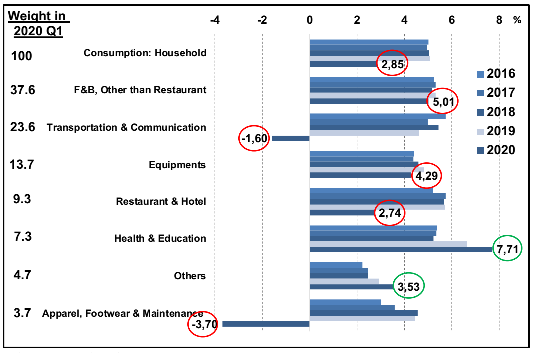
Effectiveness of Policy Execution Needed to Bolster Consumption

Household consumption, which accounts for more than a half of Indonesia's GDP decelerated to 2.84% (y.o.y), far below 5.01% recorded in the same period last year (becomes the lowest growth since Q2-2001). Sluggish domestic demand is fully reflected by the dropped in almost all subsectors in consumption as a consequence of the implementation of social distancing to curb the spread of Covid-19, which dampens demand and economic activities. In details, there is a sharp decline in both restaurant & hotel and transportation & communication consumption. Lower consumption of tourism-related activities was due to travel restrictions in March, the month of the first confirmed Covid-19 case. Likewise, the sharp decline in transport services was also due to mobility restrictions, indicated by negative growth in the number of rail and air transport passengers. In contrast, increased demand on health products has resulted in higher growth of health & education consumption, which climbed up from 5.77% in Q1-2019 to 7.71%; the highest growth in the last five years.

"The key is on the policy execution; the realization of social safety net stimulus must be deployed effectively, quickly, and on target to protect the poor and vulnerable groups who are at risk of falling into poverty and help to revive the current weak demand."

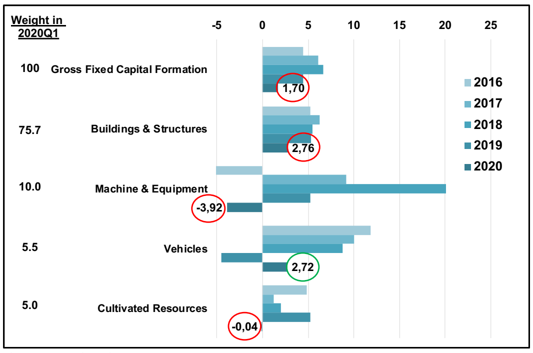
Given the size and unprecedented nature of the Covid-19 shock to the economy, high uncertainty looms over when this pandemic will end. Weakening demand and disruption of the global supply chain are expected to put further pressure on the economy in Q2 and Q3 2020. The enactment of large-scale physical distancing (PSBB) during Q2 is expected to create downward pressure on domestic demand, which actually in normal condition, the consumption peaks during Ramadan and Eid festive period. With the current economic and healthcare uncertainties, people tend to take precautionary measures by saving instead of consuming, supported by higher saving rate among the upper-class income. In addition, a significant drop in the Consumer Confidence Index (CCI) from the average of 117 in Q1-2020 to 82 in Q2-2020 after a pandemic hit, indicating consumer confidence remains low even if mobility restrictions are removed. It also signals that consumption growth will fall sharply in Q2-2020. A substantial decline in incomes are expected to weigh heavily on households and may lead to difficulties. The government swiftly put in place comprehensive stimulus packages. However, the key is on the policy execution; the massive stimulus package being provided should be sufficient to prevent a severe deterioration in consumption. Therefore, the realization of social safety net stimulus must be deployed effectively, quickly, and on target to protect the poor and vulnerable groups who are at risk of falling into poverty and help to revive the current weak demand. As of 17 July, the total realization on the social safety net has reached 37.96% of the total IDR203 trillion.

Figure 5: Growth of Household Consumption and its Components, 2016-2020Q1



Source: CEIC

Figure 6: Growth rate of Investment and its Main Components, 2015-2020Q1



Source: CEIC

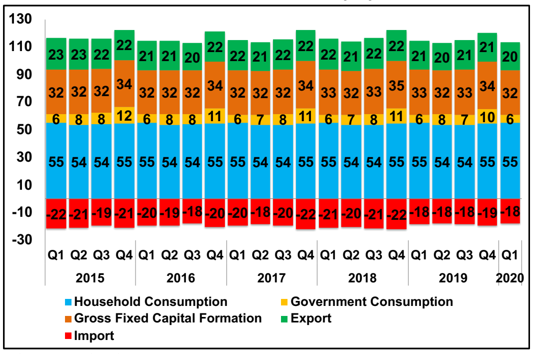
"To counter the current and ongoing subdued investment trend, the government should continue improving investment climate through deregulation and de-bureaucratization to attract investors participation in line with the economic recovery program."

Meanwhile, investment continues its deceleration trend. The real investment or gross fixed capital formation (GFCF) slowed to 1.7% (y.o.y) in Q2-2020 from 5% in the same quarter last year; the lowest growth since Q3-2006. Similar to the consumption trend, sluggish investment was captured by the dropped in most of the subsectors except vehicles. Growth of buildings & structures that dominates investment pie at about 75% slowed to 2.76% from 5.45% in Q1-2019. This mainly attributed by many infrastructure project and investments are being postponed since the early announcement of Covid-19 at the end of the first quarter. Moreover, lower commodity prices and disruption in the global supply chain contributed to a declining demand on machinery & equipment (both from domestic and imports), making a sharp decline in this subsector from positive growth to negative (8.41% in Q1-2019 to -3.92% in Q1-2020). In contrast, a positive growth seen in vehicles caused by an increase in domestic vehicle production while vehicles originating from imports contracted.

Lower business sentiment indicated by the drop on Purchasing Managers' Index (PMI) to 31.7 (average Q2 2020), far below 50.8 (average Q2 2019) and 48.8 (average Q1 2020) signaling that investment growth will continue to decline to its lowest trend in Q2-2020. However, we estimate investment activities will slowly rebound, as shown by a slight increase in PMI in June to 39.1. Amid heightened uncertainty, the government dare to lift the lockdown policy as an effort to reopen the economic activities. However, with stricter healthcare protocols and the still lower-than-average demand, we see production capacity could not operate at full capacity. All in all, to counter the current and ongoing subdued investment trend, the government should continue improving investment climate through deregulation and de-bureaucratization to attract investors participation in line with the economic recovery program.

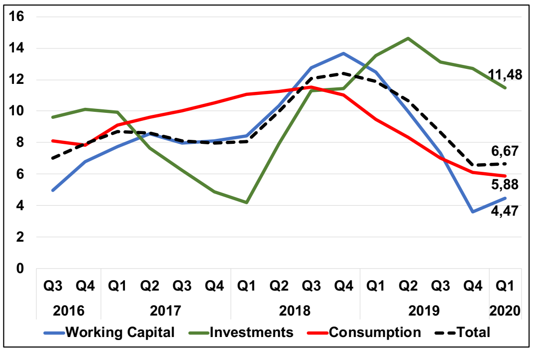
Looking closer to credit growth (Figure 8), the total credit slightly picked up to 6.67% (y.o.y) in Q1-2020 from 6.55% in Q4-2019, but much lower than the same quarter last year at 11.8%. This mainly due to lower borrowing costs. Based on the credit components, investment and consumption loan slowed to 11.48% (y.o.y) and 5.88% (y.o.y) in Q1-2020 from 12.7% and 6.11% in Q4-2019, respectively. While the working capital loan grew by 4.47% (y.o.y), higher than 3.59% in the previous quarter. Overall, we estimate lower credit growth in the upcoming quarters ahead (Q2 and Q3-2020) since banks still cautious and demand for credit still subdued. However, the policy synergy between policymakers through loan restructuring to SMEs and other affected sectors and BI's accommodative monetary policies through four consecutive rate cuts and QE might help to recover credit growth in 2H-2020 and support the sufficient liquidity in the market.

Figure 7: Shares of GDP Components, 2015Q1-2020Q1 (%)



Source: CEIC

Figure 8: Credit Growth by Purposes, 2016Q3-2020Q1 (y.o.y, %)

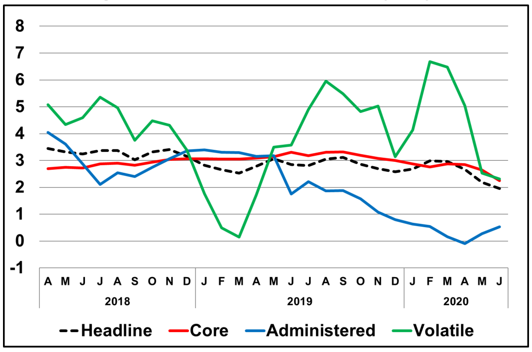


Source: CEIC

Low Inflation Condition due to Sluggish Domestic Demand and Purchasing Power

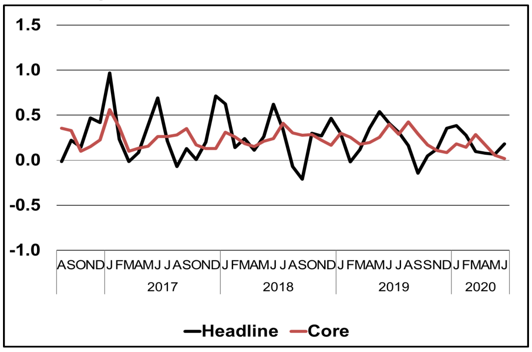
Headline inflation in June declined by 0.23% from the previous month, making it settled at 1.96% (y.o.y), which fell below BI's target range of 3%±1% for the first time in 2020. This counts as the fifth consecutive drops since February because of the sluggish domestic demand and consumption related to the large-scale social restrictions (PSBB) policy, as well as people's tendency to increase their savings. At the same time, the annual volatile food inflation shows the same trend with 2.32% (y.o.y), down from last month's inflation of 2.52% (y.o.y) due to the decreasing price of chilli and onion. On the other hand, the administered price inflation rose to 0.52% (y.o.y) mainly due to the rising tariffs of public transport after the relaxation of its operational restrictions in early June, as the economic activity started to pick up.

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



Source: CEIC

Figure 10: Inflation Rate (%, mtm)



Source: CEIC

"This low inflation conditions might make BI's move with its burden-sharing act desirable to raise the inflation rate approaching the BI's target range this year and to prevent deflation in the upcoming months."

Not only headline but also core inflation is also affected by the subdued demand and food prices' dynamics pinned by the decline of core inflation during June 2020 to 2.26% (y.o.y) from 2.65% (y.o.y). While on a monthly basis, the headline inflation was recorded at 0.18% (mtm) which remained low, although it was relatively higher compared to the previous month of 0.07% (mtm). This was influenced by a decrease in the core and administered price inflation. In contrast, the volatile food inflation experienced an increase due to a higher price of broiler chicken, eggs, and coconut. Overall, the average headline inflation in Q2-2020 has driven down from 2.87% (y.o.y) to 2.28% (y.o.y). This low inflation conditions might make BI's move with its burden-sharing act desirable to raise the inflation rate approaching the BI's target range this year and to prevent deflation in the upcoming months.

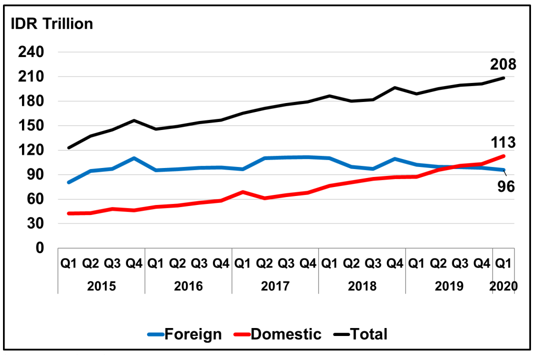
Heightened Global Uncertainty Supress Investment

The overall investment as measured by the growth of gross fixed capital formation in Q1-2020 continue to fall into 1.7% (y.o.y) from 4.1% (y.o.y) in the previous quarter; the lowest growth since 2006. The drop might be caused by the lethargic trend of business activities during the large-scale social restrictions (PSBB) period, as well as many infrastructure projects being postponed due to the pandemic. On the other hand, the Indonesian Investment Coordinating Board (BKPM) recorded an increase of 29.3% of FDI dan DDI realization in Q1-2020. This improvement was mainly contributed by the increasing domestic investment at 29.3% (y.o.y) along with a slower foreign investment realization (-6.1%). Lower FDI realization might be explained by the rise in global uncertainty during the pandemic.

"Investment rebound would be determined by how fast Indonesia could manage the storm of the crisis and whether Indonesia would deviate far enough from its long-term growth trajectory."

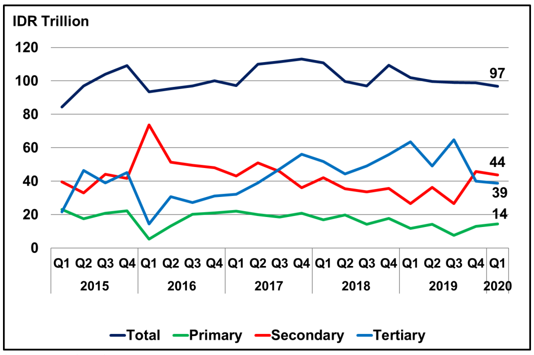
Based on the sectoral classification, foreign investors have slowed down the investment in secondary (manufacturing) and tertiary (service) sector, while the primary sector recorded positive growth. The services activity running in construction; transportation, storage, and communication; hotel and restaurant industries have attracted investors the most in Q1-2020. From the foreign direct investment realization, the total amount of investment in the last two sectors has multiplied more than twice as large as its amount in the previous quarter. However, the other sectors plunged due to slow business activity.

Figure 11: FDI and Domestic Investment (Nominal)



Source: CEIC

Figure 12: FDI Realization by Sectors (Nominal)



Source: CEIC

While the growth of investment indicator in GDP, gross fixed capital formation, is still declining, its rebound would be determined by how fast Indonesia could manage the storm of the crisis and whether Indonesia would deviate far enough from its long-term growth trajectory, among usual factors such as bureaucratical efficiency and ease of doing business.

Accelerate Exports to Boost Economic Growth

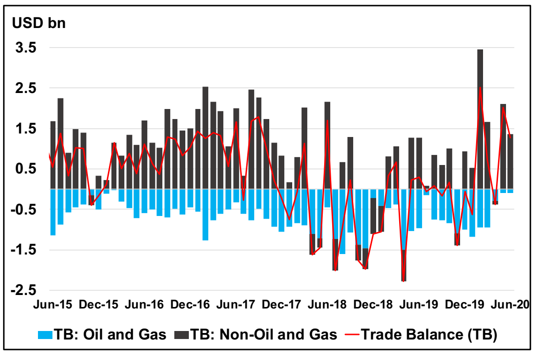
Since the production and consumption are cut down all over the world due to the unprecedented event of Covid-19 pandemic, the significant disruption in global trade is undeniable. In Q1-2020, world export has plunged by 5% compared to the same period last year. The magnitude, however, does not fully reflect the pandemic effect as the peak of the outbreak has not addressed yet in the first quarter of this year. The size of the contraction is expected to be doubled for FY2020 due to the prolonged fears of the possible second wave, which will lower global supply and demand simultaneously. For Indonesia, the pandemic impact on the trade figure was out of expectation as the monthly data of trade balance records surplus from February until June except for the trade deficit in April. Even though the trade balance reflects a significant improvement, it is not attributable to better economic performance. On the other hand, the better figure of trade balance was a result of the significant dropped in exports while imports plummeted at a higher pace. Up to June 2020, export has declined by 5% and imports plunged by 14% compared to the same period in the previous year.

Besides the disruption in domestic and global demand due to the large-scale social restrictions measurement, the lower-than-expected oil price has contributed to the significant decline in exports and imports of oil and gas in 1H-2020, which shrinked by -35% (y.o.y) and -31% (y.o.y), respectively. While the exports of non-oil and gas products were relatively benign, the imports of non-oil and gas goods, which are mainly dominated by raw and capital goods, are plunged by 11%. It happens as expected since the reduction of business production has prompted the delay in the number of goods imports, such as machinery parts and components.

The trade surplus brings a lower Indonesia's current account deficit at US$2.9 billion or equal to 1.4% of GDP in Q1-2020. This figure is narrowed from 2.8% of GDP in the previous quarter. However, we have to keep in mind that the improvement does not represent a better economic condition. On the other hand, it reflects a bleaker outlook for the Indonesia economy as lower imports, which mainly consist of capital goods, signaling a real sector contraction in the near future. Along with that, exports might be sluggish as there is still no promising sign of demand improvement. We see that the lower CAD will remains between 1.2-1.5% of GDP in Q2-2020.

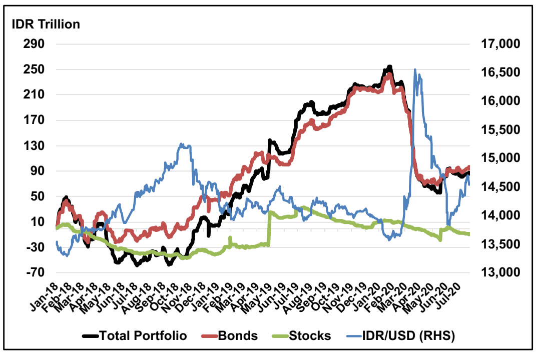
"However, we have to keep in mind that the improvement does not represent a better economic condition. On the other hand, it reflects a bleaker outlook for the Indonesia economy..."

Figure 13: Monthly Trade Balance (Nominal) (Jun2015-Jun2020)



Source: CEIC

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

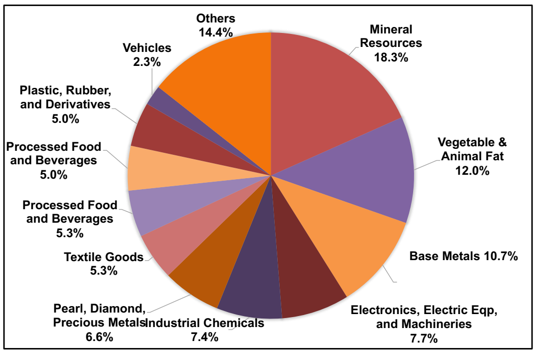


Source: CEIC

Looking deeper, the Covid-19 pandemic has slightly reshaped Indonesia's export profile to a lesser commodity-based. The export of commodity goods, particularly mineral resources, vegetable fat, and precious metals in Apr-May 2020 is amounted to 40% of total export, decreased from 43% in Q4-2019. The figure is showing a more distributed goods of export during the pandemic. At the same time, the composition of Indonesia's imports is similar to the last year's figure. The capital goods and input materials for production, such as electronics and machinery sector are still the highest contributors to imports (28.2%). The demand for medical supplies and equipment has increased the proportion of the industrial chemicals' imports to 12.6% in Apr-May 2020 from only 9% of total imports in Q4-2019. In contrast, imports of base metals are relatively benign. For the imports of mineral resources, which is dominated by crude oil, are highly relied on global oil prices. As the oil price has been picked up recently, the share of mineral resources in Apr-May recorded at 15% of total imports, increased from its figure in Q1-2020 at 9%.

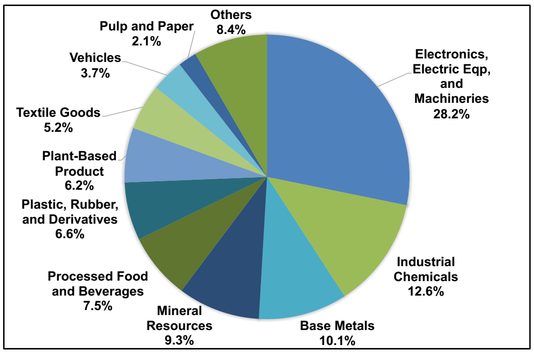
"It becomes more crucial for GoI to maintain the volatility of our trade during this time of crisis where the prices are now more volatile than ever as the result of high uncertainty.."

Figure 15: Indonesia Export Profile (Apr-May2020)



Source: CEIC

Figure 16: Indonesia Import Profile (Apr-May2020)



Source: CEIC

Given the substantial proportion of commodity-based exports and imports, whose structure is enduring in the near term, our trade will remain vulnerable to the swing in global prices. It becomes more crucial for GoI to maintain the volatility of our trade during this time of crisis where the prices are now more volatile than ever as the result of high uncertainty. To dampen the negative effect of the pandemic into Indonesia's global trade posture, GoI should ensure the industry continuity during and after the crisis. As long as the exports-oriented businesses are well-maintained, the GoI can be expected the robust commodity exports during the pandemic as it is hard to replace the global demand of the particular commodities, such as coal exports to China as well as palm oil to India and China. Further, the GoI should also support domestic demand by implementing effective measurements, particularly stimulus package for consumption. The improvement in domestic demand will gradually build up business confidence to restart the production activity; thus, it would be reflected in the higher imports of raw and capital goods. Improvement in our imports, therefore, can be reflected as a sign of a better economic performance in the near future.