Key Figures

- GDP Growth (Q2 '20)
  -5.32%
- Inflation (y.o.y. Oct '20)
  1.44%
- Credit Growth (y.o.y. Aug '20)
  1.04%
- BI Reverse Repo Rate (7-day, Oct '20)
  4.00%
- Current Account Deficit (CAD) (Q2 '20)
  -1.20%
- IDR/USD (Oct '20)
  IDR14,758

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The Great Escape:

Covid-19 in the Short-Term and Middle-Income Trap in the Long-Term

Highlights

- As the pandemic persists and will not be ending in the foreseeable future, GDP growth in Q3-2020 is expected to reach -3.9% to -2.8%; around -2.2% to -0.9% for overall 2020.
- The fall into the textbook definition of 'recession' as we almost certainly record the second consecutive negative quarterly GDP growth should not be a concern for anyone; rather, all should lie their focus on the effort of health crisis management.
- Whether economic growth can be accelerated and sustained over the long-term will highly depend on the investment that is important for industrialization aiming to increase the value-added of the output. To attract investment, efficiency in labor market is one of the crucial factors which will also help to maintain labor's living standard.
- The halted economic activity has been reflected more vividly in the Q2-2020 with the top contributor sectors experienced a more profound negative growth.
- The current inflation figure shows that aggregate demand is still at its lowest level during the pandemic and there is no definite sign of crisis ending in the near future.
- Significant improvement in trade figure is unlikely to be achieved, at least in the next few months, as the pandemic would not disappear entirely at any time soon and the resurgence of Covid-19 pandemic in some recovered countries would be likely to happen.

Economic activities continue to shrink in Q2-2020 where economic growth plunged to -5.32% (y.o.y), much lower than the positive growth in Q1-2020 of 2.97%. The health crisis has halted the economy in nearly all economic sectors with the top three sectors of Indonesia's economy (manufacturing, wholesale & retail trade, and construction sectors) experienced a more profound negative growth compared to the overall economy. Moreover, economic downturn was also fully reflected in the expenditure side, where the household consumption's growth dropped to -5.51% (y.o.y) from its positive growth in Q1-2020 of 2.84%. Mobility restriction, precautionary behavior, and labor income losses have led to a sharp contraction in almost all subsectors in consumption, except consumption in health & education and equipment. The limited business activities and household consumptions contributed to the slow credit growth. The low inflation figure during this health crisis also confirms that aggregate demand is still at its lowest level. While from the external sectors, trade continued to decline from its pre-pandemic level due to lower global demand and supply, though the figure has been slightly improving since July which is recorded by positive monthly growth. However, the deeper drop in imports than exports has contributed to the surplus in trade balance and lower CAD which is stood at US$-2.9 billion or equal to -1.2% of GDP in Q2-2020.

Table 1: LPEM FEB UI GDP Growth Forecast

Q3-2020	FY 2020	FY 2021
-3.9% to -2.8%	-2.2% to -0.9%	4.7% to 5.5%

We see that external pressures will endure in the remaining quarters of 2020 as the potential resurgence of Covid-19 pandemic in some recovered countries is looming. If the global demand drops, CAD will remain between 1.2-1.5% of GDP in Q3-2020 and for FY2020. From domestic side, people still hold back their consumption to the pre-pandemic level. Hence, there is limited sign of purchasing power improvement, at least for the next few months, as we are still uncertain of how long this crisis will take place. it is quite a certainty that the economy will still be under stress at least for this year; thus, we predict that the GDP growth for Q3-2020 and FY2020 will be on the negative territory. The economic growth is estimated to reach as low as -3.9% to -2.8% in Q3-2020; making the growth for FY2020 at around -2.2% to -0.9%. During this hard time, the focus and implementation of virus

containment strategy will play a vital role in Indonesia's economic condition. It has been demonstrated by many countries that are already far ahead of us in terms of recovery that it is rather impossible to have an economic recovery without health recovery. Given the health crisis has been handled and the recovery strategy through monetary and fiscal stimulus has been implemented in an effective manner, we predict that GDP growth will be back into a positive territory and could reach its pre-pandemic level in 2021.

Pathway to 'High-Income Country': Are We Growing Enough?

Trapped in the Middle

"Man is an animal that makes bargains: no other animal does this – no dog exchanges bones with another," wrote Adam Smith more than 200 years ago, which pointed out that conducting economic activity is one of the most basic human natures. From a broader perspective, he also wrote: "No society can flourish of which the greater part is poor and miserable." Both quotes were written on the same manifesto called 'An Inquiry into the Nature and Causes of the Wealth of Nations', popularly referred to by its shortened title 'the Wealth of Nations', which lays a philosophical ground for economic as a science and deemed as the fundamental work in classical economics. Since then, Adam Smith's work has driven numerous progressive concepts in the modern economic era, and one of the most revolutionary concepts is 'specialization'. In the context of labor, 'specialization' is the foundation of the division of labor based on their skills. On the national level, it serves as the ground concept of 'globalization', in which a country would produce certain goods and services that they have more efficiency or 'comparative advantage' in doing so, while would purchase the rest of the goods and services from other countries which could produce those more efficiently, theoretically.

In the modern era, countries, businesses, and modern-era economic agents worldwide put economic growth as one of their utmost agendas as economic growth is considered the primary means to secure prosperity and welfare. However, the path to achieving long-run economic growth is a complicated matter. The dynamic of political, geographical, and socioeconomic aspects (among others) shapes the nation's economic growth path trajectory, and those aspects are growing more complex as time goes forward. While several western nations, such as the U.S. and Western European countries have managed to attain stable economic growth in the past and managed to become 'high-income countries', many developing countries are still struggling to maintain and improve their economic growth sustainably, including Indonesia.

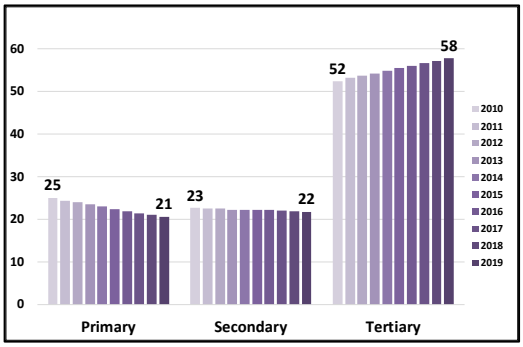
Historically, Indonesia has experienced dramatic changes in economic conditions, driven by a startling shift in political governance, structural formation, and commodity reliance. As a country with the fourth-biggest population in the world and the seventh-largest economy (in PPP terms), Indonesia experienced a relatively a continuous economic decline for at least half a century before the mid-1960s (Van der Eng, 2002) and considered as one of the world's poorest countries back then. However, a phenomenal turn of events took place. After 1966, Indonesia enacted tremendous economic advancement for the next three decades as it managed to quadruple its GDP during this period and was deemed as one of the 'East Asian Economic Miracles' until Asian Financial Crisis battered in 1997. Just as surprising as the previous recovery, Indonesia's economy recovered quickly and returned to a moderately strong growth trajectory of around 5 to 6% from 2000 until now. During that period, Indonesia's growth engine is driven by commodity and natural resources (i.e., coal, oil, and palm products), coupled with a considerable industrialization process.

However, the historical achievement of continuous high economic growth and industrialization progress is far from advancing Indonesia's status into a 'high-income country'. Specifically, the risk of a middle-income trap poses a severe challenge in its path towards achieving such status. Unfortunately,

several signs of a middle-income trap – characterized by low investment growth, slowing growth of the manufacturing, limited industrial diversification, and poor labor market conditions – are somewhat reflected in Indonesia's current state. This phase commonly occurs when a country is transitioning from resource-based growth to a more value-added driven growth. If a country fails to manage the transition with a viable and sustained high-growth strategy (driven by innovation, robust manufacturing growth, and improved productivity), it will be trapped in the 'middle-income' status for decades (e.g., Brazil and Saudi Arabia). On the contrary, countries that managed to escape the middle-income trap, such as Japan and South Korea, succeeded in implementing industrialization strategies and structural shift by pushing the industrial growth beyond its comparative advantage. Their high sustained growth was characterized by more innovative and technologically advanced firms, substantial improvement in labor skills, and higher value-added output in the economy.

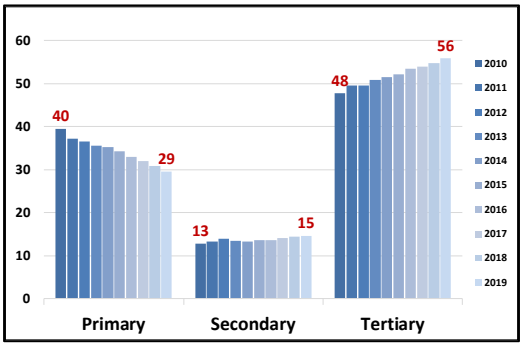
Indonesia's economy is broadly classified into three main sectors; primary (agriculture and mining), secondary (manufacturing), and tertiary (trade, services, and others). Between 2010 and 2019, the share of GDP contribution by secondary sector has slightly decreased (from 23% in 2010 to 22% in 2019) (Figure A), while the share of employment within this sector has been rising (from 13% in 2010 to 15% in 2019) (Figure B). This phenomenon indicates a relatively stagnant manufacturing growth, if not declining, and a sharp deterioration of labor productivity in the manufacturing sector. Similarly, the sign of decreasing labor productivity also emerges in the tertiary sector as the employment share rose at a faster rate than the rise in its GDP share. On the other hand, the primary sector's contribution to Indonesia's GDP has been steadily declining from around 25% in 2010 to 21% in 2019. Meanwhile, the share of employment within this sector decreased at a more rapid pace to 29% in 2019, compared to 40% in 2010, suggesting an increase in labor productivity in the primary sector. However, the rise in labor productivity in the primary sector might not help much in escaping the middle-income trap as this sector has a low value-added and relies more on commodity prices in terms of its growth.

Figure A: GDP Share by Sector (%), 2010-2019



Source: CEIC

Figure B: Employment Share by Sector (%), 2010-2019



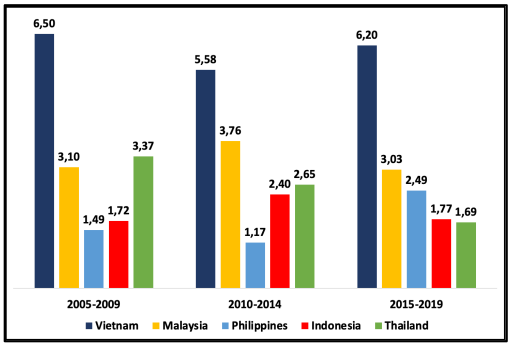
Source: CEIC

Bottleneck of Investment

Speaking about the current investment condition, Indonesia has achieved stable economic growth but with declining investment growth. The gradual economic recovery since the Asian Financial Crisis has been mostly commodity-driven and relatively not sustainable; thus, investment towards higher value-added industries is needed. Historically in the last ten years, investment has on average contributed to 32% of Indonesia's GDP, relatively higher compared to other ASEAN countries, Malaysia (24%), Thailand (24%), Vietnam (25%), Philippines (23%), but with a stagnant trend. However, Indonesia's investment growth has been sharply declining from around 9% in 2010 to only around 4% in 2019, while other peer countries such as Vietnam and Thailand have been experiencing a steady upsurge of investment growth – even reaching a double-digit level of growth. This might serve as an early warning of unattractiveness investment and business climate toward Indonesia compared to its ASEAN peers.

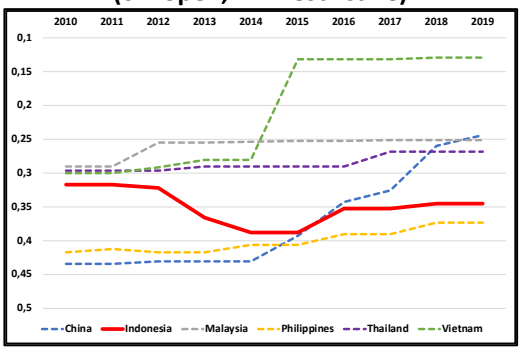
Foreign Direct Investment (FDI) has been studied extensively in the literature as an important source of technology spillover and improvement in efficiency and growth. Recent data shows that Indonesia's FDI is relatively lower than other ASEAN peers, especially during 2015-2019, where the average of FDI is only 1.7% to GDP. Indonesia is also found to have relatively restrictive policies to inward FDI, reflected by a higher FDI restrictiveness index than its peers (Figure D). In contrast, Vietnam has a very low FDI restrictiveness index, among others. This suggests that Vietnam tends to have a more open policy towards foreign investment, while Indonesia has not progressed significantly, which poses a significant challenge for its competitiveness. Besides macroeconomic stability, human capital, or financial development, institutional quality also plays a crucial role in attracting FDI, which becomes the central issue Indonesia is facing now. Several major deterrents for foreign investors include the highly complex regulatory landscape in Indonesia, large numbers of overlapping regulations at central and regional levels, and corruption practices. Excessive regulations raise business transaction costs and unduly discourage investments, leading to corruption and rent-seeking activity. Too many regulations have been forcing firms to resort to illegal payments or bribery to hasten the process of obtaining permits, clearances, and public service connections. Therefore, improved regulatory quality and the rule of law, clear enforcement of contracts and property rights, and corruption control should be addressed thoroughly; otherwise, Indonesia will continue to struggle to attract foreign investors.

Figure C: FDI (% to GDP)



Source: The World Bank Database

Figure D: FDI Restrictiveness Index (0 = open, 1 = Restrictive)



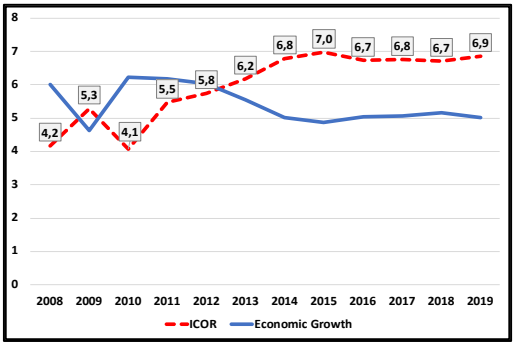
Source: OECD

On the other hand, Indonesia's Incremental Capital to Output Ratio (ICOR) level is considerably higher than in other countries. Figure E shows that the ICOR value had been worsened over the last ten years from 4.1 in 2010 to 6.9 in 2019. Meanwhile, other developing countries have ICOR levels at only around 3%. Higher ICOR suggests that the capital invested generates less output; put simply, investment spent is more inefficient in generating output. Moreover, two factors are driving the high level of ICOR. First, according to Schumpeter (1912) and Romer (1990), an increase in ICOR is due to the decreasing assessment of technological readiness and the lack of capacity and quality of human resources to innovate in utilizing incoming investment. Second, the current investment is the high capital-intensive investment, in which the outcomes can only be seen in the long term, such as investment in infrastructure. Thus, while the value of ICOR might not tell the full story of investment's productivity (especially in short-term), the dynamic of ICOR value shall serve as an indicator whether the capital invested in the past is translated into real productivity and welfare improvement.

Next, when we breakdown the investment composition over the last five years, domestic investment continues to increase while there was no significant increase in foreign investment. The value-added of investment can be inferred from the investment destination sectors. Based on the sector, the trend of foreign investment in the primary sector, such as agriculture, plantation, and mining, as well as the secondary sector (manufacture) is decreasing. Meanwhile, the tertiary sector is more attractive to foreign investors as it generates higher value-added, such as transportation, construction, tourism,

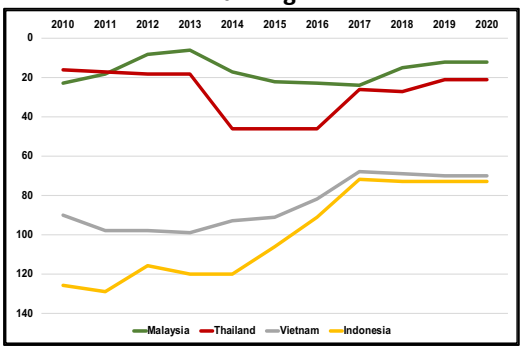
communication, and other services. In 2013, the share of foreign investment in tertiary sectors constituted only 22% of FDI but continued to grow rapidly, reaching 54% in 2019.

Figure E: ICOR and Economic Growth



Source: CEIC

Figure F: Ease of Doing Business (EoDB) Ranking



Source: The World Bank Database

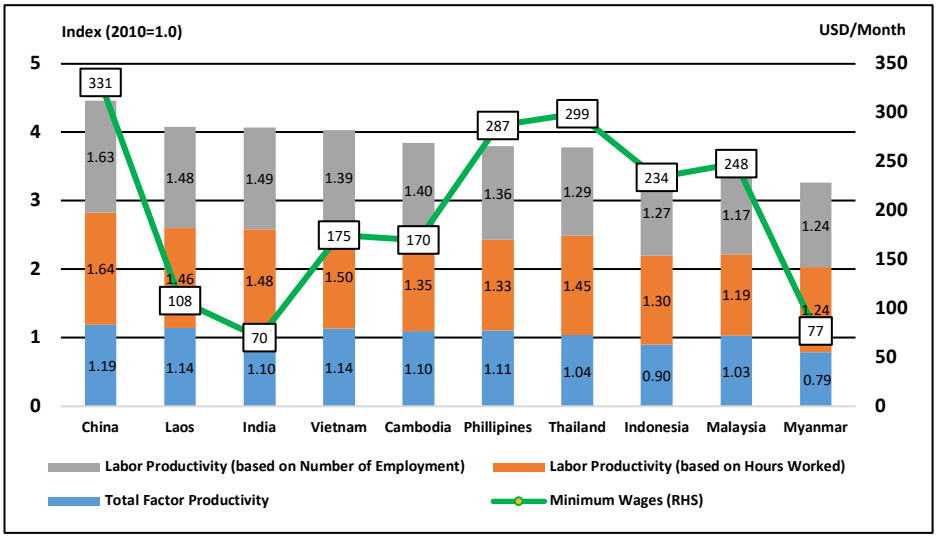
Indonesia is ranked 73 out of 190 countries in the 2020 EoDB, remained unchanged for the last two years. Indonesia's EoDB ranking is still relatively low among peer countries, such as Vietnam, Thailand, and Malaysia. To reap more investment, GoI needs to continue improving the business climate in Indonesia by addressing various regulation issues since Indonesia has a very low rank in several criteria such as starting a business (#140), dealing with construction permits (#110), and registering property (#106). Indonesia also appears to have the most restrictive labor regulations than other countries in the region. Among the key concerns of Indonesian firms with respect to labor regulations are hiring and firing procedures and wage setting. Stringent labor regulations can significantly affect a firm's decision to invest, especially if labor accounts for a large share of the production costs. In hiring and firing practices, the Global Competitiveness Report 2019 gives Indonesia a ranking of 23 out of 141 or less favorable than Singapore and Malaysia. While in terms of flexibility of wages determination, Indonesia ranks 81 out of 141 behind Singapore, Malaysia, Vietnam, and the Philippines.

Increasing the investment level is critical, but this is a daunting challenge given that investor confidence remains relatively low. An essential step toward increasing investment, especially to accelerate economic recovery when the Covid-19 subsides, are to improve the investment and business climate. We can learn from Thailand, which successfully carried out business reforms to help create jobs, attract investment, and become a more competitive economy. Since 2016, Thailand undertook regulatory reforms by cutting regulations that are burdensome for the business climate. As a result, Thailand's EoDB ranking has improved significantly, from 49 in 2015 to 21 this year. However, any improvement in EoDB does not necessarily increase FDI, since other aspects affect investment but are not included in EoDB (i.e., local content requirements, non-tariff barriers, etc.).

Poor Competitiveness due to Low Productivty

Labor productivity is a critical economic variable closely related to economic growth, competitiveness, and living standards. Labor productivity, also known as workforce productivity, can be calculated based on the number of workers or the amount of worked hours. The Asia Productivity Organization (APO) estimates the productivity of countries in the world by using a productivity index, which shows the measure of the movement of labor productivity based on the number of workers and the working hours and total factor productivity. Based on this index, Indonesia is far below China, India, and some other ASEAN countries. Indonesia's productivity index in terms of the number of workers and working hours is 1.27 and 1.30, respectively. Indonesia is in the bottom three positions after Myanmar and Malaysia. However, Indonesia's minimum wage per month is relatively high compared to other countries, including Vietnam, which is one of Indonesia's competitors in the manufacturing industry.

Figure G: Comparison of Productivity Indices and Minimum Wages between Countries



Source: APO Productivity Databook 2019, Trading Economics

Indonesia's relatively low productivity is partly due to the Indonesian workers' level of education and training, where there are still many unskilled workers who affect productivity levels. This is also in line with Indonesia and Vietnam's average working hours, where Indonesia is slightly higher than in Vietnam. The sizeable wage differentials and slight differences in working hours can be one reason for shifting employment to Vietnam. Furthermore, a survey conducted by the Japan External Trade Organization (JETRO) in 2019 included questions about the appropriateness of minimum wage set by the local government from the perspective of productivity. Based on the survey, Cambodia and Indonesia's productivity are among the lowest in the region, while the wage increase ratio is very high. More than half of the Japanese companies said they were not satisfied with the minimum wage from the perspective of productivity in Indonesia and Cambodia.

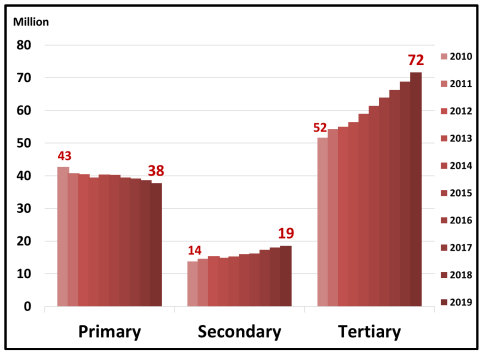
'New Sector, Same Old Competence'

Indonesia is currently enjoying the demographic dividend phase, in which the productive-age group dominates the population. In that regard, several employment issues have become a major concern, such as job creation, productivity, and the disparity between men and women worker treatment. Based on Figure H, we see that employment in Indonesia has increased over time. Looking deeper into Indonesia's employment profile, we see that majority of labor is agglomerated in the tertiary sector, accounted for 56% of the total labor employed in 2019 or equivalent to 72 million people. Consists of six sectors ranging from trade to other service-related sectors, the amount of labor in the tertiary sector has consistently increased over time, with an average annual increase of 1.8%. However, Indonesia's largest proportion of employment is contributed by agriculture in the primary sector, with a 28% proportion of the total labor employed in 2019. Unfortunately, the primary sector, especially agriculture, has faced a decreasing trend since 2010. The decreasing trend of labor in agriculture, along with the increasing trend of labor in the secondary and tertiary sectors, on the other hand, implies that the current labor trend has shifted from the low value-added sector to the higher value-added sectors.

However, the shifting trend from the primary sector to the secondary and tertiary sectors has not been accompanied by an increase in educational level. Whereas, the skill capacity and educational background hold an essential point that shaped the quality of labor and their competitiveness. Referring to Figure I, primary school labor has dominated the labor proportion since 2010. The domination of labor from primary school has persisted and recorded a 25% proportion in 2020. A study from OECD in 2016 found that labor with a minimum education level of post-secondary school is likely

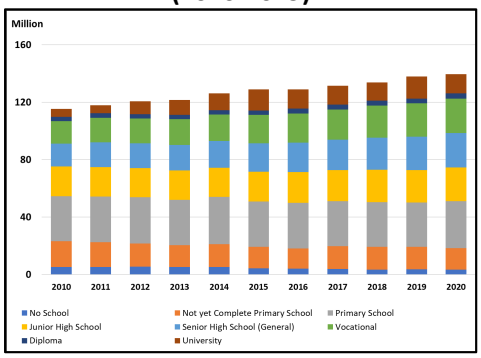
to elevate his career and become more flexible in the labor market. The shifting trend in the Indonesian labor market that has not been followed by an increase in the educational level will likely shift the unskilled labor into the secondary and tertiary sector from the primary sector. As a result, the two sectors' productivity will remain unchanged or even face a lower productivity trend. Consequently, the secondary sector's output will be dominated by low value-added manufacturing products, and low value-added services will dominate the tertiary sector.

Figure H: Employment by Sector (2010-2019)



Source: CEIC

Figure I: Employment by Education Level (2010-2019)

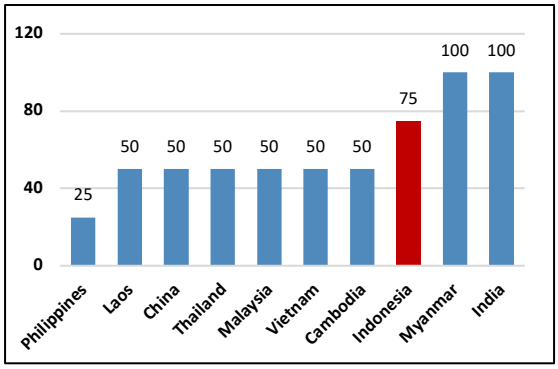


Source: CEIC

Cost of Hiring/Firing and Employee Benefits Comparison

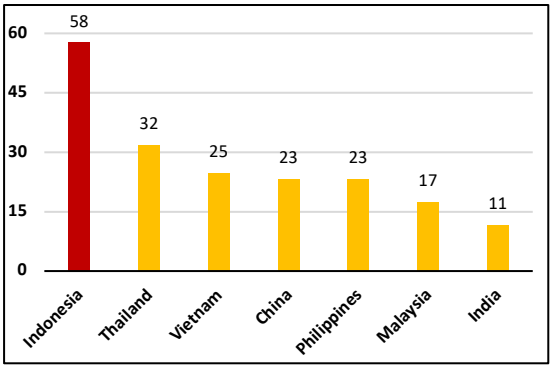
Costs of hiring and firing can affect the risks and costs of investments and other business strategies, including decisions related to employment by firms. Lower costs in hiring and firing can influence the growth of companies and increase the adaptability of firms to adjust following the business cycle. The hiring/firing costs differ across countries, notably because of differences in employment protection legislation and regulations regarding minimum wages. The hiring and firing costs can affect the firm's access to skilled labor, including from abroad. Therefore, it will affect competitiveness. Martin and Scarpetta (2012) find that stringent labor protection laws have a sizeable negative effect on labor flows and, as a consequence, on aggregate productivity growth.

Figure J: Overtime Pay (% of Hourly Pay)



Source: Doing Business, The World Bank

Figure K: Severance Pay (Weeks of Salary)



Source: Doing Business, The World Bank

The hiring-firing costs here include the minimum wages explained earlier, the direct costs associated with the minimum wage, obligatory social charges, and the employment protection legislation (EPL) that includes provisions for redundancy and severance pay for workers. Based on the Doing Business Report in 2018, additional costs beyond the working hours in Indonesia are 75% of the payment per day. This amount is higher than the average cost in neighboring countries such as Thailand, Malaysia, or even Vietnam. Besides, the cost of severance pay due to employment termination in Indonesia is also the largest among several other countries in Asia, which is equivalent to 57.8 weeks of salary. The

high cost of employment termination makes it difficult to replace workers who are no longer productive with new workers who have more abilities.

This also includes incentives offered by employers to the employee. The following table shows a comparison of worker incentives in several countries. Other incentives are also often provided by companies, such as health, dental, and vision insurance; flexible hours and remote working options; student loan or tuition assistance; free gym membership or fitness classes; etc. In Indonesia, most of the employee incentives offered to depend on the individual firm. However, some are also arranged, including annual leave; maternity leave; and Statutory Sick Pay (SSP). When compared to several other countries, the period of maternity leave and annual leave in Indonesia is relatively shorter, although it does not rule out the possibility of obtaining an extension with specific terms and conditions that must be met by workers.

Table L. Employee Benefits Comparison

Employee Benefits	Country	Amount of Benefits
Statutory Sick Pay (in GBP)	Switzerland	£802.47
	Norway	£667.32
	Australia	£661.85
	Luxembourg	£617.69
Paid Vacation Days/Annual Leave (days per year)	UK and Lithuania	28
	Sweden, Luxembourg, Finland, France, Denmark, Austria	25
	Iceland	24
	Norway	21
	Indonesia	12
	Japan	10
	USA	0
Maternity Leave/Paid Leave Available to Mothers (weeks, full-rate equivalent)	Estonia	85
	Austria	51
	Japan	36
	Indonesia	12
	Australia	8
	USA	0

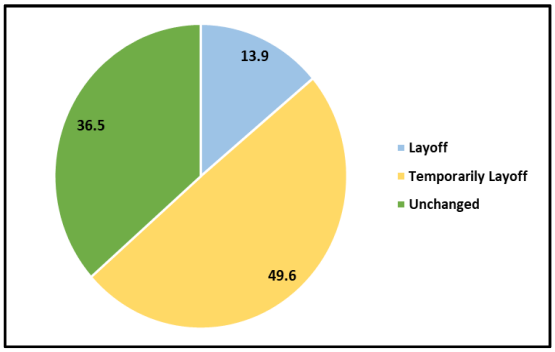
Source: Indonesia Payroll and Benefits Guide (2018), UNICEF Report (2016)

Labor Incentives during Pandemic

The Covid-19 pandemic has put many sectors on the critical stage of the economic, business, and social aspects. On the business side, several policies to prevent the transmission of the virus, such as large-scale social restriction (PSBB), have negatively impacted the revenue. As a result, to keep the business alive, the owner has to implement several strategies, including layoff and downsizing. A survey from LIPI, Ministry of Labor, and LD FEB UI (2020) mentioned that approximately 13.9% of businesses permanently reduce their workers' numbers. During the pandemic, the layoff trend was also reflected in the early withdrawal rate of retirement plan from the Institution of Social Security for Worker (BP Jamsostek) with a total increase of 22.2% (y.o.y). As the pandemic shows no sign of ending period shortly, the labor condition will remain vulnerable along with the business condition.

Regarding the vulnerability of Indonesia's labor, the GoI has decided to grant the workers the unemployment benefit. Referring to Table N, several ASEAN countries have implemented the unemployment benefit, with Vietnam as the country with the broadest coverage accounted for 66.6% of the total population in 2019. As stated in the new Job Creation Law, the unemployment benefit that will be received by the workers is the layoff grant. The program's ultimate goal is to secure the life quality of Indonesian labor and increase their well-being.

Figure M: Survey of Covid-19 Impact on Employment



Source: LIPI, Ministry of Labor, and LD FEB UI

Table N: Unemployed Receiving Unemployment Benefit in 2019 (% of Population)

Vietnam	66.6
Thailand	61
Laos	7.6
Malaysia	3
Indonesia	0
Cambodia	0
Philippines	0

Source: ILO

Higher Investment to Expand Job Creation

The structural changes in labor and job creation regulation are vital to secure long-term labor's welfare and higher economic growth. Given the above discussion of Indonesia's existing labor condition, several issues need to be addressed by GoI while expanding the job creation, such as the relatively low labor productivity, high share of unskilled labor, and high cost of hiring or firing. The low productivity in Indonesia's labor is recorded due to the high share of unskilled labor in the market, as 59% of labor has either a junior high school degree or lower. The low productivity is expected to persist or even declining, particularly in secondary and tertiary sectors, if there is no improvement in the labor's educational attainment level. The historical data shows that labor has shifted from primary to secondary and tertiary sectors, but the increase has not followed the shift in educational background. Thus, productivity in both sectors is unlikely to change in the future.

On the other hand, the labor cost is relatively expensive. The costs related to labor in Indonesia, not only the wage but also the additional costs beyond the working hours, are relatively higher than the other countries. The cost of severance pay due to termination of employment is also the highest. It becomes one of the factors that lead to the currently rigid domestic labor market as it is difficult for a firm to replace workers who are no longer productive with new workers who have more capabilities. If the workers' current benefit can be partly shared with the firm by giving more flexibility, particularly in the cost of the real minimum wage, it will further boost economic conditions along with improvement in worker's living standards. Since informal workers dominate Indonesia's dual labor market structure compared to labor in formal sectors, the higher real minimum wage will reduce the demand for formal labor in the market, thus increasing the informal market's labor supply. The higher number of labor queuing in the informal sector will only hurt the informal labor even further as their wages decrease. Conversely, if some benefits are transferred to the firm, the transformation in the labor market from informal to formal sectors becomes likely to be achieved as the firms are getting more confident in entering the formal business. However, the informal to formal sector's structural transformation also requires an improvement in the labor's educational attainment level in the labor market, which has been dominated by low-educated labor.

To tackle the above issues related to the labor market, the GoI has made an effort through the new Job Creation Law. The law is expected to attract more investors to develop their business in Indonesia as the obstacles related to labor are easing. Besides attracting investment, the first-ever regulation of unemployment benefit stipulated in Job Creation Law will secure labor welfare amidst the potential layoffs due to business cycle or unprecedented events such as this year's health crisis. As the pandemic

shows no sign of ending period soon, the labor condition will remain vulnerable along with the business condition.

All in all, Job Creation Law is one of the GoI's efforts to tackle the inefficiency in the labor market. If it is well-implemented, Indonesia will create more jobs and maintain labor's standard of living due to higher investment realization amidst the recovery period from the Covid-19. To achieve the law's objective, prudent preparation on the technical details of the regulation is required to consistently implement the law. Further, a solid monitoring system of the law implementation by both government and non-government bodies, particularly regarding the details on other aspects that have not been mentioned yet in the above discussion (e.g., environmental or regional authority issues), will ensure the effective implementation of the regulation. The GoI is also required to increase the frequency of public socialization regarding the Job Creation Law's implementation to accelerate people's and investors' confidence further. All national stakeholders should expect that the more efficient labor market will attract investment, which is urgently needed to create jobs.

Moreover, the investment is also crucial for developing an industrialization strategy in the economy, aiming to increase the value-added of the output, thus, escape the economy from the middle-income trap and achieve long-term sustained economic growth. Nevertheless, Job Creation Law alone might not overarchingly increase the investment since other drivers affect investors' decisions, such as regulatory framework, financial development, and institutional quality. The GoI should keep an eye and put efforts into other aspects to boost the investment, thus stepping-up economic growth.

We are in Recession, but That's Not the Point

While the talks and discussions regarding the crisis brought by the Covid-19 have evolved since the early days the outbreak hit, there is not much certainty nor clarity could be drawn; especially on the discussion of how vast the impact of the crisis could damage the economy. So far, the crisis has hit the countries around the world differently. Some countries are already on their courses toward recovery process as the daily recorded cases are around its lowest level, while others are still struggling on how best to reduce the number of daily cases which still shows an increasing trend. While it might be too early to infer that countries have hit the rock-bottom of economic turmoil, many forecasts suggest that the economic growth of countries will gradually raise after Q2, including the estimates towards Indonesia. Regardless, any predictions these days are much less accurate compared to in normal days and has been revised more frequent than ever. Despite the lower accuracy, the growth trajectory is rather reliable, especially if we compare data for each quarter. Looking at the Q2 GDP data of Indonesia, it shows the worst decline of economic growth since the Asian Financial Crisis in 1998. Despite the fact that the economic shrink of Q2-2020 is not as severe as the economic decline in mid-1998, the recovery path of today's crisis might not be as clear as it was back in 1998 as we are still uncertain of how long this crisis will take place.

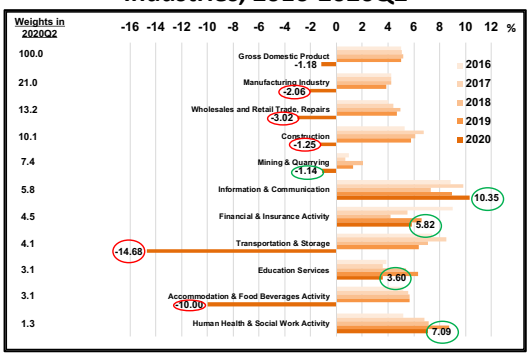
"…whether we fall into the textbook definition of 'recession' is only a matter of technicality and rather beside the point."

Regardless, it is quite a certainty that the economy will still be under stress at least for this year; thus, we predict that the GDP growth for FY2020 will be on the negative territory. We also predict that the GDP growth will still be on the negative territory in in Q3-2020, hence putting Indonesia in a technical recession status. However, whether we fall into the textbook definition of 'recession' is only a matter of technicality and rather beside the point. During this crisis, many countries has fallen into that definition and it should not be a concern for anyone. The focus should be put solely on the management of virus containment and the reduction of daily cases and providing people who lost their income to be able to maintain their subsistence. It has been demonstrated by many countries that are already far ahead of us in terms of recovery that the it

is rather impossible to have an economic recovery without health recovery. This phenomenon speaks volume in terms of where the GoI should lie its focus. The focus and implementation of virus containment strategy will play a vital role in Indonesia's economic condition, at least for the rest of this year and next year. In 2021, while it is rather difficult to estimate the economic growth, we predict that GDP growth will be back into a positive territory and could reach its pre-pandemic level, given the health aspect crisis management deployed in an effective manner.

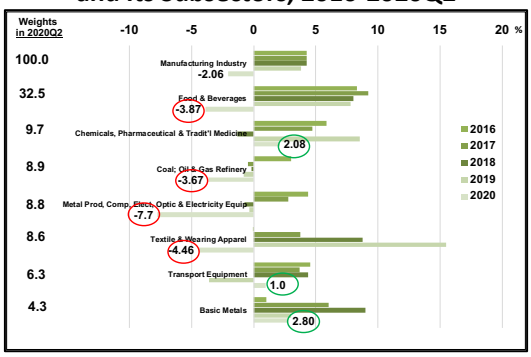
Looking back, similar to what happened in Q1-2020, the growth of -5.32% in Q2-2020 came as a shock to many. While some predicted a worse drop than the realization, most prediction was more optimistic compared to the actual data published. The top three sectors of Indonesia's economy (e.g. manufacturing, wholesale & retail trade, and construction sectors), which attributed to almost half of the GDP, experienced a more profound negative growth compared to the overall economy. Manufacturing industry, accounted for more than 20% of GDP, shrank by -6.19% (y.o.y) in Q2-2020, substantially lower than a positive growth of 2.06% (y.o.y) in Q1-2020. Similarly, wholesale and retail trade sector recorded a negative growth of -7.58% (y.o.y) in Q2-2020 from an increase of 1.54% in the previous quarter, capturing pertinently the plunge in purchasing power. Furthermore, most of the infrastructure and project development is being halted and conveyed by the growth of construction sector of -5.39% (y.o.y) in Q2-2020, a sharp decline from Q1-2020 of 3.90% (y.o.y). While several sectors are thriving and enjoying a rapid growth during the pandemic period (e.g. ICT, Financial and Insurance activity, Human health & social work activity sectors), others which affected unfavorably by the crisis recorded a negative growth in Q2-2020 for the first time as majority were still showing a positive growth – despite significant decline – in the first quarter of 2020.

Figure 1: Growth of GDP and the Main Industries, 2016-2020Q2



Source: CEIC

Figure 2: Growth of Manufacturing Sector and Its Subsectors, 2016-2020Q2



Source: CEIC

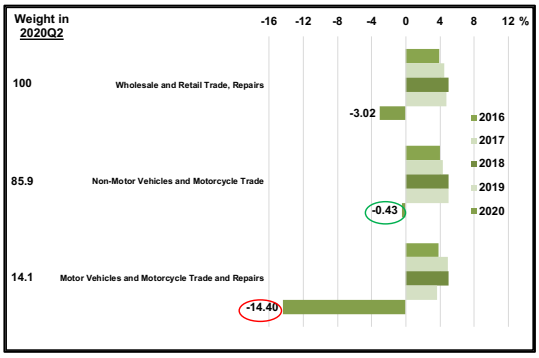
Focusing on the manufacturing industry and its subsectors, it is relatively telling the same story with the overall conditions in which majority of the subsectors experienced a record low of growth. However, accounted for almost a third of the whole manufacturing industry, food and beverages subsector somehow managed to record a slight positive growth of 0.22% (y.o.y), though worse than the growth of 3.94% (y.o.y) in Q1 2020 or even around 7.78% (y.o.y) in 2019. Undoubtedly, chemicals, pharmaceutical & traditional medicine subsector recorded a rapid growth of 8.65% (y.o.y) in Q2-2020, continuing its accelerating growth pace from 5.59% (y.o.y) in Q1-2020 as the demand for these products is higher than ever. Before pandemic, this subsector was the fifth biggest subsector within the manufacturing industry and now it became the second-largest contributor after food and beverages. On the other hand, while their size is relatively smaller compared to the previous subsectors, several subsectors recorded double-digit negative

growth. Transport equipment (-34.29%, y.o.y), textile & wearing apparel (-14.23%, y.o.y), machinery (-13.42%, y.o.y), rubber(-11.98%, y.o.y), tobacco (-10.84%, y.o.y), and coal, oil & gas refinery (-10.31%, y.o.y) are among the biggest losers during this crisis as these subsectors recorded a massive decline of output in Q2-2020. While the figure is rather depressing, this all is not much surprising as we have predicted in our previous outlook that the materialization of halted economic activity will be reflected more vividly in the second quarter of 2020.

"…The considerably high-income population chose to restrain their consumption as the precautionary effort."

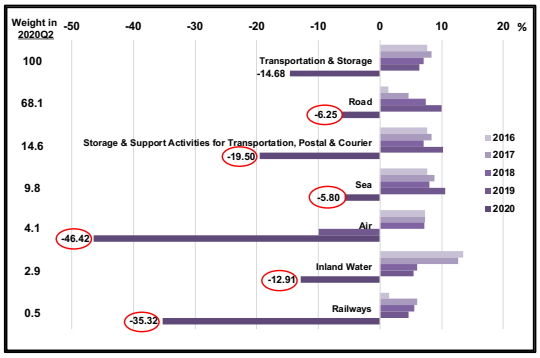
The impact of Covid-19 in Q1-2020 has not been entirely escalated as the impact of the pandemic in Q2-2020 has drowned the economy way deeper than the previous period. Similar to the manufacturing sector, wholesale and retail trade sector also recorded negative growth in Q2-2020. The regarding sector marked its lowest growth in history with the value of -7.58% (y.o.y) compared 1.54% (y.o.y) growth in the previous quarter. The implementation of large-scale social restriction (PSBB) that has limited been limiting public mobility was directly affecting the purchasing activity in society. Besides, as the pandemic has not shown any sign of ending period, the considerably high-income population chose to restrain their consumption as the precautionary effort. Purchasing activity of any durable goods has become a non-preferred option since then. Looking further, both components of wholesale and retail trade also have not presented any better performance to maintain the growth of the main sector. The non-motor vehicle trade declined and recorded negative growth of -2.51% (y.o.y) compared to 1.66% (y.o.y) in Q1-2020. Given the valuable proportion of 85.9%, the negative growth in non-motor vehicle trade subsector is firm enough to deteriorate the performance of wholesale and retail sector. Marked the same pattern, but worse, the subsector of motor vehicle collapsed to -29.83% (y.o.y) compared to 1.03% (y.o.y) in the preceding quarter. Despite the proportion of motor vehicle trade is relatively small than the non-motor vehicle trade, the hefty amount of decline should be categorized as the main driver of the negative growth in wholesale and trade sector.

Figure 3: Growth of Wholesale and Retail Trade and Its Subsectors, 2016-2020Q2



Source: CEIC

Figure 4: Growth of Transport and Its Major Subsectors, 2016-2020Q2



Source: CEIC

The real cataclysm happened in the transportation and storage sector. The regarding sector was considered as the main loser in Q2-2020 that recorded negative growth of -30.76% (y.o.y), tremendously lower than the 1.41% (y.o.y) in the previous quarter. Drew the same pattern as the wholesale and retail sector, the transportation and storage sector also marked its lowest growth in history. The Covid-19 impact was materialized and showed its real effect in Q2-2020 along with the implementation of large-scale social restriction (PSBB) in almost all regions in Indonesia. The increasing number of additional Covid-19 cases also shared a big proportion of role in the declining growth of transport and storage sector as people has become more cautious about the pandemic. Examining deeper into the subsector of transportation and storage, all the

components experienced a declining output and marked a negative growth in Q2-2020. Among all subsectors in transportation and storage, the air and railway transport subsector was considered as the components with the hardest hit. In Q2-2020, the respective subsector recorded a negative growth of -80.12% (y.o.y) and -63.73% (y.o.y). Despite the declining pattern in Q1-2020, the growth in Q2-2020 certainly showed a tighter economic activity halt as the enforcement of large-scale social restriction (PSBB) had been conducted by the legal officer both in regional and central government. The same driver also applied to the declining activity of road and sea transport in Q2-2020 that recorded respective growth of -17.65% (y.o.y) and -17.48% (y.o.y) compared to the positive growth in the preceding quarter.

The impact of Covid-19 in the previous quarter had been considered only as of the beginning and didn't tell us the full story of Covid-19 impact scale, given the performance in Q2-2020 that presented a bleaker realization. Majority of sectors were defined as the losers, but worse, as the impact of the pandemic has wholly set in Q2-2020. The increase in Covid-19 case has made society more cautious about the pandemic. However, despite the slumped growth of overall GDP, the particular sectors were consistently enjoying a higher growth since Q1-2020. The ICT sector recorded a favorable growth of 10.88% (y.o.y), increased 1.07 point from the previous growth of 9.81% (y.o.y) in previous quarter. As most workers are forced to work from home and students to study not in the class, everyday physical face-to-face interaction was replaced by online interaction and this increased the growth of the ICT sector. Last but not least, the agriculture sector also marked a higher growth of 2.21% (y.o.y) in Q2-2020 compared to the rather insignificant growth of 0.06% (y.o.y) in Q1-2020. Given the notable proportion of agricultural sector in GDP that accounted for 11.9%, the regarding sector might worth considering, especially during the recovery process, to be supported by the GoI as they are having potentials and an ample room of growth.

Seeking Measures to Fasten Economic Recovery

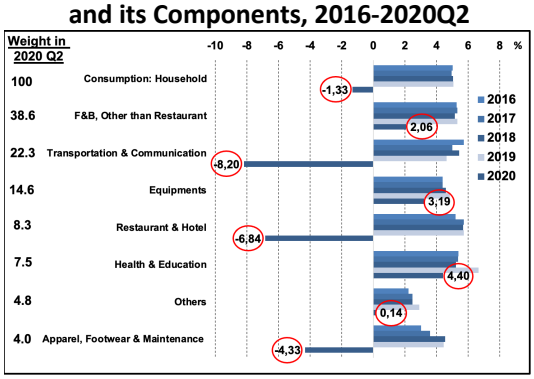
"Mobility restriction, precautionary behavior, and labor income losses led to a sharp contraction in almost all subsectors in consumption, except consumption in health & education and equipment."

Covid-19 heavily impacted Indonesia's economic growth as the outbreak creates widespread disruptions in all aspects of the economy. The GDP growth sharply contracted by -5.32% (y.o.y) in the second quarter of 2020, fall sharply from positive growth of 5.05% (y.o.y) on the same quarter last year and marked as the worst plunge since the 1998 Asian Financial Crisis. The economic downturn was also fully reflected in the expenditure side, which negative growth was observed across all GDP components. Notably, household consumption and investment, which make up to more than 80% of GDP, dropped by -5.51% and -8.61% (y.o.y) respectively.

Mobility restriction, precautionary behavior, and labor income losses led to a sharp contraction in almost all subsectors in consumption, except consumption in health & education and equipment. In details, the highest sharp decline recorded in restaurant & hotel followed by transportation & communication consumption, which contracted by -16.41% and -14.79% (y.o.y), making the overall growth in 1H-2020 to -6.84% and -8.2% respectively. On the other hand, high uncertainty, low commodity prices, and weak demand depressed all subsectors in investment. A contraction in investment in buildings & structures that dominates investment pie at about 75% was mainly attributed by the postponed in infrastructure projects in almost all regions. Moreover, the decline in the capital goods' demand due to a halt in production in almost all sectors as well as the disruption in the global supply chain contributed to a declining demand on investment in machinery & equipment as well as investment in vehicles.

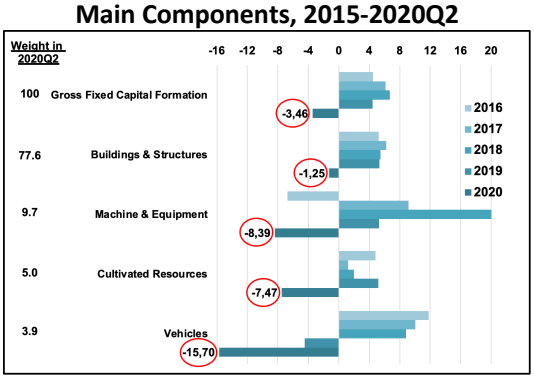
Given the size and unprecedented nature of the Covid-19 shock to the economy, high uncertainty looms over when this pandemic will end. The probability of slower economic activity in Q3-2020 compared to its figure last year is inevitable since the business cannot operate at full capacity. Moreover, several economists, institutions, and government officials have projected another contraction in the third quarter, which would lead to a recession, though the number is expected to be less severe compared to the second quarter. This figure is underpinned by an improvement in the average Consumer Confidence Index (CCI) in Q3-2020 to 85.5 from 82.1 in the average of Q2-2020, but still in the pessimistic zone (<100). However, there is a slight drop in the CCI in September to 83.4 from 86.9 in August mainly due to lower consumer expectations of economic conditions in the next six months. The similar story can also be seen in the business activities, indicated by a drop in Purchasing Managers' Index (PMI) to 47.2 in September from 50.8 in August. This shows a recent deterioration in Indonesia's manufacturing conditions during September due to the re-imposition of large-scale social restrictions (PSBB) in Jakarta in the mid-September when an increase in infection rates adversely affected sales and manufacturing production. After enjoying a positive rise in demand during August, the inflow of demands eased sharply in September, albeit at a slower pace than the intense contraction that occurred between March and June as the earliest stage of pandemic.

Figure 5: Growth of Household Consumption and its Components, 2016-2020Q2



Source: CEIC

Figure 6: Growth rate of Investment and its Main Components, 2015-2020Q2



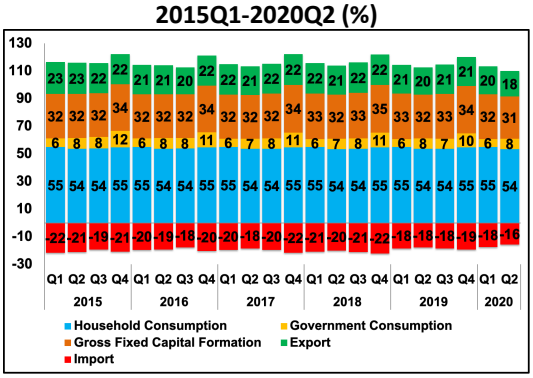
Source: CEIC

"In addition, to counter the current and ongoing subdued investment trend in order to accelerate the economic recovery, the newly passed Job Creation Law is expected to help improving investment climate through deregulation and de-bureaucratization to attract investors participation."

All in all, the recovery implementation will be highly dependent on the capacity to contain the outbreak and the government support. The government has swiftly put in place comprehensive stimulus packages. However, the effectiveness will depend on the speed and performance of the targeting and distributional aspects. Since fiscal space is rather limited, the stimulus should be targeted for the most vulnerable people and for the business sectors and SMEs towards income groups and economic sectors that are most severely affected. In addition, to counter the current and ongoing subdued investment trend, the newly passed Job Creation Law is expected to help improving investment climate through deregulation and de-bureaucratization to attract investors participation, thus, accelerate economic recovery.

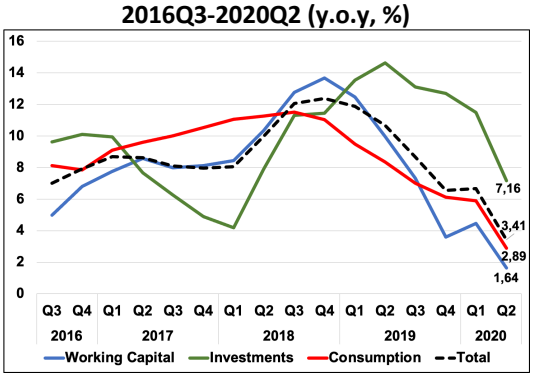
Looking deeper into credit growth (Figure 8), the total credit continues its downward trend from the beginning of last year to the sharpest level of 3.41% (y.o.y) since banks are still cautious and demand for credit is still subdued. Based on the breakdown of the credit components, the lowest trend recorded at working capital loan which only grew by 1.64%, lower than 4.47% in the previous quarter. Following is the decline in consumption and investment loans, which slowed to 2.89% and 7.16% in Q2-2020 from 5.88% and 11.48% in Q1-2020, respectively.

Figure 7: Shares of GDP Components, 2015Q1-2020Q2 (%)



Source: CEIC

Figure 8: Credit Growth by Purposes, 2016Q3-2020Q2 (y.o.y, %)



Source: CEIC

Overall, we estimate that the current lower credit growth will gradually improve and start to recover at the beginning of 2021, in line with the signs of recovery in business activity in Indonesia in Q3-2020 following some easing of social distancing measures since June. In addition, several stimuli from policymakers such as loan restructuring and monetary policy easing through four consecutive rate cuts and QE might help to recover credit growth in 2H-2020 and support the sufficient liquidity in the market. However, the pace of recovery will be slow as companies are not allowed to operate at full capacity. At the same time, a decline in households' income will lead to consumers remain cautious with their spending.

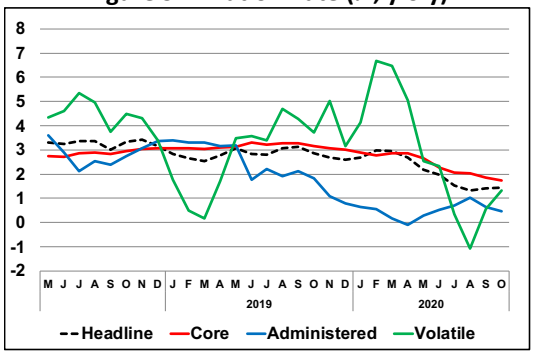
Prolonged Low Inflation due to Sluggish Domestic Demand and Purchasing Power

"However, there is a downward trend on the annual and monthly core inflation in October 2020, which indicates that the purchasing power is still far from being recovered."

Headline inflation in October slightly picked up by 0.02% from the previous month, making it settled at 1.44% (y.o.y). This counts as the fifth consecutive decline to fall below BI's target range of 3%±1% since June 2020. At the same time, both of the annual and monthly volatile food inflation shows the same trend with 1.32% (y.o.y), increase from last month's inflation of 0.55% (y.o.y) due to the rising price of cooking oil, onions, and chili. However, there is a downward trend on the annual and monthly core inflation at 1.74% (y.o.y) and 0.04% (mtm), compared to 1.86% (y.o.y) in the previous month and 0.13% (mtm) in October 2019, which indicates that the purchasing power is still far from being recovered.

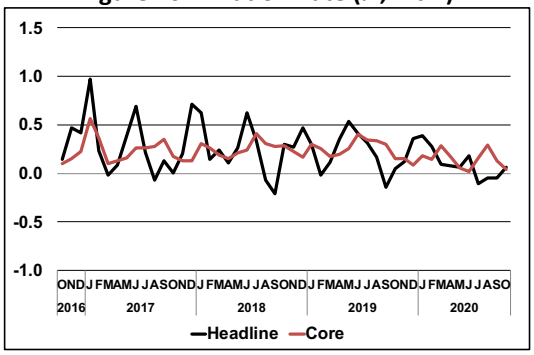
The administered price also plunged both in its annual and monthly rates. Recorded at 0.46% (y.o.y) and -0.15% (mtm), administered price decline from last month's annual record of 0.63% (y.o.y) in September and from October 2019 inflation rates of 0.20% (mtm), suggesting a prolonged weak purchasing power. The current inflation figure shows that aggregate demand is still at its lowest level during the pandemic and there is no definite sign of crisis ending in the near future. People still tend to increase their savings and being hesitant to put their consumption back into the normal level. Hence, there is no robust channel that would provide a fundamental improvement in purchasing power, at least for the next few months.

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



Source: CEIC

Figure 10: Inflation Rate (%, mtm)



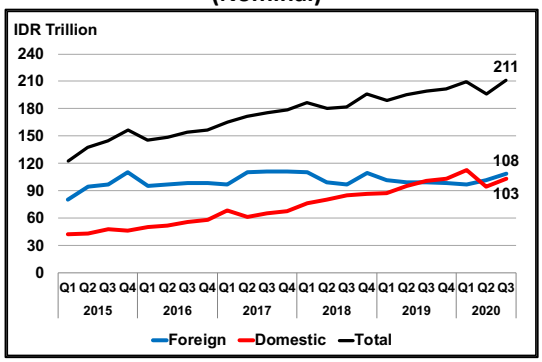
Source: CEIC

Heightened Global Uncertainty Supress Investment

The overall investment as measured by the growth of gross fixed capital formation in Q2-2020 continue to fall into -8.61% (y.o.y) from 1.7% (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 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 7.8% of FDI dan DDI realization in Q3-2020. This improvement was mainly contributed by the increasing domestic investment at 9.1% (y.o.y) which in the previous quarter experienced a decline, along with the foreign investment realization of 6.7%. Lower FDI realization might be explained by the rise in global uncertainty during the pandemic.

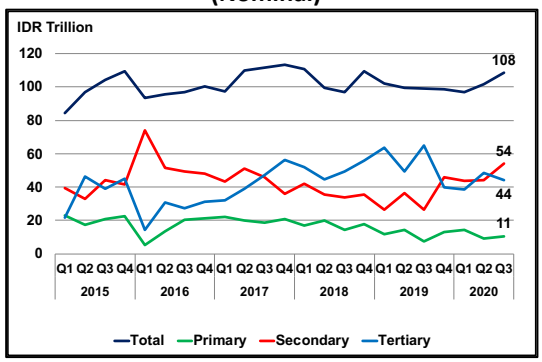
"The overall investment as measured by the growth of gross fixed capital formation continue to fall into -8.61% (y.o.y) which is the lowest growth since 2006."

Figure 11: FDI and Domestic Investment (Nominal)



Source: CEIC

Figure 12: FDI Realization by Sectors (Nominal)



Source: CEIC

Based on the sectoral classification, foreign investors have slowed down the investment in the tertiary (service) sector, while the primary and secondary sectors recorded positive growth. The services activity running in construction; transportation, storage, and communication; hotel and restaurant industries have experienced a downward trend since Q4-2019 due to the Covid-19 pandemic and slow business activity. While the growth of investment indicator in GDP, gross fixed capital formation, is still declining. The GFCF 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.

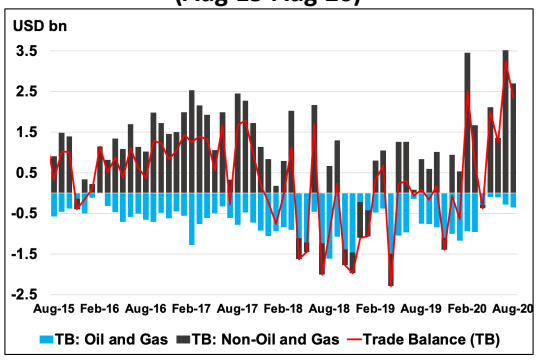
Maintaining Domestic Demand Amidst External Uncertainty

"The progress was supported by higher international demand, particularly from China, as this country has beaten the Covid-19 pandemic since April 2020. .."

The global health crisis has significantly hit international trade since the first outbreak started until around the end of 1H-2020. Recently, the trade data is showing a sign of recovery, though the spread of Covid-19 is reviving in some countries. The improvement in international trade outpaced expectations as the world trade performance has improved in July due to the easing of several movement restrictions. As a result, in early October, the WTO slashed its forecast for global merchandise trade to fall only -9.2% in FY2020 compared to April's forecast of -12.9% drop. The disruption in worldwide demand and supply is expected to affect economic activity in all countries around the world, including Indonesia. After experiencing a significant reduction in export transactions, Indonesia's export has been gradually improving since July 2020 as recorded by persistent positive monthly growth until September 2020, except for August. The progress was supported by higher international demand, particularly from China, as this country has beaten the Covid-19 pandemic since April 2020. However, on an annual basis, the export from Indonesia continues to decline, with the annual growth in Jan-Sept 2020 recorded at -6% (y.o.y) compared to its figure previous year. It shows that exports have not put back yet.

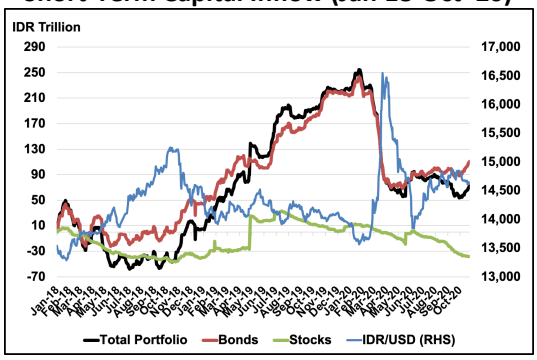
Besides exports, imports in Jan-Sept 2020 plunged even deeper at -25% (y.o.y) compared to its figure in 2019. The lower number of imports is contributed by the delay in the number of goods imported from other countries due to the reduction in business production. However, the import component has also been gradually improving as the monthly data shows a positive growth of imports in August and September 2020. It might reflect a promising sign of the real sector recovery in the near future, as imports mainly consist of raw and capital goods.

Figure 13: Monthly Trade Balance (Nominal) (Aug'15-Aug'20)



Source: CEIC

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



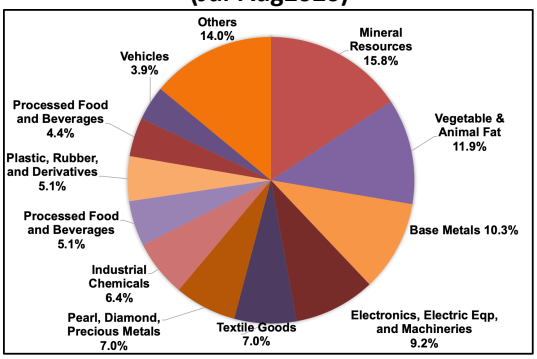
Source: CEIC

Since the decline in imports is deeper than exports during the pandemic, the trade balance of goods trade has recorded a surplus. The second quarter's trade surplus brought improvement in current account deficit which is stood at US$2.9 billion or equal to 1.2% of GDP in Q2-2020, lower than the deficit in Q1-2020 of US$3.7 billion or equal to 1.4% of GDP. Again, we have to keep in mind that the improvement does not represent a better economic condition as the trade surplus was spurred by a significant drop in imports due to weak international and domestic demand. However, the low demand for international transactions at least supports the central bank to manage the stable exchange rate amidst the high uncertainty in the capital market. By looking at the latest trend of trade, we see that lower CAD will remain between 1.2-1.5% of GDP for FY2020.

Moreover, looking at the details of exported products, the export profile continues to become lesser commodity-based compared to previous condition. The export of mineral resources,

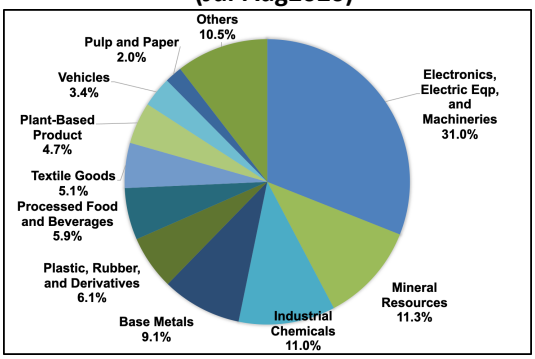
vegetable fat, and precious metals in Jul-Aug 2020 is amounted to 38% of total export, decreased from 41% in Q2-2020. The figure is showing a more distributed goods of export during the health crisis, particularly to the relatively higher value-added products compared to commodities, such as electronics and machinery as well as textile products. Meanwhile, the composition of Indonesia's imports in July-August shows no significant changes where the capital goods and input materials for production, such as electronics and machinery sector are still the highest contributors to imports (31%). The second-largest imported goods are mineral resources which are dominated by crude oil. The value of imported oil is increasing as the global crude oil price has been bouncing back from its April record low. Further, the industrial chemicals are the third-highest products imported by Indonesia from foreign countries as the high demand for medical supplies and equipment during the Covid-19 pandemic. The composition might persist into the end of the year following the continuance of the health crisis.

Figure 15: Indonesia Export Profile (Jul-Aug2020)



Source: CEIC

Figure 16: Indonesia Import Profile (Jul-Aug2020)



Source: CEIC

Given the gradual improvement in international trade since July as mobility restrictions were eased and demand consequently surged, Indonesia's real sector might accelerate their activities in the near future. However, this promising sign should not be translated directly into higher economic growth since our international trade (exports and imports) only contributes to around 37% of the national GDP. Moreover, the high domination of commodity goods in our exports also brings a limited effect from exports to economic condition as the major exported products have a relatively low value-added. Indonesia's exports still also face high uncertainty due to the volatility of commodity prices, though the share of higher value-added products, such as electronics and machinery, is increasing. To boost the economic growth in the remaining quarter of 2020, GoI needs to keep an eye on the external pressures while maintaining the domestic demand. Even though international trade is accelerating, it would likely hard for GoI to boost the transactions into its pre-pandemic figure as the pandemic would not disappear entirely at any time soon in Indonesia. Besides, the potential resurgence of Covid-19 pandemic in the recovered countries at Q4-2010 will also hold back the global demand.

"To boost the economic growth in the remaining quarter of 2020, GoI needs to keep an eye on the external pressures while maintaining the domestic demand"

Further, the trade figure in 2021 will highly depend on the recovery period of the health crisis and economic condition. If there is no sign of vaccine or medical treatments invention to cure the virus soon, the extension of lower exports and imports in Q1-2021 is undeniable. Nevertheless, GoI should prepare for the worst possible outcomes by designing and implementing robust monetary and fiscal policies while continuing several containment and mitigation measurements of the Covid-19 pandemic.