LPEM FEB UI
UNIVERSITAS INDONESIA

Macroeconomics Analysis Series

Indonesia Economic Outlook

Q1 2022

Key Figures

GDP Growth (Q3 '21)
3.51%

Inflation (y.o.y. Dec '21)
1.87%

Credit Growth (y.o.y. Q3 '21)
1.29%

BI Repo Rate (7-day, Jan '22)
3.50%

Current Account Balance (%GDP) (Q3 '21)
1.49%

IDR/USD (Jan '22)
IDR14,330

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Anticipating the Unexpected:

Economic Recovery in the Turbulence Period

Highlights

- *Indonesia's GDP growth rate of Q4 2021 is estimated at 5.1% (y.o.y), bringing overall 2021 forecast at 3.7% (y.o.y). We see a potential for a rebound to pre-pandemic level GDP growth rate at 4.9-5.1% (y.o.y) in 2022.*
- *The massive stimulus programs have created a faster-than-expected demand recovery in various countries, especially developed ones, creating a new problem of rising inflationary pressures as the supply side is relatively slower to catch up.*
- *Rising production costs also add more pressure to the current inflation spiral. Three main channels contributing to the rise of production costs are increasing labor price (wage), input material price, and energy bills.*
- *Indonesia reaps the benefit of high energy price, especially coal and CPO, as the trade balance of these two commodities recorded at USD54 billion in 2021, equivalent to 157% of Indonesia 2021 total trade surplus of USD35 billion.*
- *Furthermore, the higher energy price also boosted state revenues and managed to record a temporary realization of Non-Tax State Revenue (PNBP) of IDR451.98 trillion in 2021, equivalent to 151% of 2021 state budget target and 31.46% higher compared to previous year realization.*
- *Sooner-than-expected monetary normalization program taken by advanced economies as a measure to curb the overheating inflation will likely to have a relatively manageable impact on Indonesia's financial sector.*
- *Compared to 2013 taper tantrum, the ongoing tapering off has smaller impact on Indonesia's capital outflow and Rupiah depreciation due to lower share of foreign ownership of Indonesia's asset, current trade surplus compared to then-deficit, and clearer forward guidance by Fed officials.*
- *Indonesia's risk of overheating inflation is relatively low due to a relatively low stimulus size and gradual recovery progress as it allows supply side to have more time to catch up with demand rise.*

The domestic spread of Delta variant has dragged down the promising upward trend of economic growth from 7.07% (y.o.y) in Q2 2021 to only 3.51% (y.o.y) in Q3 2021 as consumption declined and business activity in various sectors that relies on physical activity was halted. The implementation of PPKM to limit the transmission of Covid-19 hit severely the transportation & storage and accomodation & FnB sectors. Aside from agriculture, Indonesian main economic sectors, such as manufacturing, wholesale & retail trade, and construction, also experienced slower growth in Q3 2021. The second wave has also slammed brakes on all expenditure components of GDP, particularly the household consumption as the biggest contributor of GDP, which was only grew by 1.03% (y.o.y) in Q3 2021, down from 5.93% (y.o.y) in previous quarter. Amidst the ongoing crisis, credit performance has shown a favourable outlook for overall 2021 as it has gradually increased along with

the improved business and consumers sentiment as economic recovery intensifies compared to its ruinous trend during 2020. However, the inflation rate throughout 2021 remains below BI's target range. The low inflation in 2021 was influenced by domestic demand that was not yet fully recovered.

On external side, the investment realization shows a promising sign with the total investment realization reached IDR901.02 trillion in 2021, which exceeded the target stated in the National Medium-Term Development Plan (RPJMN) of 104%. In Q4 2021, the main contributors to the increase in foreign investment realization came from the primary sector, with an increase of almost 42% compared to the previous quarter. Further, export continued to increase until the end of 2021 with the annual growth of 142% (y.o.y). This can be explained by the jump in almost all commodity prices, particularly coal and vegetable oil. The trade balance improvement during the Covid-19 pandemic era had a positive impact on the current account that reach an all-time high surplus in Q3 2021 at USD 4.5 billion or 1.49% of GDP. The robust performance of trade balance and current account balance has helped Indonesia to maintain relatively stable net capital flows and Rupiah throughout 2021.

Table 1: LPEM FEB UI GDP Growth Forecast (y.o.y)

Q4 2021	FY 2021	FY 2022
5.1%	3.7%	4.9% - 5.1%

The Delta variant might signal an important message that the pandemic has not yet reached its ending stage. The upcoming risk of the third wave and some possible other waves in the future may hamper the economic and social condition all over again. Nevertheless, considering the easing of social and economic activity in Q4 2021 after the second wave, the higher consumer and business confidence will be expected to continue in Q4 2021. We see that the economic growth in Q4 2021 will be recorded at around 5.1% (y.o.y); making the estimated growth for FY 2021 at 3.7% (y.o.y). Despite the recent upsurges in daily positive cases of Covid-19 due to the spread of Omicron variant, the economy is expected to be better prepared to deal with Covid-19 as we already have higher vaccination rate and lessons learned from containing the second wave of pandemic. A firm plan of recovery agenda by GoI is expected to avoid another turmoil in health, social, and economic sectors. In turn, GDP is projected to grow higher at 4.9%-5.1% (y.o.y) for overall 2022.

The Rise of Global Inflation

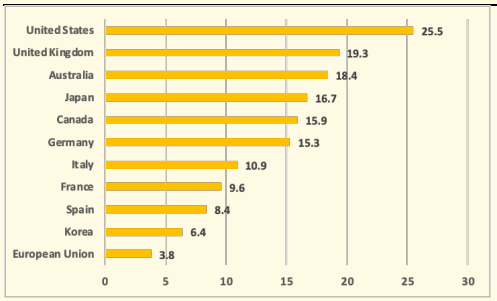
"We are in this together" is a jargon commonly used since the early days of Covid-19 to highlight that society and policymakers across the globe are fighting the same crisis and emphasize the importance of global collaboration and coordination to ensure the health crisis is managed in a swift and pertinent manner. This spirit has been proven rather effective in pushing all parties involved taking the steps towards the right direction. Governments, both from developed and developing countries, injected massive stimulus to the economy to cushion business and vulnerable groups from the pandemic hit. On the other hand, researchers were able to develop various widely accepted Covid-19 vaccine quicker than expected, which have been distributed globally. Despite a stark gap in vaccination rate between developed and least developed countries, a vaccination rate of more than 70% in several countries is an extraordinary achievement. Regardless of the emergence of new variants and other persisting issues, 2021 ends with encouraging milestone in the health aspects, indicated by vaccines rollout, and in the economic aspects, implied by the robust real sector recovery.

However, despite the similar recovery trend across countries, the rate of demand recovery is escalating at a different pace. The variation in the demand recovery rate might came from the different capacity of each country to deploy stimulus in the first place. Some countries, like developed ones, are in the luxury to run sizable budget deficit; thus, enabling them to inject massive stimulus to their domestic economy. On the other hand, despite exceeding their normal deficit limit in times of crisis, the relative size of stimulus deployed by developing countries are substantially smaller compared to developed ones. The good news of robust demand recovery in countries deploying massive stimulus is met by another problem of inflation, while some countries with smaller size of stimulus still grappling with accelerating the rate of demand recovery. Today, each country are pushed to focus on their problems and formulate the policy suited to their own needs as they are on different stages of recovery, despite starting off in a relatively similar position and circumstances.

Asymmetrical Rebound of Demand and Supply

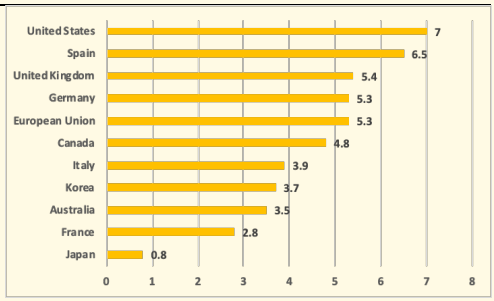
While rising prices are happening everywhere, the US stands out. What makes it different from the rest of the world is probably that it committed large fiscal stimulus in response to the pandemic. The US government passed three primary relief packages and one supplementary package back in March and April 2020. It then passed the USD3 trillion HEROES Act back in May 2020. The Consolidated Appropriations Act, which contained a USD900 billion stimulus plan, was enacted by the US Congress in December 2020, offering further assistance for those who were affected by the pandemic. Deemed unnecessary as the economy is already healing, President Biden signed the USD1.9 trillion American Rescue Plan into law on 11 March 2021. Eligible taxpayers can expect to receive up to USD1,400 per person with the payments quickly phasing out for those with higher incomes. The bill also provided money to extend unemployment benefits of USD300 per week until September 2021. The fiscal stimulus and relief to the US economy during the Covid-19 pandemic clocked in at more than 25% of its GDP in September 2021, the largest among advanced economies.

Figure A: Above-The-Line Fiscal Measures in Response to the COVID-19 Pandemic, Selected Countries As Of 27 September 2021 (% of GDP)



Source: IMF Policy Responses to Covid-19 Database

Figure B: Annual Inflation in December 2021 in Selected Countries (%)



Source: CEIC

While the deficit-financed stimulus was effective in keeping Americans out of poverty and help them get back on their feet, the country was spelled with another problem. From its inflection point throughout the pandemic at 0.12% (y.o.y) in May 2021, consumer prices is persistently increasing hitting 7% (y.o.y) in December 2021, the highest level in four decades. Despite supply bottlenecks that have pushed up prices, many believes that the main source of inflation in the US is the robust increase in demand due to the massive amounts of dollar pumped to the economy. This is indicated by 6.1% annual growth of the US household disposable income in 2020, the fourth highest change among OECD countries just below Canada, Chile, and Ireland. The vaccine rollout led the US to reopen businesses earlier than most countries, resulted in post-lockdown demand rush. Americans are spending more on goods more than before, unleashing the pent-up demand, while supply chains remain a mess. Borrowing Milton Friedman's language, what is happening in the US is a classic helicopter drop explaining how money easily causes inflation.

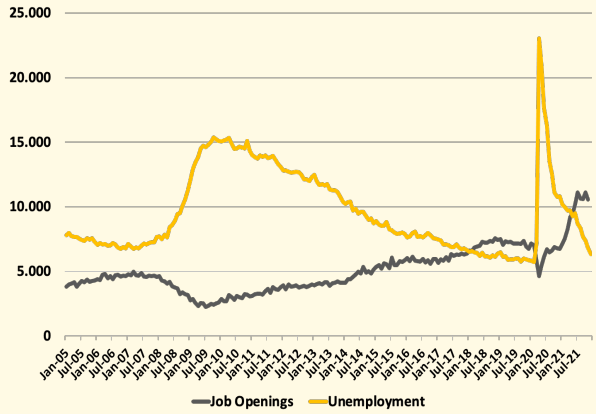
Channels of Rising Production Costs

Thanks to the massive stimulus injection to the economy, demand is rebounding stronger-than-expected in the second half of 2021. The skyrocketing demand, however, was not met by the recovery on the supply side. Global supply-side shocks may stall the economic recovery as they put global inflationary pressures in jeopardy. Cost-push inflation, a situation that there is a decrease in aggregate supply stemming from the higher cost of production which is currently occuring around the world, is mainly driven by three channels: higher cost of labor, raw materials, and energy.

The first channel of rising producers price is labor market. The recovery process has been accompanied by labor shortages that have emerged among developed economies, such as Eurozone, UK, US, and Japan, with pressures most evident in the US. Massive stimulus packages in the US, particularly the USD1.9 trillion Biden Covid relief bill consisting of USD1,400 stimulus checks and unemployment benefits, recover all jobs lost during the pandemic and keep people out of workforce. Looking at the cyclical and fundamental drivers of these shortages, we can see that the US economy has experienced an unusual phenomenon (Figure C): jobs are available, with the job openings rate is around 50% above pre-pandemic levels while unemployment is at a pandemic low, suggesting there is labour shortage. At the same time, there is a declining trend of labor-force participation from around 63% before pandemic to 61% (or the workforce to fill the jobs has contracted around 4.7 million than the pre-pandemic trend). Accordingly, the disequilibrium in the labor market forces the price of labors to go up. Consequently, the increase

in wages has pushed up the cost of a unit of production in terms of unit labor costs. This circumstances have put enormous pressure on businesses to raise to retain their profit margin -- the situation points to what economists call a "wage-price spiral" explaining embedded inflation or rising prices as a result of higher wages.

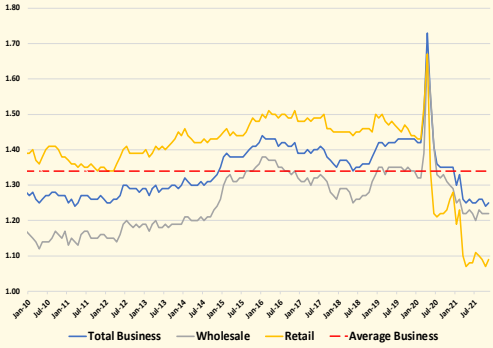
Figure C: US Job Openings and Unemployment Level, 2005 - 2021



Source: U.S. Bureau of Labor Statistics

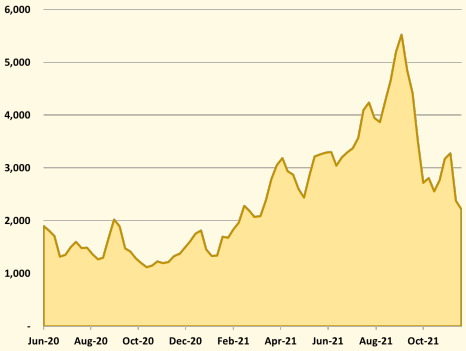
The second cause of supply-side inflation is the higher cost of input materials. The recurrent waves of pandemic has pushed many ports, production plants and factories across the globe to temporarily shut down its operations. For instance, China's "Zero-Covid Policy" has disrupted the global supply chain as it halts the flows of final goods and raw materials across the globe. The bottleneck has been exacerbated as the business-activity shutdown in China occurred near the end-of-year holiday season, in which demand for products were skyrocketed. In addition, US inventory-to-sales ratio for wholesale and retail trade were significantly decreasing since mid-2021, suggesting the occurrence of supply shortage in the domestic trade already took place even before the end-of-year supply chain disruption (Figure D). Moreover, the below-capacity operations of ports and global logistic networks has also contributed to the clogged of freight and multiplied the logistic costs across regions (Figure E). These factors play a role in increasing the cost of input materials.

Figure D: US Inventory-to-Sales Ratio



Source: CEIC

Figure E: Baltic Dry Index (USD)

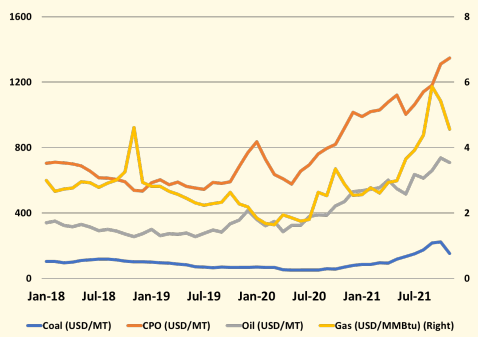


Source: Investing.com

The unbalance recovery phase is creating a massive upward pressure on the energy prices as the energy producers and those who transport goods around the world are still under lockdown. Furthermore, the extreme weather, lower-than-expected renewable productions, and winter season also contribute to creating a glaring mismatch between energy supply and demand.

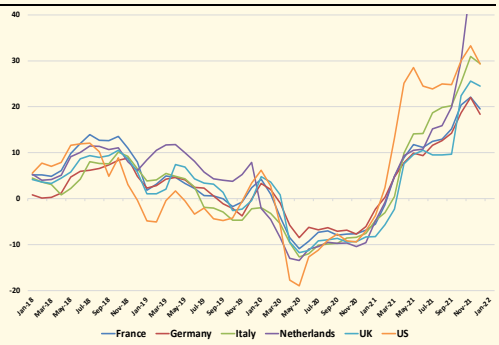
Ramifications were felt for all major conventional energy sources, including oil, coal, gas, and CPO. In 2021, coal prices hike more than double to around USD170/MT from around USD80/MT at the end of 2020 (Figure F). In addition, wholesale gas prices have risen almost 300% in the past year due to unusually low storage levels, increased demand from Eastern European economies, and capped flows from Russia.

Figure F: Major Conventional Energy Prices



Source: Bloomberg and Index Mundi

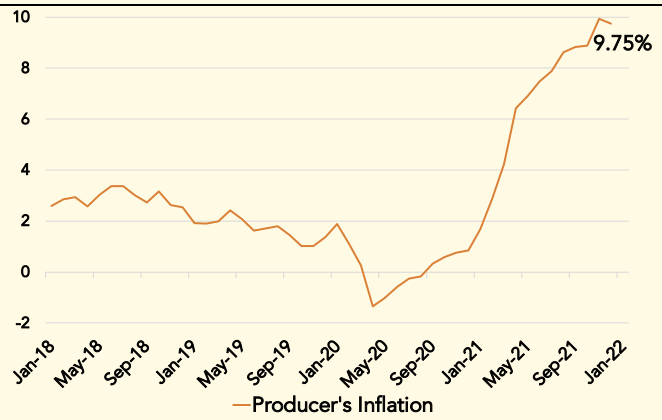
Figure G: Consumer Price Index (CPI) Energy - US and Euro Area, (% y.o.y)



Source: OECD

Stellar rally of energy prices was inevitably materialized in the price component. As shown by Figures G, energy inflation in advanced economies reached its highest level in years, driving up power costs. Rising energy prices are putting the squeeze on households, increasing expenses ranging from heating bills to gasoline costs, with the most impact potentially felt by the poorest household. In the UK, two dozen household energy suppliers have collapsed, illustrating the dire consequences of the ongoing energy price surge. Until recently, there is no sign that the energy crunch will moderate in the near future and this could serve as a potential headwind to the recovery as overheated inflation is emerging rapidly in more countries.

Figure H: US Producers Price Index (% y.o.y)



Source: CEIC

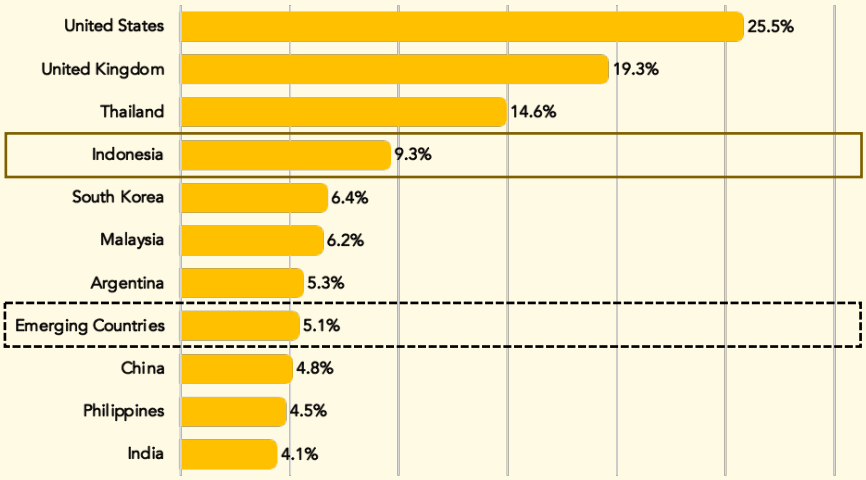
The combination of rising labor price, input materials, and energy bills plays a role in the surge of producer's price in the US (Figure H). Averaging of around 2.30% during 2018-2019, producers price inflation in the US recorded at a tremendous level of 9.75% (y.o.y) in the last month of last year, despite lower than its peak of 9.93% (y.o.y) compared to the previous month. Hence, we

are seeing a rather complex problem of inflation which face upward pressure not only from demand side (consumers aspect), but also from supply side (producers aspect).

Repercussions of Global Inflation to Domestic Aspect

While many developed and developing countries are currently facing the challenge of overheating inflation, Indonesia has not even reached its normal rate of inflation yet. This is reflected by the inflation figure. Despite its latest upward trend, FY 2021 inflation is recorded at 1.87% (y.o.y), below BI's target range lower bound of 2%. While core inflation, a broad proxy of purchasing power, is recorded at 1.56% (y.o.y) in 2021 which further confirms that demand has not reached its normalcy. This could probably be explained by the level of stimulus the GoI provided. Indonesia's fiscal response to the pandemic is at 9.3% of 2020's GDP, above emerging countries' average of 5.1% of 2020's GDP. However, compared to other developed countries, this is significantly lower as they issued an outstanding amount of stimulus. Fiscal stimulus in the US and the UK, for example, amounting in total to 25.5% and 19.3% of their GDP, respectively.

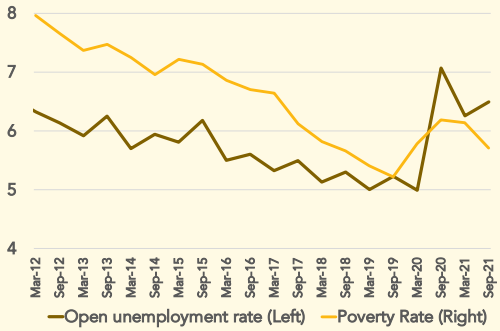
Figure I: Above-The-Line Fiscal Measures in Response to the COVID-19 Pandemic, Selected Countries As Of 27 September 2021 (% of GDP)



Source: IMF Policy Responses to Covid-19 Database

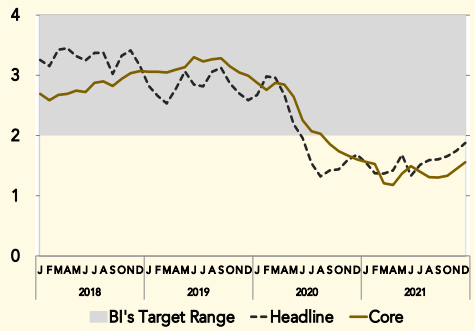
Although open unemployment rate decreased from its pandemic peak of 7.07% to 6.49% in August 2021 and poverty rate down by 0.43% from 10.14% in March 2021 to 9.47% in August 2021, they are still considerably high and nowhere near the pre-pandemic level. As of September 2021, the GoI recorded the Pre-Employment Card program have reached 10.6 million beneficiaries since the first batch opened in April 2020 with a total of 5.5 million participants in 2020 and 5.1 million participants in 2021. Apart from training assistance of IDR1 million, eligible recipients receive a monthly incentive of IDR600,000 for four months and a three-time survey incentive totalling IDR150,000. This is significantly lower compared to the very generous stimulus money Americans receive, explaining why Indonesians are not discouraged to go back to work. As people are still looking for jobs, labour shortage is not happening in Indonesia, at least for now.

Figure J: Open Unemployment and Poverty Rate (%)



Source: CEIC

Figure K: Headline and Core Inflation (% y.o.y)

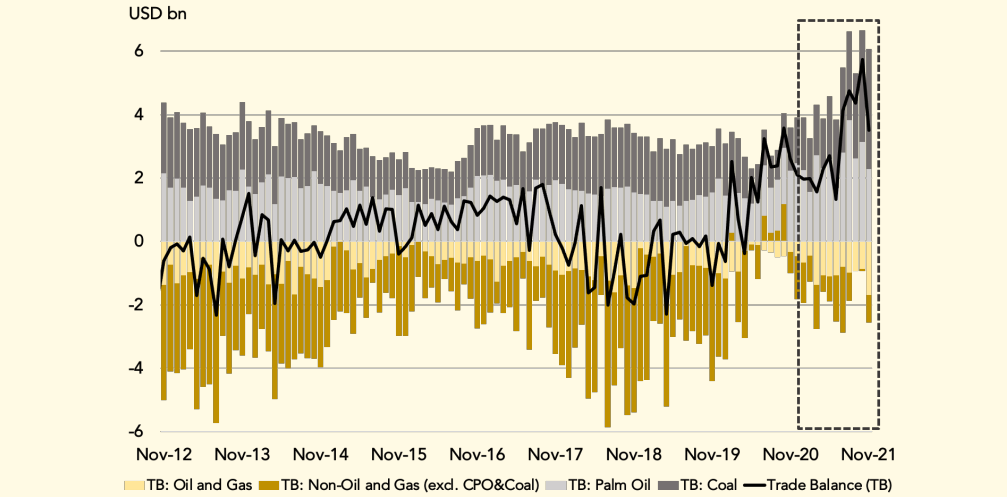


Source: CEIC

Along with rising global commodity prices, domestic prices understandably increase. This can be seen from the increase in prices of Indonesia's leading commodities, namely coal, gas, nickel, and crude palm oil (CPO). CPO price in the global market has increased since last year and scored its highest price in January 2022. At the same time, global energy crisis also drives up coal price. Surging global commodity prices result in the increase in exports and the highest trade balance surplus of USD35 billion in Indonesia throughout 2021. The contribution of trade surpluses in two major export commodities, namely coal and palm oil, is recorded at 157% of the total surplus or equivalent to USD54 billion (Figure L).

Higher exports due to soaring commodity prices has helped government to earn additional increase in export taxes in 2021. Additionally, the higher value of oil and gas as well as coal production also boosted state revenues and managed to record a temporary realization of Non-Tax State Revenue (PNBP) of IDR451.98 trillion in 2021 (151.57% of the 2021 APBN target), a positive growth of 31.46% compared to the previous year's results. In more detail, the realization of Natural Resources PNBP reached IDR150.82 trillion or grew by 55.12% (y.o.y), which was mainly driven by the increase in ICP and mineral and coal commodity prices. The rising commodity prices also contributed to the overall 2021 APBN deficit, which fell to 4.65% compared to the previous year that was recorded at 6.14% of GDP.

Figure L: Major Commodity Goods Trade Balance (USD billion)



Source: CEIC

However, the increase in coal prices due to the energy crisis has also sparked a polemic because although it can help increase state revenues, it also encourages coal producers to export rather than sell it to the domestic market. This has an impact on the reduced supply of coal for domestic industries, such as cement, fertilizer industries, and the state-owned power plants (PT PLN). The GoI put a temporary coal export ban in January 2022 to ensure domestic stock. The sufficient and manageable domestic supply of coal is essential to maintain market stability and lower the domestic inflationary pressure.

Overall, the impetus for rising global prices has the potential to disrupt supply chains not only in global markets, but also in domestic industries. This is reflected in, among other things, the Indonesian Manufacturing PMI which showed a slight decline in December 2021 which was recorded at 53.5, down from 53.9 in November 2021. This decline indicates the pace of recovery across Indonesia's manufacturing sector slowed since October 2021. Supply constraints remain as the main reason, as supplier performance continues to deteriorate and companies continue to report higher price pressures, impacting production processes. Therefore, the GoI needs to continue to be vigilant of the potential risk of overheating inflation and its impact on the domestic industry while continuing to encourage domestic recovery.

Besides the pressure from business production activities, the US's higher than expected inflation also exacerbates the impact of global inflation to domestic financial market. The jump in US's inflation has pushed the Fed to cut its purchases of bonds sooner since November 2021. Inflation has also rose sharply in some other advanced and emerging countries, such as US, UK, Turkey, and India due couple of reasons, including rising energy prices and persistent supply disruptions. As a result, major central banks are considering hiking their benchmark rates soon adjusting their accommodative stance. A number of emerging countries central bank in Latin America region, namely Mexico, Chile, Costa Rica and Asia region, such as Russia and Armenia, even have raised their benchmark rate in the end of 2021 to respond the acceleration in prices and the Fed's faster tapering of bond purchases.

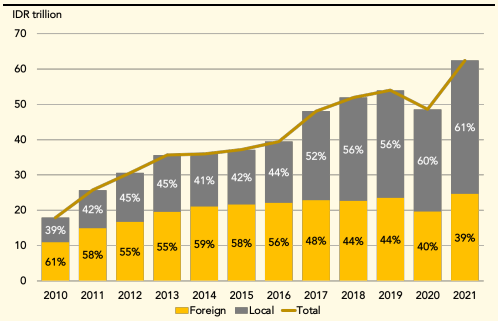
Considering the ongoing situation, most investors has shifted to more risk-averse stance and limited their investment into risky assets. This influences capital outflows in emerging countries, including Indonesia. The total capital flows have been slashed to USD3.35 billion in January 2022 compared to USD8.07 billion at the same period last year. The massive outflow started since Q4 2021 poses risks to Rupiah with the yearly depreciation rate touching 2.7% (y.o.y), making Rupiah at around IDR14,300 in the beginning of 2022. The currency depreciation, however, is fewer than the other currencies in emerging countries, such as Malaysian Ringgit, Philippines Peso, and Thailand Bath. The weaker depreciation rate might be explained by the robust national domestic economy fundamental as seen by the higher Indonesia's economic growth. Even though Indonesia's PMI figures shows a deteriorating figure in Q4 2021, its figure of 53.5 in December remains higher than other countries, namely Malaysia (52.8), Vietnam (52.5) the Philippines (51.8), and Thailand (49.5). This demonstrates that business growth in Indonesia is still robust and promising.

Additionally, the relatively low foreign ownership in Indonesia's asset helped to alleviate the risk of the Fed tapering to Rupiah, which can be seen from the proportion of foreign ownership in Indonesia's securities at 39% in 2021 compared to its figure during the Fed tapering in 2013 that was recorded at 55%. In 2013, the high dependence on assets from abroad has led to massive capital outflow of IDR36 trillion and excessive depreciation of Rupiah at around 26% (ytd). Given that the share of foreign assets currently stands at lower rate, central bank has better chance of

dealing with capital outflows from the taper tantrum. Hence, resulting in relatively manageable Rupiah this time around.

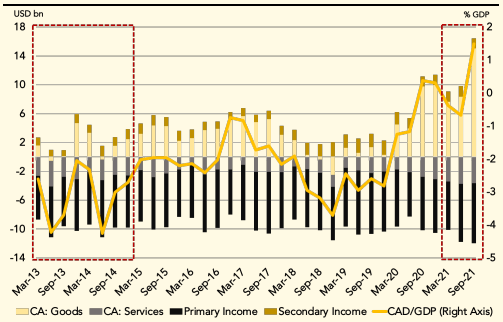
The stronger performance of Rupiah is also supported by the robust performance of trade and current account balance throughout 2021. The trade surpluses for 19 consecutive months starting from May 2020 has promoted the relatively stable Rupiah as it reflects the higher demand for Rupiah than dollar to finance the export. As trade balance of goods increases, the current account balance, which is persistently in negative territory since 2011, records a surplus of USD4.5 billion or equivalent to 1.49% of GDP in Q3 2021. The better condition of current account in 2021 compared to the deficit CAD in 2013 tapering indicates that foreign exchange market currently has sufficient amount of dollar as current account surpluses reflect bigger amount of dollar received than paid by the country. This low risk of dollar shortage has helped to maintain a more stable Rupiah compared to the similar the Fed tapering in 2013. On other external factors, better communication of the Fed's policy this time compared to the tapering in 2013 also plays important role in managing the pressures to emerging market, including Indonesia, as market reactions have certainly been more considered.

Figure M: Total Securities by Ownership (IDR trillion, %)



Source: CEIC

Figure N: Current Account and Current Account to GDP (USD billion, %)



Source: CEIC

Despite the rise in commodity prices, persistent global supply chain disruptions, and surge in global demand after the Covid-19 recession, domestic inflation is still relatively muted as reflected by the lower than BI's target figure. This may indicate that aggregate demand has not fully recovered, making the domestic inflationary pressures relatively manageable than other countries. The improvement in inflation will highly depend on the progress of economic activity. Considering the persistent optimistic figure of Indonesia's Consumer Confidence Index (CCI) recently, domestic purchasing power is expected to improve at least to its pre-pandemic level this year. However, this improvement will likely take in place in longer time than previously expected as GoI has to face the potential risks of the soaring spread of Omicron cases. To date, the seven-day average of new cases is reaching around 8,000 cases per day, which is similar to the number of new cases in the beginning of the second wave in mid-June 2021. The domestic aggregate demand is expected to be held back if the number of cases continues to increase. Nevertheless, the economy will be better prepared to deal with Covid-19 as Indonesia has learned the lessons from containing the second wave pandemic and pushed the efforts to increase the vaccination rate. All in all, as long as the economic recovery continues, inflation is likely to gradually rise in 2022.

Considering a relatively low risk of overheating inflation in Indonesia compared to the advanced economies, the directions of monetary policy should maintain the pro-growth stance as the

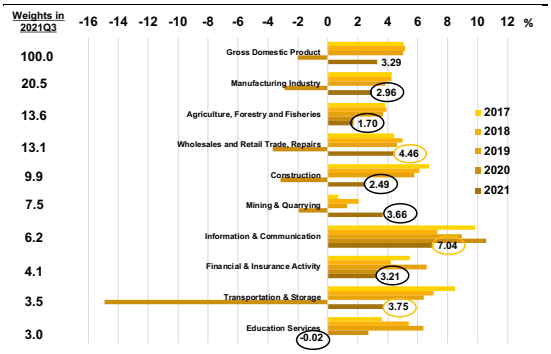
urgency to push for aggressive tightening is beyond the horizon, at least in the near future. The failure to take a proper timing and scale in implementing monetary tightening would surely create a counterproductive impact to the built momentum of demand recovery. Thus far, current stance of Indonesia's monetary policy taken by BI is deemed as appropriate as the initial steps of normalization. Recently, BI has announced its plan to gradually reduce the high amount of liquidity in the financial sector through the gradual increase in reserves requirement ratio (RRR). BI will raise the RRR by a total of 300bps from 3.5% to 6.5% for conventional banks and by 150bp 3.5% to 5% for sharia banks, starting this March. On the other hand, a low interest rate stance is still required until inflation begins to increase significantly to ensure the affordable credit until the real sector reached its optimum recovery.

Growth Upward Trend Disrupted by Delta Variant

"This came at a cost of slower economic growth after enjoying a year of quarterly improving growth. Indonesia's GDP grew by 3.51% (y.o.y) in Q3 2021 as consumption declined and business activity in various sectors that relies on physical activity was halted."

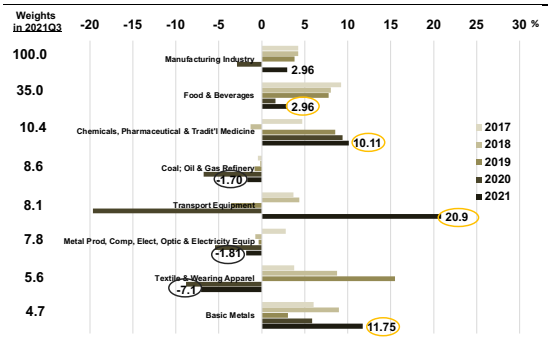
Since hitting its worst dip of economic growth in mid-2020, Indonesia's GDP growth has been gradually improving from its lowest level of -5.32% in Q2 2020 to a tremendous growth of 7.07% in Q2 2021. Unfortunately, this promising upward trend has been disrupted by the domestic spread of Delta variant. Putting the health aspect first, the GoI has implemented an aggressive social mobility restriction in July and August 2021, which practically muted the economic activity for around half the period of the third quarter. The measure taken was proven effective as the daily new cases of Covid-19 could be reduced from its peak of around 56,000 in mid-July to below 1,000 at the end of September 2021. However, this came at a cost of slower economic growth after enjoying a year of quarterly improving growth. Indonesia's GDP grew by 3.51% (y.o.y) in Q3 2021 as consumption declined and business activity in various sectors that relies on physical activity was halted. This phenomenon is reflected on the growth figure of transportation & storage and accomodation & FnB sectors. Transportation & storage sector experienced a discernible growth decline of 0.72% (y.o.y) in Q3 2021 after grew robustly by 25.10% (y.o.y) in the previous quarter. Similarly, the growth of accommodation & FnB sector also crossed a negative territorry with a decline of 0.13% (y.o.y) in Q3 2021, a significant drop from positive growth of 21.58% (y.o.y) in Q2 2021. Furthermore, elevated health risks increased demand of health sector, continuing its growth from 11.68% (y.o.y) in Q2 to 14.68% (y.o.y) in Q3 2021. Except agriculture, Indonesian main economic sectors, such as manufacturing, wholesale & retail trade, and construction, experienced slower growth in Q3 2021. The growth of manufacturing sector declined to 3.68% (y.o.y) in Q3 2021 from 6.58% (y.o.y) from the previous quarter. Slower economic activity also moderated the growth of wholesale & retail trade and construction sector from 9.45% (y.o.y) to 5.16% (y.o.y) and from 4.42% (y.o.y) to 3.84% (y.o.y), respectively.

Figure 1: Growth of GDP and the Main Industries, 2017-2021Q3



Source: CEIC

Figure 2: Growth of Manufacturing Sector and Its Subsectors, 2017-2021Q3

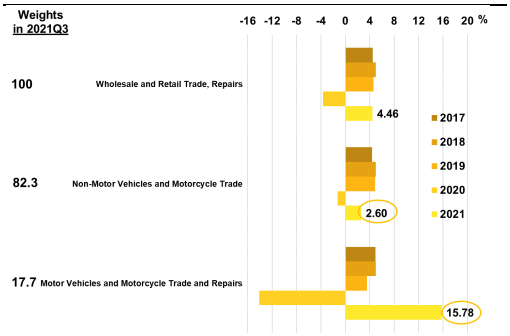


Source: CEIC

"Although the low-base effect was still following the wholesale and retail trade sector in Q3 2021, the impact of the Delta variant outbreak, along with the end of Ramadhan and Eid al-Fitr season limited the recovery effort."

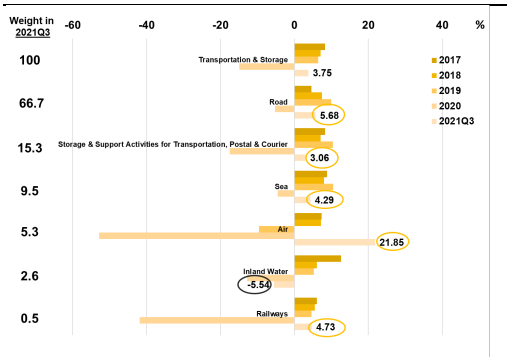
Despite following the trend of Indonesia economic activity growth slowdown, subsectors within manufacturing industry had a rather varied growth rate. For instance, growth of FnB subsector increased to 3.49% (y.o.y) in Q3 2021 from 2.95% (y.o.y) in the previous quarter. Accounted as the biggest subsector for 35% of the total manufacturing industry, FnB subsector persistent growth increase since Q2 2020 might indicate that people's purchasing power is steadily recovering as the implementation of the higher intensity of social mobility restriction in Q3 2021 did not slow down the consumption towards FnB products. Similarly, the growth of chemical, pharmaceutical & traditional medicine subsector slightly increased from 9.15% (y.o.y) in Q2 to 9.71% (y.o.y) in Q3 2021 as the health risks elevated due to the wave of Delta variant. Furthermore, muted economic activity and people mobility drove down the demand for fuel and energy as the growth of coal, oil & gas refinery product dipped substantially to -0.77% (y.o.y) in Q3 2021 from 3.37% (y.o.y) in the previous quarter. On the other hand, the relaxation of sales tax on luxury goods (PPnBM) for cars still had a positive impact as transport equipment subsector enjoyed a rapid growth of 27.84% (y.o.y) in Q3 2021, despite considerably lower than the growth rate in the previous quarter of 45.70% (y.o.y).

Figure 3: Growth of Wholesale and Retail Trade and Its Subsectors, 2017-2021Q3



Source: CEIC

Figure 4: Growth of Transport and Its Major Subsectors, 2017-2021Q3



Source: CEIC

In Q3 2021, the wholesale and retail sector were still hovering in positive territory despite the slower growth. The sector recorded a substantial growth decline to 5.16% (y.o.y) from 9.44% (y.o.y) in Q2 2021. Although the low-base effect was still following the wholesale and retail trade sector in Q3 2021, the impact of the Delta variant outbreak, along with the end of Ramadhan and Eid al-Fitr season limited the recovery effort. Looking deeper into the sub-sector, non-motor vehicles and motorcycle trade recorded a 3.27% (y.o.y) of growth compared to 4.77% (y.o.y) growth in Q2 2021. While the non-motor subsector experienced a rather small contraction, the motor vehicles subsector marked a significant slump of growth. The growth of motor vehicles sub-sector recorded at 14.91% (y.o.y) compared to 37.88% (y.o.y) in Q2 2021. From the implementation of another series of public activity restrictions (PPKM) that instantly hamper the business activities to the restrain of consumption choice of society, potential risk carried by the Delta variant outbreak seems to have a substantial impact on the wholesale and retail sector.

"Transportation and storage sector as well as accommodation and F&B activity were acknowledged as the vulnerable sectors which movements are delicate to any transition in the pandemic phase."

The second wave of pandemic marked by the presence of the Delta variant also troubled the transportation and storage sector all over again. After a steep growth of 25.01% (y.o.y) in Q2 2021, the implementation of PPKM to limit the transmission of Covid-19 hit severely the transportation sector, which recorded another unfavourable growth of -0.72% (y.o.y). The contraction was mainly driven by air transportation with -19.74% (y.o.y) growth in Q3 2021 compared to a triple-digit annual growth rate in the preceding quarter. Following the air transportation, railways transportation also marked another negative growth of -7.96% (y.o.y) compared to 67.19% (y.o.y) in Q2-2021. A high level of positive rate during July to September 2021 which was recorded at 30.72% or six times higher than WHO standard put many people in a panic and restrain their travelling activity, especially a long travel. While the sub-sectors for long travel accommodation were back in negative growth position, the road transportation continued its positive-yet-slower growth with 3.28% (y.o.y) compared to an aggressive growth of 18.15% (y.o.y) in the previous quarter. In summary, the transportation and storage sector is classified as a vulnerable sector that is rather sensitive to any movement of pandemic phase.

After a strong rebound in Q2 2021, several economic sectors were back to negative territory in Q3 2021 along with the Delta variant outbreak during June to September period. Transportation and storage sector as well as accommodation and F&B activity were acknowledged as the vulnerable sectors which movements are delicate to any transition in the pandemic phase. Moreover, the end of seasonal events of Ramadhan dan Eid al-Fitr also participates in the slower growth that recorded by the other sectors. Looking further to the rest of GDP sector, the education service sector also experienced another negative growth at -4.42% (y.o.y). The sectoral growth rate was at its lowest since the beginning of the pandemic period. The Delta variant might signal an important message during its upsurge period that the pandemic has not yet reached its ending stage. Further, the upcoming risk of the third wave and some possible other waves in the future may hamper the economic and social condition all over again. A firm plan of recovery agenda must be arranged to avoid another turmoil in health, social, and economic sectors.

Better Prospect of Domestic Fundamentals in Facing the Headwinds

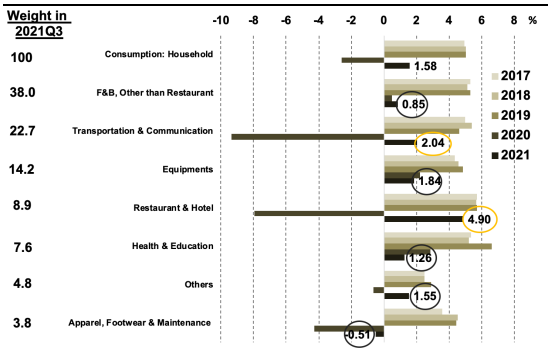
"Considering easing mobility restriction in Q4 2021, we expect household consumption to grow more than in Q3 2021. Investment and imports are also projected to continue to rise in the last quarter of 2021, suggesting domestic production recovery."

Following the surge of Delta variant cases, GoI launched the emergency public activity restrictions (PPKM Darurat) on 3 July 2021 and its multi-tiered PPKM. The restrictions slammed brakes on all expenditure components of GDP. Government consumption grew by 0.66% (y.o.y) during Q3 2021, the slowest pace since Q3 2020. This was driven by the National Economic Recovery (PEN) budget refocusing and reallocation to increase the budget absorption. For instance, PEN reserves of IDR32.9 trillion is used for capital injection (PMN) to four state-owned enterprises. Responding to the increase in the number of daily confirmed cases, the PEN budgets for health and social protection have been increased by IDR214,95 trillion dan IDR187,84 trillion, respectively. However, the PEN budget realization up to 17 September 2021 was only IDR395.92 trillion or 53% of the total PEN budget of IDR744.77 trillion, resulting in a low government expenditure growth in Q3 2021. Similar to what happened in Q2 2021, exports rose by 29.16% (y.o.y) while imports up by 30.11% (y.o.y), which brought 26.18% (y.o.y) growth in net exports that was the source of growth in Q3 2021. Considering easing mobility restriction in Q4 2021, we expect household consumption to grow more than in Q3 2021. Investment and imports are also projected to continue to rise in the last quarter of 2021, suggesting domestic production recovery.

Household consumption, the biggest contributor of GDP, expanded by 1.03% (y.o.y) in Q3 2021, down from 5.93% (y.o.y) in the previous quarter. All components of household consumption except transportation & communication and apparel, footwear & maintenance indicated positive growth in the third quarter of 2021. Lower household consumption growth, as well as contraction in transportation & communication components, can be explained by mobility restriction that was introduced in a fight to control the Delta variant outbreak. The mobility restrictions also caused consumption of restaurant & hotel to slow down to 2.43% (y.o.y) in Q3 2021 from 16.37% (y.o.y) in Q2 2021. Consumption of food and beverage that accounts for 38% of total consumption posted a slowing growth of 0.79% (y.o.y) in Q3 2021 compared to 4.13% (y.o.y) during April to June quarter.

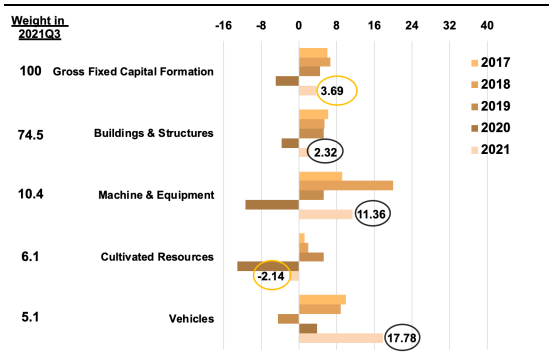
Investment component experienced a positive growth of 3.74% (y.o.y) in Q3 2021, a lower level of growth compared to 7.54% (y.o.y) during the previous quarter. Investment in buildings & structure that accounts for 74.5% of total investment grew by 3.36% (y.o.y), lower than 4.36% in Q2 2021. As domestic and global recovery are in place, investment in machine & equipment grew by 11.54% (y.o.y) in Q3 2021, down from 19.05% (y.o.y) in the previous quarter.

Figure 5: Growth of Household Consumption and its Components, 2017-2021Q3



Source: CEIC

Figure 6: Growth rate of Investment and its Main Components, 2017-2021Q3

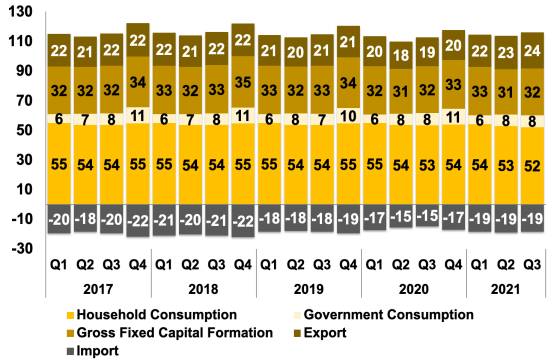


Source: CEIC

"Looking at the performance of the banking sector, demand for credit is expected to continue this year together with domestic economic recovery. We also project the banking industry to remain strong with ample capital and liquidity as well as stable asset quality."

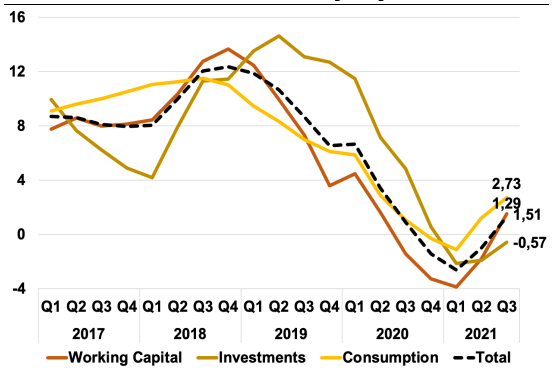
Amidst the ongoing crisis, credit performance has shown a favourable outlook for overall 2021 as it has gradually increased along with the improved business and consumers sentiment as economic recovery intensifies compared to its ruinous trend during 2020. Total credit growth accelerated to 1.29% (y.o.y) in Q3 2021, officially out of negative territory in the past three quarters. The highest growth was seen in consumption credit, followed by working capital credit that respectively accelerated to 2.73% and 1.51% (y.o.y) compared to 1.21% and -1.80% (y.o.y) in the previous quarter. Similarly, there was a slight pick up trend in investment credit compared to the previous quarter but still in negative growth at -0.57% (y.o.y). Entering Q4 2021, we capture a better prospect in credit performance. Latest data in October 2021 showed that total credit grew by 3.24% (y.o.y), higher than 2.21% (y.o.y) growth in Sept 2021. Remarkable credit growth will be expected to continue in Q4 2021 and Q1 2022 due to easing social and economic activity after the interruption by the Delta variant during Q3 2021. Working capital and consumption credit enjoyed accelerating trends with 4.66% and 3.75% (y.o.y) growth respectively in Oct 2021 compared to 2.85% and 2.95% (y.o.y) in Sept 2021. Meanwhile, investment credit declined to 0.28% (y.o.y) from 0.37% in the previous month.

Figure 7: Shares of GDP Components, 2017Q1-2021Q3 (%)



Source: CEIC

Figure 8: Credit Growth by Purposes, 2017Q1-2021Q3 (y.o.y, %)



Source: CEIC

Looking at the performance of the banking sector, demand for credit is expected to continue this year together with domestic economic recovery. We also project the banking industry to remain strong with ample capital and liquidity as well as stable asset quality. Deposit growth accelerated to 10.2% (y.o.y) in Nov 2021 from 9.4% (y.o.y) in Oct 2021. Furthermore, BI injected liquidity through QE program into the banking system totalling IDR141.2 trillion in overall 2021. On the other hand, asset quality as reflected from NPL was also stable at 3.2% (y.o.y) based on the latest data from OJK per November 2021. However, it should be noted that in the latest BI's Board of Governor meeting in January this year, BI announced to normalize its liquidity policy by gradually increasing Rupiah reserve requirement ratio (RRR) for both conventional and sharia commercial banks in 2022. The decision was taken to support Rupiah stability and mitigate the impact of global monetary normalization amid global inflationary pressure, particularly sourced from the US. BI will raise the RRR by a total of 300bps from 3.5% to 6.5% for conventional banks and by 150bp 3.5% to 5% for sharia banks. The higher requirements will be introduced gradually, with the first increase of 150bps for conventional banks and 50bp for sharia banks effective 1 March 2022. The next increases will take place on 1 June and 1 September 2022.

Nevertheless, this liquidity normalisation policy should not significantly affect liquidity in the banking sector, which remains well above the normal level. Thus, banks actually have adequate liquidity to absorb higher requirements. We expect the RRR increase to exert minimal pressure on banks' net interest margins, helped partly by BI's decision to continue providing 1.5% interest on statutory reserves. Overall, despite the uncertainty regarding how long the Omicron variant will last domestically and external volatility, profitability prospects for banking sector remain favorable in 2022. This view is based on our expectations of improved credit, lower credit costs as NPL improves gradually, the ongoing macroprudential measures from BI, and better cost efficiency from a pandemic-induced acceleration of banking business through digital rather than traditional channels.

"The low inflation in 2021 was influenced by domestic demand that was not yet fully recovered as a result of the Covid-19 pandemic. However, it was the highest annual inflation since June 2020."

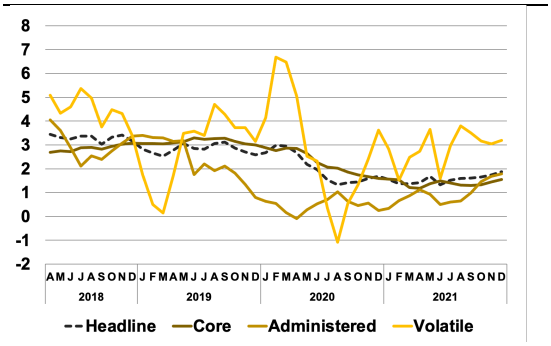
Despite Increasing, Inflation will likely be still within BI's Target Range

The annual figure of 2021 inflation rate remains low and below BI's target range of 2% to 4%. It was recorded at 1.87% (y.o.y), a slight increase compared to 2020 inflation of 1.68% (y.o.y). The low inflation in 2021 was influenced by domestic demand that was not yet fully recovered as a result of the Covid-19 pandemic. However, it was the highest annual inflation since June 2020. Core inflation edged up to an 11-month high of 1.56% (y.o.y) in December 2021, from 1.44% (y.o.y) in the previous month, suggesting recovering demand as public's purchasing power gradually improves. Food and volatile prices each jumped to 3.20% (y.o.y) compared to the same month of last year, reflecting higher demand. Looking into commodities, the most talked-about price increase was in cooking oil, which has a contribution of 0.31% to the 2021 inflation. Meanwhile, it comes as no surprise that administered prices grew by 1.79% (y.o.y), continuing its upward trend since June 2021, as public

mobility increases. The price increase was driven by rising airfares during the year-end festive period.

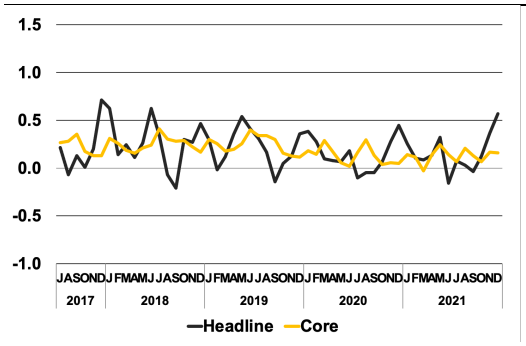
On a monthly basis, the December 2021 inflation rate was recorded at 0.57% (mtm). This increased from 0.37% (mtm) in the previous month and was higher than the average inflation in December 2020 of 0.51% (mtm). Rising inflationary pressure at the end of the year was driven by volatile foods and administered prices inflation components as mobility restrictions were relaxed and consumption strengthened during the holiday season. Core inflation was recorded at 0.16% (mtm), relatively stable compared to inflation in the previous month of 0.17% (mtm). Inflation in the volatile foods category was recorded at 2.32% (mtm), higher than last month's inflation of 1.19% (mtm), in line with the seasonal pattern at the end of the year. At the same time, the administered prices category recorded an inflation of 0.45% (mtm), an increase from 0.37% (mtm) in November 2021 in line with increased demand for air transportation during Christmas and New Year.

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



Source: CEIC

Figure 10: Inflation Rate (%, m.t.m)



Source: CEIC

High Realization of FDI Shows Signs of Stronger Recovery

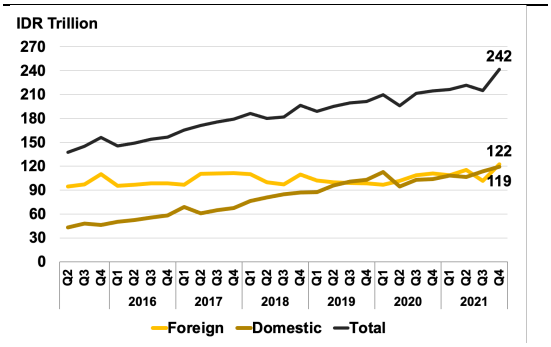
"Overall, the total investment realization in 2021 reached IDR901.02 trillion, which exceeded the target stated in the National Medium-Term Development Plan (RPJMN), which was 104%."

The Investment Coordinating Board (BKPM) recorded the investment realization of IDR241.6 trillion in Q4 2021. In this period, the realization of foreign investment is higher than domestic investment. It was recorded that the FDI realization was IDR122.3 trillion or equivalent to 50.6% of Indonesia's total investment, while the realization of Indonesia's domestic investment was IDR119.3 trillion or contributed 49.4% to Indonesia's total investment realization. During this period, investment realization grew by 12.6% on an annual basis (y.o.y) and 11.5% (qtq). The high realization of FDI is due to the fact that the world economy has started to recover. FDI realization increased by 18.5% on a quarterly basis (qtq) and 10.1% on an annual basis (y.o.y). Nevertheless, the performance of domestic investment is also no less good. It was recorded that the increase in domestic investment was 5.1% (qtq). On an annual basis, it grew 15.2% (y.o.y), higher than FDI growth.

Based on the business sectors, all three sectors experienced an increase which showed signs of a stronger economic recovery. However, the main contributors to the increase in foreign investment realization came from the primary sector, with an increase of almost 42% compared to the previous quarter. In terms of the distribution

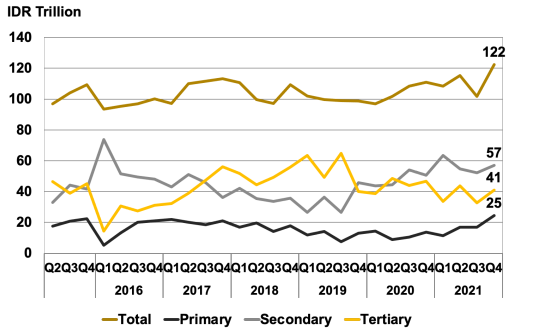
of investment itself, BKPM recorded that as much as IDR127.5 trillion or 52.8% of Indonesia's investment was outside Java. While in Java, it was IDR114.1 trillion or 47.2%. This shows that Indonesia's investment is increasingly dispersed. Overall, the total investment realization in 2021 reached IDR901.02 trillion, which exceeded the target stated in the National Medium-Term Development Plan (RPJMN), which was 104%.

Figure 11: FDI and Domestic Investment (Nominal)



Source: CEIC

Figure 12: FDI Realization by Sectors (Nominal)



Source: CEIC

Maintained Trade Surplus and All-Time High Current Account Balance

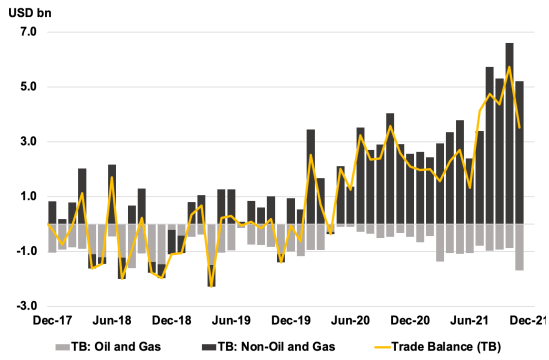
On external side, export continued to increase until the end of 2021, thanks to the jump in almost all commodity prices. Indonesia's annual exports grew by 142% (y.o.y) from the previous year with the largest increase coming from main export commodities, namely coal and vegetable oil. The increase in gas prices due to gradually recovering global demand also contributed to the jump in exports throughout 2021. On the other hand, imports increased sharply with an annual growth of 139% (y.o.y) compared to the previous year which was driven by the rise in domestic purchases of international goods, mainly capital goods and raw materials for production. Machinery equipment, electrical equipment, and iron and steel are some of the most important contributions to imports. Even though the value has increased, import growth was slower than exports; resulting in the highest trade balance surplus of USD35 billion in 2021. This surplus increased 63% (y.o.y) compared to the trade surplus in 2020 which was only USD22 billion.

"The surplus in current account is expected to persist until Q1 2022, but with a narrowing surplus due to the previously soaring commodity prices starting to normalize."

The trade surpluses coupled with positive growth in imports indicate that the economy is improving, but the pace is likely to be gradual. The trade balance improvement during the Covid-19 pandemic era had a positive impact on the current account that reach an all-time high surplus in Q3 2021 at USD4.5 billion or 1.49% of GDP. This surplus figure was recorded as the highest in 12 years, where Indonesia had a persistent current account deficit in previous years. The surplus in the current account is expected to persist until Q1 2022, but with a narrowing surplus due to the previously soaring commodity prices starting to normalize. The effect of commodity prices is quite significant on trade balance as 42% of total national exports are mineral resources, vegetable and animal fat, as well as pearl, diamond, and precious

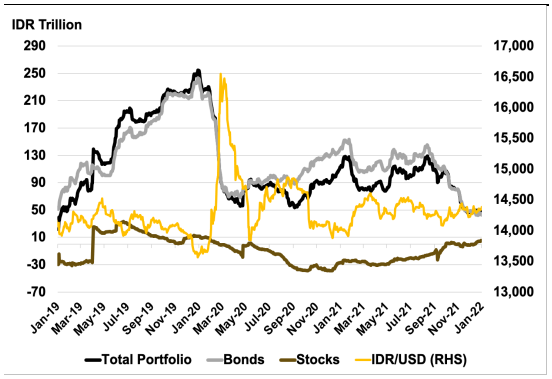
metal. In addition, the ongoing economic recovery is expected to encourage further increases in imports, causing the trade balance to return to deficit territory.

Figure 13: Monthly Trade Balance (Nominal) (Dec'17-Dec'21)



Source: CEIC

Figure 14: Exchange Rate and Accumulated Short-Term Capital Inflow (Jan'19-Jan'22)

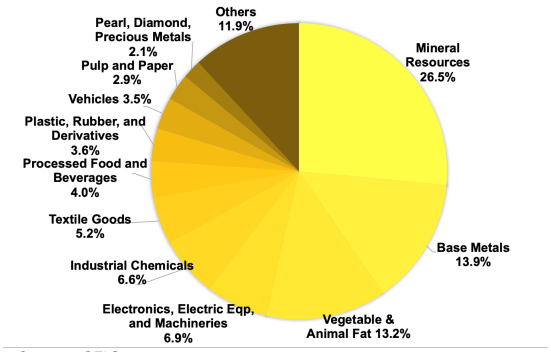


Source: CEIC

"The robust performance of trade balance and current account balance has helped Indonesia to maintain relatively stable net capital flows and Rupiah throughout 2021."

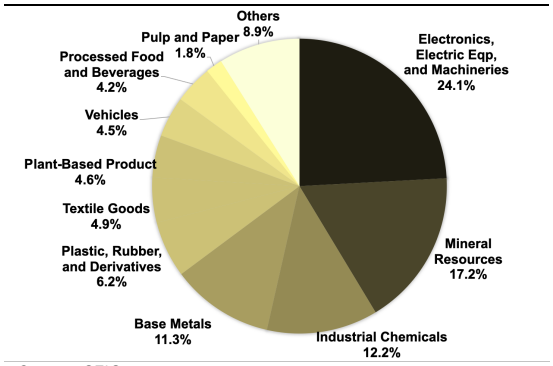
The robust performance of trade balance and current account balance has helped Indonesia to maintain relatively stable net capital flows and Rupiah throughout 2021. Rupiah is one of the best performers with the least depreciation rate amongst other developing country currencies in ASEAN. Rupiah was recorded at IDR14,330 on average in January 2022 after touching IDR14,540 in July 2021 due to the panic of the second wave of Covid-19. The value of Rupiah was also relatively stable at the end of 2021 in the midst of tapering off by the Fed, thanks to heavy capital inflows. Until mid-January 2022, some investors continue to prefer riskier assets in emerging markets despite facing the imminent hike in the Fed Fund Rate (FFR), disruptions in global supply chains, rising inflation, and the rising spread of Omicron cases. Investor appetite for Indonesian assets remains robust given that BI maintains its policy rate stable at 3.5% and the overall domestic economic situation remains favourable through 2021.

Figure 15: Indonesia Export Profile (October-November 2021)



Source: CEIC

Figure 16: Indonesia Import Profile (October-November 2021)



Source: CEIC

In 2022, the capital flows in Indonesia is expected to be maintained as BI will most likely continue to perform the accommodative monetary policy amidst the global

inflationary pressures and expected rate hikes in the US. Several central banks in other countries, including South Korea, South Africa, and Mexico, have responded to the threat of soaring inflation by increasing short-term interest rates to lessen the monetary policy. Even though the inflation in Indonesia is still below-the-target, the rising interest rates in some other countries may force Indonesia to begin raising interest rates sooner to keep the interest rate spread. Further, the GoI is expected to maintain economic recovery momentum by strengthening anticipative measures to prevent another Covid-19 wave in the beginning of 2022 as they already confirmed the first recorded case of the Omicron variant. However, with the rapidly increasing vaccination rate and lessons learned from containing the second wave of pandemic, the economy is expected to be better prepared to deal with Covid-19. Additionally, the Ministry of Finance's plan of expanding government bonds issuance this year will continue to support the economic recovery and carry out precautionary measures to anticipate any turbulence in 2022.