Indonesia Economic Outlook 2017

In Search for New Growth

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Economic and Market Research

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Executive Summary

- **Global growth in 2017 still hinges on the recovery of US**. The Federal Reserve has raised Fed Fund Rate (FFR) by 25bps in December 2016 with median estimate of 3 hikes, instead of 2 hikes, in 2017. Aside from steady improvement in labor market and purchasing power, the change has partially took into account an additional fiscal stimulus that would potentially be disbursed by President Trump. Yet with China still in consolidation mode, then global trade opportunities will remain selected.

- In 2016, we have witnessed a decoupling between deflator and real output. This means that improved real income was not necessarily a product of better earnings but on the back of lower prices. But now commodity prices, including oil and coal, are trending up that is reflected in the inflation of both domestic and import partners. The government has also unveiled plans to revamp subsidies for electricity, which pushed up our **inflation forecast from 3.7% to 4.2% in 2017. We suspect this will mildly curb real income next year**.

- **Key points that have shown several shifts in state budget management** include: 1) a notion of "spend on what we have" as the posture hinges on revenue. This is opposed to previous budgets where expenditure needs would drive how much revenue to collect and how much financing to raise, 2) diverging infrastructure commitments from State Owned Enterprises (SOEs) to regional governments, and 3) tighter financing strategy with a focus on primary deficit.

- **It will be challenging for central banks to utilize any easing measures left**, due to a combination of strong USD and higher commodity prices. Bank Indonesia has refrained from disclosing their current monetary stance, hinting that between now and next January is a crucial time to get more clarity over the outlook. Timing of such events would be the turn key, if impacts to domestic economy converge at the same time, then BI may want to safeguard a volatile Rupiah in order to maintain BoP and macro stabilities.

- A common theme that market players are looking for is the **search for growth stories**. Aside from trade potentials, private investments may still book an above-average-result next year. These trends may continue next year and stimulate some demand for loan. We have set our FY17 GDP growth forecast flat at 5.04%.

Shifts in Geo-economical Environment

"-The only thing that is constant is change-",

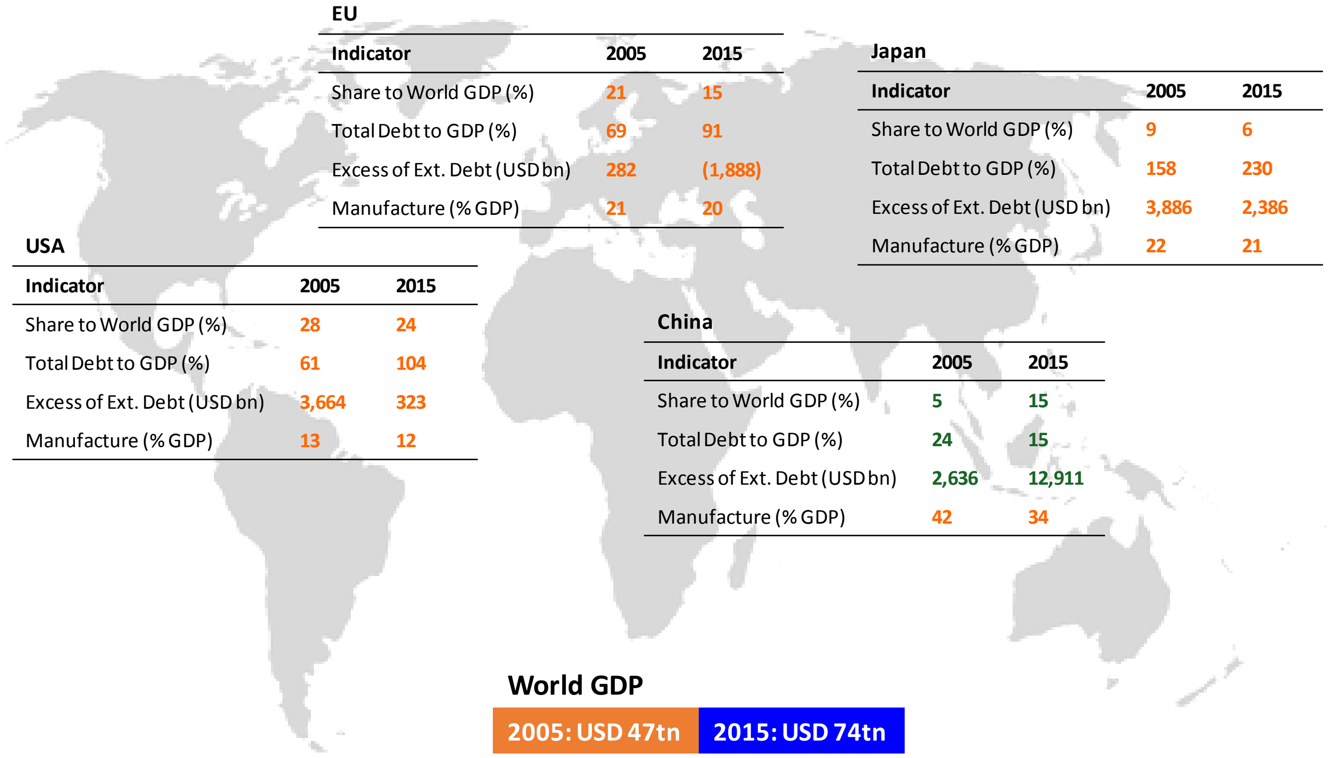
Heraclitus

As we embark on the journey of 2017, it is worth listing upcoming events that could shape the global economy and potentially have significant impact to markets. From US Presidency inauguration on January 20th that would be followed by a definitive cabinet line-up, to QE tapering by ECB on April when, at the same time, France would also have a leadership change. Then, a federal election in Germany will take place somewhere between August to October. One should expect that **change is always constant, bearing opportunities and temporary volatility**, but will it be for the better?

All eyes on US…

Global growth in 2017 still hinges on the recovery of US. The Federal Reserve has raised Fed Fund Rate (FFR) by 25bps in December 2016 with median estimate of 3 hikes, instead of 2 hikes, in 2017. Aside from steady improvement in labor market and purchasing power, the change has partially took into account an additional fiscal stimulus that would potentially be disbursed by President Trump. Economic growth may rise from around 1.6% this year to 2.2% next year. Our baseline scenario of 3x25bps FFR hikes also incorporated that the new administration will only carry out its campaign promises in parts, as several post-elected events indicated attempts of scaling back.

Chart 1. Indicators in the Drivers of Global Economy



EU

Indicator	2005	2015
Share to World GDP (%)	21	15
Total Debt to GDP (%)	69	91
Excess of Ext. Debt (USD bn)	282	(1,888)
Manufacture (% GDP)	21	20

Japan

Indicator	2005	2015
Share to World GDP (%)	9	6
Total Debt to GDP (%)	158	230
Excess of Ext. Debt (USD bn)	3,886	2,386
Manufacture (% GDP)	22	21

USA

Indicator	2005	2015
Share to World GDP (%)	28	24
Total Debt to GDP (%)	61	104
Excess of Ext. Debt (USD bn)	3,664	323
Manufacture (% GDP)	13	12

China

Indicator	2005	2015
Share to World GDP (%)	5	15
Total Debt to GDP (%)	24	15
Excess of Ext. Debt (USD bn)	2,636	12,911
Manufacture (% GDP)	42	34

World GDP

2005: USD 47tn | 2015: USD 74tn

Source: Bloomberg, Danamon Calculations
Note: Excess of External Debt = (Nominal GDP + FX Reserve) – External Debt

… But can they lead alone?

There are 2 important points that can be deliberated from Chart 1. First off, the market share and external resiliency indicators in G3 economies have gradually deteriorated, whilst that of China has gotten stronger. In this respect, we think that **it would need both the US and China to push for a solid global trade recovery**, at least in the short-run. Yet with China still in consolidation mode, then global trade opportunities will remain selected.

Manufacturing sector needs to catch-up

Secondly, the **contribution of manufacturing sector has slipped worldwide**. Main drivers of global growth lean toward services sectors -e.g. financial and information technology- for some time, and with a gap that widens. We are not saying that it isn't a good thing since these services create efficiencies. However, we reckon that without an equally responsive manufacturing product that underlies trade transactions, then growth in the supporting sectors may also find its limit.

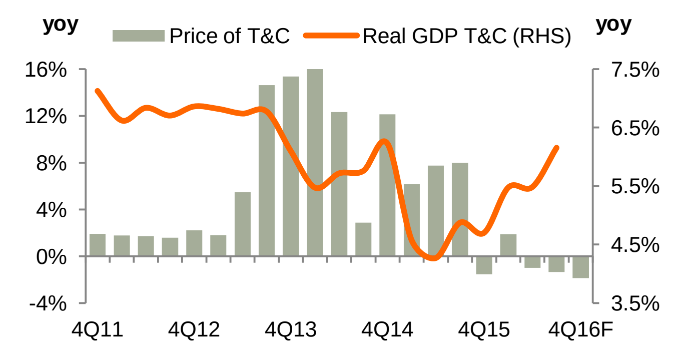
Direction of Indonesia's Economy

Inflation Risks to Curb Household Consumption

Consumption has been supported by low inflation

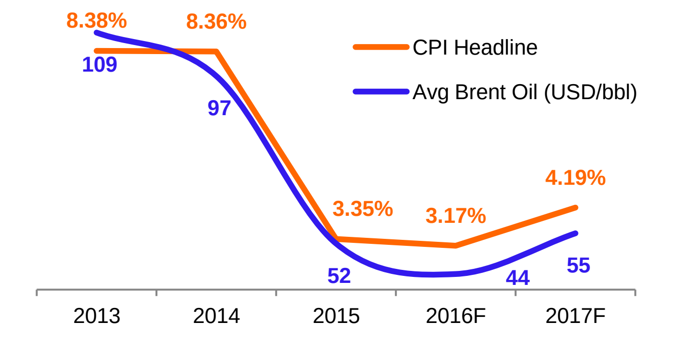
Household or private consumption has long been the backbone of Indonesia's GDP, accounting around 54% of the overall economy. In 2016, we have witnessed a decoupling between deflator and real output. A GDP deflator is essentially use to measure price inflation for all new domestically produced goods and services, derived by dividing nominal GDP with real GDP. Nominal GDP has slightly fallen while real GDP increased, resulting in an even softer deflator. This means that improved **real income was not necessarily a product of better earnings but on the back of lower prices** (*please see Chart 2*).

Chart 2. Transport and Communication



Source: BPS, CEIC

Chart 3. Oil Price and Inflation



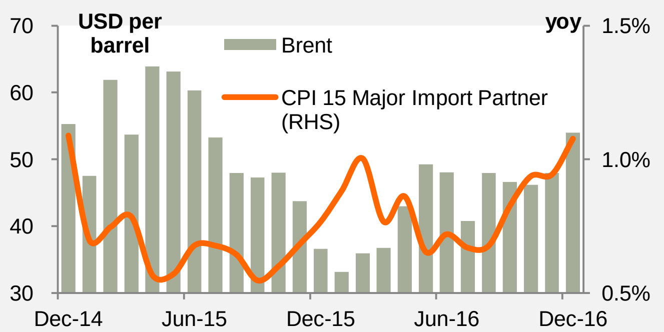
Source: BPS, CEIC, Danamon Estimates

Inflation outlook trending up on energy cost

Off course, in 2016 we saw oil price plunged that affected not only domestic fuel price but also transitory deflation in many of major import partners. Hence, low inflation environment. But now **commodity prices, including oil and coal, are trending up** that is reflected in the inflation of both domestic and import partners (*please see Chart 3*). The government has also unveiled plans to revamp subsidies for electricity, which pushed up our inflation forecast from 3.7% to 4.2% in 2017. We suspect this will mildly curb real income next year.

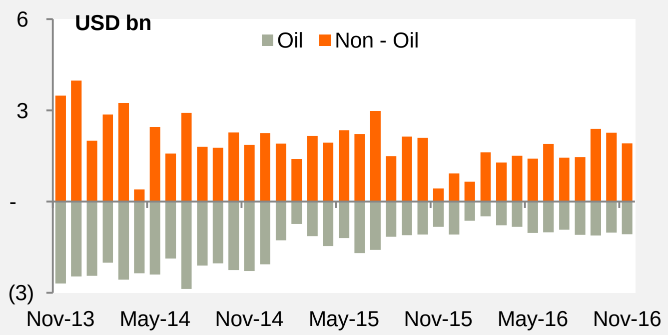
Box 1. Impact of Rising Oil Price

The result of OPEC Convention in Vienna at end-November was to cut oil production. Oil price has continued to rally ever since, which effected both domestic and global inflation. Although our baseline scenario assume oil price to average at USD 55/bbl in 2017, we separately conducted a partial simulation on the impact to inflation and trade. By our calculation, there's potential risk to inflation and Balance of Payment (thus Rupiah) should average oil price exceed USD 65/bbl.



Inflation

There are two areas of inflation that need to be monitored in terms of impact from oil price, domestic and trading partners. As shown on the left-hand graph, transitory inflation due to energy cost is starting to reflect abroad. While on domestic front, we took a back-step approach by asking what level of oil price will result in core inflation equaling to FasBI rate of currently 4.00%. The answer is USD 65/bbl on average (assuming that the government imposes flexible pricing for domestic fuel).



Merchandise Trade

Indonesia is a net oil importer country since 2003, which means that a drop in oil price would be beneficial for the trade account, and vice versa. We took a similar approach to lay a finger on the oil price limit that trade and current account can withstand. The answer is an average of USD 85/bbl, during which any potential non-oil trade surpluses may be wiped-off and current account deficit touches 3.0% of GDP.

Sensitivity to Budget (in IDR tn)

Budget Post	Every +USD1 in Oil Price
Revenue	*3.4 – 4.0*
Tax	0.8 – 0.8
Non-Tax	2.7 – 3.2
Expenditure	*2.2 – 2.6*
Central Gov't	1.7 – 2.0
Regional Transfer	0.5 – 0.6
Surplus/(Deficit)	***1.3 – 1.4***

Government Budget

Post 2014 fuel subsidy reform, the sensitivity analysis of oil price and its impact to the state budget has been inverted. What was once negatively correlated is now positive, which means for every USD 1/bbl oil price increase would result in an additional IDR1.3tn surplus for the budget.

Source: BPS, BP, MoF, CEIC, Danamon Estimates
Note: the currency assumption used in this calculation was IDR 13,555/USD

Restoring Confidence to Fiscal Policy

Budget focus has shifted

Key points that have shown several shifts in budget management include: 1) a notion of "spend on what we have" as the posture hinges on revenue. This is opposed to previous budgets where expenditure needs would drive how much revenue to collect and how much financing to raise, 2) diverging infrastructure commitments from State Owned Enterprises (SOEs) to regional governments, and 3) tighter financing strategy with a focus on primary deficit.

Realistic tax target

On tax revenue, the government is targeting 13.5% yoy growth. If we calculate the natural growth rate of tax at around 9.0% (from the sum of 2017 GDP and inflation), then extra effort programs are expected to contribute by merely 4.5%. This is much lower than the last 2 budgets, whereby extra effort portion accounted for an average of 18.0% (e.g. from tax amnesty proceeds). **Our calculation also indicates that the aim is for 10.8% tax ratio** vs 10.7% in 2015, mostly by means of optimizing third party data.

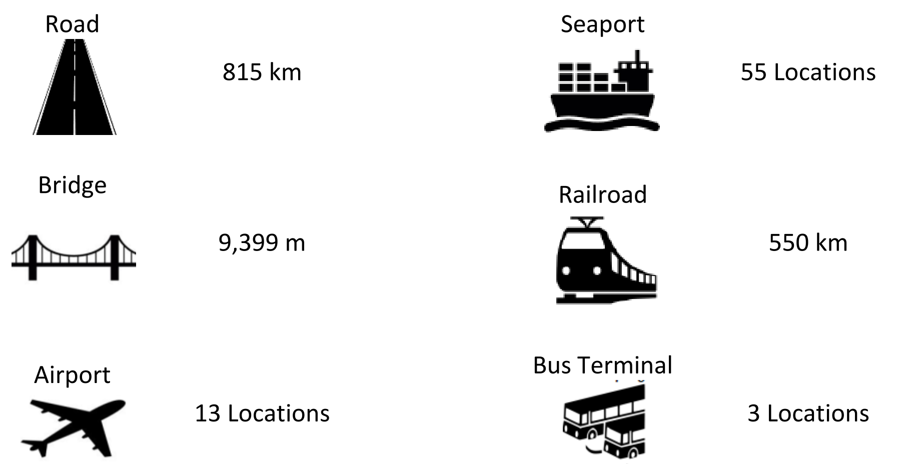
Enforcing regional government...

Infrastructure spending through SOEs was written off **as the MoF opted to enhance regional participation**, stating that "regencies must be given trust first, so that they are encouraged to boost competencies". Part of the ongoing decentralization program, rural fund has been given a total of IDR 60tn in 2017, up by IDR 13tn compared to a year earlier. We believe this would help to minimize inequality in the Eastern region of Indonesia –i.e. Sulawesi, Maluku, and Papua-, as the number of rural areas have grown rapidly this past decade and outpaced the western region.

... By requiring to spend on infrastructure

Furthermore, an earmark program for regional transfer next year is the **25% requirement of general allocation fund to be utilized for infrastructure**. We think it would help to increase cross-governmental check on spending quality. But the central government is also aware that each region has its own timing and pace when it comes to infrastructure needs, thus restraining from an over excessive push.

Chart 4. Government's Infrastructure Target for 2017



Source: MoF

Prudently managing primary deficit

On financing, the strategy is to manage primary deficit. Since 2012, Indonesia has been on a primary deficit, which means it has raised fund to cover its principal debt payment. In GDP term, primary deficit has doubled from 0.6% in 2012 to 1.2% in 2015, yet the target in 2017 is 0.8%. We believe this to be prudent in making sure that fiscal stability is in-tact amid longer-than expected global consolidation.

And shaping for a better budget structure

Gross issuance of government bonds will reach IDR 597tn (IDR 400tn net) in 2017, with overall budget deficit targeted at 2.4% of GDP. By comparing our macro assumptions with the state budget, we derive an additional IDR 9tn of surplus. Meanwhile, we remain conservative in tax collection whereby only accounting for the natural growth rate of 9.2%, which resulted in an expected shortfall of IDR 49tn. To the extent that tax revenue falls below their target, we think non-priority spending cut strategy will come into effect first. But should the IDR 40tn gap is financed through bond issuance, then **overall budget deficit may widen to 2.6% of GDP**. As such, our model suggests that fair value for 10Y government bond is at 8.17% next year.

Balance of Payment (BoP) and Exchange Rate Outlook

A healthy current account

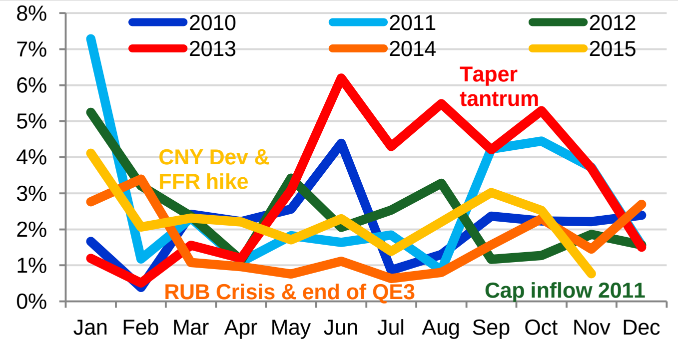
We are on the view that there are potential upside on: 1) export of primary commodities, namely coal and CPO, given the recovery in global prices this year to benefit next year, and 2) export of manufactured apparels and furniture to the US amid the revival of consumers' purchasing power. **Current account deficit may improve further from 2.0% of GDP in 2016 to 1.8% of GDP next year**. Another positive tone materialized in the form of narrowing deficit in the service account, which mostly comprises of freight transport for trade. Usage of foreign flags in merchandise trade shipments has been declining, providing leeway for local players to push its market share. Overall, the structure of current account had become healthier and more sustainable.

Yet concern over financial account

However, our concern on the performance of BoP mainly stems from the fact that financial account hinges on capital flow to portfolio assets. And since every episode of uncertainty (risk-off) leads to asset reallocation towards safe haven instruments, the Rupiah looks vulnerable. Looking at the coefficient of variation[1] in charts 5 and 6, we can conclude that both the currency and securities are relatively more volatile compared to other countries in the region. Hence, our **FY17 Rupiah forecast of IDR 13,555/USD**.

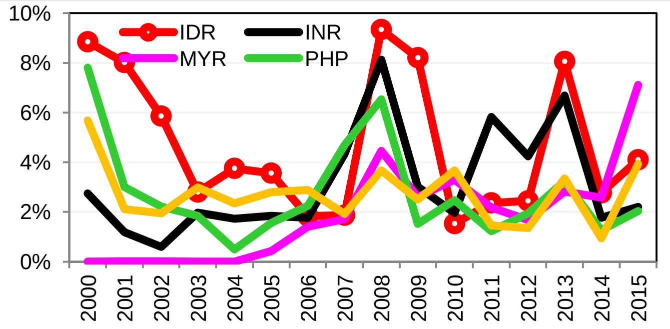
[1] *The coefficient of variation = standard deviation / mean * 100%, with higher percentage reflecting more volatility and vice versa.*

Chart 5. CoV – 10Y IDR Bond Yield



Source: Bloomberg, Danamon Estimates

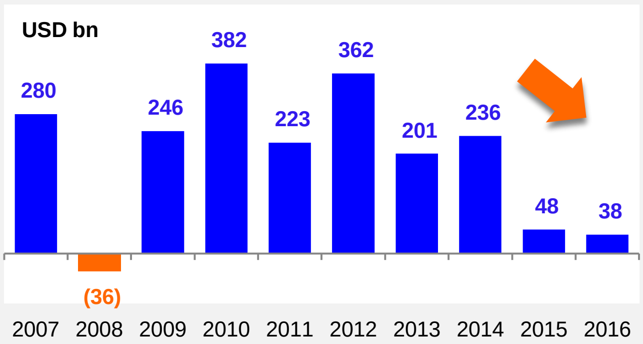
Chart 6. CoV – ASEAN 5 Currencies



Source: Bloomberg, Danamon Estimates

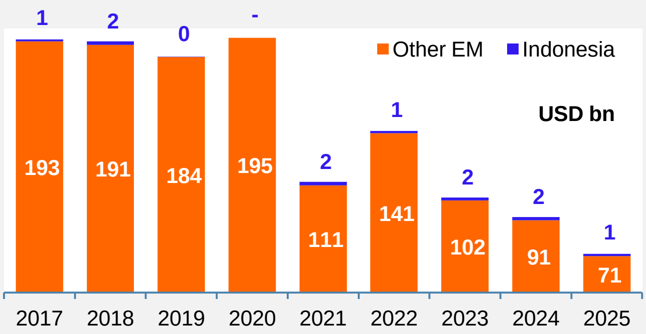
Box 2. EMs on the Lookout for Global Liquidity

The European Central Bank decided that it would continue its expanded asset purchase program (APP) at a monthly pace of EUR 80bn until the end of March 2017. From April 2017, this is scaled back to EUR 60bn per month, until inflation is consistent with its target. An EU tapering coupled with Rising US interest rates may tighten liquidity in the global financial pool.



Fund Flow to Emerging Market

Amid the sudden flood of capital and low interest rates post 2008, EM countries sought an opportunity to boost growth by tapping into the global financial pool. But inflows have significantly decline after the end of the Fed's Quantitative Easing (2014).



Maturity Profile of Corporate External Bonds

Outstanding corporate external bond in EM stood at USD 1.5tn with a heavy potential of refinancing in the next 4 years.

Outstanding of Indonesia's corporate external bond reached USD 21.8bn, of which USD 1.5bn is issued by banks and the rest is from non-bank. Furthermore, 70% of the total issuers are SOEs. Largest refinancing risk in 2018.

Source: Institute of International Finance, IMF, Bloomberg, Danamon Estimates

Monetary Measures Directed to Sustain Momentum

Limited room for easing

In 2017, **it will be challenging for central banks to utilize any easing measures left**, due to a combination of strong USD and higher commodity prices. Central bankers across region intriguingly shared a common view whereby spillover effects from global financial turbulence has to be managed and taken into account in monetary policy decision making. In spite of the common ground, proposal for a more coordinated policy between countries had raised concerns from several decision makers that domestic interest should and will be prioritized.

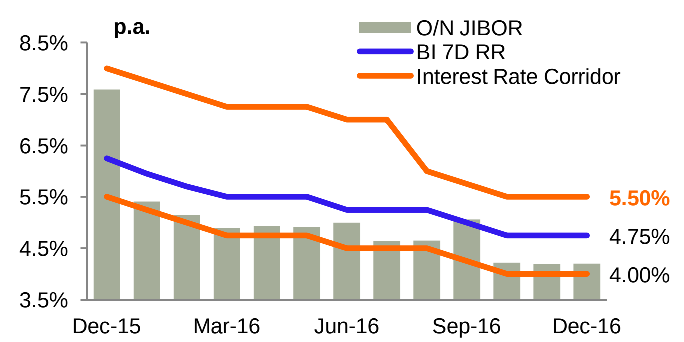
Monetary stance in transition

From a local perspective, Bank Indonesia has refrained from disclosing their current monetary stance, hinting that between now and next January is a crucial time to get more clarity over the outlook. While in the scope of managing Rupiah, monetary policymakers have stated that they will “keep maintaining market mechanisms”. This was to address rising concern from market players on whether Indonesia will follow other countries in adopting a more controlled-approach on capital mobility. The answer was a firm NO. **We expect more color on the stance will be provided around February**, giving time to assess the early days of President Trump’s administration.

A balance between stability and growth momentum

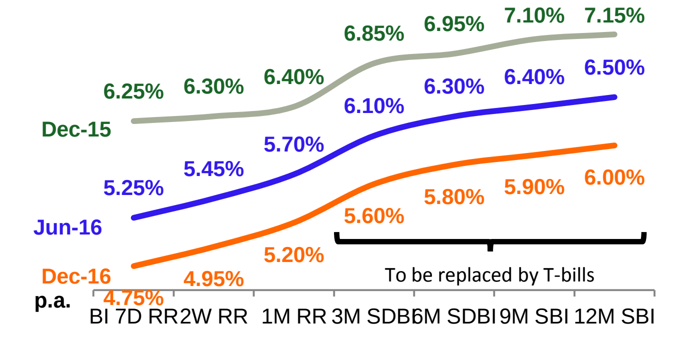
Going forward, **we think that a transition will be made towards a more tightening bias** on the backdrop of rising inflation and flight to US. Timing of such events would be the turn key, if impacts to domestic economy converge at the same time, then BI may want to safeguard a volatile Rupiah in order to maintain BoP and macro stabilities. Yet judging from the number of global events next year, our baseline assumption has incorporated a potentially low magnitude rate hike in 2017. An alternate or complimentary measure, depending on the need, to this could be by narrowing the symmetrical interest rate corridor from currently 75bps to 50bps.

Chart 7. Policy and Market Rates



Source: Bank Indonesia, Danamon Estimates

Chart 8. Monetary Operation Term Structure



Source: Bank Indonesia, Danamon Estimates

Deepening the financial market

Nevertheless, it seems that the central bank is hell-bent in keeping current growth momentum. Several optics have been disclosed for next year, including **a partial averaging of primary reserve requirement for banks and replacing BI papers with Treasury Bills for monetary operation**. We think these two intertwined with each other. The first is actually a monetary easing measure with purpose of giving banks more authority to manage their short-term liquidity. The hope is that banks can leverage this and be more agile in fund placement.

While upgrading monetary operation

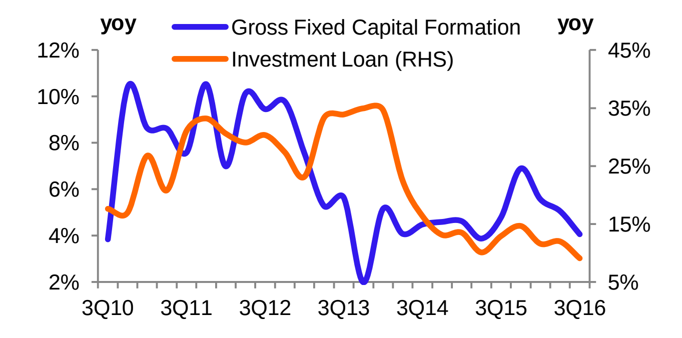
Meanwhile, the latter optic provides a deepening and safety net for short-term government bonds. In 2017, the central bank will no longer issue BI Certificates and gradually scale back the usage of BI Certificate of Deposit, which will be replaced by Treasury Bills (3M to 12M tenor) as monetary operation instruments. Size of the aforementioned Certificates are currently around IDR 150tn, thus **we expect BI may start to ramp up its collection of T-bills**. This is also congruent with MoF's plan to upsize the issuance limit of T-bills from IDR 2tn per auction to IDR 5tn per auction next year.

Awaiting for Loan to Revive

Trade and Investment to stimulate loan demand

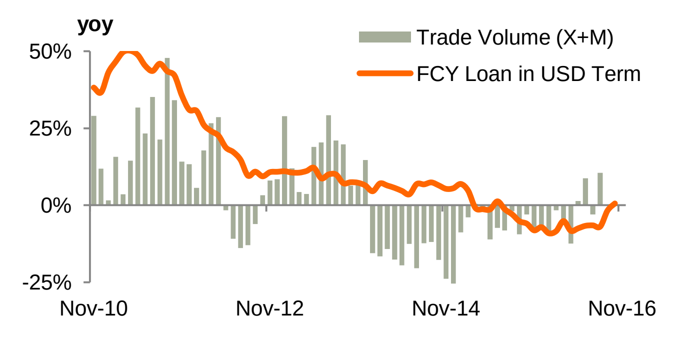
A common theme that market players are looking for is the **search for growth stories**, be it from a revival of old engines or emergence of new ones. Aside from the aforementioned trade potentials, private investments may still book an above-average-result next year. Real investment appears to have recoverd from its low amid broader-based improvement in corporate profits (*please see chart 9*). We think these trends may continue next year and stimulate some demand for loan.

Chart 9. Investment Loan and Volume



Source: BPS, Bank Indonesia

Chart 10. Trade Volume and FCY Loan Growth



Source: BPS, Bank Indonesia

But may be limited by supply

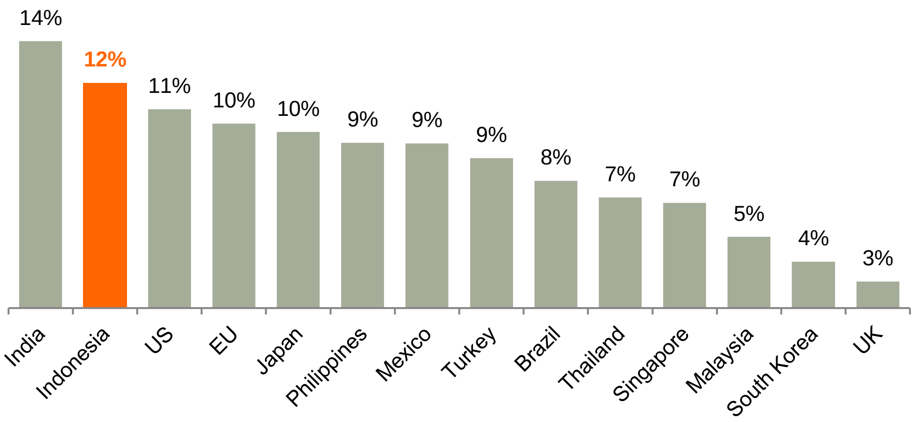
On the supply side of loan, we have been repeatedly flagging that low policy rate helps to consolidate banks' NPL at a faster pace and that interest spread –i.e. between deposit and lending- will automatically narrow once NPL issues subside. Taking a closer look into the NPL data suggest that it would start after 1H17. However, the upside potential may not be in the same league as previous investment cycle (between 2010-2012). These were during times when LDR was around 70%, meaning that there were still excess of liquidity in the banking system to go around. At present, the LDR is only marginally lower compared to the 92% regulatory cap. Therefore, **we have set our FY17 GDP growth forecast flat at 5.04%**.

Converting Cash to Accounts

What next?

Taking a step back to reminisce, these past three years were marked with “simple ideas” that are complex in implementation yet successfully became actions: subsidy reform in 2014, infrastructure investments in 2015, and Tax Amnesty in 2016. Markets are clearly waiting on the next simple idea for 2017. We wanted to pitch our thoughts by using a simple observation.

Chart 11. Currency in Circulation as % of M2 – Sep 2016



Source: Bank Indonesia, CEIC, Danamon Calculation

Lure in investments to manufacture

There are 2 interlinked issues that need to be addressed: 1) how to revitalize the manufacturing sector, and 2) how to streamline business licenses and reduce high cost economy, in order to lure in investments toward the manufacturing sector. In a global economy that is currently driven by services sector (financial and ITE), Indonesia needs to have a competitive edge by producing and exporting a unique manufactured good.

Absorbing cash into the system for leverage

To support and finance this move, the challenge in banking industry is how to draw in capital and intensify liquidity. One approach is by absorbing domestic cash held by public into the financial system. Indonesia’s currency in circulation (held by mass public) as percentage of money supply is relatively high compared to peers (*please see chart 11*). Absorption into the banking system may also reduce liquidity risk.

By learning from other EM countries

In comparison, emerging countries that are in need of leverage for growth - e.g. Brazil and Philippines- have succeeded in absorbing money into their financial system this past decade. While advanced economies, like Singapore and UK, have pushed to increase cash on public hands to intensify consumption.

Indonesia: Selected Economic Indicators

	2013	2014	2015	2016E	2017E
National Accounts					
Real GDP (% y-o-y)	5.6	5.0	4.8	5.0	5.0
Domestic demand ex. inventory (% y-o-y)	5.0	5.4	3.9	5.0	4.9
Real Consumption: Private (% y-o-y)	5.4	5.2	5.0	5.0	4.9
Real Gross Fixed Capital Formation (% y-o-y)	5.0	4.6	5.1	5.0	5.2
GDP (USD bn) — nominal	915	890	862	893	925
GDP per capita (USD) — nominal	3,668	3,530	3,374	3,453	3,577
Open Unemployment Rate (%)	6.3	5.9	6.2	5.6 (A)	5.5
External Sector					
Exports (% y-o-y, BoP Basis)	-2.8	-3.7	-15.4	-3.7	7.0
Imports (% y-o-y, BoP Basis)	-1.3	-4.5	-19.7	-4.4	6.6
Trade balance (USD bn, BoP Basis)	5.8	6.9	13.3	13.7	15.2
Current account (% of GDP)	-3.7	-3.2	-2.1	-2.0	-1.8
Central government debt (% of GDP)	21.3	23.6	25.0	27.8	30.2
International Reserves –IRFCL (USD bn)	99.4	111.9	105.9	119.0	114.0
Reserve Cover (Months of imports & ext. debt)	5.4	6.5	7.4	8.8	8.4
Currency/US$ (Year-end)	12,189	12,440	13,795	13,400	13,555
Currency/US$ (Average)	10,428	11,900	13,392	13.360	13,504
Other					
BI policy rate (% year end)	7.50	7.75	7.50	6.50*	N/A
BI 7-Day Reverse Repo rate (% year end)	N/A	N/A	6.25	4.75 (A)	5.00
Consumer prices (% year end)	8.08	8.36	3.35	3.17	4.19
Fiscal balance (% of GDP; FY)	-2.24	-2.26	-2.70	-2.70	-2.60
S&P's Rating – FCY	BB+	BB+	BB+	BB+	BB+

*Source: CEIC, E = Danamon Estimates, A = Actual, *) Up to August 2016*

Economic and Market Research

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