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Indonesia Economic Briefing

2019: Growing Amid Headwinds

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Beefing Up Buffers, Reducing Vulnerabilities

- **As the year approaches its-end, the big picture of the world economy seems to take a turn.** In the recent months, pessimism is growing over the state of the global economy amid trade war woes and tighter global financial condition. The US economy as one of the main driver of the world economy had shown some signs of softening which triggered expectations of a milder pace in future Fed's interest rate hikes.

- **A notable change of tone in the Fed's statement,** with Jerome Powell quoted saying the current rate is 'just below neutral', reinforced the view that the peak is near and expectation of a milder pace of monetary tightening next year.

- **Yet the near term risks on global financial condition remains high.** Uncertainty of trade tension, political, fiscal and normalization policy in Europe, as well as the resilience of emerging markets will continue to be the dynamic that will affect volatility.

- **Given the lingering global risks, it is crucial for Indonesia to reinforce buffers and reduce vulnerabilities to maintain the appeal of investment in IDR assets.** High uncertainty in the global economy had led foreign investors to be more selective in scrutinizing economic fundamentals factors across the emerging countries.

- **Thus far, the authorities had been quite responsive in issuing an array of policies aimed to improve the (balance of payment) BoP performance.** Monetary policy had been hawkish, increasing the appeal of IDR assets. Fiscal policies had been cautious but accommodative focusing on efforts to bring more investment by giving more tax incentives.

- **The economy in 2019 should still be able to grow modestly amid headwinds.** We expect the economy to grow by 5.18%yoy driven largely by consumption with higher government's social transfer and election spending.

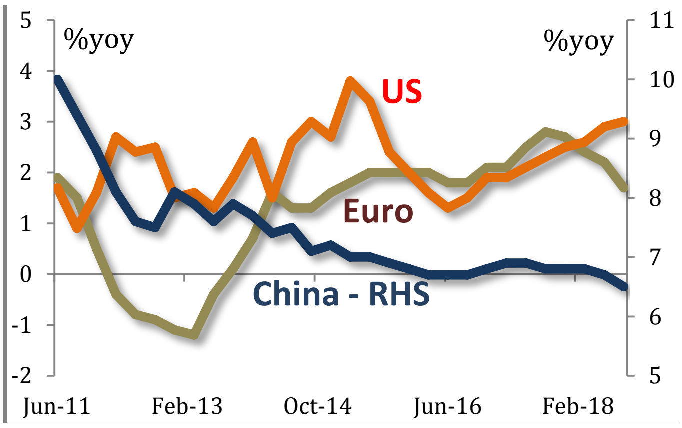
Global: Calm before the Storm?

In 2018, the engine of the global economy is centered on the revival of the US economy, as higher interest rates and loose fiscal policy brings liquidity back to the US. US fiscal policy had been loose, with tax cut given to large corporates, while monetary policy tightened which drew back the overseas funds to the US. Tax cut policy reached the US$1.5 trillion, adding to the liquidity in the US. In Q3, the US economy beats analysts' estimate at 3.5% growth, though weaker from its 4-year peak at 4.2% in Q2 (annualized rate). Household spending–which accounts for two-thirds of the economy- was the strongest since 2014, but the overall economic growth started to feel the pinch of lower export performance due to Trump's trade war-policy.

Dissipating tailwinds (tax cuts, softening global growth) met with growing headwinds (tighter monetary policy and increased trade protectionism) underlies concern that the economy's strength is not sustainable. Some of the market view had estimated a bigger likelihood of a recession for the US in the next two years. Varying indicators had been in line with the hypothesis. The US leading economic indicators had pointed to a dip in October, after a steady rebound since 2011. A fraction of the UST yield curve had inverted (spread between UST 5yr and 2yr dipped below zero), the first time since 2007. Many have regarded the inverted yield curve as a leading indicator of recession, as it has preceded the past 7 episodes of recession in the US. **This concern continues to build up as market participants noted a change of tone in the Fed's statement, with Jerome Powell quoted saying the current rate is 'just below neutral', reinforcing the view that the peak is near with expectation of a milder pace of monetary tightening next year.**

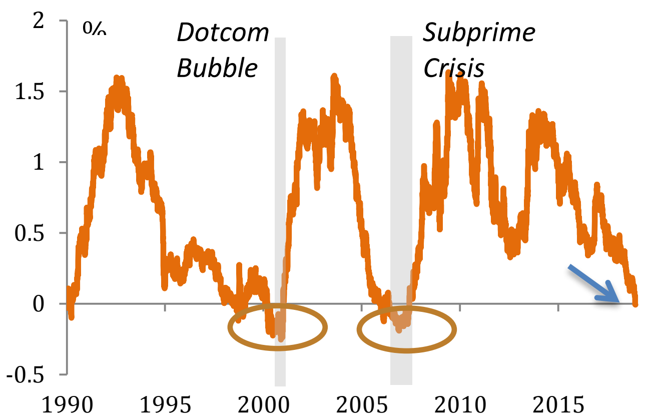
Sentiment over weaker growth spread out across the world. Weaker than anticipated data from the US, Europe, China, and Japan adds to mounting worries about the outlook in 2019. Europe's economy grapples with trade barriers, political uncertainty over Brexit, and Italy's budget breaching, which undermines the confidence. Germany saw its first contraction in Q3 (by -0.2%qtq), the first time since 2015, while Japan's economy contracted by 2.5% (annualized pace), the worst downturn since 2014, due to declining business spending.

Chart 1. Growth of Largest Economies



Source: Bloomberg

Chart 2. Spread between UST 5yr and 2yr

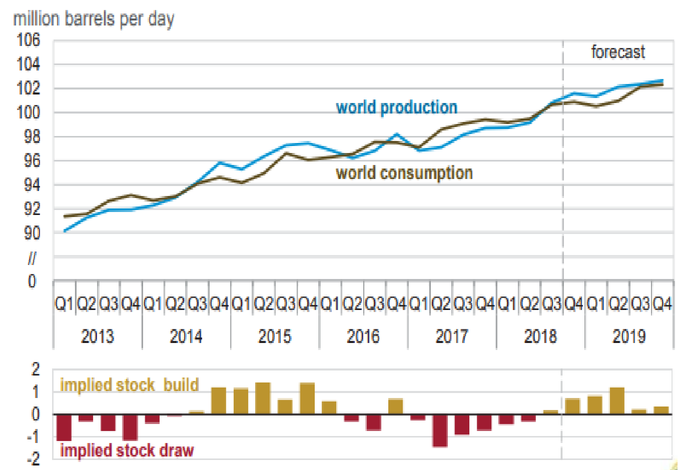


Source: Bloomberg

A milder tone coming from the IMF that still expects the US economy to post a decent growth next year and that the large impact of higher rates and trade tension would be more obvious in 2020. IMF expects US growth to reach 2.5%yoy in 2019 before slowing down faster to 1.8%yoy in 2020. In line with the US path, the world economy expected to grow modestly by 3.73%yoy in 2019 and slow down to 3.65%yoy in 2020.

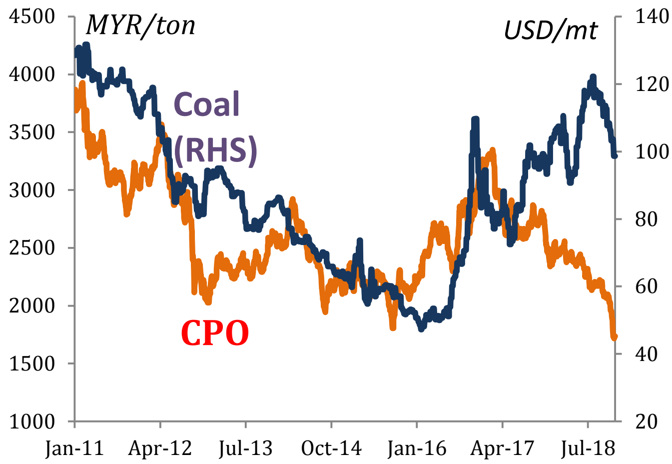
Expectations of a softer global demand had put pressure on the commodity prices. Oil price had been volatile this year, as it reached its highest point at USD86 per barrel in Oct 2018 -as OPEC limits production quota- before sliding back down to the current USD60 per barrel in response to the weakening global growth concern. Looking at the fundamental factors, supply for oil is expected to surpass the oil demand up to next years. The underlying fact is that once oil price climbs to a certain level, production will increase both from the OPEC countries, Russia, and the US.

Chart 3. Oil Fundamentals



Source: Bloomberg

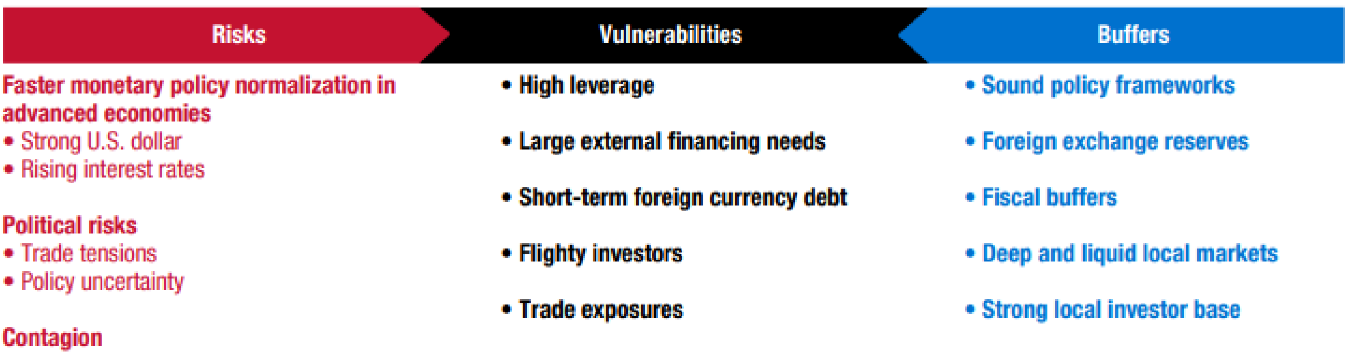
Chart 4. Commodity Prices



Source: Bloomberg

The softening demand had also influenced other commodity prices to decline, which brings pressure to the export performance, exacerbating the current account deficit (CAD) problem. Year to date, commodity exports had been hindered by CPO and Rubber Price that each had declined by 27% and 22%, while Coal price posted a more modest decline by 5%.

Diagram 1. EM Risk Metrics



Source: GFSR October 208

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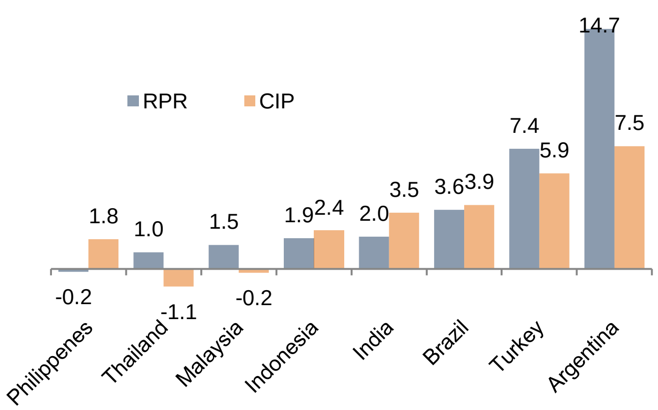
Uncertainty over the US-China trade deals still lingers and remains a risk next year, despite the softening tone shown by both sides as they agreed on a temporary halt in trade dispute at the G20 meeting. This means that global volatility may still be in the cards next year for EM countries. Competition of attracting external financing may still be tight as foreign investors will be more selective in channeling funds focusing on the country's specific fundamental factors. **Thus, it is imperative for EM countries including Indonesia to reinforce domestic fundamental factors and reduce vulnerabilities to win the appeal over other peer countries.**

Domestic: Focus on Improving the Balance of Payment

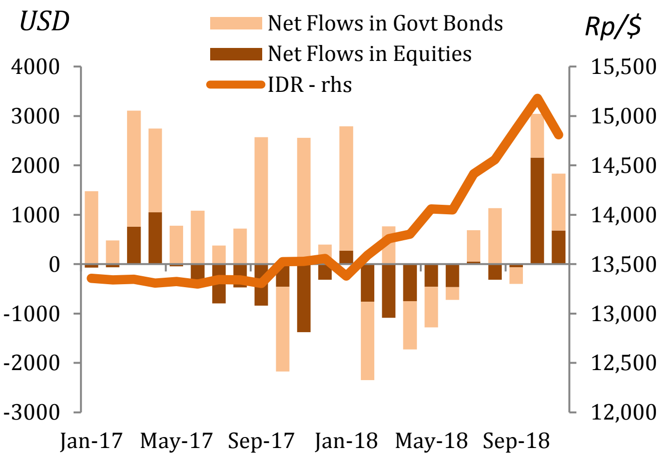
BI and the government continue to coordinate to shield the economy from global shocks, focusing on efforts to stabilize the currency, which means policies are directed to improve the structure of the BoP (particularly the CAD). The recent BoP condition resembles the large external financing needs; therefore, tight monetary stance is needed to increase market confidence and the appeal of IDR assets. Interest rate had been raised by 175bps this year, widening the spread with the FFR, which should increase the competitive valuation of IDR assets.

Chart 5. Competitive Valuation of EM Assets



Source: BI, CEIC

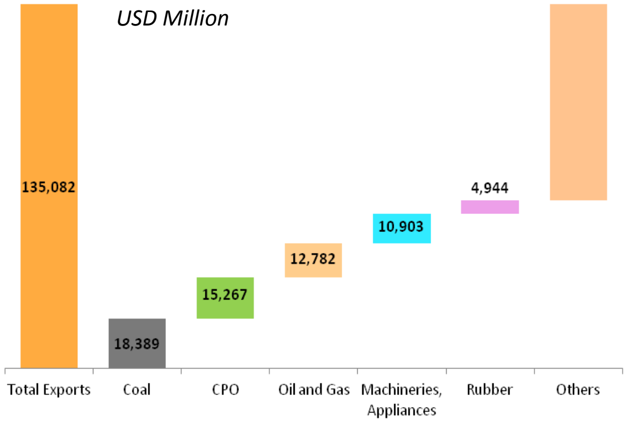
Chart 6. Short term Portfolio Flows



Source: BI

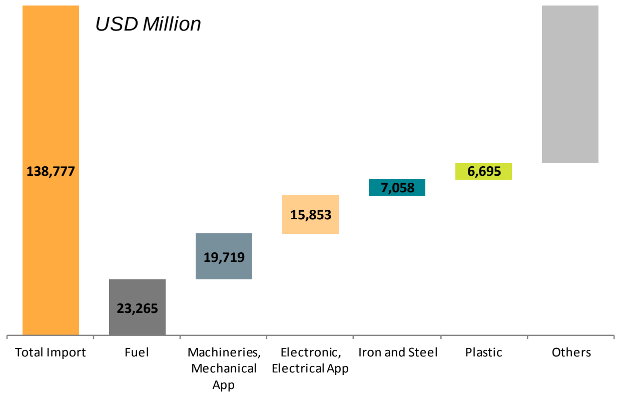
CAD had widened to 3.4% of GDP in Q3 (largest since 2014) due to high capital goods and fuel imports, while commodity exports distressed. Efforts to pick up the slack in the infrastructure development have had the consequence of rising imports of capital goods (Machineries, mechanical appliances, iron and steel). Along with fuel, these imports had continued to weigh on the trade balance. Higher fuel import was caused by some factors i.e. higher average price, unplanned shutdown in some of the local refineries. However, in terms of volume, fuel consumption is actually only expected to grow by around 5%yoy.

Chart 7. Main Exported Commodities (ytd 2018)



Source: CEIC

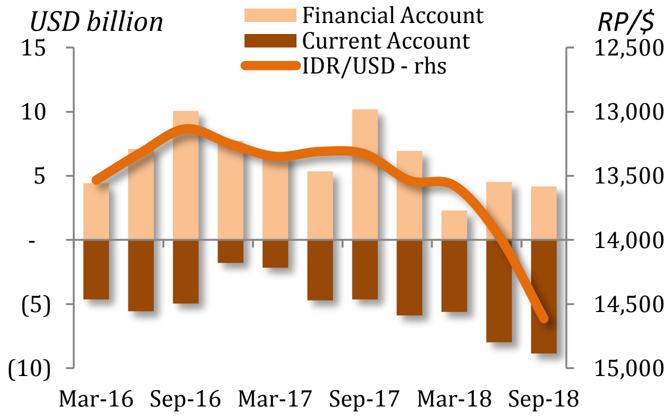
Chart 8. Main Imported Commodities (ytd 2018)



Source: CEIC

The government had responded by raising the tariff for a large part of consumption goods, though the impact is unfortunately limited, as it only accounts for a small portion (4%) of imports. **A more long-term policy is the enforcement of the use of Biofuel and the production of coal gas as alternative source of energy to reduce reliance on oil.** The policy is viewed positively, as it can cushion CPO and Coal industry amid falling prices and redirected these commodities for domestic use.

Chart 9. Balance of Payment



Source: BI, CEIC

Chart 10. Net Payment vs. Net Receipts

Source: Danamon

Back to the structure of the BoP, declining inflows of foreign investment (especially the short term portfolio investment) is also a factor of the deteriorating BoP (Chart 9). Therefore, we need more of the long term stable investment to improve the financing structure. **In a bid to attract more of these, the government adds incentives in the form of tax holiday for new investment and expands sectors that are open to foreign investment by revising the Negative Investment List.** Policies to improve dollar supply was also released with exports proceeds from natural resource must be repatriated and given the option to earn incentives in the form of income tax cut on deposit.

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The Importance of Strengthening Economic Buffers

The IMF identifies economic buffers as sound policy framework, forex reserve, fiscal sustainability, deep and liquid local market and strong local investors' base (Diagram 1). Among those factors, we are still lagging in the areas of market deepening and expanding the local investor base. The two areas are important to help absorb external shocks. However, **BI had started to build up a foundation for a deeper financial market by introducing the Indonesia Overnight Index Average (INDONIA) in the interbank market and Domestic Non Deliverable Forwards (DNDF)** in the forex market aimed to build deep and liquid local market to better absorb external shocks.

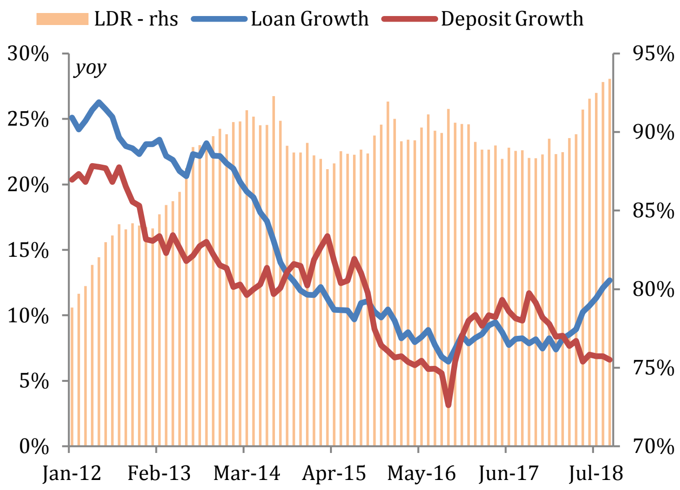
Meanwhile to improve the local investor base, the government has had some strategy up its sleeves. **Next year, the government had decided to increase the issuance of retail bonds in an effort to gradually widen the local investor base and reduce reliance on external financing.** The retail bond auction will also be conducted through online system, which will be more practical for investors. The effort to expand domestic investor base will consequently impact the proportion between foreign and domestic investors. The portion of foreign exchange denominated bonds may be lower than this year. Yet, while it is a good strategy to increase domestic investor base, there is a concern that it could lead to a tight liquidity condition as banks will have to compete to acquire funding.

Other important buffer is fiscal sustainability. The government had managed to keep the budget in check, which results in a potentially lower fiscal deficit this year at around 1.9% of GDP (vs. initially expected 2.2% of GDP). Rising oil price and weaker exchange rate had led to a higher collection of state revenues, which for the first time in history is able to surpass the initial target. Consequently the narrower fiscal deficit led to a smaller amount of financing needs. In times of pressure, this would be positive for the bond market, as limited supply will support prices.

The government bonds issuance target a smaller fiscal deficit next year at -1.84% of GDP (vs. 2018 at 2.19%). Yet, with the remaining uncertainty of the global factors, maintaining front-loading strategy may be the best option to achieve the financing target. Net bond issuance is estimated to reach Rp388.96 trillion while gross issuance could reach Rp825.7 trillion to refinance the notable amount of matured debt next year.

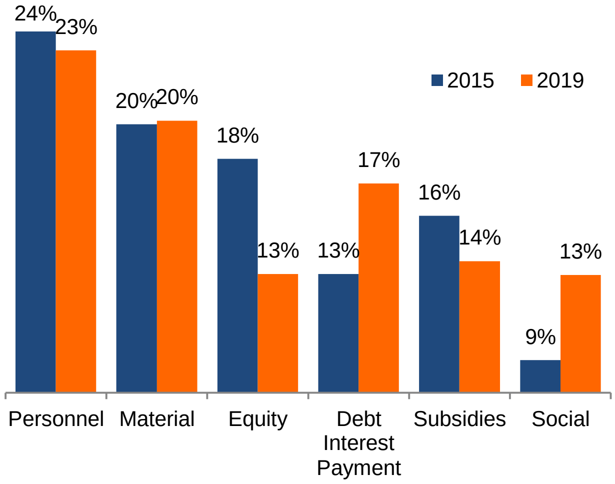
Higher interest rate will eventually impact the economic growth with a lagging period, which will depend on the pace of transmission to the market interest rate. Currently, we are seeing higher interest rate being passed on to the deposit rate, but not yet fully transmitted to the loan side. This year we still see modest credit growth at the range of 10-11%yoy as economic expansion picks up. Liquidity in the banking system is relatively tighter than the previous year, as reflected in the LDR that had reached 94% as deposit only grew by 6%. Yet, banks still have placement on BI of around Rp450 trillion, which means liquidity in a larger perspective is still relatively manageable. A wider measure of liquidity, which incorporates the loans/debt (wholesale funding) earned by banks (Loan to Funding Ratio-LFR) is at a smaller ratio of 85.7%, which means banks still has room to raise funding. Furthermore, BI had complement the strategy by issuing macro-prudential policies i.e. (implementation of Macro Prudential Intermediary Ratio (MIR), relaxing the Macro Prudential Liquidity Buffer (MLB), the averaging Reserve Ratio) aimed to ease liquidity condition in the system.

Chart 11. Banks Liquidity



Source: BI, CEIC

Chart 12. Government's Budget Allocation



Source: CEIC

2019: Modest Growth amid Headwinds

The tight liquidity condition may ease next year, as higher interest rate and national election period may temporarily deter credit growth. Investment may be sideways in 2019 as investors wait for more certainty on political direction after the election. However, we think **consumption may still be supported by the government's increase in social spending.** Next year's spending will be directed more on improving the quality of human resource. There will be higher allocation of investment in education and higher funds for social protection program. Consumption on the low to middle income class should be supported. **Any adjustment in the subsidized energy price will be done gradually, thus impact to inflation may be relatively modest.**

Exports outlook may be a challenge next year with the prospect of softening global demand. The world is moving toward bilateral deals and higher trade barriers as efforts to protect the national industry. CPO exports had to deal with the increasing barriers in the form of environmental issues. Declining demand from India as one of the large exports destination also had a big impact. Coal exports face the same challenge from China as the local coal production in China is increasing. Thus, main commodity prices are expected to still be on a declining trend. CPO and Coal industry may be directed more to cater domestic industry with the policy of biofuel and coal gas being enforced. Efforts to diversify exported products (reviving the manufactured exports) as well as diversify destination countries need to be stepped up.

The government needs to continue to develop other source of economic strength to reduce reliance on commodities. While reviving the manufacturing exports may take a while as it depend on the prospect of investment to improve, the government may focus on other 'easier' sectors to promote, i.e. tourism, culinary, fashion, and digital economy or what we called the creative economy sector.

Table 1. Economic Forecast

	Unit	2017	2018F	2019F	2020F	2021F
Global						
US GDP	% yoy	2.2	2.8	2.6	1.8	1.8
US Fed Fund Rate	% p.a.	1.50	2.50	3.25	3.25	3.25
Avg Brent Oil Price	USD/bbl	55	70	70	65	60
Indonesia						
Real GDP Growth	% yoy	5.1	5.1	5.2	5.0	5.0
Consumer Price Index	% yoy	3.6	3.6	4.3	3.8	3.5
BI 7D RRR	% p.a.	4.25	6.00	6.75	6.75	6.25
LPS Rate	% p.a.	5.75	7.00	7.75	7.75	7.25
10Y Bond - Fair Yield	% p.a.	6.59	8.29	9.17	9.06	8.71
FX – Average	IDR/USD	13,383	14,170	14,725	14,675	14,390
FX – Year End	IDR/USD	13,548	14,525	14,820	14,465	14,235
Current Account Balance	% GDP	-1.7	-2.7	-2.5	-2.2	-2.0
Loan	% yoy	8.2	10.0	8.8	8.2	7.8
Third Party Fund	% yoy	9.4	8.2	8.0	9.1	9.5
Loan to Deposit	%	89.6	91.1	91.7	91.0	89.6

Source: IMF, Danamon Calculation

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