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Indonesia Economic Flare

Swimming Upstream

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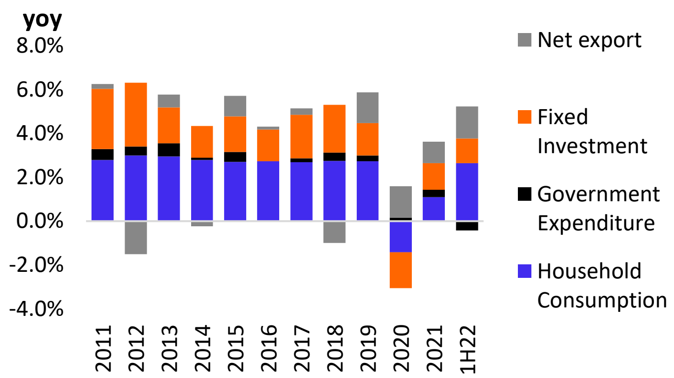
- **Sound growth in 2023, despite global economic turbulence.** The Indonesian economy posted an astounding growth of 5.2% yoy in the first half of this year, beating market expectation. Domestic demand as main engine of growth was, in fact, expected by many (Chart 1). Yet most might have undermined the transmission of domestic purchasing power, which is understandably clouded by inflation expectation and global economic slowdown. Throughout the pandemic, Indonesia has benefitted from soaring commodity prices and robust direct investment, helping deposits to grow double-digit in the past two years. Such phenomenon is well-known as pent-up demand, and we believe would bolster growth to 5.3% in the following year.

- **Dwindling external balance.** Risk of global recession has pushed commodity prices down quite substantially, though still above pre-pandemic levels. Aside from price factor, the world trade volume also displayed persistent moderation, while shipping costs remained elevated on the back of European demand for energy-related vessels. Therefore, we maintain our view of a current account deficit at 0.5% of GDP this year, then widens to 1.0% of GDP by next year.

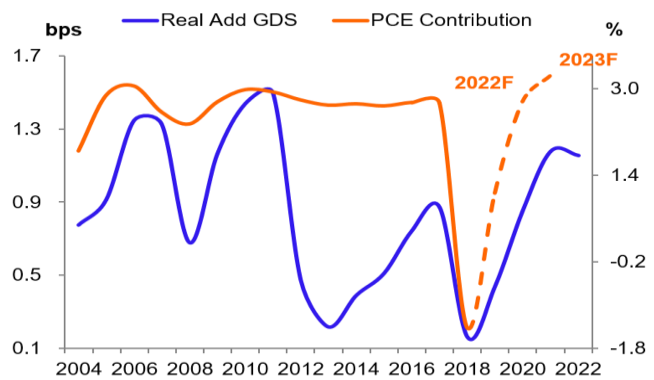
- **Sticky inflation leads to higher rates**. Based on latest figures, core inflation had accelerated to 3.2% yoy across the board. This signaled that producers have begun adjusting output prices to compensate for previous margin losses. Prior to Russia-Ukraine conflict, the global supply chain did not improve immediately, even after a period of relatively manageable pandemic. As such, we revise our forecast of inflation up to 6.5% yoy this year and assume that monetary policymakers would need to walk a tightrope by frontloading its rate hike to 5.25% this year with another 100 basis points next year.

Chart 1. Indonesia's GDP Growth Contribution



Source: Indonesian Bureau of Statistics

Chart 2. GDS and Household Consumption (PCE)



Source: Bank Indonesia, Danamon

Spending splurge on the back of Gross Domestic Savings (GDS). The pandemic had restrained people from going out, which means they spent less on recreation, transportation, and dine-in at restaurants. Breaking down by income classes, the middle-upper has benefitted from a surge in commodity prices and robust direct investment since 2H21, while the middle-lower was supported by government stimulus. This was the backdrop of deposit's double-digit growth during the pandemic and benign household consumption growth in 2021. Throughout 1H22, we have seen a substantial improvement as household consumption was the most significant contributor to Indonesia's economic growth at 2.6%, followed by net export at 1.5% and fixed investment at 1.1%. Gross domestic savings, a combination of trade and investment flows adjusted to inflation, has fittingly explained the movement of household consumption with a lag of t+2 (Chart 2). Based on this, household consumption would likely contribute as much as 2.8% to Indonesia's economic growth this year and 3.2% for next year.

Homecoming of durable goods. Appetite for durable goods, which has always been associated with consumer confidence, enhanced considerably. During the pandemic, spending in this category plunged as uncertainties loomed. In 2022, most durable goods categories have recorded growth. For instance, retail clothing sales grew by 58.2% yoy in Aug-22, while cultural & recreation goods and motor vehicles grew by 20.9% yoy and 6.3% yoy, respectively. Please note that it was despite a backlog in supply. Household equipment remain contracted yet persistently improving (Table 1). Given these indicators, we believe that consumer confidence is inching up and would help foster household consumption, especially next year.

Table 1. Durable Goods Consumption (Retail Sales Index YoY)

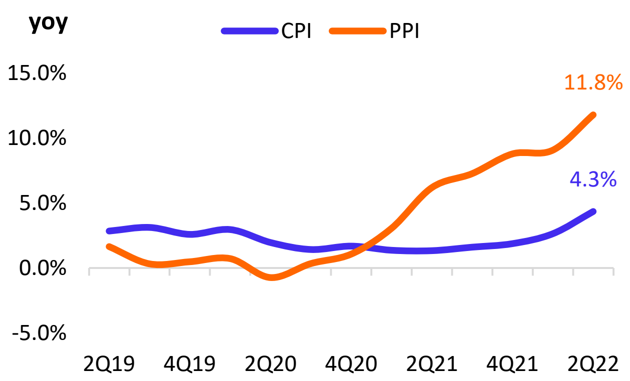
	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22	Jun-22	Aug-22
Durable											
Motor Vehicles	-14.7%	-37.8%	-23.3%	-20.0%	-13.2%	22.8%	-10.1%	-3.4%	6.2%	3.4%	6.3%
Communication Equipment	-7.6%	-16.3%	-22.2%	-39.2%	-38.8%	-31.8%	-28.8%	-16.2%	-18.0%	-26.5%	-26.3%
Household Equipment	-5.5%	-23.1%	-26.2%	-25.0%	-23.3%	-5.7%	-24.9%	-24.0%	-18.8%	-27.7%	-7.3%
Cultural & Recreation Goods	-20.5%	-44.6%	-39.5%	-40.0%	-41.9%	-4.5%	-12.6%	-11.9%	-1.4%	5.4%	20.9%
Clothing	-60.5%	-73.7%	-59.7%	-59.7%	-10.8%	39.9%	-12.0%	-0.1%	6.4%	-3.8%	58.2%
Non-Durable											
Food & Beverages	3.7%	-7.6%	3.1%	-10.3%	-9.0%	7.3%	5.3%	23.9%	15.7%	11.3%	7.6%
Auto Fuels	-18.7%	-27.0%	-18.7%	-12.0%	3.2%	47.4%	22.8%	37.9%	48.5%	18.6%	55.3%

Source: Bank Indonesia

Prospect of current account. Indonesia booked USD 4.3 bn worth of current account surplus in 1H22, even larger than the USD 3.5 bn surplus for the whole year of 2021. This was a result of rising commodity prices and lagging import recovery. Fast forward to 4Q22, prices of exported commodities, especially Crude Palm Oil (CPO), have declined along with global demand. CPO price almost returned to its pre-pandemic level of around MYR 3,000/t, while coal price dropped below USD 400/t in Sep-22. From a volume perspective, Indonesia's two major trading partners (i.e. US and Europe) will likely book a much lower growth next year as monetary tightening starts to bite. On the other hand, import begins to catch up. During the first half of this year, the setback of import activity mainly came from consumers' durable goods (i.e., clothing, household equipment, etc). That said, such import will accelerate in the wake of consumers' return to durable goods, which result in a moderating trade surplus going forward. The current state of the global energy crunch has shifted shipping costs upward, since European countries are willing to pay more for vessels to carry coal, gas, and other alternative energy sources to replace Russian supply, and leaving Asian buyers as collateral damage. Shipping cost is a significant factor in services account that has always been a deficit contributor to Indonesia's current account.

Producers have not fully pass-through their output prices yet. Global energy crunch and supply chain disruption have intensified input cost pressure for producers across the globe, including Indonesia. Producer Price Index (PPI) increased by 11.8% yoy in 2Q22, up from 9.1% yoy in the previous quarter. However, producers could not fully pass-through these costs to consumers since recovery was fragile back then; otherwise, the profit margin would fall further as sales quantity dropped. Hence, Consumer Price Index (CPI) increased only gradually, and not as fast as PPI (Chart 3). In the first half of this year, profit margin was 1.3% below its 2017-2020 average (Table 2). The manufacturing sector, whose forward and backward linkage is the largest among others, still has room to improve its margin to at least the average of the last three years prior to the pandemic. Should manufacturers adjust their output prices, it will be multiplied to other sectors as well. With a hefty domestic demand recovery, producers will likely seize this opportunity to pick up some margin loss from the last two years.

Chart 3. Producer Price Index vs Consumer Price Index



Source: Indonesian Bureau of Statistics

Table 2. Profit Margin by Sector

Sectors	Average Margin (2017-20)	2021	1H22	Δ to Average
Agriculture	18.5%	20.0%	19.8%	1.3%
Mining	16.3%	17.7%	15.8%	-0.6%
Manufacturing	15.0%	14.1%	13.9%	-1.0%
Utilities	14.3%	13.3%	12.0%	-2.3%
Construction	16.7%	15.1%	15.3%	-1.4%
Trade, Hotel, Restaurant	17.1%	14.8%	16.6%	-0.5%
Transportation & Communication	17.6%	14.7%	15.3%	-2.3%
Financial, Real Estate, Corp Services	16.6%	14.7%	14.6%	-2.3%
Total	**16.6%**	**15.3%**	**15.3%**	**-1.3%**

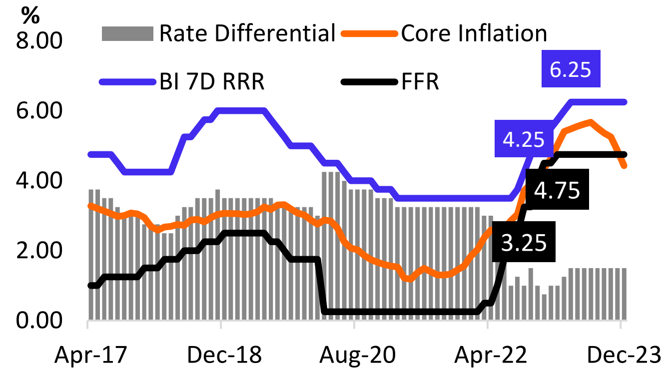
Source: Business Survey Bank Indonesia, Danamon

Lagging supply chain adjustment. The pandemic has taught us one crucial lesson about global supply chain; it does not recover rapidly once the pandemic ended. Despite a significant drop in worldwide covid cases, supply shortage remains an issue, even before the Russia-Ukraine conflict. PMI reported that the input shortage index peaked at approximately 4.5 in Nov-21, indicating that global shortages were roughly 4.5 times than normal amount. The index has been going down since then yet remained above normal at 2.2 per Aug-22. It took ten months for the global input index to halve since its peak. Given geopolitical uncertainties and pace of global input index, it is doubtful that supply disruptions will be fully untangled by early next year. Accordingly, we expect the peak of headline inflation is 7.34% at the beginning of the second quarter next year, taking into account all the second-round impact of subsidized fuel price adjustment last month.

More rate hikes to come. Monetary policymakers vowed to tame inflation back to their targeted range by end of 2023. To achieve this objective, Bank Indonesia (BI) has increased its policy rate by 75 bps in the last two meetings. The call for 50 bps in September was a surprise to many. BI sounded more bullish on core inflation and economic growth this year, saying that core inflation will accelerate further amid the second-round impact of subsidized fuel price adjustment. Despite the 50 bps surprise last month, IDR remained under pressure. IDR depreciated to above

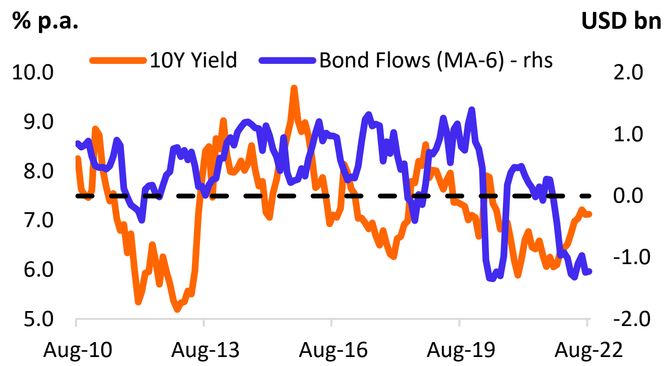
IDR 15,200/USD within a week after the meeting, on the back of a more hawkish Fed's dot plot. The latest dot plot ended the hope of a Fed pivot. It resulted in a new terminal rate of 4.75% in 2023, with the first-rate cut pushed back to 2024. This pushed BI to walk on a tightrope to defend IDR stability. The spread between BI 7D RRR and Fed Fund Rate reached its record low with a 100 bps margin. As external pressure heightens and core inflation accelerates, we believe BI will protract its pre-emptive policy measures and raise the terminal rate for BI 7D RRR at 6.25% in 2Q23 (Chart 4).

Chart 4. BI 7 Day Reverse Repo vs Core Inflation



Source: Ministry of Finance

Chart 5. 10Y INDOGB Yield vs Bond Flows (MA-6)



Source: Bloomberg, Danamon

Resilient IDR with higher volatility. The recent pressure on IDR would likely be temporary amid sound fundamentals. FX liquidity and reserve remain sufficient on the back of current account surplus. Real yield of domestic portfolio assets is relatively attractive compared to peers. Should BI decide to widen the rate differential between domestic policy rate and FFR, there is a good chance that the IDR would appreciate towards year-end to around IDR 14,820/USD. However, IDR would be more burdensome next year, especially in the 1H23. Indonesia's external resilience would likely deteriorate along with the above-mentioned widening of current account deficit. Meanwhile, Fed's dot plot shows that there's another 25 bps possible hike in 1Q23. Nonetheless, pressure to IDR will likely soften in the second half as we expect foreign inflows to bond market coupled with a reversal in USD trend. Along with BI 7D RRR reaching its terminal rate in 2Q23, we also see INDOGB yield reaching its peak. Historically, foreign flows will keep entering the domestic market within six months from the peak of yield (Chart 5). Since Indonesia's bond market remains attractive for foreign investors, we expect inflows next year considering positive real yield and healthy macro fundamentals. All in all, the average IDR movement is expected to be around IDR 14,927/USD in 2023.

Indonesia's Selected Economic Indicators

	2019	2020	2021	2022E	2023E
National Accounts					
Real GDP (% y-o-y)	5.0	-2.1	3.7	5.1	5.3
Domestic demand ex. inventory (% y-o-y)	3.6	-3.1	2.8	5.0	5.2
Real Consumption: Private (% y-o-y)	5.0	-2.7	2.0	5.0	6.1
Real Gross Fixed Capital Formation (% y-o-y)	4.4	-4.9	3.8	4.5	3.5
GDP (USD bn) — nominal	1,119	1,059	1,186	1,212	1,296
GDP per capita (USD) — nominal	4,193	3,917	4,350	4,422	4,593
Open Unemployment Rate (%)	5.3	7.1	6.0	5.7	5.5
External Sector					
Exports (% y-o-y, BoP Basis)	-6.8	-3.0	42.5	30.7	4.3
Imports (% y-o-y, BoP Basis)	-8.9	-18.1	39.9	31.1	13.2
Trade balance (USD bn, BoP Basis)	3.5	28.2	43.8	56.0	36.9
Current account (% of GDP)	-2.7	-0.4	0.3	-0.5	-1.0
Central government debt (% of GDP)	30.5	38.1	41.0	37.8	35.8
International Reserves –IRFCL (USD bn)	129.2	135.9	144.9	130.2	135.7
Reserve Cover (Months of imports & ext. debt)	7.3	9.8	7.8	5.8	6.2
Currency/USD (Year-end)	13,901	14,050	14,253	14,820	14,890
Currency/USD (Average)	14,146	14,529	14,296	14,738	14,927
Other					
BI 7-Day Reverse Repo rate (% year end)	5.00	3.75	3.50	5.25	6.25
Consumer prices (% year end)	2.72	1.68	1.87	6.49	5.73
Fiscal balance (% of GDP; FY)	-2.20	-6.09	-4.65	-3.92	-2.71
S&P's Rating – FCY	BBB	BBB	BBB	BBB	BBB

Source: CEIC, E = Danamon Estimates

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