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Indonesia Economic Outlook 2023

At the Break of Dawn

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Executive Summary

- **Impact will fully bite in 2023.** Signs of further slowdown in the US economy is getting obvious. Looking at the PMI data, both manufacturing and service activities have been deteriorating since Aug-22 (index <50). The pace of deterioration was faster over each month, signaling a continuous softening in demand. As a result, the Fed changed into lower gear of raising FFR by 50 bps to 4.50% p.a. in Dec-22. Many expect that the US economy will experience a mild recession out of this. A similar phenomenon also applies to other advanced economies whose central banks aggressively hiked its policy rate -i.e. ECB and BOE-. The probability of recession is even higher among European countries, as high interest rate coupled with the impact of Russia-Ukraine war would expedite further weakening of their economies.

- **Sound growth in 2023, despite global turbulences.** The Indonesian economy posted an astounding growth of 5.7% yoy in 3Q22, equivalent to 5.4% yoy in 9M22, beating market expectation. Domestic demand as the main engine of growth was, in fact, expected by many. 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 2023.

- **Positive signal in 2023.** We have seen inflows to domestic bond market since end of 2022, fostering USD 1.6 bn in the month of December, then another USD 1.0 bn up until 17 January 2023. Such flows were driven by the deceleration in Fed tightening and the indication that it might end soon. Meanwhile, equity market still booked USD 1.3 bn of outflows in Dec-22 and another USD 0.4 bn as of 17 January 2023. These net inflows have led the IDR to appreciate by 2.6% to IDR 15,165/USD in January. Historically, the bond market would book significant inflows within six months after the end of rate hike cycle, as asset prices bottomed. And considering that both the Fed and BI may reach their terminal rate in 1H23, we expect inflows to bond market would provide a buffer for IDR to strengthen in 2H23. Based on our calculation, the IDR would appreciate to IDR 14,984/USD this year.

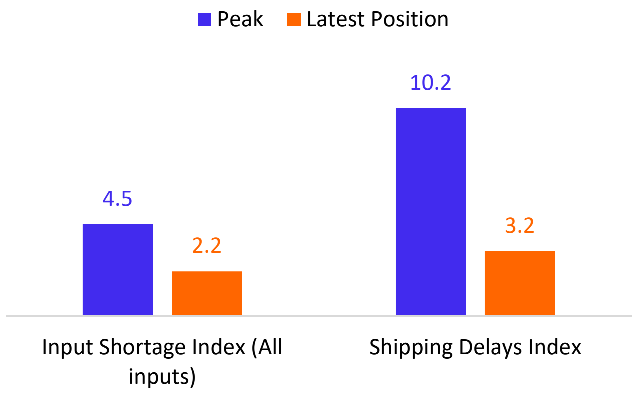
- **Sound recovery in ROA.** During the pandemic, financial intermediary was disrupted by subsiding demand for loan. Banks shifted its deposit allocation from loan to domestic financial assets, especially bonds. Share of banks in government bond increased significantly from around 20% of total outstanding to 35% by end of 2022. Since core banking business was hit by the pandemic, Return on Assets (ROA) ratio declined to 1.6% in 2020, from 2.4% in 2019, with conventional banks experiencing a deeper impact compared to Islamic banks. But as the economy recovers, banks managed to gain back ROA to as high as 2.5%.

Global Economy: Advance or Retreat?

Supply disruptions are fading…

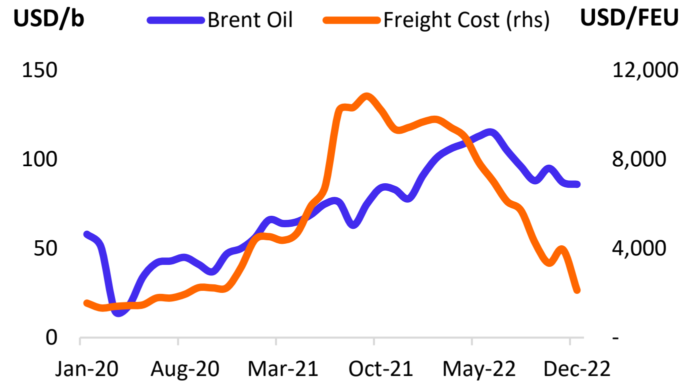
Improving global supply chain. Due to the economic reopening in 2H21, global demand increased substantially, yet supply side adjustment is slower than expected. Producers did not deliver as many products as pre-pandemic era. Labors were not willing to go back to work with neither the same wage level nor flexibility, thus, rehiring was not as easy as employers thought back then. This leads into a shortage in overall inputs of production, reaching its peak by Nov-21. Input shortage index, released by S&P Global Markit, signaled that input shortage was 4.5x worse than normal condition (pre-pandemic), while global freight was heavily congested due to closed borders. Examples were seen in Europe and the west coast of the US, as backlogs of cargo ships at large ports reached an all-time high. Shipping delays index in Dec-21 was mind-boggling, where delays in shipping was 10.2x worse than pre-pandemic level. Since then, these same indicators gradually improved by 50% for input shortage and almost 70% for shipping delays, despite still beyond normal condition.

Chart 1. Input Shortage & Shipping Delays



Source: S&P Global Markit, Latest: Oct-22

Chart 2. Energy Prices & Freight Cost

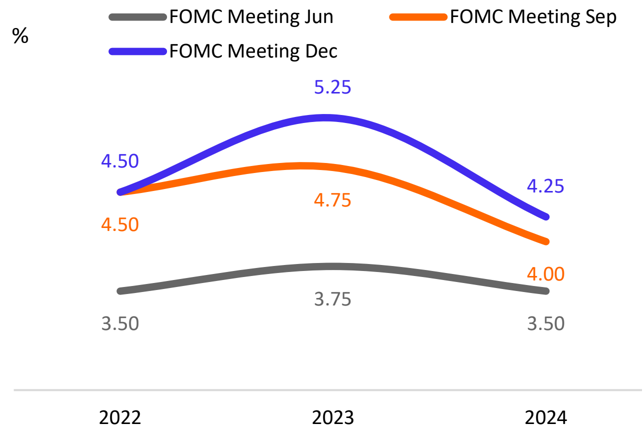


Source: Bloomberg, Freightos Baltic Index

... Yet oil price is sticky

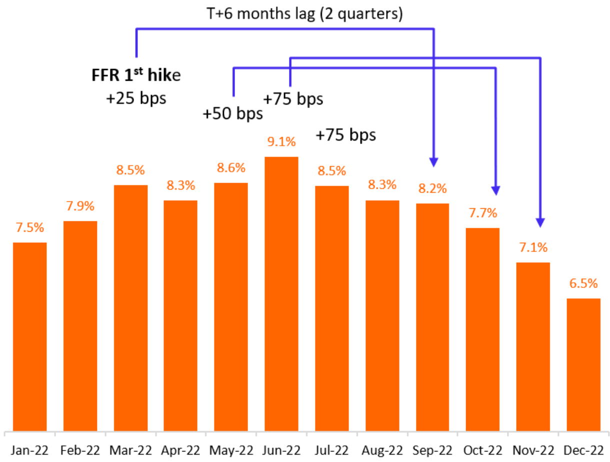
Cost normalization. Along with the development in global supply chain, freight cost moderated since 2Q22 then closed the year at USD 2,126/FEU or down by 80.4% from its peak of USD 10,839/FEU in Sep-21. Energy cost, on the other hand, seems obstinate in comparison. The geopolitical dynamics between Russia and Ukraine has worsened the oil market amid supply cuts from OPEC+ countries and deescalating demand. Brent price was USD 78/b in Dec-21, up from USD 56/b in the beginning of 2021, as OPEC+ countries were cautious on increasing their productions on the back of demand uncertainty. It surged to USD 123/b in Jun-22 because of the import ban for Russian oil, resulting in a tight net supply as other OPEC+ countries scrambled to cover the gap. Oil price began to soften with global economic activities and eventually went back to USD 86/b in Dec-22. In response, OPEC+ countries decided to impose a deep production cut of 2 Mn bpd (eq. 2% of global supply), starting in Nov-22. Thus, we believe that oil price would be stickier than freight, as OPEC+ aims to maintain price at least above pre-pandemic level.

Chart 3. FOMC Members' Expectation on FFR



Source: The Fed, Danamon

Chart 4. US CPI vs Fed Fund Rate



Source: The Fed

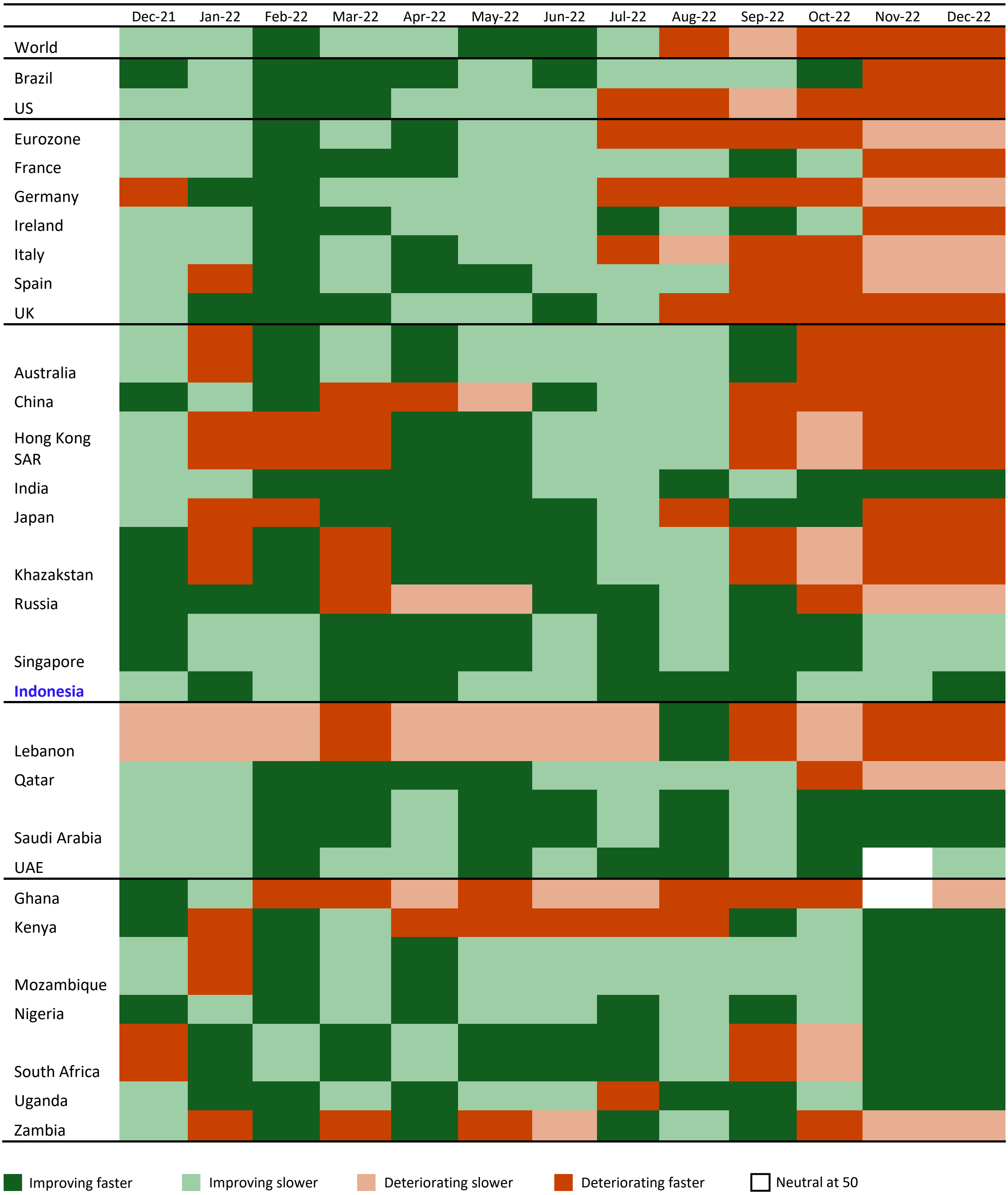
"Whatever it takes"?

Aggressive monetary tightening. In order to contain inflation, central banks across the globe aggressively tighten their monetary policies. This was led by the Fed with 25 bps increase of Fed Fund Rate (FFR) in Mar-22 then escalated its pace of tightening by imposing larger hikes in following months, with 50 bps increase in May-22 and 75 bps hikes afterwards. Cumulatively, the FFR was raised by 425 bps throughout 2022 to 4.50% p.a. Even the dot-plot that consists of Fed members' quarterly expectation on FFR, signaled a progressively hawkish stance. The terminal of FFR increased from 3.75% in June to 5.25% in December, due to stickier than expected inflation. Monetary policymakers seem determined to suppress the economy enough for a disinflation.

To tame inflation in the medium run

Jumbo rate hikes kicked in. Although inflation remained far from the Fed's target of 2.0%, latest figures indicate that it can be fulfilled in the medium-term. Actual data recorded below market's expectation and posted an inflation of 6.5% yoy in Dec-22. This was in-line with the lag of monetary policy transmission in the US, which roughly takes 2 quarters. The first jumbo hike of 75 bps delivered by The Fed was in Jun-22, translated into full transmission in Nov-22. Having moderated cost push inflation and restrained demand from monetary tightening, we believe that the US inflation rate will return within the Fed's target beyond 2023.

Table 1. Global PMI Heatmap



Source: S&P Global Markit

Western wind…

Impact will fully bite in 2023. Signs of further slowdown in the US economy is getting obvious. Looking at the PMI data, both manufacturing and service activities have been deteriorating since Aug-22 (index <50). The pace of deterioration was faster over each month, signaling a continuous softening in demand. As a result, the Fed changed into lower gear of raising FFR by 50 bps to 4.50% p.a. in Dec-22. Many expect that the US economy will experience a mild recession out of this. A similar phenomenon also applies to other advanced economies whose central banks aggressively hiked its policy rate -i.e. ECB and BOE-. The probability of recession is even higher among European countries, as high interest rate coupled with the impact of Russia-Ukraine war would expedite further weakening of their economies.

… Meets Eastern wave

China's reopening. Manufacturing and services sectors in some Asia Pacific countries are still expanding, including Indonesia. This signals a brighter outlook for the region's growth this year, compared to advanced economies. Despite the economic slowdown in most of advanced economies, Asia Pacific intra-trade could be a buffer and positive catalyst for the region. On top of that, one of the world's largest economies, China, has reopened its economy early this year. It will temporarily unleash pent-up demand for goods and commodities, providing boost for its trading partners, not to mention inbound tourism. As one of the major trading partners, China could help cushion and shift Indonesia's trade structure.

Indonesian Economy: A Domestic Demand Play

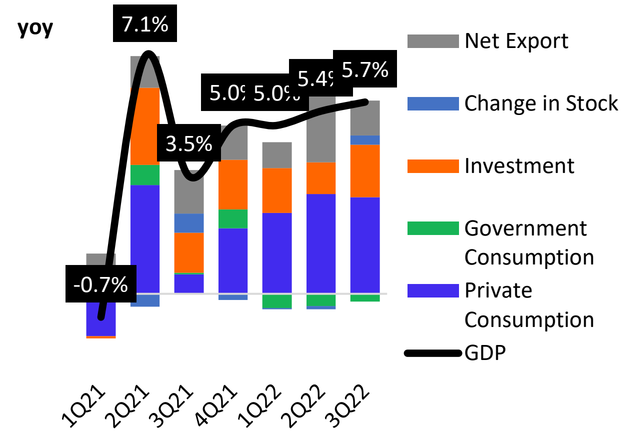
Purchasing impaired…

Sound growth in 2023, despite global turbulences. The Indonesian economy posted an astounding growth of 5.7% yoy in 3Q22, equivalent to 5.4% yoy in 9M22, beating market expectation. Domestic demand as the main engine of growth was, in fact, expected by many. 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 2023.

… Or powered?

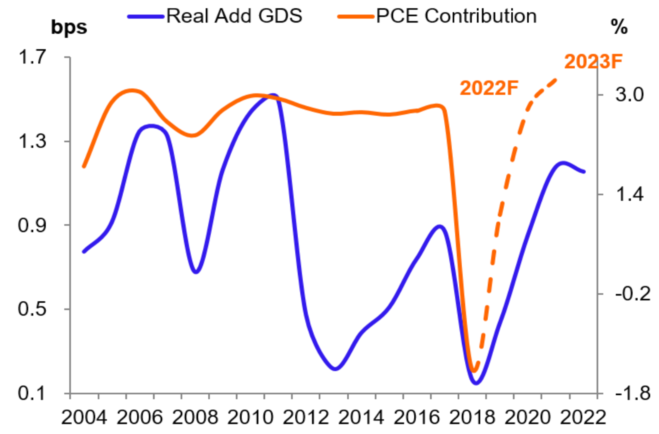
Spending splurge on the back of Gross Domestic Savings (GDS). The pandemic had restrained people from going out, which means they spent less on recreation, transportation, and dine-in at restaurants. Breaking down by income classes, the middle-upper has benefitted from a surge in commodity prices and 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 9M22, we have seen a substantial improvement as household consumption was the most significant contributor to Indonesia's economic growth, followed by net export and fixed investment. 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. Based on this, household consumption would likely contribute as much as 2.8% to Indonesia's economic growth in 2022 and 3.2% for 2023.

Chart 5. Indonesia's GDP Growth Contribution



Source: Indonesian Bureau of Statistics

Chart 6. GDS and Household Consumption (PCE)



Source: Indonesian Bureau of Statistics, Bank Indonesia, Danamon

Gaining confidence

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. Motor vehicles grew by 3.3% yoy in Dec-22, communication equipment booked double digit growth of 22.8% yoy, while clothing and cultural & recreation goods posted 6.8% and 1.8% yoy growth, respectively. Given these indicators, we believe that consumer confidence is inching up and would help foster household consumption, especially this year.

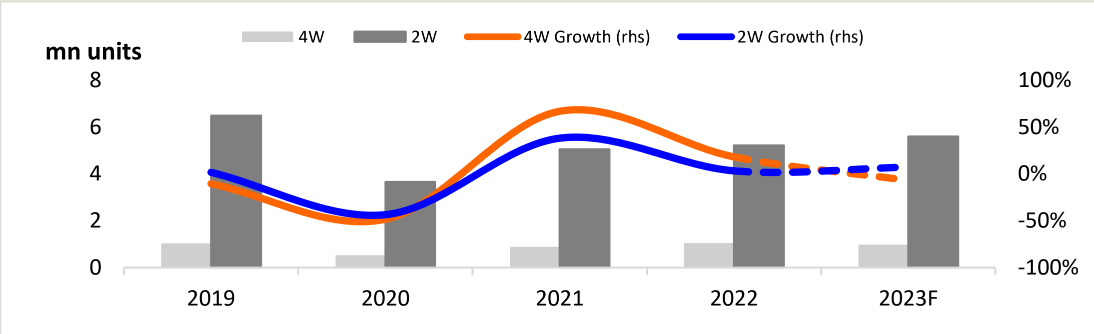
Table 1. Retail Sales Index: Durable Goods Consumption

% yoy	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22	Jun-22	Sep-22	Oct-22	Nov-22	Dec-22
Durable										
Motor Vehicles	0.0	-1.5	-6.3	3.5	12.1	3.3	-12.5	-1.3	0.8	3.3
Communication Equipment	-1.5	-0.5	1.2	2.7	-4.5	-16.2	-0.5	2.3	3.0	22.8
Household Equipment	2.1	-0.8	-7.8	-2.7	7.4	-4.8	-5.5	-5.3	1.6	-2.9
Cultural & Recreation Goods	2.5	0.6	0.5	2.6	1.3	-3.3	-6.5	-1.6	-0.9	1.8
Clothing	8.4	-16.6	6.6	13.3	4.6	-7.1	-8.3	3.8	-1.3	6.8
Non-Durable										
Food & Beverages	7.4	-15.7	-1.7	9.0	2.5	-13.0	-0.6	2.9	0.3	5.8
Auto Fuels	8.1	9.9	19.6	6.5	3.5	-6.5	-9.7	3.2	0.1	0.8

Source: Bank Indonesia

Box 1. Automotive Industry

Graph 1. Automotive sales



Source: Associations

As consumption of durable goods strengthened and mobility increased, automotive sector is expected to strive this year. Throughout 2022, total cars sold was 1,048,040 units, growing 18.1% from last year. The number even exceeded the pre-pandemic level (1,030,126 units in 2019). The sales increase was in line with the increase in people's purchasing power and sales tax incentives implemented by the government (PPnBM-DTP).

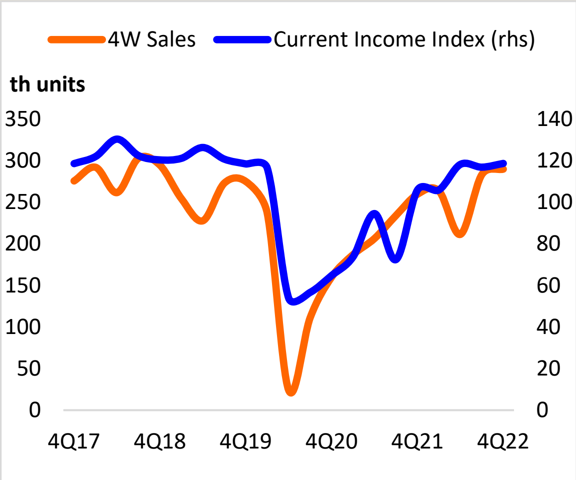
Moreover, we see that current income index has been increasing in 2022. Based on the observation within 1Q18-2Q21, car sales and current income index from BI's survey have 84% correlation. Meanwhile, motorcycle has 79% correlation. In other words, the high sales are also contributed by increasing current income since they are highly correlated.

Toyota still holds the biggest market share in automotive where its wholesales contributed 31.6% of total during 2022. Hyundai climbed to the eighth position as its wholesales increased by 700.8% yoy. Both Hyundai's EVs and conventional vehicles increased in Dec-22 compared to Jan-22. Meanwhile, Wuling dropped to the 10th position where its conventional vehicles wholesales fell during the months of August until November, even though its Air EV sales is skyrocketing. Growth is also seen in motorcycle sales. A total of 5,221,470 motorcycles were sold during 2022, growing 3.2% from 2021.

The automotive industry is and will be prospective, especially with the government's ambitious plan to promote and develop EV ecosystem in Indonesia. The EV sales kept increasing along the year of 2022, with the total of 10,296 units. Today, the EV market is dominated by Wuling with its Air EV series, selling 8,053 units, and taking 78.2% of total EV sales in 2022, followed by Hyundai with its IONIQ series, selling 1,874 units in 2022.

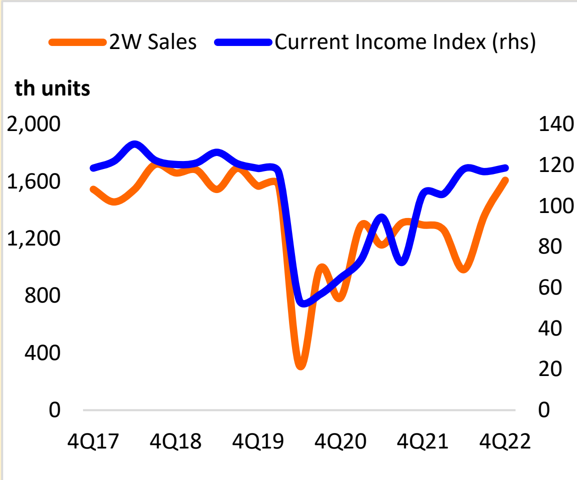
The significant price difference and limited supply drove people toward affordability and availability, which is Wuling's Air EV with a price range of IDR 238-311 million and shorter waiting time for the cars to arrive. However, the challenge for EV is that the infrastructure is still under development and the public's questions about EV's maintenance costs also contribute to why people prefer to buy Wuling's Air EV or stayed with conventional cars.

Graph 2. Four-wheel sales and Current Income Index



Source: Bank Indonesia, Gaikindo

Graph 2. Two-wheel sales and Current Income Index

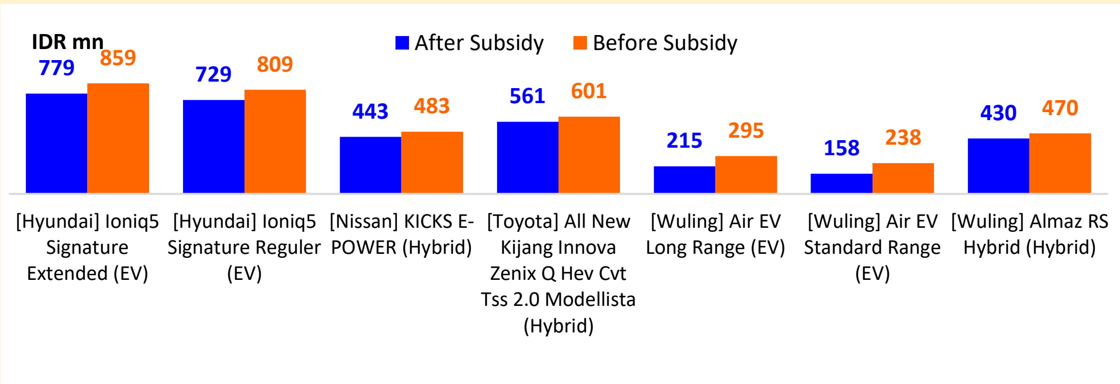


Source: Bank Indonesia, Gaikindo

In promoting electric vehicles, the government implements tax incentive, only paying 10% of the vehicle tax. In addition, the government plans to subsidize electric vehicle sales. The amount is estimated to be IDR 80 mn for Battery Electric Vehicle (BEV) and IDR 40 mn for hybrid cars. The subsidy will only be applied to vehicles that are produced domestically. As for cars, there are at least eight vehicles, which come from Hyundai, Nissan, Toyota, and Wuling. The graph below shows that such subsidy will decrease prices by 15% on average; Wuling AIR EV gets the most significant price cut by 27-34%, whereas other models get 7-10%.

Last year's satisfactory performance and various incentives give automotive industry immense potential to grow and might be the catalyst for growth. Referring to Graph 1, the Indonesian Motorcycle Industry Association (AISI) stated that the motorcycle sales target for 2023 is 5.6 million units. The target is higher than last year's sales but still lower than pre-pandemic level (6.5 mn units in 2019), as there might be supply constraints of semiconductor chips for two-wheeled manufacturers.

Graph 4. EV Prices Before & After Subsidy



Source: Gaikindo, katadata

On the other side, Indonesian Motor Vehicle Industry Association (Gaikindo) projects domestic car sales in 2023 to remain at level of 975,000 units regardless of the performance achievements of the automotive industry last year. The lower target for this year coincided with the expiration of PPnBM-DTP in Oct-22. Meaning that there will be less incentive for people to buy new cars in 2023. However, there is a silver lining after the end of PPnBM-DTP, which is people's preference towards EV as there are promising incentives. However, rising interest rate poses as a challenge, since 70% of vehicle sales are on credit schemes. In addition, securing domestic production to balance out possible increase in demand is imperative.

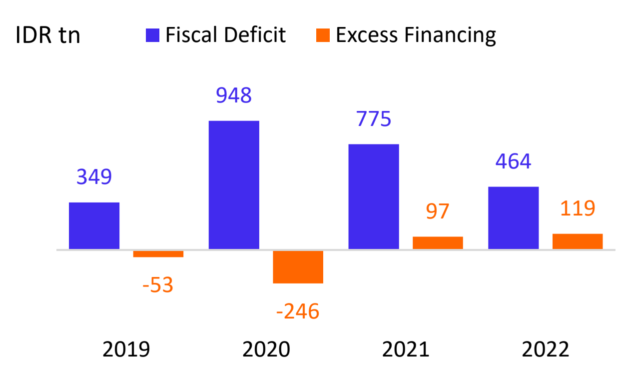
A good initial fiscal footing

Fiscal as a shock absorber. 2022 was an extraordinary year for Indonesia's fiscal performance, as commodity prices helped to boost revenue. The Finance Ministry reported a total of IDR 2,626 tn in revenue, equivalent to 115% of its full year target. As a result, last year's fiscal deficit decreased to IDR 464 tn (2.4% of GDP). According to Law No.2/2020, the Indonesian government is required to return its fiscal deficit to below 3.0% of GDP in 2023, which was achieved earlier than targeted. The MoF also recorded excess in financing of IDR 119 tn, increasing from previous year at IDR 97 tn. This provides space for the government to allocate more buffer and seal the role of fiscal as a shock absorber this year.

With a balanced risk in bond market

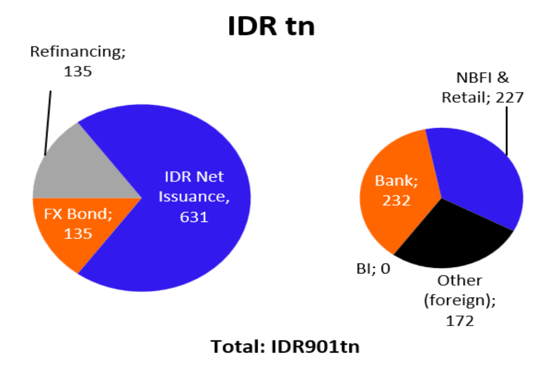
The rise of local investors. Despite the carried over excess, the MoF is still holding onto its plan of issuing bonds and withdrawing loan. We expect that gross bond issuance will be around IDR 766 tn this year. Net issuance of IDR bonds is expected at IDR 631 tn. We still see banks as the main buyer of bonds amid sufficient liquidity. However, the role of retail investors would expand along with personal savings that posted strong historical growth. Other sources to lean on would either be from insurance or foreign institutions.

Chart 7. Fiscal Deficit & Excess Financing



Source: Ministry of Finance

Chart 8. Equilibrium of Government Bond, 2023

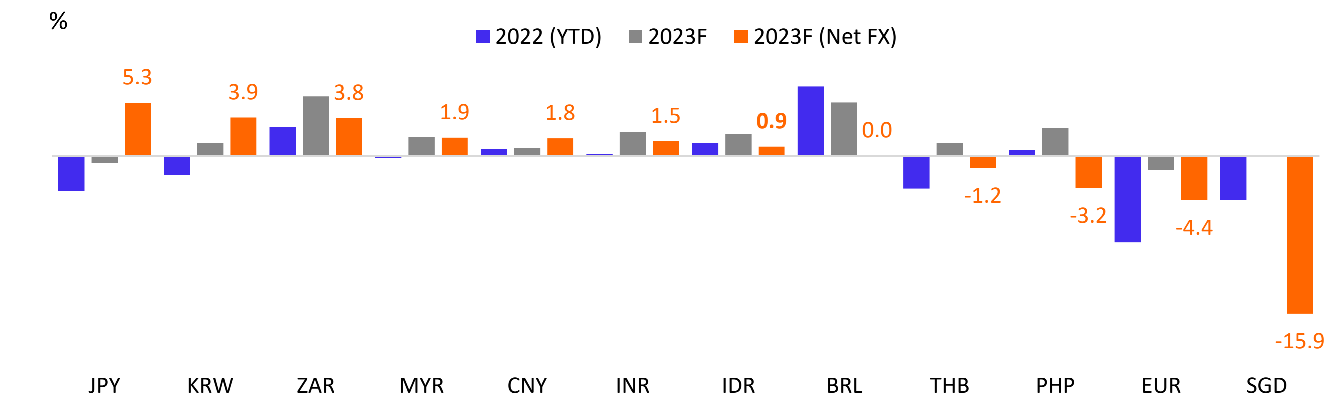


Source: Ministry of Finance, Danamon

Provides stability and average return

Middle ranked for attractiveness. The real yield of government bond remains attractive compared to peers, as BI implements operation twist to maintain yield differential. Forward looking, Indonesia's real yield in 2023 is expected to be above MYR, KRW, CNY, and THB. However, net yield against change in FX is less attractive this year, amid tight margin between BI 7D RRR and FFR. IDR bond offers lower real yield net of FX compared to KRW, MYR, CNY, and INR.

Chart 9. Real Yield Comparison

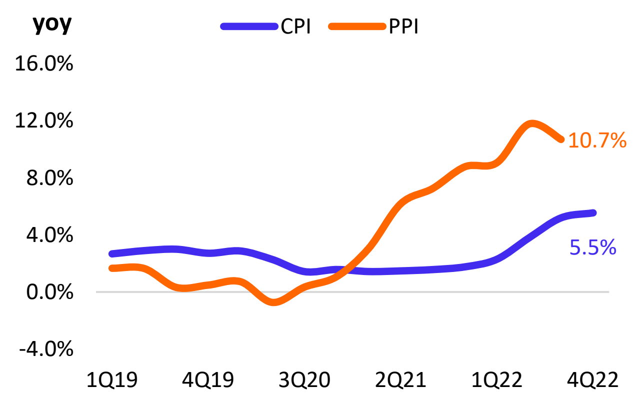


Source: Bloomberg, MUFG, Danamon

Core inflation is key

How fast is the disinflation? Based on the latest figures, core inflation had accelerated to 3.4% yoy across the board. This signaled that producers have begun adjusting output prices to compensate for previous margin losses. Meanwhile, the other two components of headline inflation may moderate this year, along with lower prices in soft commodity and energy. We project that headline inflation would normalize to 4.5% yoy at the end of 2023 and remain outside of BI's target of 4.0%, driven by core inflation.

Chart 10. 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

Driven by producers

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. In 3Q22, the cost pressure was slightly lower, yet remain high considering base effect. However, producers could not fully pass-through these costs to consumers since demand recovery was fragile back then; otherwise, profit margin would fall further as sales quantity dropped. Hence, Consumer Price Index (CPI) increased only gradually, and not as fast as PPI. In the first half of this year, profit margin was 1.3% below its 2017-2020 average. 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.

Box 2. A Comparison of Indonesia's Crisis Episodes

Indonesia has a solid initial point to face the risk of recession this year, compared to previous crisis episodes. The pandemic had severely hit Indonesia's economy in 2020, but also changed Indonesia's macroeconomic landscape. From real sector perspective, Indonesia's export booked a tremendous growth performance, helped by soaring commodity prices. This trend is expected to sustain in 2023, although with lower commodity prices, the level will remain above pre-pandemic level. This will provide support for export to grow positively this year. In terms of volume, Russia-Ukraine war has changed the landscape of global commodity supplier (i.e. oil, coal, CPO). Indonesia has benefitted from the shift, by expanding coal and CPO export to European countries and few of Asia Pacific countries.

The large flows of export revenue also helped increase savings during the pandemic, while people could not spend their money like in normal times. Hence, private consumption in 2023 will likely grow higher on the back of double digit savings growth in the past two years.

From the perspective of financial sector, Indonesia has become less sensitive to global crisis. Share of domestic investor in portfolio assets has increased substantially, amid abundant liquidity from export as well as from government stimulus. On the other hand, foreign investors exposure to domestic portfolio assets has declined sharply. For instance, foreign ownership in government bond declined to 14% of total outstanding in 2022, compared to around 37% in 2019 before the pandemic. This figure is even lower than during Global Financial Crisis. Thus, the magnitude of external shock to domestic financial sector should be milder this time. On top of that, Indonesia's monetary policy tightening is not as aggressive as advanced economies or other peer countries and started from a record low level of interest rate.

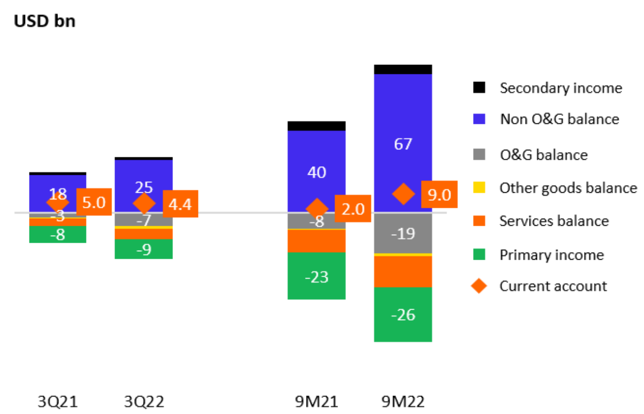
		Global Financial Crisis	COVID-19	2023
Real Sector	Export Growth	As global economy contracted by -1.2% yoy in 2009, export dropped by -9.7% yoy	Export dropped -7.7% yoy in 2020 along with global economic recession. Yet, import dropped deeper at -14.7% yoy	Lower export volume but commodity prices would remain aloft, cushioning from export moderation
	Private Consumption	Private consumption only grew by 4.9% yoy (below its normal rate of 5.0% yoy) due to lower export revenue	Private consumption declined by -2.6% yoy in 2020 as mobility was restricted	Private consumption has begun to recover on the back of ample domestic savings
Financial Sector	Foreign Ownership	Foreign ownership in Indonesia government bond was 19% of total bond outstanding	Foreign ownership in Indonesia government bond was 25% of total bond outstanding	Foreign ownership in Indonesia government bond is 14% of total bond outstanding
	Policy Rate	Initial point of policy rate at 9.25% in 2008, and cut to 6.50% in 2009	Initial point of policy rate at 5.00% in 2019	Initial point of policy rate at record low of 3.50%

USD/IDR: Rebound then Pivot

Domestic demand led import

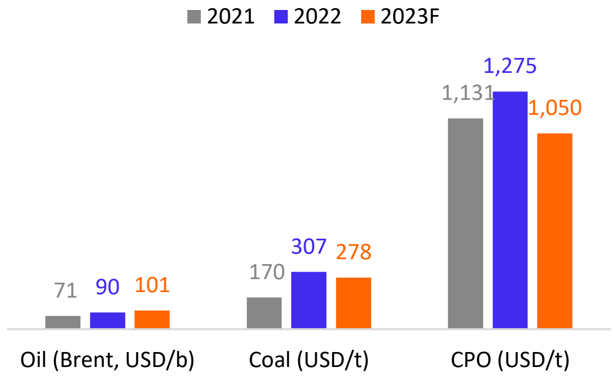
Dwindling external balance. Indonesia booked USD 9.0 bn worth of current account surplus in 9M22, larger than the USD 2.0 bn surplus during 9M21. This was a result of rising commodity prices and lagging import recovery. Fast forward to 4Q22, prices of exported commodities, especially Crude Palm Oil (CPO), have declined along with global demand. CPO price almost returned to its pre-pandemic level of around USD 980/t, while coal price dropped below USD 404/t in Dec-22. From a volume perspective, Indonesia's two major trading partners -i.e. US and Europe- will likely book a much lower growth this year as monetary tightening starts to bite. On the other hand, import begins to catch up. During the first nine months of 2022, 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 development of trade balance reflects IDR's fundamental value. Amidst a narrowing trade surplus this year, we believe IDR to remain vulnerable to global sentiments -e.g. FFR, geopolitical tension, etc-.

Chart 11. Indonesia's Current Account



Source: Bank Indonesia

Chart 12. Commodity Prices

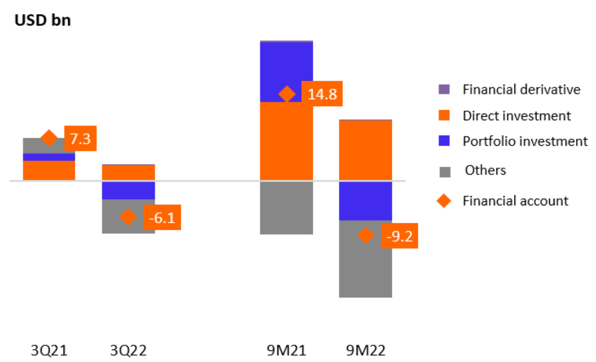


Source: Bloomberg, MUFG

IDR swings with sentiment…

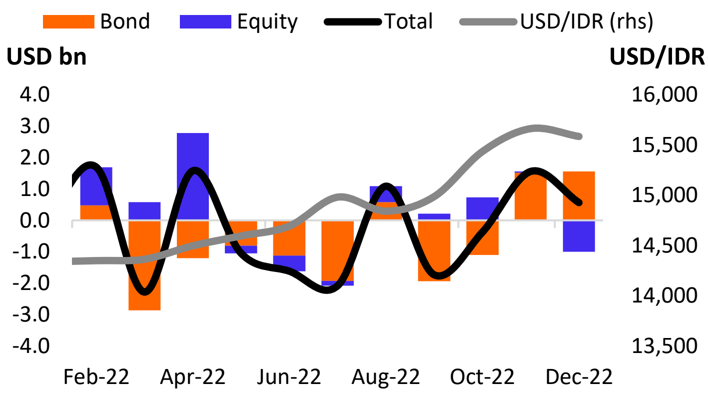
Sentiment factors were leading fund flow and IDR. Throughout 2022, Indonesia was facing a headwind of portfolio flows due to the Fed's monetary tightening. As of Sep-22, financial account reported a deficit of USD 9.2 bn, of which USD 6.6 bn came from portfolio outflows. Since the pandemic, portfolio inflows have been on the sideline as investors turned risk-off due the uncertainties. However, in 2021, when covid pandemic seemed more manageable, inflows began to enter the domestic market. Thus, Indonesia booked portfolio inflows of USD 10.1 bn as of 9M21. This explained why IDR depreciated quite significantly to IDR 15,573/USD at the end of 2022, from IDR 14,263/USD at the end of 2021.

Chart 13. Financial Account



Source: Bank Indonesia

Chart 14. Portfolio Flows vs USD/IDR



Source: Bloomberg

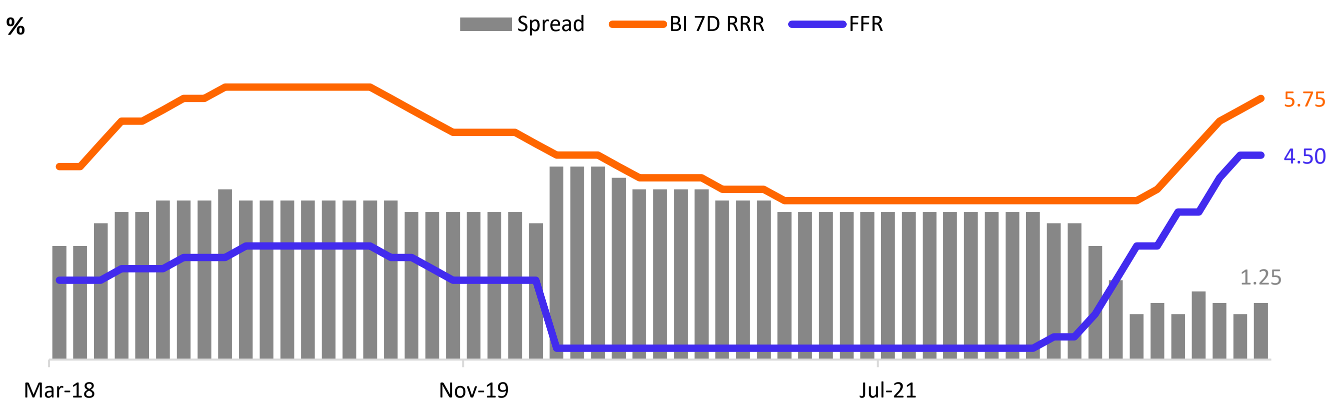
… And is expected to turn positive

Positive signal in 2023. We have seen inflows to domestic bond market since end of 2022, fostering USD 1.6 bn in the month of December, then another USD 1.0 bn up until 17 January 2023. Such flows were driven by the deceleration in Fed tightening and the indication that it might end soon. Meanwhile, equity market still booked USD 1.3 bn of outflows in Dec-22 and another USD 0.4 bn as of 17 January 2023. These net inflows have led the IDR to appreciate by 2.6% to IDR 15,165/USD in January. Historically, the bond market would book significant inflows within six months after the end of rate hike cycle, as asset prices bottomed. And considering that both the Fed and BI may reach their terminal rate in 1H23, we expect inflows to bond market would provide a buffer for IDR to strengthen in 2H23. Based on our calculation, the IDR would appreciate to IDR 14,984/USD this year.

Hence, a convergence in terminal rate

BI at the end of rate hike cycle. BI 7D RRR was increased by 200 bps to 5.50% p.a. in 2022. Monetary policymakers emphasized that the pre-emptive measure was taken to anchor expectation and return inflation rate within BI's target range of 2.0%-4.0%. On top of that, the increase in policy rate was also to address the Fed's hawkish stance and maintain IDR stability. According to our above-mentioned analysis, the Fed raised its terminal rate and domestic core inflation has an upside risk, while BI keeps a tight interest rate differential (between BI 7D RRR and FFR) of 100 bps. In Jan-23 MPC meeting, BI hiked policy rate by 25 bps to 5.75%. Governor Perry also mentioned that the current policy rate is sufficient, signaling a pause on the cycle. However, we believe that BI will be data dependent, should core inflation shoot up, there's room for another 25 bps hike in February meeting.

Chart 15. Rate Differential



Source: Bank Indonesia, The Fed

Risk to our view is inflation

Global inflation is the main risk for IDR. IDR movement throughout 2022 was mainly driven by market expectation on inflation that eventually determined Fed's policy steps. Significant change in USD/IDR direction in May-22 was mainly due to a surprise from the Fed, which increase the pace of tightening. Another significant depreciation in Sep-22 was caused by a more hawkish dotplot from the Fed, signaling a higher terminal rate. FOMC members previously thought inflation would recede, yet the moderation was milder than expected. In Dec-22 to Jan-23, IDR appreciated and traded below IDR 15,000/USD, as the Fed shift into lower gear along with substantial disinflation. We believe that inflation remains as the main source of risk this year for USD/IDR, which could be stickier than market's expectation.

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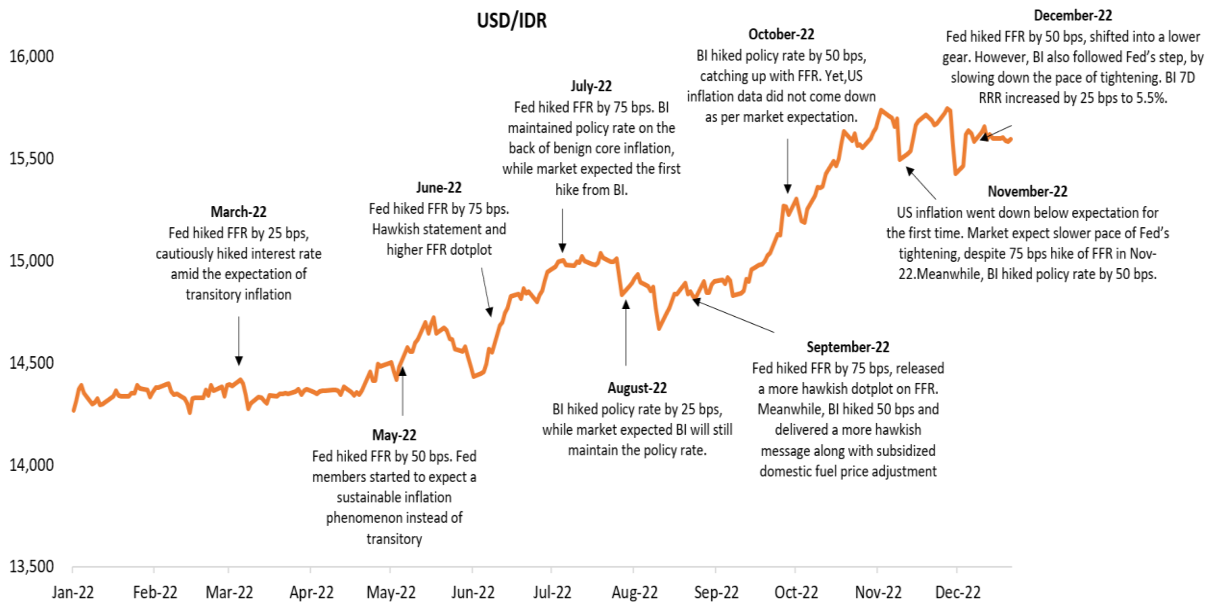
Chart 16. USD/IDR Event Analysis



Source: Bloomberg, Danamon

Box 3. Bank Indonesia's Supplementary Policies

On top of the increase in policy rate, BI also strengthened other policy instruments. According to the press release from BI's MPC meeting, there are three main instruments that will be prioritized to equip policy rate:

1) Implementing "operation twist" strategy in the bond market by stabilizing long-end yield while pushing short-end yield higher to attract investors. In 2022, BI switched around IDR 70 tn of short-tenor to long-tenor and will continue this year without specific details yet.

2) In order to boost growth during recovery period, BI utilize its macroprudential measures to provide incentives for banks that disburse loan to priority sectors -i.e. MSME, green economy, motor vehicles, property-. The rate of incentives was doubled for MSME segment to 1% and provide new incentives for green financing.

3) BI also plans to issue new open market operation instrument, specifically designed for export proceeds from natural resources to be placed onshore. This instrument will address the issue of offshore placement for natural resource related export revenue and ramp FX supply within the domestic financial market. There is no further details on the effective date, yet expected to be implemented in March 2023. For the features of instrument, BI mentioned about competitive yield and tax incentives for the instrument.

Apart from BI's new FX instrument, Government plans to issue new regulation which requires exporters to hold its export receipt onshore for at least 3 months. The initiative is led by coordinating ministry of economic affairs, which committed to finalize the regulation within the 1H23.

Operation Twist

BI will continue the operation twist to push short-end yield higher, in order to attract portfolio investors

Macroprudential

- Doubled the incentive of RRR for banks which disburse MSME credit to 1%
- Provide incentives for banks which disburse green credit/financing (green property and/or motor vehicles, max 0.3%)
- Higher RRR incentives to 280 bps max, from 200 bps previously

New OM Instrument

BI plans to issue new FX monetary operation instrument for natural resources export. The instrument will be issued with competitive yield and equipped with tax incentives

Banking Sector: Vibrant despite Liquidity Normalization

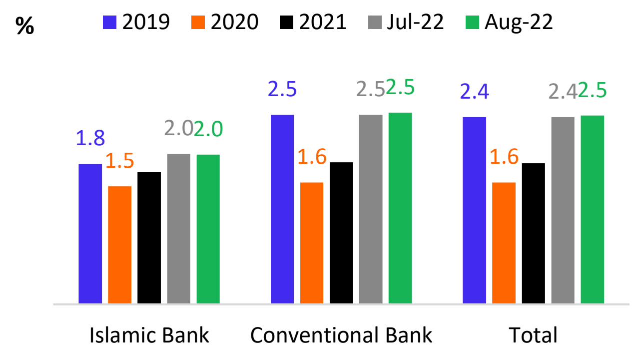
Core banking back in business

Sound recovery in ROA. During the pandemic, financial intermediary was disrupted by subsiding demand for loan. Banks shifted its deposit allocation from loan to domestic financial assets, especially bonds. Share of banks in government bond increased significantly from around 20% of total outstanding to 35% by end of 2022. Since core banking business was hit by the pandemic, Return on Assets (ROA) ratio declined to 1.6% in 2020, from 2.4% in 2019, with conventional banks experiencing a deeper impact compared to Islamic banks. But as the economy recovers, banks managed to gain back ROA to as high as 2.5%.

Strong support of capital and policy

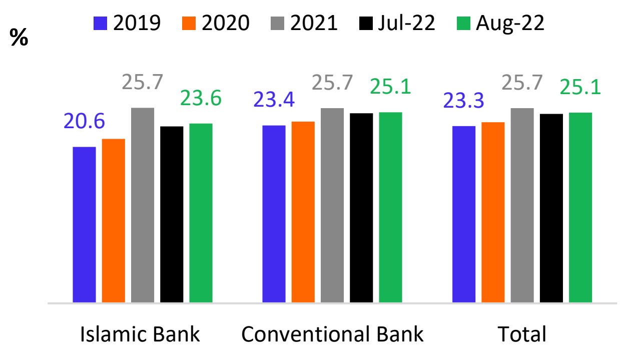
Well capitalized. Despite severely impacted, Capital Adequacy Ratio (CAR) was quite stable at around 23% in 2020. A prudent monitoring from Indonesia’s Financial Services Authority (OJK) as well as the timely loan restructuring program have helped banks to maintain its capital at a healthy level. CAR reported at 25% as per Aug-22, higher than 2019’s figure of 23%, in line with improving economic activities. As we expect domestic recovery to persist this year, ROA and CAR are expected to improve as well.

Chart 17. Return on Assets



Source: Financial Service Authority

Chart 18. Capital Adequacy Ratio

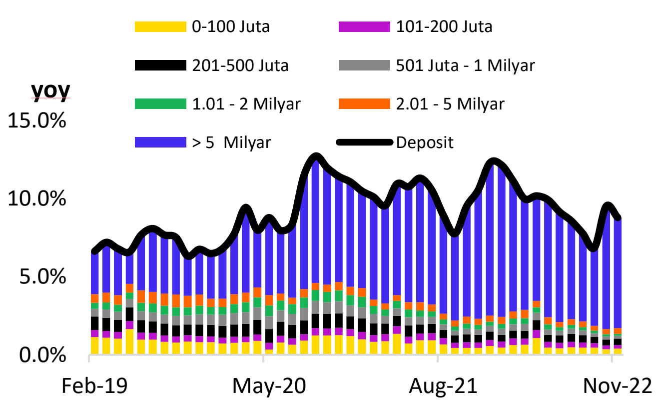


Source: Financial Service Authority

Cheap funding provides good foundation

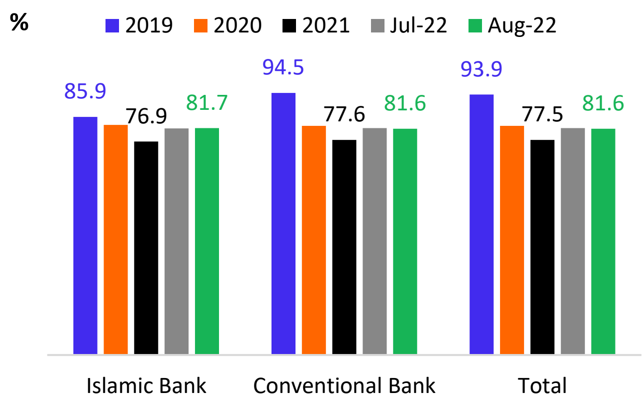
Liquidity abundance from monetary financing. During the pandemic, deposit growth booked double digit growth from 2H20 to the end of 2021. This was driven by mobility restriction where customers could not spend their money as much, export revenue due to surging commodity prices, and government stimulus. At the end of 2022, deposit managed to grow above its historical rate by 8.8% yoy, despite high base effect and was mainly on upper-income class segment with account balance above IDR 5 bn. This explained the phenomenon of increasing export revenue and stay-at-home behavior from upper-income class. Meanwhile, Loan to Deposit Ratio (LDR) declined to 78% in 2021, from 94% in 2019, on the back of lower credit disbursement and higher deposit growth. Along with economic recovery, LDR has gradually increased amid loan disbursement. Abundant liquidity is also reflected through banks' excess reserve in BI's monetary operation. Bank's placement in BI's open market operation increased by almost 300% compared to normal period. In the end of 2021, BI reported IDR 1,020 tn worth of placement from banks in the IDR open market operation.

Chart 19. Deposit Growth by Nominal



Source: Indonesia Deposit Insurance Corporation

Chart 20. Loan to Deposit Ratio

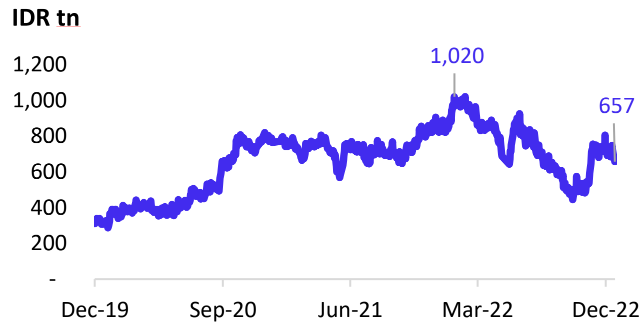


Source: Indonesian Financial Service Authority

Yet liquidity Is normalizing

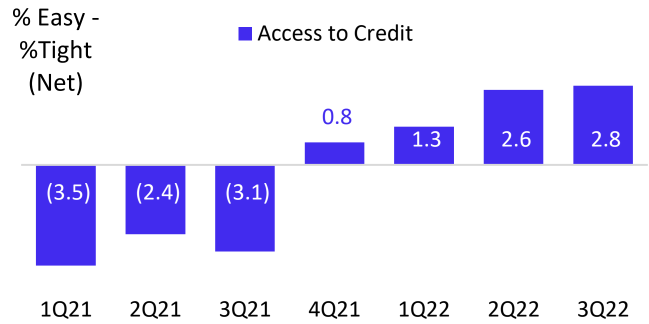
Lag in transmission from policy rate. Although BI has increased policy rate by 200 bps throughout 2022, weighted average lending rate in the banking sector has only increased by 12-21 bps. This is a result of abundant liquidity in the banking system, which provide banks with relatively cheaper funding. However, it is only a matter of time for policy rate increase to be fully transmitted. The recovery that we expect to sustain this year would induce faster growth of loan demand, which will lead into normalizing liquidity condition in the banking system. This will eventually increase lending rate, in line with policy rate. Our calculation shows that banking system liquidity will likely go back to normal period this year, considering higher loan growth assumption as well as the absence of any scheme of monetary financing.

Chart 21. IDR excess Reserve in BI's OMO



Source: Bank Indonesia

Chart 22. Corporate Financing Condition

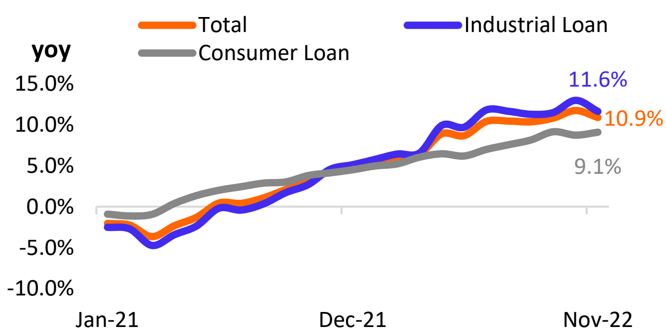


Source: Banking Survey-Bank Indonesia

The return of demand

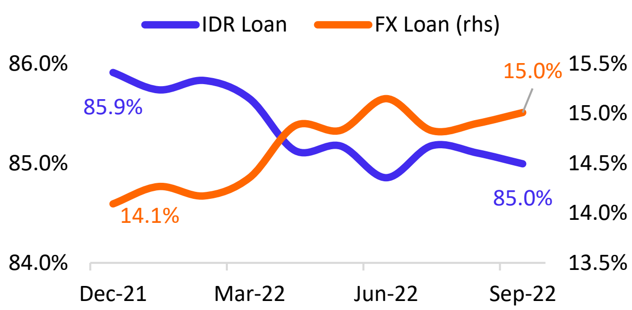
Robust loan growth. In line with the solid performance of domestic economic growth, loan growth also booked strong numbers in 2022. Per Nov-22, loan grew by 10.9% yoy, which was mainly driven by demand from industry with 11.6% yoy growth. Not only demand, from the supply side, banks have also gained back confidence to disburse more credit to customers. BI's survey on banking sector showed that access to credit as of 3Q22 became easier compared to previous quarters. In terms of currency, share of FX loan increased in 2022, along with solid performance of mining sectors and expansionary manufacturing activities. In 2023, we expect the trend would reverse, as domestic activities accelerate.

Chart 23. Loan by Type



Source: Bank Indonesia

Chart 24. Loan by Currency



Source: Indonesian Banking Statistics

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	5.9	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	39.6	35.8
International Reserves –IRFCL (USD bn)*	129.2	135.9	144.9	137.2	140.7
Reserve Cover (Months of import & ext. debt)*	7.3	9.8	7.8	5.9	6.5
Currency/USD (Year-end)*	13,901	14,050	14,253	15,573	14,984
Currency/USD (Average)*	14,146	14,529	14,296	14,855	15,150
Other					
BI 7-Day Reverse Repo rate (% p.a.)*	5.00	3.75	3.50	5.50	6.25
Consumer prices (% year end)*	2.72	1.68	1.87	5.51	4.50
Fiscal balance (% of GDP; FY)*	-2.20	-6.09	-4.65	-2.38	-2.71
S&P's Rating – FCY*	BBB	BBB	BBB	BBB	BBB

Source: CEIC, E = Danamon Estimates, *FY22 actual data

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