Key Figures

- GDP Growth* (Q3 '17)
  5.2%
- GDP Growth* (2017)
  5.2%
- GDP Growth* (2018)
  5.3%
- Inflation (ytd Oct '17)
  2.67 %
- Inflation (y.o.y. Oct '17)
  3.58%
- Credit Growth (y.o.y. Aug '17)
  8.26%
- Trade Surplus (Q3 '17)
  USD 3.2 billion
- Current Account (Q2 '17)
  -1.96%

*) Forecast

Making Infrastructure Investments Work

Highlights

- GDP growth to increase slightly from 5.2% in 2017 to 5.3% in 2018; manufacturing to still grow below GDP in 2018 while service-based sector to still grow faster than GDP
- Consumption growth to remain subdued, may reverse course if the trend of increased real investment and sustained higher commodity price continue
- Growth in 2018 and possibly 2019 will be driven by investment and export, supported by increase in FDI and more robust recovery in developed economies
- External risks to remain manageable as major central banks managed to raise interest rate without disrupting financial market and China have found more sustainable growth at lower rate (around 6%)
- Jokowi's push for infrastructure development should put more emphasis on private sector participation, given the limit on government's fiscal capacity

In its pursuit of higher growth and inclusive prosperity, Jokowi administration put infrastructure constructions as its flagship agenda and allocate massive budget for infrastructure development. While in theory infrastructure investments should accelerate growth, there is growing disconnect between infrastructure push by government and economic growth; even as budget allocation for infrastructure in 2017 increased by 177% from 2014, GDP growth in 2017 still has not picked up pace. Job creations that are touted as positive effect of infrastructure spending and construction have also yet to materialize. This issue will be discussed in detail in our dedicated section below (see "Infrastructure-Growth Paradox" in p. 10).

The crowding out of private sector investments, both in infrastructure sector and other sectors, by state-owned company makes overall investment growth rather disappointing and may feed into the overall economic growth for the rest of Jokowi administration. We forecast that the economy may grow by 5.2% in Q3 and for full 2017.

Table 1: LPEM FEB UI GDP Growth Forecast

Q3 2017	FY 2017	FY 2018	FY 2019
5.2%	5.2%	5.3%	5.5%

Given stable and higher price for key export commodities, particularly for CPO and coal, we expect growth to moderately pick up pace for the next year. However, expect growth to increase moderately in 2018 and 2019, given several unfavorable factors. First, we do not see energy-related exports, particularly oil, gas, and coal, to rise much further as price for renewables energy are becoming more affordable faster than expected, thanks largely to China. Going forward, pre-crisis oil and coal prices is highly unlikely, even if global demand for energy soar to pre-crisis level. Second, consumption might pick up only slightly to above 5%. Consumption growth will continue to move more slowly than other expenditure components of the economy (i.e. exports, investments), especially because it is dependent on consumer confidence and real wage growth. Barring massive changes in policy direction or external conditions, we do not see growth to increase its pace significantly in the next 2 years.

Macroeconomic & Financial Sector Policy Research

Febrio N. Kacaribu, Ph.D.
(Head of Research)
febrio.kacaribu@lpem-feui.org

Alvin U. Lumbanraja
alvin.lumbanraja@lpem-feui.org

Denny Irawan
denny.irawan@lpem-feui.org

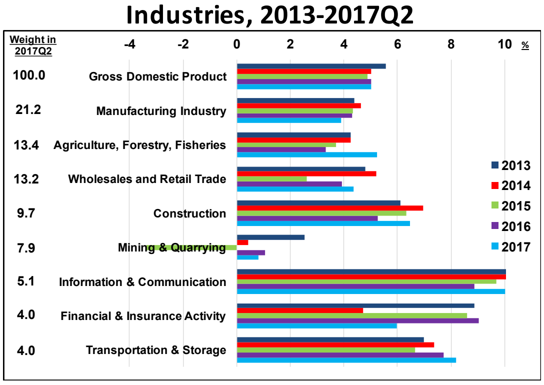
Uneven Sectoral Recovery

Further deceleration in manufacturing industry in Q2 may reverse in Q3, albeit still within 4% range. Overall, we expect slowdown in growth have not bottomed out yet. Production of Food and Beverages is still leading this sector with strong growth of demand in Q2, while other sub-sectors exhibit mixed dynamics. Some manufacturing sub-sectors, particularly wood-related, pulp & paper, and rubber-related industries experience particularly sharp decline in Q2 and may not quickly reverse course in Q3. Sustained sub-5% growth in manufacturing sector is concerning, given that (i) manufacturing sectors productivity can help the economy converge to developed economies relatively quickly without massive investment in human capital, thus providing wage boost to the economy and (ii) transition of workers from manufacturing sector to growing service sector usually happens rather slowly.

"…unlike in major industrialized nations, the most influential culprits of retail weakness in Indonesia are the combination of significant growth in available retail spaces in recent years and weak consumption growth, not due to stiff competition from e-commerce"

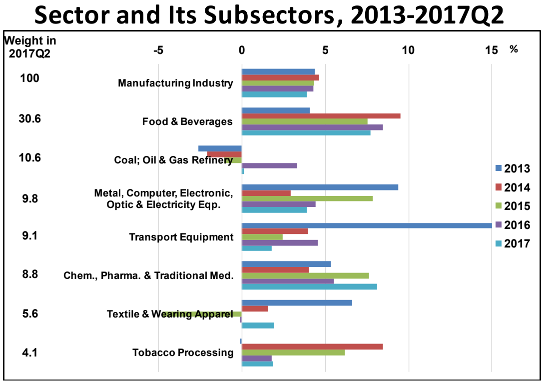
Food and beverage manufacturing seems to buck the trend among broader manufacturing sector, with healthy growth of 7.19% (y.o.y) in Q2 2017. The dynamics of food and beverages from the expenditure side of GDP matches this, which indicates that food and beverage manufacturing largely caters to domestic market and seem pretty immune to fluctuation in global and Indonesian economy. Strong growth in food and beverage manufacturing owes to long-term trend of steady increase of new middle class and urban populations, who values convenience of pre-packaged foods and drinks.

Figure 1: Growth rate of GDP and the Main Industries, 2013-2017Q2



Source: CEIC

Figure 2: Growth rate of Manufacturing Sector and Its Subsectors, 2013-2017Q2



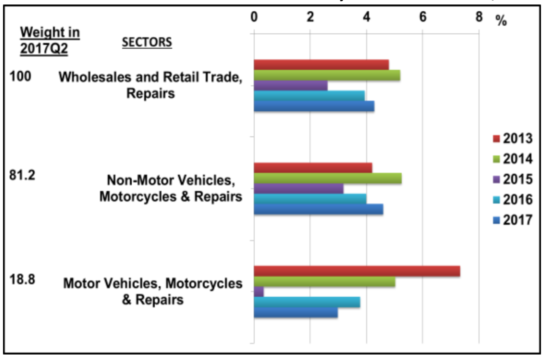
Source: CEIC

Although steady increase of disposable income continues to benefit food and beverage manufacturing industry, consumer may not be so confident to spend on other less essential goods and services. In another signal that consumer confidence is still rather weak, Wholesale and Retail Trade decelerate back in Q2, which was contributed by decrease in growth of non-vehicle retail especially home equipment sales. This trend is noteworthy given that Eid-Mubarak 2017 has shifted to June and therefore some Ramadan-related uptick in sales should have begun in later period of Q2. Growth for subsectors that should have benefited from recovery in consumer confidence, such as textile and wearing apparel, are also weak.

Apparent decrease in foot traffic in major shopping centers and overall weak retail growth, which becomes topic of recent conversations in the media, are also closely related to textile and wearing apparel manufacturing (Figure 2) and flagging apparel and footwear consumptions (see Figure 4). This is a clear indication that unlike in major industrialized nations, the most influential culprits of retail weakness in Indonesia are the combination of significant growth in available retail spaces in recent years and weak consumption growth, not due to stiff competition from e-commerce.

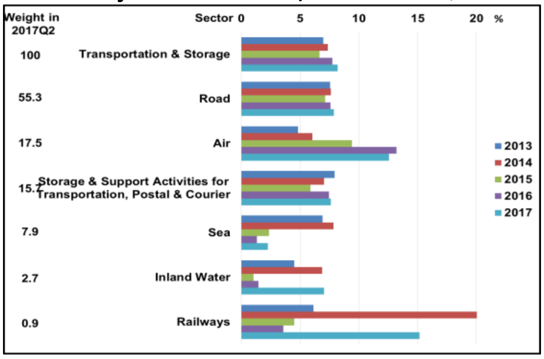
We expect the growth of wholesale and retail trade to stabilize in Q4 2017 and start to moderately accelerate by 2018 following rate cuts by Bank Indonesia. However, recovery in this sector, along with vehicle manufacturing and real estate, depends heavily on how quickly consumer respond to BI's more accommodative policy. So far, the signs show that consumers are still adjusting to new electricity price and slower wage growth following years of decline in economic growth.

Figure 3: Growth rate of Wholesale and Retail Trade and Its Sub-sectors, 2013-2017Q2



Source: CEIC

Figure 4: Growth rate of Transport and Its Major Sub-sectors, 2013-2017Q2



Source: CEIC

"Several rate cuts by Bank Indonesia this year may eventually induce consumers to spend more, but only gradually"

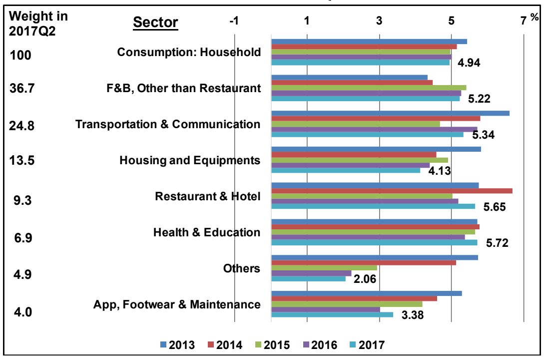
Transportation and storage services remain strong and even accelerate (see Figure 4), which as a whole is driven by the rise of e-commerce activities and infrastructure boom. The acceleration of growth in transportation services may be sustained in 2018 as rising income for middle class and affluent consumers drive more domestic tourism and eating out (shown by growth acceleration in accommodation and F&B sector). Rapid urbanization in secondary and tertiary cities further support this trend.

We also expect the adoption of BPJS Kesehatan to further improve growth in pharmaceutical manufacturing (7.38% y.o.y in Q2) and healthcare services (6.40% y.o.y in Q2) as JKN program approaches its universal coverage target in 2019. If the trend continues to follow the pattern of more developed countries, coupled with rapidly aging population, it is very reasonable to expect the growth in healthcare services to still be faster than GDP growth well beyond 2019.

Still Weak Domestic Consumption for Q3; Moderately Positive Outlook in 2018

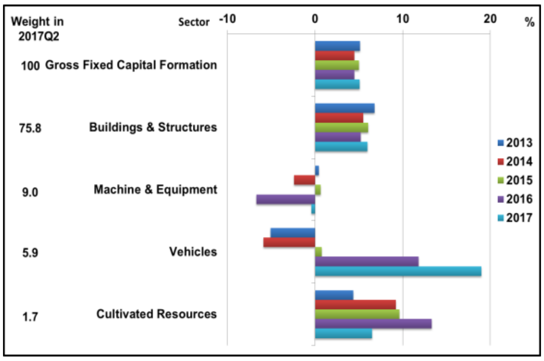
Stagnating consumption growth in second quarter of 2017 will rebound slightly in Q3 while still lags overall GDP growth into 2018. We are skeptical that government spending can compensate weakness in consumption growth. Lower-than-expected consumption growth, which reduce pre-tax corporate profits, will almost certainly be accompanied with spending cut, as planned budget deficit (2.94%) is set very close to statutory budget deficit limit of 3%. Several rate cuts by Bank Indonesia this year may eventually induce consumers to spend more, but only gradually. This is because consumers, particularly lower-middle income ones, have just weathered increase in electricity price and adjusted to permanently lower trajectory of minimum income growth. Lower wage growth trend can be attributed to two main factors. First, slower GDP growth hurt corporate profitability and public-sector budget, which limits room for wage growth for public. Second, several years of drastic increase in minimum wage across Indonesia was halted in 2015 after the introduction of government's regulation (PP 78/2015 on Wage), which limits the increase of formal sector wage.

Figure 5: Growth rate of Household's Consumption and its Components, 2013-2017Q2



Source: CEIC

Figure 6: Growth rate of Investment and its Main Components, 2013-2017Q1

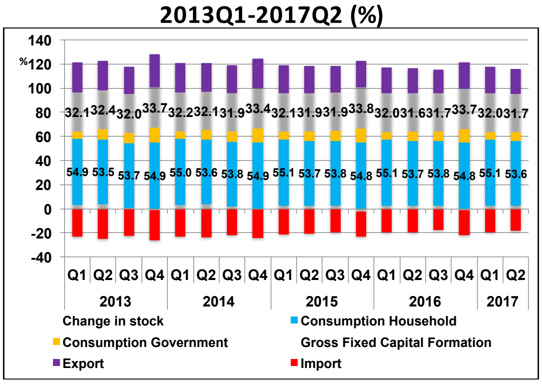


Source: CEIC

"...if the consumption growth in Q3 and Q4 shows only slight trend of recovery, we do not see much reason to expect more aggressive GDP growth as assumed by 2018 budget"

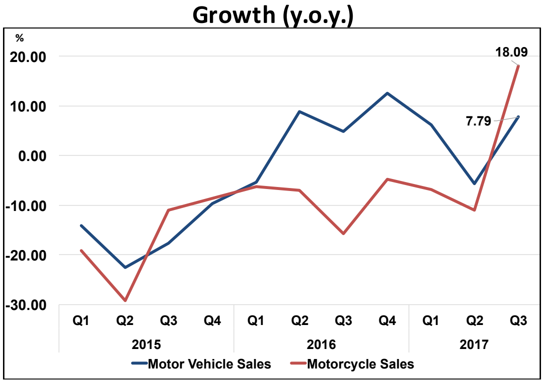
Most of the components that constitute household consumptions growth (see Figure 5) stay relatively stable since Q1, with notable exceptions of healthcare and education (slowing down to 5.40% from 6.04%) and restaurants and hotel (accelerating to 5.87% from 5.43%). Consumers are also still postponing their purchase of durable goods; growth of equipment consumptions for households in Q2 is reported at only 4.12%. However, this trend of restraint in durable goods consumption may be reversed, as evidenced by increase in motor vehicle and motorcycle sales for Q3 2017, which increased by 7.79% and 18.09% (y.o.y) respectively. If the trend holds for other types of durable goods, backed with further policy loosening by Bank Indonesia, consumption growth may increase to 5.0% level in Q3. It should nevertheless be stressed that further acceleration in 2018 is contingent on the result of consumption-related metrics up to Q4 2017; if the consumption growth in Q3 and Q4 shows only slight trend of recovery, we do not see much reason to expect more aggressive GDP growth as assumed by 2018 budget.

Figure 7: Shares of GDP Components, 2013Q1-2017Q2 (%)



Source: CEIC

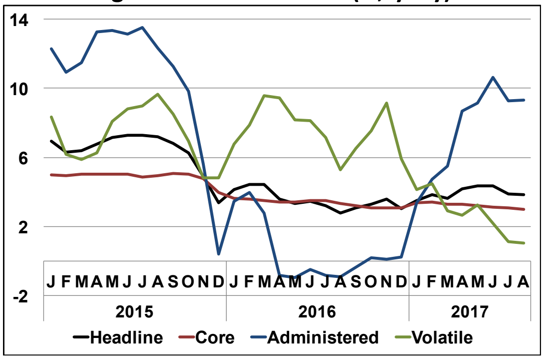
Figure 8: Motor Vehicle and Motorcycle Sales Growth (y.o.y.)



Source: CEIC

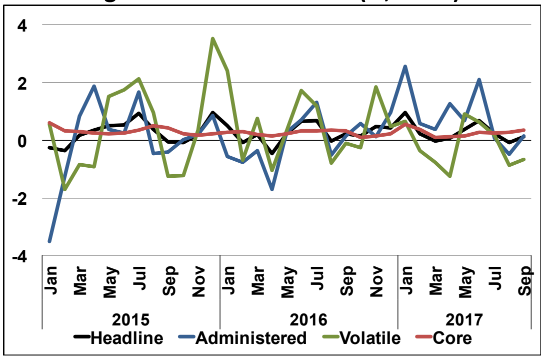
Unchanged growth rate of domestic consumption and reluctance of consumers to spend is also manifested by exceptionally low inflation throughout 2017, despite major increase in electricity throughout first half of 2017. On year-to-date basis, inflation stands at 2.67%, with only Christmas period as the only remaining potential source of inflationary pressure for 2017. Inflation by the end of 2017 may very well be below 3.5% range, barring sudden and unlikely jump in energy prices. If downward trajectory of inflation turns out to be structural in nature (i.e. driven by better infrastructure, more developed supply chain, and/or lower inflation expectation), we expect inflation for 2018 to be within 3-4% range as the economy start to expand.

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



Source: CEIC

Figure 10: Inflation Rate (%, mtm)



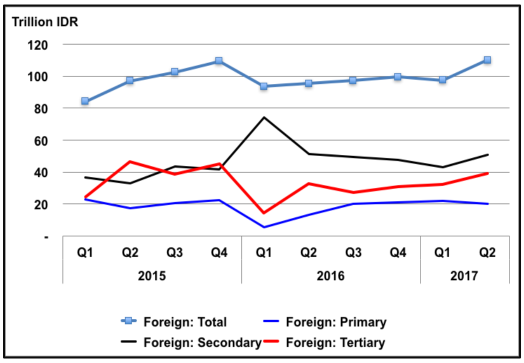
Source: CEIC

"Planned and better-communicated policy tightening by major central banks, such as The Fed, European Central Bank, and Bank of Japan, also allows investors to set expectation correctly and thus made capital inflow remain unabated"

More Investment and Strong Export: Key Growth Drivers for 2017 and 2018

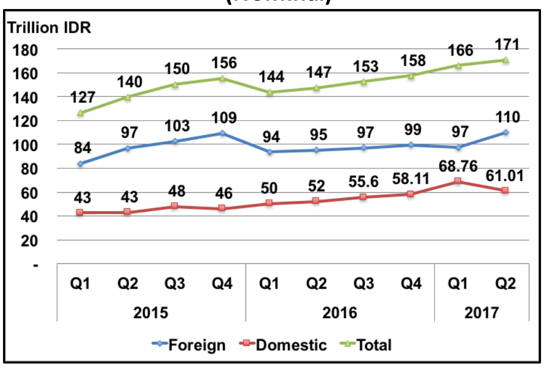
We expect acceleration in investment to still be the key driver in the rest of 2017 and in 2018. Gross fixed capital formation, the measure of investment in GDP, grows faster than the economy in Q2 (5.35% y.o.y), particularly with construction boom and rebound in vehicle sales that surrounds large-scale infrastructure projects. Planned and better-communicated policy tightening by major central banks, such as The Fed, European Central Bank, and Bank of Japan, also allows investors to set expectation correctly and thus made capital inflow remain unabated. This is evident in 15.7% (y.o.y.) increase, in nominal Rupiah term, in foreign direct investment realization during the second quarter of 2017, even as Rupiah started to appreciate and Bank Indonesia started to cut rates since last year.

Figure 11: FDI Realization (Nominal)



Source: CEIC

Figure 12: Foreign and Domestic Investment (Nominal)



Source: CEIC

Strong FDI realization in Q1 and Q2 is especially noteworthy, given the uneasiness surrounding Jakarta election earlier this year. This shows relative confidence of foreign investors on peaceful transfer of power and relatively low risk of turbulence to the magnitude of 1998. However, the same cannot be said of foreign investors' confidence in Indonesia's legal system; major global news outlets have expressed concerns about the credibility of Indonesia's legal system and we expect foreign investors to still rely on Singapore law for cross-border disputes for their investments.

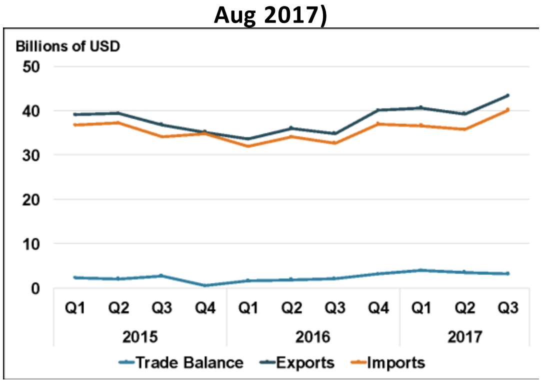
We also see reduction of domestic investments in Q2 2017 to be temporary, but we see some other measures regarding investments to be rather concerning. Most of the growth in gross fixed capital formation is contributed by investment in building and structures (construction) (6.07% y.o.y) and vehicles (12.58%), while growth in stock of machineries and equipment are equipment is negative (-2.19% y.o.y). This means that growth in investments are not allocated to purchases that directly increase productive capacity of manufacturing sector, which partially explains why high level of investments-to-GDP is not accompanied by faster growth.

"…growth in investments are not allocated to purchases that directly increase productive capacity of manufacturing sector, which partially explains why high level of investments-to-GDP is not accompanied by faster growth"

Another sign to watch regarding investment is deceleration in credit growth; while at the end of Q1 total credit increased by 9.15% (y.o.y.) on quarterly basis, by end of Q2 credit growth is only 7.57%, even as credit growth jumped again to 8.26 % (y.o.y) in August on monthly basis. The rates of credit growth are also different across different types of credit; consumption credit accelerate from 9.28% to 9.86% (y.o.y) in Q2, while investment credit slumped from 10.32% to 6.44% (y.o.y) in Q2 and working capital loans from 8.61% to 7.21% in Q2.

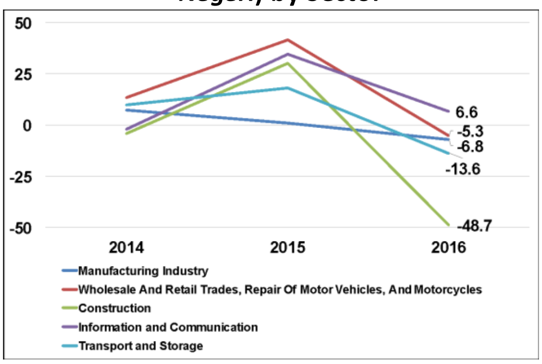
Reduction in investment-related loans, which supports the trend of reduction in domestic direct investments, may be explained by (i) businesses were expecting further rate cuts, which makes delay in investment-related loan more profitable or (ii) increase in government budget deficit crowds out loanable funds to private sectors. The first explanation may be supported by very gradual decline in interest rates for working capital (decreased by only 0.29% since end of last year) and investment loan (decreased by 0.24% since end of last year). The second explanation is supported by the increase of budget deficit to total domestic financing capacity (Expected financing of Rp 397 trillion under APBN-P 2017 equals to 8.8% of all outstanding credit extended by banks).

Figure 13: Trade Balance (Nominal) (2015Q1 – Aug 2017)



Source: CEIC

Figure 14: VAT Revenue Growth (PPN *Dalam Negeri*) by Sector



Source: CEIC

Another source of growth in first half of 2017, net export, also still shows positive trend, if somewhat tapered in Q2 and Q3 2017. Even if trade balance posted surprising deficit in July, overall Q3 trade balance is still positive. Booming commodity prices, around USD 60 per barrel for crude oil and around USD 85 per metric ton for coal, helped boost oil and gas export by in

Q3 2017. Increase in commodity prices also lead increase in imports, given Indonesia's status as net oil importing nation and the fact that. Total current account deficit is projected to be below 2.0% in Q3 2017.

We expect export to further improve, thanks to higher demand from China, Japan, and Eurozone, rebound in commodity prices, and implicit commitment of Bank Indonesia to keep Rupiah from appreciating further. Depending on prices of commodity prices and the impact of large-scale infrastructure programs by government to trading activities, current account may even return to surplus as early as 2018. We also do not see imports growth to be as strong as export, particularly for final goods and intermediate goods, in light of somewhat muted domestic consumption.

Higher Budget Deficit and Limits of Fiscal Stimulus

"…2018 budget to still be overly ambitious and may fall to the same problem that was perennially present in previous budgets, namely unrealistic target and the need for budget revision midway"

As of September 30, overall revenue reached IDR 1,099.3 trillion (63.3% of 2017 revised target), while the overall spending reached IDR 1,082.6 trillion (60.6% of 2017 revised target). Stagnating tax receipts (IDR 896.5 trillion for first nine months of 2017, compared to IDR 896.3 trillion for the same period in 2016) are partially caused by one-time boost in tax receipts from tax amnesty program. However, there are also signs that, excluding receipt from tax amnesty, there are notable increase in tax receipt realization this year. For example, VAT revenue for first 9 months increased notably, from IDR 270.2 trillion last year to 307.3 trillion this year. This is particularly supported by improvement in motor vehicle sales and other key sectors that contribute to VAT revenue the most, including manufacturing, construction, information and communication, and transport and storage.

Nevertheless, the fact that overall revenue for the first 9 months only amount to 63.3% means that there is a very high risk of government revenue to fall short of target. If current trend continues until end of year, we expect that revenue realization will only amount to 85-90%. This has major implication on expenditure side, particularly as APBN-P 2017 deficit target (2.92%) is very close to 3% limit, so that unmet revenue target should be balanced by automatic downward adjustment in government expenditure. This means that government cannot act in countercyclical manner as intended and may have to postpone disbursement of large-scale infrastructure plans to next year, further add to adverse risk to GDP growth and long-term budget credibility.

We still see the revenue growth target set for 2018 budget to still be overly ambitious and may fall to the same problem that was perennially present in previous budgets, namely unrealistic target and the need for budget revision midway. With expected 85% realization for 2017 budget (c. IDR 1.300 trillion), 2018 budget effectively targets 23% increase in tax revenue. Increase in tax revenue within 1 fiscal year for more than 23% have only happened once in 2008, which was primarily due to Sunset Policy program during that year. This poses high risk for government's ambitious infrastructure development target and therefore requires even more private-sector involvement to mitigate the risk of unmet need for infrastructure to support long-term growth target, something that seems to be missing in the last 3 years of infrastructure development realization.

Another less apparent but no less severe negative impact of high budget deficit is the more pronounced crowding-out effect of deficit spending. As Government of Indonesia increasingly relies on domestic sources for financing, particularly IDR-denominated bonds, increase in budget deficit would have to be financed from finite pool of domestic Rupiah savings[1]. This inevitably will lead to increased competition for loans, which reduces the amount of domestic savings that can be channeled to private borrowers and increase the interest rate for all loans. Reduction in funds channeled to private borrowers and increased interest rate will ultimately reduce investments and consumptions. This phenomenon where increased public-sector spending leads to reduction in private-sector investment and consumption is what economists dub as crowding-out effect.

While crowding-out effect would not entirely cancel out the stimulus created by increase in government spending, it would significantly limit the effectiveness of fiscal stimulus. To ensure that deficit spending creates net positive effect to the economy, government have to cut non-essential, non-productive spending and increase the efficiency and effectiveness of existing public service deliveries. With respect to current key policy priority, particularly infrastructure building, this means government should prioritize its spending on infrastructure projects with marginal profitability but high net-positive economic and social impact. The nexus between government financing capacity, crowding out of private sector role in infrastructure development, and the appropriate mix of state and private involvement in infrastructure is discussed in our special section on infrastructure below.

"…government should prioritize its spending on infrastructure projects with marginal profitability but high net-positive economic and social impact"

Aside from the concern about macro posture of current budget there are some promising signs about the direction of spending pattern by the central government. For example, we see that more allocation of spending towards infrastructure, universal healthcare program (JKN), and education represents a much better way to spend government budget. Another initiative, such as government's pledge to promote labor-intensive infrastructure program (Padat Karya Cash), also have the potential to spur both investment in infrastructure and purchasing power, which makes spending stimulus more effective. We have to note, however, that government now have effectively broken its own pledge to leave gasoline price to market mechanism and limit fuel subsidies by letting Pertamina bear the losses of not increasing price in higher oil price environment. This pattern of behavior is disappointing as it represents a step back at creating more market-based economy and more pro-poor budget.

External Risks to be Manageable for 2018 and 2019

We identify some new developments that should be noted for 2018 and 2019 that may affect domestic economy significantly. First, the trend among major central banks, particularly US, Eurozone, UK, and possibly Japan, to normalize its monetary policy. This scenario may have somewhat been priced in by the market, given the somewhat muted response of global financial market to more adverse events. This muted response is due to two factors; first, better communication of monetary policy and central bankers' effort to avoid surprise moves means that investors have largely anticipated rate cuts well in advance. Second, there is a general trend of more risk-taking among market participants. We expect this elevated pattern of risk-taking behaviors by market participants to continue to 2018 and 2019, thus continuing the trend of more capital inflow to emerging market, including Indonesia, despite higher interest rate environments.

[1] Savings can be said to include broad category of funds that represents money not spent by household on consumption or by corporation on investments. In economics context, savings include but are not limited to money deposited by individuals and non-financial corporations in the banking system or channeled to domestic bonds and stock markets

Second, we see that China, which during last year and until the start of this year poses risk of hard landing, seems to have managed to find more sustainable, if somewhat lower GDP growth. This success of soft landing means that demand for commodity will continue to be brisk, even if commodity price will continue to remain well below its pre-2008 price. Coal prices will not experience downturn like the ones until 2016, but we are skeptical that coal industry will remain sustainable in the long run, thus limiting upside potential of mining industry and coal-related exports for 2018 and 2019.

Thirdly, we note that increased risk-taking behaviors have left some analysts to sound alarm bell about possible repeat of 2008 scenario of global-scale financial crisis. While it is true that excessive risk-taking behaviors and complacency of regulators are evident in some sector, particularly technology, we do not see significantly higher risks for crisis, at least for 2018. Interest rates in US and other major economies are raised in much slower pace, which allows market to adjust to tighter monetary environment more gradually. Additionally, in Indonesia context, government and Bank Indonesia still have sufficient means to support the economy and reduce exchange rate volatility in cases of sudden adverse events in 2018. However, some measures of vigilance about possibility of increasingly unsustainable risk-taking behaviors in 2018 and 2019 are warranted, particularly if Trump administration can push through more reckless deregulations and unsustainable tax plans.

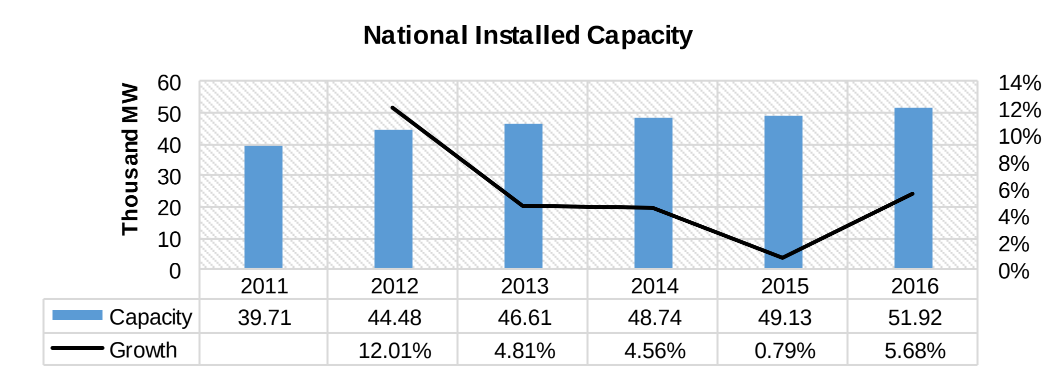
"…we are skeptical that coal industry will remain sustainable in the long run, thus limiting upside potential of mining industry and coal-related exports for 2018 and 2019"

"As past growth model, driven by natural resources rent extraction, is unsustainable in perennially low commodity prices environment, promoting diversified manufacturing and service-based activities through infrastructure is even more critical"

Infrastructure-Growth Paradox

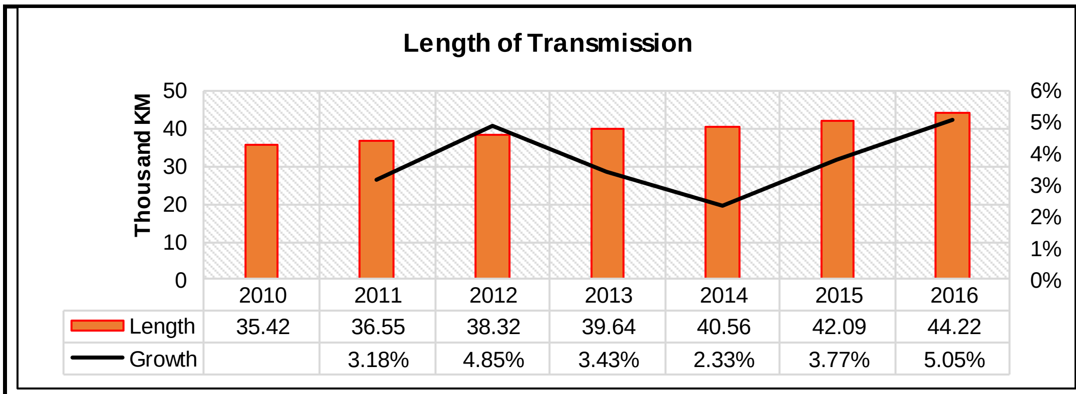
The push by Jokowi administration to significantly improve the state of infrastructure across Indonesia is well-intentioned and based on sound principle of promoting entrepreneurship through provision of necessary public goods, such as roads, rails, airports, power plant and grid, or irrigation system. As past growth model, driven by natural resources rent extraction, is unsustainable in perennially low commodity prices environment, promoting diversified manufacturing and service-based activities through infrastructure is even more critical. This vision, laid down in National Medium-Term Development Plan (RPJMN 2019), is very ambitious; the whole plan requires total investments of 5,519 trillion Rupiah in funding, both from public budget and private sector involvement.

To illustrate the sheer scale of infrastructure undertaking by current administration, consider the details of the infrastructure plans. For transportation infrastructures alone, the plan calls for 2,650 km of new roads, not including planned new 1,000 km long toll road (e.g. Trans Sumatera, Trans-Java, Non-Trans Java, Samarinda-Balikpapan, and Manado-Bitung segments). In terms of length, the new toll roads that have been constructed in the first 3 years of Jokowi administrations is more than total toll road built in the preceding 40 years combined. Those targets are also accompanied by the task to maintain the total of 46,770 km long existing road. The government also plan to build 3,258 km long railroads which spread in Java, Sumatera, Sulawesi and Kalimantan, not to mention LRT and MRT projects planned in several cities. The government also targeted development of 24 new seaports and 15 airports to provide better intercity and inter-island linkage and trade.



	2011	2012	2013	2014	2015	2016
Capacity	39.71	44.48	46.61	48.74	49.13	51.92
Growth		12.01%	4.81%	4.56%	0.79%	5.68%

The infrastructure boom envisioned by government is also evident in electricity sector, with targeted 35,000MW new capacity for 2015-2019. The plan consists of 109 new power plants, of which 35 (10,681MW) are funded by government and PLN, which will be financed through state budget (APBN). The rest will depend on private financing through Independent Power Producer (IPP) scheme.



Even so, the data demonstrates that the growth of total installed power plant capacity has been slowing down since 2012 until 2015, from 12.01% to only 0.79%, before increasing to 5.68% in 2016. This growth might be the signal of acceleration of the development as boosted by the government. This is supported by the fact that after facing stagnant growth of length of transmission lines from 2011 to 2015, the growth of the length of the transmission line accelerated to 5.05%.

"However, the limits of sustainability of this approach to infrastructure financing through state-owned enterprises becomes increasingly inevitable"

A more glaring fact, however, is that the infrastructure spending does not necessarily spurred economic activities, particularly manufacturing renaissance, even well into 2017. Indeed, massive growth in government spending in 2016 are not translated to higher growth of overall infrastructure spending (public + private) in 2016, with the possibility of such trend to continue in 2017. This creates some big paradoxes: if government's infrastructure budget has grown by around 177% from 2014 to 2017, why are total infrastructure spending growth (public and private) stagnant in 2016? Also, if infrastructure lowers logistic and transaction costs, why are massive increase in infrastructure provision not followed by considerable increase in GDP growth in 2017?

Hidden Deficit and Financial Market Intervention

So far, government has gone to great length to provide various financing schemes for infrastructure financing that relies on state-owned enterprises (BUMN). Government's preference for BUMN-led infrastructure development is understandable, as such model allows government to commence project quickly, without having to go through messy budgeting process or negotiation with the private sector. However, the limits of sustainability of this approach to infrastructure financing through state-owned enterprises becomes increasingly inevitable.

For the case of APBN-funded projects, the government gives direct assignment to the BUMN to handle construction for certain infrastructure. Later, as the national fiscal capacity has been facing many challenges, the payment flow from the government then becomes stalled. This condition has impacted the cash flow of many BUMN, which is reflected in their stock price movement. Most BUMN in infrastructure sector experienced plummeting stock price, for instance PPRO (-85% ytd), WASKT (-27%), PTPP (-30%), WTON (-31%), WIKA (-21%), and CMNP (-25%).

For projects with concessional scheme that do not rely on APBN, such as power plant and toll road, many BUMN have preferred issuance of global bond for project financing. The method works in various cases, but not anymore for certain sectors. For instance, in the electricity sector, PLN, who had already had substantial amount of debt, caused by a long series of losses of which mainly caused by electricity subsidy and internal inefficiency, could hardly issue a new debt. To solve the problem, the government then issued a series of regulations that give PLN sovereign guarantee for its financing activity related to the development of electricity infrastructure.

The policy so far has been regarded as a success. PLN could attract new financing from investors, allowing massive development of both new power plant and transmission line to continue unabated. However, that does not mean everything is going well. Recently, Minister of Finance sent letters to Minister of State-Owned Enterprises and Minister of Energy and Mineral Resources to warn about the scale of PLN debt, which according to Q2-2017 financial statement amounted to 299 trillion IDR. This amount is equivalent to about 8% if compared to total sovereign debt of 3,667 trillion IDR on Q2-2017.

Another strategy to provide financing for infrastructure projects is by redirecting investment allocation of government-owned endowment funds. Those funds, including but not limited to BPJS, Asabri, Taspen, LPDP, PT SMI, PT PPA, and BPIH, are mandated to reallocate some of their portfolio to infrastructure-related bonds or even equity investments. OJK, presumably after being consulted by government, issued POJK 36/2016 that require Life Insurance and Pension fund to invest at least 30% of its fund to infrastructure related bonds issued by BUMN and BUMD.

The government needs to pursue more of long term financing strategy for infrastructure investments; currently it is still dominated by short-term strategy.

These efforts might be very effective in the short-term. However, the long-term effect of these policies and efforts is questionable at best. We view these efforts to reallocate investments of professionally-managed financial institutions to be concerning as those funds have their own investment horizon preference that does not necessarily match with infrastructure-type of investment, which spans to more than 20 years. This effort is also distortionary, as government willingly distort allocation of capital from its most profitable use for the sake of increasing infrastructure investments.

Private Sector Involvement

Given the limited capability of state budget to cover all infrastructure funding and the limit of sustainability of BUMN-led government's ambition to develop infrastructure, private sector involvement in infrastructure financing is very crucial for sustainable long-term infrastructure development strategy. Yet there continue to be some obstacles; in the last five years, we have been experiencing the period of slow growth in infrastructure investments by private sectors. The FDI realization in infrastructure related sectors has been growing in moderate pace. The condition also applies for Domestic Direct Investment (DDI), in which significant progress has not been seen yet. The data show the FDI for the last five years to grow significantly in 2012-2015, though it experienced a major decrease in 2016. For the case of DDI, the pattern shows fluctuation for the last five years.

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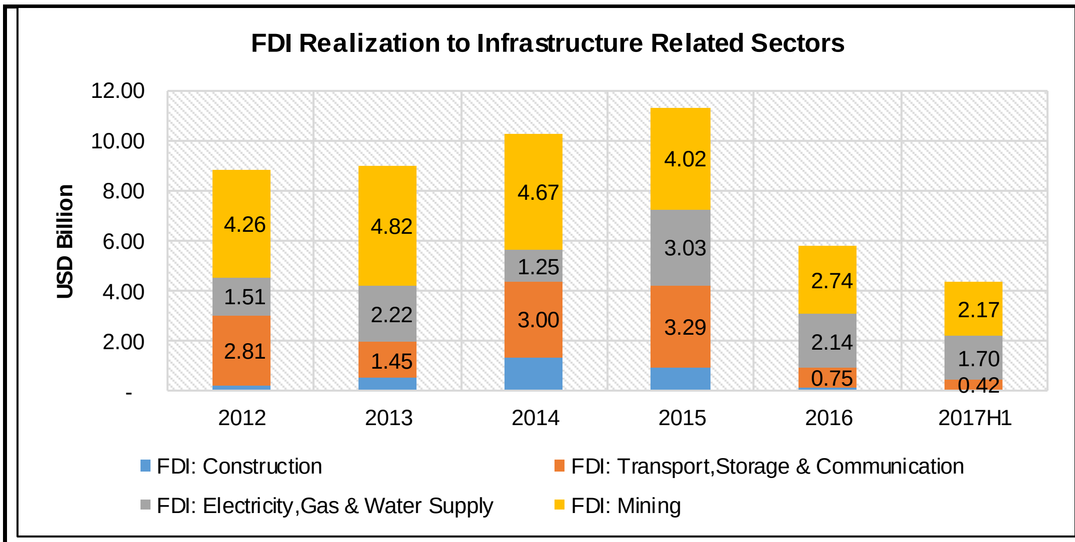
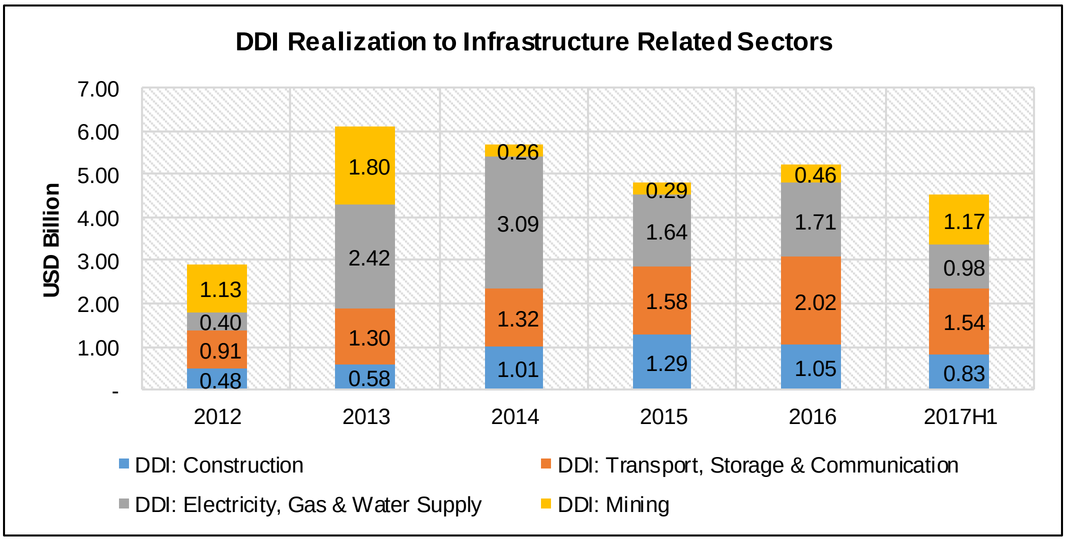


On broader level, the data show private involvement in infrastructure-related sectors to be stagnant for the last five years. We only see substantial increase in government investment for year-on-year basis. Ideally, the government funding plays role only as a stimulus to attract private participation, or as previously mentioned, to invest in areas and projects that may not be profitable but economically and socially important. Yet the fact indicates the opposite. As the government infrastructure budget keeps growing exponentially, the private investment in infrastructure related sector seems to be stagnant or even decreases.



This might happen for several reasons. For many cases, as in for toll-road, especially in Sumatera Section, the government chose to give direct assignment to Hutama Karya for the development, which includes 40 years long contract of total 322.9km-long toll road. On one hand, this decision may be a good step to ensure more opportunity to increase experience of BUMN in development of project at such scale. On the other hand, the financing requirement is far beyond Hutama Karya capacity. The condition becomes worse as HK does not get capital injection from APBN to develop the project. Meanwhile inviting private funder to finance the development does not seem to be promising since Hutama Karya may not share the contract ownership with potential investors.

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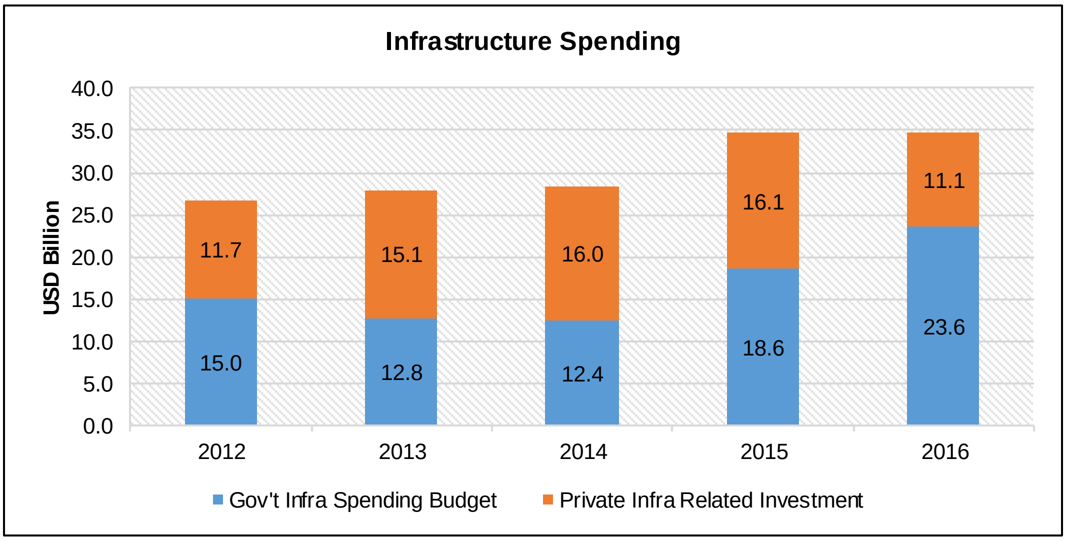

For the case of electricity, the plan to attract private participation to build around 25,000MW of IPP-generated capacity is hampered by the government ability to adjust the electricity costs and the risks associated with sudden, unexpected policy changes. These aspects related to regulatory risks disincentivize private sector investment to finance electricity project. Other infrastructure projects that are less profitable have even less certainty, particularly from profit sharing scheme and legal perspective, which diminish the attractiveness of infrastructure for private sector scheme.

What to Do Next?

As government's infrastructure blueprint key design of the infrastructure development put private funding as major sources of financing, government should proactively facilitate infrastructure development through incentives and legal certainty. The facts so far, however, shows otherwise. One of the biggest problems is the incentive system. For the case of toll-road and electricity, both have problems in terms of attractiveness of pricing and revenue scheme. Higher price would attract private investors, yet such practice imposes burden toward end-users, which is politically impossible. Second, the government should start prioritizing offering more profitable projects to private sector rather than to BUMN.

Lastly, a structural hurdle for more participation in attracting private sector, is the legal issue. The problem is not so much about what current regulations dictate but more on investors' perception of the ability of government to honor the concept of sanctity of contract and not to frequently change regulations, which poses unforeseen risks to investors' revenue projection. Based on that condition, we predict that the total infrastructure spending will grow only at a modest pace in the next two years (2018-2019). There is even some risk of stagnation as the recent push toward the fiscal management has been worrying the private sector to participate in the infrastructure development.