Key Figures

- GDP Growth* (Q2 '18)
  5.1-5.2%
- GDP Growth* (FY 2018)
  5.2-5.3%
- Inflation (y.o.y. Jun '18)
  3.12%
- Credit Growth (y.o.y. May '18)
  10.26%
- Trade Balance (Q2 '18)
  USD -1.40 billion
- Current Account (Q1 '18)
  -2.15 %

**) Forecast*

Fiscal Management Dilemma and Global Uncertainties

Highlights

- GDP to grow 5.1-5.2% in Q2 2018, reduced FY2018 forecast at 5.2-5.3%
- Manufacturing sector growth is more robust, will sustain a slight acceleration for 2018 and 2019
- Consumption growth still lags, may cross 5% level this year if inflation remains under control
- External risks have increased considerably; trade wars between US, China, and Europe could seriously lower global GDP growth rate in 2018 and 2019
- Government has increased the budget for energy subsidies by to Rp163 trillion, but total costs of energy subsidies remain underreported

Persistently muted household consumption growth, which is still under 5%, signals that households remain very vigilant to fluctuations in income growth and external risks despite very low and manageable inflation. Under better circumstances, both government and central banks might want to push growth further by relaxing monetary policies and increasing government expenditure. However, both fiscal, current account, and capital flow positions do not give much room for expansionary policies. Indeed, central bank has increased benchmark interest rate by 100 basis points and the government has pledged to postpone some infrastructure projects to 2019 and beyond to contain current account deficit.

Table 1: LPEM FEB UI GDP Growth Forecast

Q2 2018	FY 2018
5.1-5.2%	5.2-5.3%

The shift in government's policy stance from growth-oriented to stability-oriented is complicated by rise in oil price. On one hand, the government seems to want better fiscal discipline by announcing that there will be no amendment to 2018 Budget. On the other hand, government officially backtracked its pledge for a fixed subsidy by announcing increase in total energy subsidy to Rp163.47, which is mainly driven by rise in diesel fuel subsidy. Furthermore, we are still concerned that even that decision may not be enough to undo the damage of previous decision to force Pertamina to absorb the losses from selling RON 88 gasoline price (Premium) and diesel fuel below its economical price. Government's short-term fixes to contain rising fuel price are likely to deteriorate fiscal and current account position, reduce investors' confidence, and further increase debt servicing costs.

External risks are also becoming increasingly pronounced in recent months, following erratic decisions by Trump administrations to start trade wars with its largest trading partner, China and EU, and to follow through with tax cuts at the time of record US corporate profitability. This unfortunate decision comes at the time when US seems to be at late-cycle phase, as shown by flattening US yield curve and record-low unemployment rate. While trade war between US and China may provide medium-term benefits to Indonesia, the risks of reduced China growth and declining US growth as early as late 2018 may weigh down Indonesia's growth and worsens current account deficit.

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

Syahda Sabrina
syahda.sabrina@lpem-feui.org

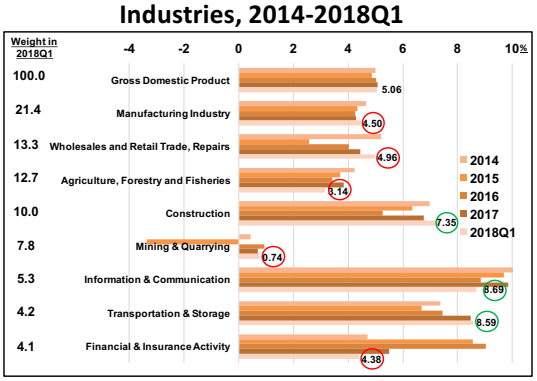
Infrastructure Push Has Started to Bear Fruit, More Structural Reforms Needed

Amid lack of external positive news, strong Indonesia's corporate profitability, as shown by upbeat stock market index following the release of 2017 financial statement by publicly traded companies, and 17-levels increase in Logistic Performance Index to the 46th position are strong indications that Jokowi administration's infrastructure push may have started to bear fruit. Combined with government's persistence in honoring its formula-based minimum wage increases, current administration has increased Indonesia's relative competitiveness and successfully induced inward investments by foreign and domestic investors alike (see Figure 11 and 12). Indeed, logistic and infrastructure-reliant industries, such as manufacturing, construction, and transportation sectors, are among the beneficiaries of government's infrastructure push.

"Indeed, logistics- and infrastructure-reliant industries, such as manufacturing, construction, and transportation sectors, are among the beneficiaries of government's infrastructure push"

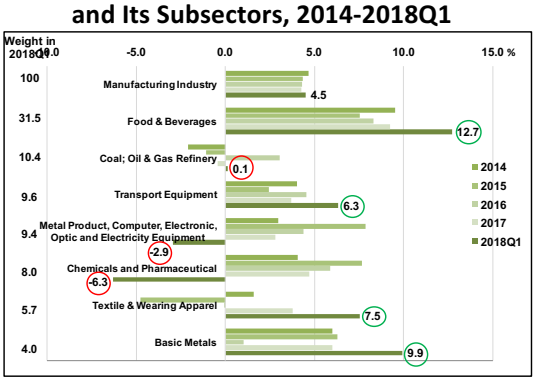
Manufacturing industry as a whole has accelerated again in Q1 2018 to 4.50% from 4.38% in Q4 2017. Food and beverage industry is still the biggest and fastest growth driver of manufacturing industry, with growth of 12.7% (y.o.y). This growth level is admittedly lower than in 2017 Q4 (13.76%), partially due to industrial-grade salt shortage induced by government's own salt import policy until later in Q1 2018. This growth might accelerate again in Q2 2018 due to earlier Ramadan season. Transport equipment, textile, and basic metals manufacturing also enjoyed strong growth in Q1 2018, growing 6.3%, 7.5%, and 9.9%, continuing similar trend from previous quarters. Although not directly related to manufacturing, construction sector also continues to enjoy high growth, growing 7.35% in Q1 2018, despite signs that government may postpone some infrastructure projects to contain current account deficit and higher interest rate due to increase in benchmark policy rate

Figure 1: Growth of GDP and the Main Industries, 2014-2018Q1



Source: CEIC

Figure 2: Growth of Manufacturing Sector and Its Subsectors, 2014-2018Q1



Source: CEIC

Admittedly, manufacturing industry growth is not evenly spread among its subsectors. Metal, computer, electronic, and electric equipment manufacturing, one of the more technologically-advanced manufacturing subsectors, experienced negative growth in Q1, with growth of -2.9% (y.o.y), continuing previous trends of relatively low growth. Similarly, chemical and pharmaceutical subsector experienced -6.3% (y.o.y) growth in Q1 2018. This could be due to the early impacts of the fluctuations of the exchange rate that started in Q1 2018. Coal, oil, and gas refinery practically stagnated in Q1 2018, with growth of 0.1% (y.o.y), given secular downward trend in crude oil output in Indonesia.

While relatively faster growth in manufacturing industries is good news, the task to revive Indonesia's competitiveness is still far from done. Manufacturing industry's growth is still well below overall GDP growth of around 5.1% and total consumption growth of around 4.9%. In fact, some policies still serve as obstacles to higher competitiveness and should be the target of broad-based structural reforms.

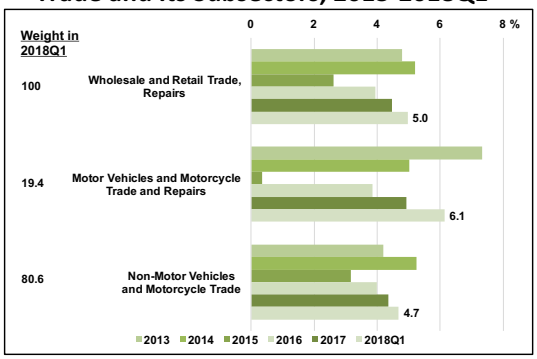
As mentioned in our previous quarterly outlook, one of the most significant roadblocks for faster manufacturing growth is the creeping protectionism through proliferations of non-tariff barriers. Marks (2017) highlighted that effective rate of protections, which shows the degree of tariff and non-tariff, e.g. import quota, had increased considerably across almost all range of goods from 2008 to 2015. Such policy direction is counterproductive to Jokowi administration's efforts to be more pro-business and harm manufacturing industries in particular. Import quota, particularly when artificially constrained by officials in order to extract economic rent, may constrain supply and raise prices of input goods for industrial users; putting local manufacturers at disadvantage in terms of ability to supply goods consistently to buyers and cost competitiveness. This increases the relative appeal of Indonesia's more business-friendly neighbors such as Vietnam, thus putting Indonesian manufacturers at further disadvantage given their inability to participate in a more integrated global value chain.

"While relatively faster growth in manufacturing industries is good news, the task to revive Indonesia's competitiveness is still far from done"

Other areas of structural reforms also need to be addressed through bold and significant steps. Creating a more reliable judicial system, for example, may lead to reduction in legal and contracting costs, by removing business uncertainties and the need for local and foreign investors alike to use Singapore courts and law for contract arbitration. Push to streamline regulations is also needed to reduce regulatory burden for businesses and remove the room for bribery. Additionally, both central and local governments should also steer away from temptations of populist policies that may create uncertainties for businesses, such as arbitrary policies to lengthen bank holidays and attempt at heavy-handed price controls.

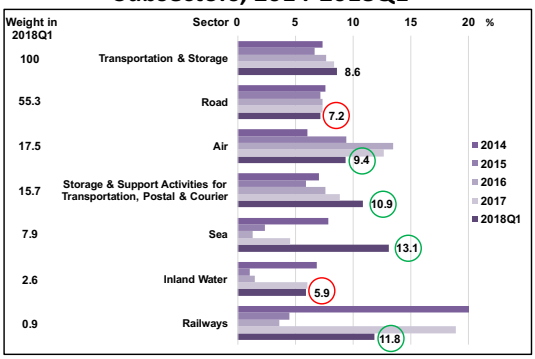
No Retail Apocalypse, But Experience Goods Remains Source of Service-Sector Growth

Figure 3: Growth of Wholesale and Retail Trade and Its Subsectors, 2013-2018Q1



Source: CEIC

Figure 4: Growth of Transport and Its Major Subsectors, 2014-2018Q1



Source: CEIC

Far from being a sign of absolute decline in brick-and-mortar retail trades, as experienced by many retailers in developed world, weak retail growth in recent quarters may just be a sign of weak consumption in general. Wholesale and retail trade growth grew by 5.0% in Q1 2018, driven by higher increases in motor vehicle sales, which grew by 6.1% in Q1 2018. More importantly,

non-motor-vehicle retail trade grew 4.7% (y.o.y), up from 3.8% (y.o.y) in Q4 2017, suggesting that increasing affluence of Indonesian middle class still provide room for growth for retail sectors.

However, in relative term, we still maintain our view that consumer preference and purchasing habit will continue to dampen growth prospect of non-motor vehicles retail industry, particularly for retailers of durable goods. Increased competition from e-commerce sellers and depressed profit margin for retailers means that sales growth may not be easily translated into an increase in value-added, the figure that is recorded in GDP growth. Furthermore, until tax officials can increase compliance of the under-the-radar online sellers, particularly from P2P online retail sales that are conducted through Facebook or Instagram, underreporting of GDP figure from retail sales may continue to worsen.

Stagnant consumption growth proves no obstacle for growth of industries that serve experience goods, particularly restaurant and tourism-related industries. Transportation sector, for example, grew by 8.59% in Q1 2018, up from 8.21 % in Q4 2017. Aside from increased demand from consumers for leisure-related activities, transportation sector enjoys sustained high growth, thanks to large-scale infrastructure push by government. Therefore, despite the growth risk posed by higher oil price, transportation sector can sustain or accelerate their growth throughout 2018.

"Stagnant consumption growth proves no obstacle for growth of industries that serve experience goods, particularly restaurant and tourism-related industries"

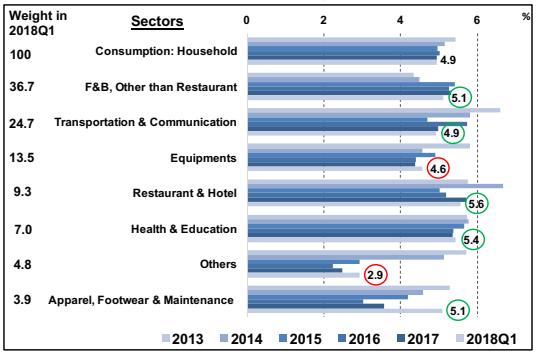
Increase in leisure activities, particularly tourism related, is particularly pronounced in growth of air transport and accommodation, food and beverages activities. Air transport growth accelerated from 9.1% in Q4 2017 to 9.4% in Q1 2018, while Accommodation, Food and Beverages Activities sector accelerated from 5.49% in Q4 2017 to 5.54% in Q1 2018. This boom in tourism trend is in no small part due to increase in the use of visual-heavy social media, such as Facebook and Instagram, which facilitates sharing of holiday experiences to wider social circle. Additionally, the use of social media also prompts the creation of more visually appealing dining experiences, which command higher price and higher value-added for restaurant and café industry. The use of social media is therefore related to relative rise experience goods in overall share of household consumptions.

Also related to leisure activities, we expect communication sub-sector, which grew by 8.69% in Q1 2018, to still grow by around 8-9% in 2018. Despite the fact that Indonesia's cellphone penetration may have rather limited potential given relatively saturated market, we still see growth for communication and information sub-sector from increase in digitalization of day-to-day activities. More digital-intensive urban population, who are now continuously connected to internet, will drive demand for more internet data and internet-related services. Intensification of data usage of rural and entry-level consumers may also be another source of growth for communication industry going forward.

Consumption to Grow around 5.0% in 2018

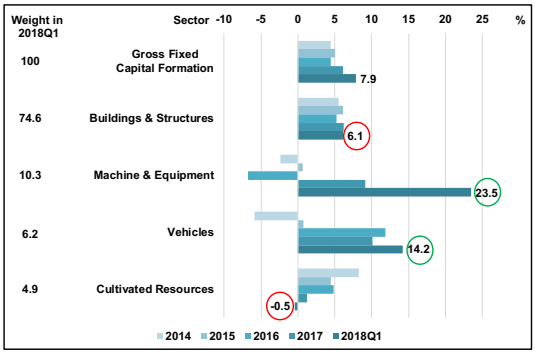
The growth rate of consumption remains virtually unchanged; household consumption grew by 4.95% in Q1 2018, compared to 4.96% in Q4 2018, despite acceleration in outstanding consumption credit growth accelerated to 11.50% (y.o.y) in March 2018. Looking at credit growth in May that stands at 11.88% y.o.y. and better consumer sentiments, we expect consumption to be able to touch 5.00% level in Q2 2018. However, rapid increase in policy rate in the first half of 2018 may put a dent on credit growth and durable goods consumptions, which prompts us to reduce our forecast of consumption growth in to around 5.0% in 2018.

Figure 5: Growth of Household Consumption and its Components, 2013-2018Q1



Source: CEIC

Figure 6: Growth rate of Investment and its Main Components, 2014-2018Q1

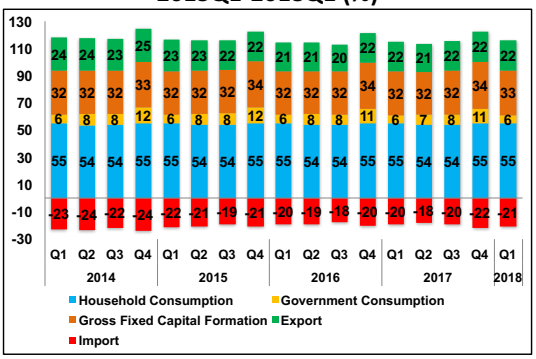


Source: CEIC

"Most of the components that constitute household consumptions growth (see Figure 5) stay relatively stable since 2017"

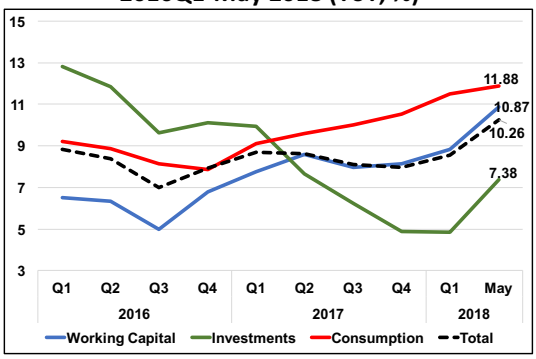
Most of the components that constitute household consumptions growth (see Figure 5) stay relatively stable since 2017, with notable exception of apparel, footwear, and maintenance (accelerating to 5.09% in Q1 2018 from 3.88% in Q4 2017). Consumption on restaurant and hotel remains considerably faster than overall consumption, despite decelerating to 5.56% in Q1 2018 from 5.71% in Q4 2017. Spending on transportation and communication accelerated to 4.92% in Q1 2018 from 4.45% in Q4 2017. Spending on non-restaurant food and beverages, however, grew slower in Q1 2018 (5.12% y.o.y from 5.52% y.o.y in Q4 2017). We expect growth of constituent components of household consumptions not to change considerably in Q2 2018.

Figure 7: Shares of GDP Components, 2015Q1-2018Q1 (%)



Source: CEIC

Figure 8: Credit Growth by Purposes, 2016Q1-May 2018 (YoY, %)

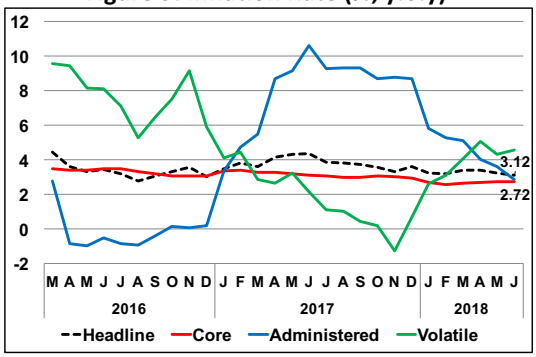


Source: CEIC

Relatively stagnant consumption growth is becoming apparent when looking at core inflation, which stood at 2.72% (y.o.y) in June and despite considerably higher headline inflation at 3.12% (y.o.y). We see core inflation to have stabilized at around 2.5%-3.0% throughout 2018, conveniently within the lower bound of Bank Indonesia's inflation target. We see this trend of low core inflation to be another positive result from government's infrastructure push, which reduce cost and price differential across regions.

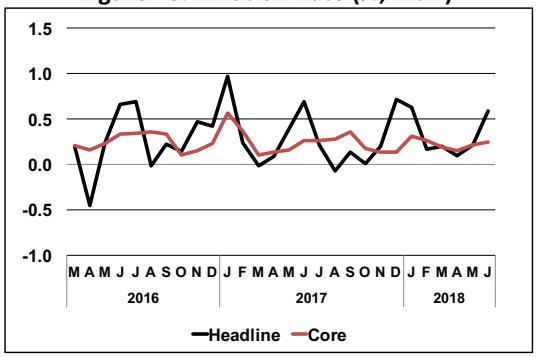
At current trend of GDP growth rate, we do not expect core inflation to accelerate much further, given government's explicit indication that they were backtracking their pledge to float the price of subsidized fuel price, particularly as 2019 General Election nears. The upward risk to inflation for 2018 comes mostly from exchange rate risks, which have depreciated by 6.71% from the start of this year. However, government has also indicated that fuel price may increase in 2018, particularly if OPEC continues to gradually reduce supply to maintain price level.

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



Source: CEIC

Figure 10: Inflation Rate (%, mtm)



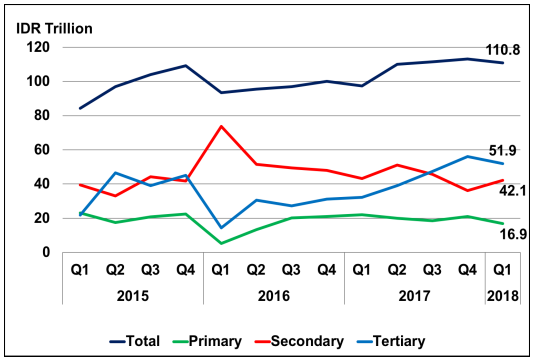
Source: CEIC

"Given that investment in machines and equipment investments have yet to be translated to manufacturing growth, perhaps due to time needed for machineries installations and years of negative growth, we expect that this growth will show up in growth of manufacturing industry by the second half of 2018."

Investment to Grow 6.5-7.5% in 2018

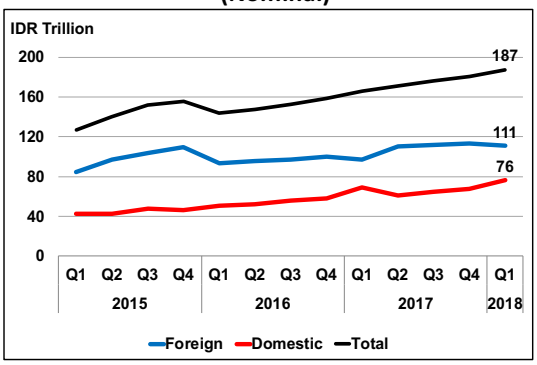
We continue to expect investments to accelerate considerably in 2018, continuing the trend in 2017. Gross fixed capital formation, the measure of investment in GDP, grew considerably faster than the economy in Q1 2018 at 7.89 % y.o.y, compared to 7.25% y.o.y in Q4 2017. Key drivers of investment growth in Q1 are still machine and equipment investments. This type of investment grew by 23.49% in Q1 2018, up from already-high 22.27% in Q4 2017. This growth trend is last seen in 2011, when quarterly GDP growth was consistently above 6%. Given that investment in machines and equipment investments have yet to be translated to manufacturing growth, perhaps due to time needed for machineries installations and years of negative growth, we expect that this growth will show up in growth of manufacturing industry by the second half of 2018.

Figure 11: FDI Realization (Nominal)



Source: CEIC

Figure 12: Foreign and Domestic Investment (Nominal)



Source: CEIC

Similar with trend that was shown by machine and equipment investments, other components of gross capital formation also enjoy high growth. Vehicle investments continued to show a very volatile dynamics as this subsector recorded growth of 14.24% in Q1 2018. However, growth in building and structures somewhat slowed to 6.13% (y.o.y) in Q1 2018 from 6.68% (y.o.y) in 2017, and we expect some slowdown in investment in structures due to government's decision to postpone some infrastructure projects to alleviate current account position.

Direct investment data by the Indonesian Investment Coordinating Board (BKPM) show that investments by both foreign and local enterprises also continue to increase in Q1 2018, as shown by increase in foreign direct investment and domestic direct investment by 13.9% and 11.0%

(y.o.y.) respectively in nominal Rupiah term. Direct investments still grow despite considerable currency depreciation, which further shows that Indonesia growth fundamental remains strong.

Strong investment growth in Q1 continued to be accompanied by record-low growth banking sector loans for investment purposes. Loan for investment purposes and working capital purposes grew at 7.38% and 10.87% in May 2018, considerably faster than throughout 2017 (see Figure 8). However, in light of higher interest rate and more contractionary monetary policy worldwide, we expect investors to continue relying on equity-based financing for their investments going forward.

Subsidies to Significantly Increase in 2018, Budget Deficit Could be Worse than Expected

"Our concern in February outlook on the problem of fiscal management, particularly on fuel subsidy, apparently has materialized as the fuel subsidy bill become too costly to be ignored by government in recent months"

Our concern in February outlook on the problem of fiscal management, particularly on fuel subsidy, apparently has materialized as the fuel subsidy bill become too costly to be ignored by government in recent months. Ongoing rumors in the media about Pertamina's financial performance is inextricably linked to the problem of fuel subsidy. Additionally, recent announcement that government increases overall energy subsidy budget to Rp163.47 trillion from Rp94.53 trillion suggests that government has indicated it is willing to increase fuel subsidy in order to keep fuel price constant.

Even after government's decision to increase subsidy for diesel fuel (Solar) to Rp2,000/liter, the amount of allocated subsidy falls short of the amount required to compensate Pertamina for selling Solar, Premium, and LPG at its current price of Rp6,450/liter (Rp6,550/liter in Java), Rp5,150/liter, and Rp16,000/3kg. Following Ministry of Energy and Mineral Resources' formula to calculate economical price for RON88 gasoline and gasoil, government's decision to keep RON88 gasoline price, we estimated that the amount of subsidy for Solar, Premium, and LPG should be Rp77.29 trillion for 2018, Rp35.76 trillion, and Rp40.48 trillion respectively, with total fuel and LPG subsidy bill of Rp153.54 trillion. However, government's recent announcement only stipulated subsidy of Rp103.48 trillion for these fuel categories.

Table 2: 2018 Energy Subsidy (Billion IDR)

	APBN 2018	July Announcement	LPEM Projection
Fuel and LPG	46,865	103,480	153,538
Electricity	47,660	59,990	59,990
Total	**94,525**	**163,470**	**213,528**

This leaves Pertamina with an estimated Rp50 trillion of unfunded subsidy that should be absorbed by Pertamina in 2018. Letting Pertamina shoulder the losses of current oil price may further hurt Pertamina's ability of doing business by forcing them to operate with deteriorating cash flow. In the short term, this will reduce remaining Pertamina's dividend or retained earnings, which will show up in reduced non-tax revenues. In the long term, production capacity and competitiveness of Pertamina will deteriorate due to shortage of capital for investment.

Government's overdue decision to increase fuel subsidy and to still leave some part of unfunded subsidies to be shouldered by Pertamina also negatively affect government's credibility in various ways. First, with no transparency about the latest pricing mechanism for Solar, Premium, and LPG, there is no way to assess true cost of fuel subsidy without resorting to estimation (as we

did). This creates doubt about government's commitment to both budget transparency and commitment to promote best practices among State-Owned Employees. This may inevitably invite some unwanted accusations that government tries to manipulate budget by shifting cost of subsidies from government's balance sheet to Pertamina's balance sheet and deteriorate trust in government's budget statistics.

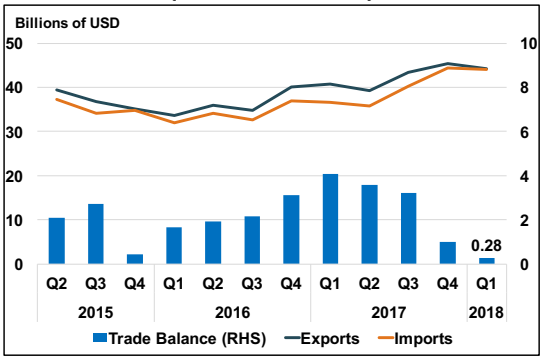
Furthermore, the problem surrounding cost of fuel subsidy also overshadows government's other successes in implementing 2018 Budget. For example, overall revenue realization for first half of 2018 is 44.0% of total 2018 revenue projection, up from 41.4% in 2017. Tax revenue realization also increased to 40.4% revenue projection in 2018 from 38.8% in 2017. Furthermore, expenditure realization in the first half of 2018 also increased across-the-board (42.5% in 2018 vis-à-vis 41.5% in 2017), suggesting increased ability to smooth governments' consumption throughout the fiscal year.

"In our view, the government is best positioned to stick to the pre-announced fuel subsidy formula and let fuel price fluctuates according to market mechanism, as originally intended."

Ultimately, government's decision to increase energy subsidy will lead to increase in fiscal deficit and current account deficit, through higher oil demand, given that Indonesia is a net importer of oil. We expect an additional Rp119 trillion in deficit as direct cost of fuel subsidy should government compensate Pertamina with true cost of fuel subsidy. Assuming other posts remains constant, we expect budget deficit to increase from 2.2% GDP to 2.3% GDP. Alternatively, to keep the budget deficit in line with the target of 2.2%, the government could introduce cuts on other spending items; but this option will jeopardize the target of GDP growth rate. In our view, the government is best positioned to stick to the pre-announced fuel subsidy formula and let fuel price fluctuates according to market mechanism, as originally intended.

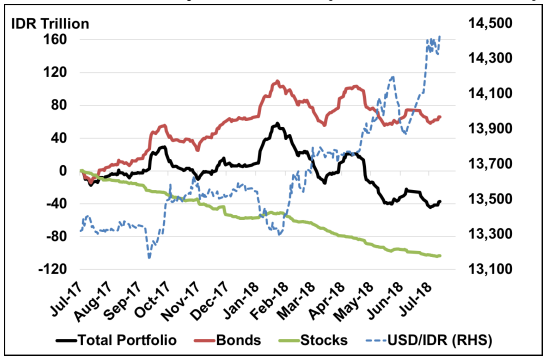
Rising External Risks, Deteriorating Current Account Position in 2018

Figure 13: Quarterly Trade Balance (Nominal) (2015Q2-2018Q1)



Source: CEIC

Figure 14: Exchange Rate and Accumulated Short-Term Capital Inflow (Jul 2017-Jul 2018)



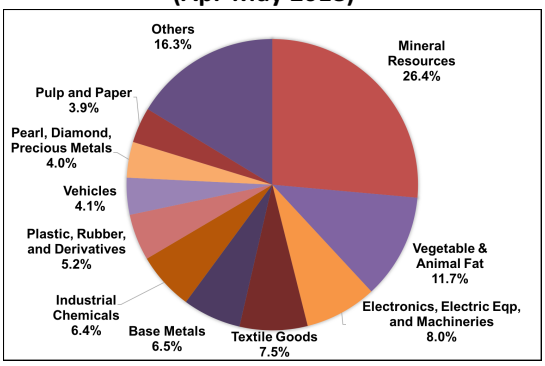
Source: CEIC

While net goods export used to be a growth driver in 2016 and 2017, net goods export continues to worsen in 2018, particularly in second quarter. While trade balance recorded surplus of more than $1.74 billion in June, total trade balance for Q2 2018 started to enter negative territory in Q2 2018. This trend is driven by the fact that imports, which depends on domestic demand condition, rise faster relative to increase in exports, which depends on external factors.

Given the dominance of mineral resources, particularly oil, in Indonesia's import structure, rise in oil prices throughout first half of 2018, coupled with increase in consumption, push imports considerably. This is compounded with the needs associated with governments' push to

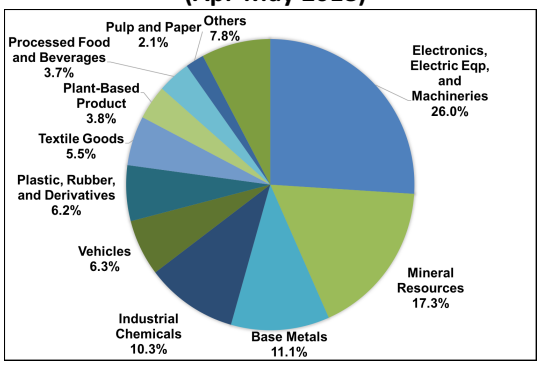
complete signature infrastructure projects before 2019, which requires assortment of imported heavy machineries, steel, and other infrastructure-related imports. As the result, imports continue to rise in Q2 to $45.08 billions in Q2 2018.

Figure 15: Indonesia Export Profile (Apr-May 2018)



Source: CEIC

Figure 16: Indonesia Import Profile (Apr-May 2018)



Source: CEIC

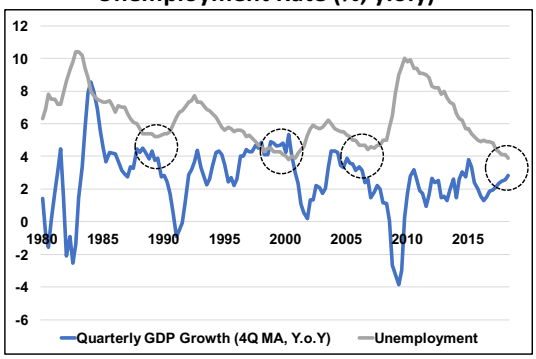
"Aside from imbalance between domestic demand and price level of Indonesia's key export commodities, another risk for current account position and exchange rate stability comes from risks of subdued global growth"

In contrast, Indonesian export is heavily dependent on export of raw materials, particularly mineral resources, vegetable fat/CPO, and precious metals, which means Indonesian's export value depends heavily on the price of these commodities. Together these three categories account for 42.1% of total exports, and the relatively stagnant demand for key export commodities reduce the export value to $43.75 billion in Q2 2018. We expect trade balance in 2018 to be slightly negative, unless prices of key export commodities like CPO and coal start to rise again. The trade deficit will also slightly worsen Indonesia's current account position in 2018, possibly in the range of 2.0-2.5% GDP for FY2018 depending on fluctuation of key commodities prices.

Aside from imbalance between domestic demand and price level of Indonesia's key export commodities, another risk for current account position and exchange rate stability comes from risks of subdued global growth. If 2018 was opened by relatively sanguine expectation about prospect of global growth, such expectations may be derailed by two factors that come from United States. First, faster increases in Fed Fund Rates have created uncertainties across emerging markets, although market fluctuation surrounding Fed Fund Rates increases have receded in recent weeks and capital inflow to emerging markets have resumed. Second, and the more serious risk, is ongoing trade war between United States and European Union and China that was initiated by Trump administration.

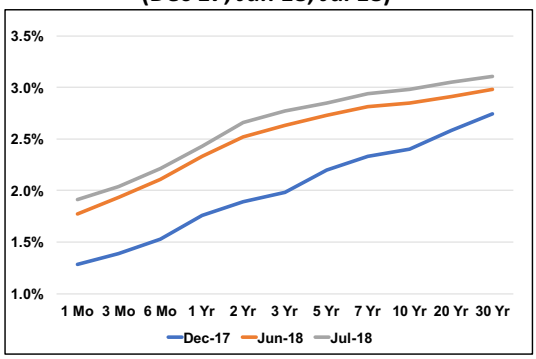
While it is easy to point out that trade war between these three major economies are not in all sides' best interests, we do not see easy way out from current situation. In the first place, the current trade war waged by Trump administration is not based on pragmatic economic administration, but rather by wishful thinking on part of US government that engaging in trade war may reduce US' current account deficit, just after US government passed tax cuts. Furthermore, US and its counterparts, China and EU, are now engaged in retaliations, which raises the number of products that are covered by increased tariffs; although US and EU are now putting proposed tariffs on hold and currently engaging in dialogues to reduce tariffs.

Figure 17: US Inflation Rate and Unemployment Rate (%, y.o.y)



Source: FRED (Federal Reserves of St. Louis)

Figure 18: US Treasury Yield Curve (Dec 17, Jun 18, Jul 18)



Source: FRED (Federal Reserves of St. Louis)

"The government therefore should pay close attention to the risks posed by US and perform appropriate stress tests to ensure that local financial market, banking sector, and government's budget posture, can withstand severe adverse events in the near future."

Should the current trade war continue, we may expect both US and China's GDP growth to be lower for 2018 due to reduction in trade among these two economies. Concern about the impact of trade war to US economy may also accelerate potential US recession, although such possibility remains relatively low at the moment. Even now, without the impact of trade war, there are signs that US has entered late cycle of economic boom and is heading towards recessions. US unemployment rate has touched lowest level in decades and yield curve has flattened considerably in recent months and historically, record-low unemployment and inverted yield curve often preceded recessions, mostly in less than 12 months. Policies that hurt growth prospect such as trade war may accelerate the end of boom cycle and reduce US growth potential.

Should US and China's GDP growth decelerate considerably as early as end of 2018, there is significant risks that Indonesia's export will deteriorate further, hitting Indonesia's GDP growth through widening of current account deficit and capital outflow first. The government therefore should pay close attention to the risks posed by US and perform appropriate stress tests to ensure that local financial market, banking sector, and government's budget posture, can withstand severe adverse events in the near future.