

## 2023 Indonesian Macroeconomic Outlook

# *“Steady ship amidst rough global seas”*

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## Executive summary

1

Indonesia had been a relative global over-performer during the tumultuous year of 2022, and it is likely to repeat that feat in 2023. Domestic consumption, as ever, remains key to growth, and mild inflation (coupled by global disinflation in H1-23) should help maintain purchasing power. However, employment outlook is softening while household saving rates seem to be declining except for the very richest, implying growing disparity and a slight slowdown in consumption growth.

2

Investment is the one GDP component with a headroom to accelerate in 2023, but the traditional “Jokowinomics” model (public sector-driven construction) is limited by fiscal retrenchment and the increase in subsidies and debt service burdens. Meanwhile, the private sector’s appetite for CAPEX has been rather lacklustre except for commodity-related sectors. Indonesia’s growth model, then, may become even more dependent on commodities, both on the export side (demand from China and India) and the investment side (strong FDI/DDI into mining and metals)

3

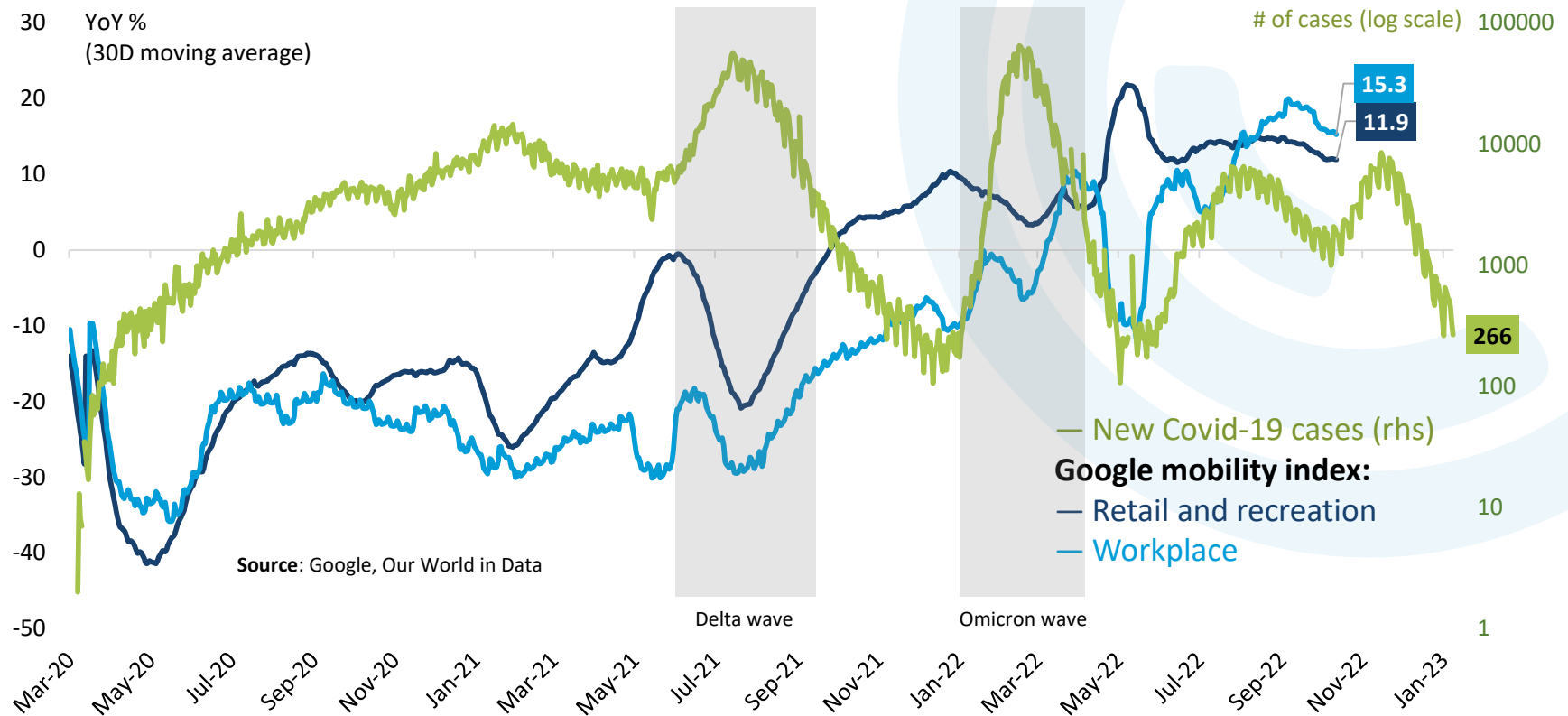
Expectations of soft landing, China reopening, *and* Fed pivot have helped the fortunes of emerging markets in Dec-22/Jan-23, but they may yet be premature. Nonetheless, Indonesia’s fundamentals are materially better than most other EMs – with robust growth, CA surplus, and more predictable/prudent policies – that it should over-perform no matter the situation. The most likely monetary outcome is not a return to accommodative conditions per se, but a “steadier-for-longer” situation where rates are kept near current (elevated) levels while the Rupiah show less drastic improvement more in line with its fundamentals – “leaky” inflows coupled with strong FX demand.

# #1: Introduction

## A year of extremes

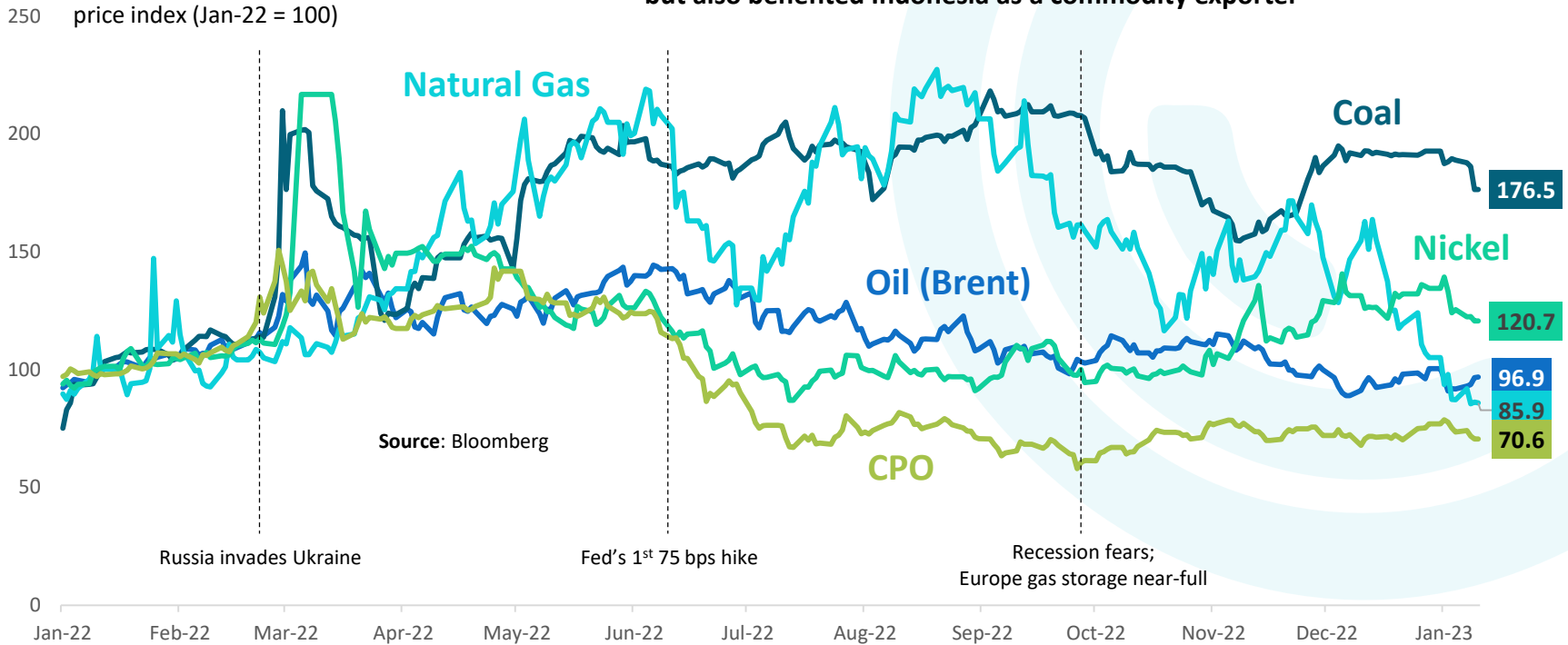
It was the best of times, it was the worst of times. The year 2022 saw the Indonesian economy bouncing back strongly from the Covid-19 pandemic, while spiking commodity prices was a boon for the country's exports and a magnet for FDI. But at the same time, the government had to undertake drastic actions to hold back the tide of inflation, while BI had to raise rates quite rapidly in response to the Fed's hikes and the ensuing capital outflows.

Chart I-1. Mobility has normalized as people learned to live with endemic Covid-19



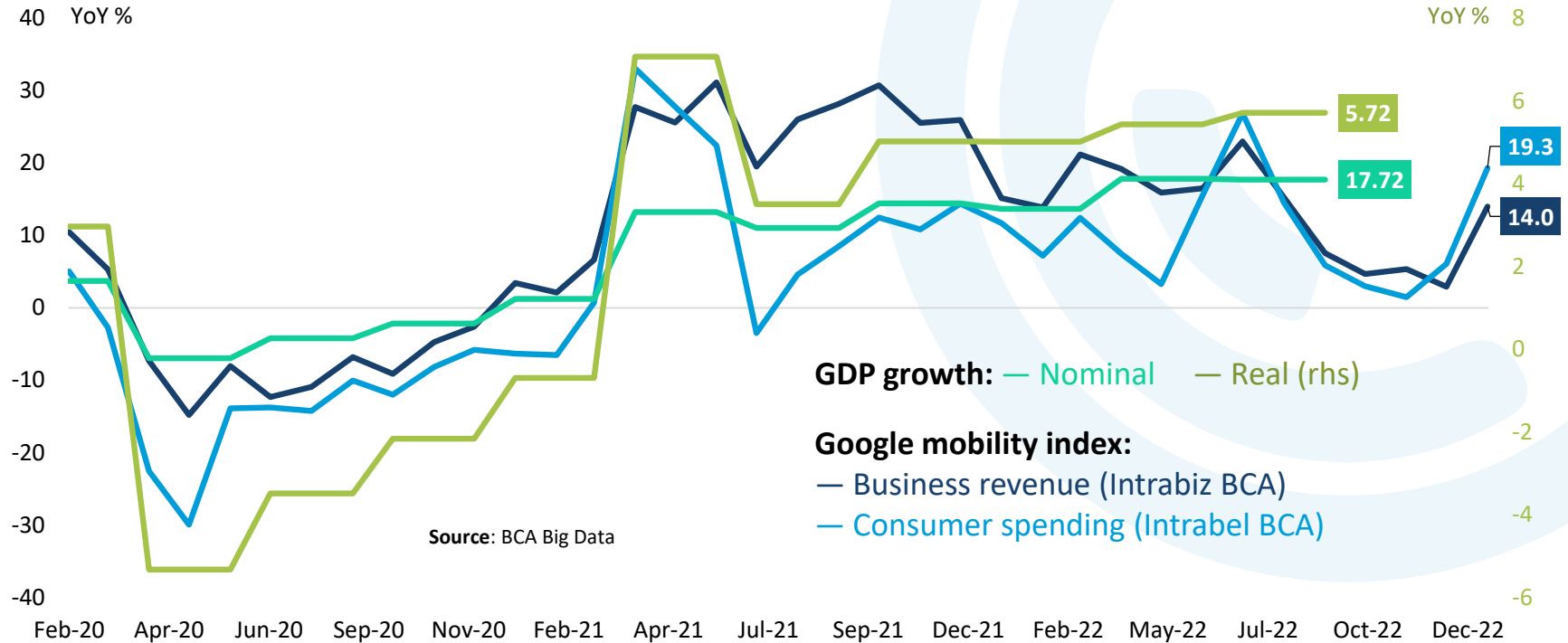
- The year 2022 had been a roller coaster ride, to say the least. It kicked off with glimmering hope of economic recovery, which did materialize for quite a while. After two years of on-and-off lockdowns, the government began to relax mobility restrictions – a move supported by widespread vaccination and declining hospitalization numbers. **Mobility recovered in a big way, which unleashed pent-up consumer demand, especially during the Ramadan and Lebaran festivities.** Sectors dependent on mobility, such as tourism, restaurants, and small/medium enterprises (SME) in general, reclaimed the fortunes they lost during the pandemic. Hope and optimism were returning, at last.

Chart I-2. Rising commodity prices brought inflation, but also benefited Indonesia as a commodity exporter



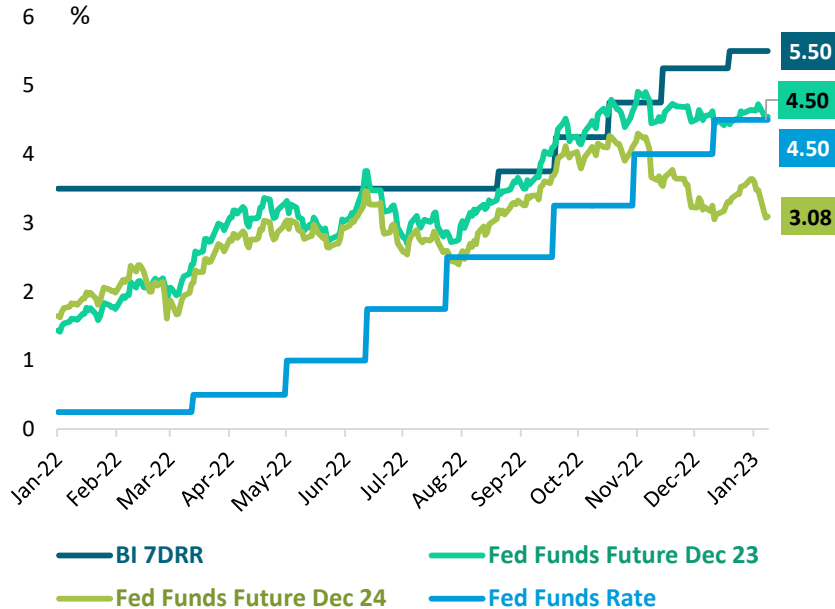
- Alas, Russia's invasion of Ukraine in February changed all that. The war upended the commodity markets, energy in particular, sending global inflation to levels unseen in decades. **The rising commodity prices actually benefited Indonesia, although the government had to scramble several emergency measures to fight the inflationary impact at home**, from fuel subsidies to domestic price caps to temporary export moratoriums on coal and CPO.
- The Fed turned decidedly hawkish to fight the inflation, starting with 25 bps hike in March and picking up in June with the first of four consecutive 75 bps hikes, before slowing to 50 bps in December. Recession fears began to rise, leading to widespread declines in industrial commodities although not yet energy commodities. By the end of the year, however, signs of recession are becoming ever more apparent, which – coupled with gas oversupply and mild winters in Europe – finally brought down energy prices as well.

Chart I-3. The recovery momentum is slowing, but perked up again during the year-end shopping season



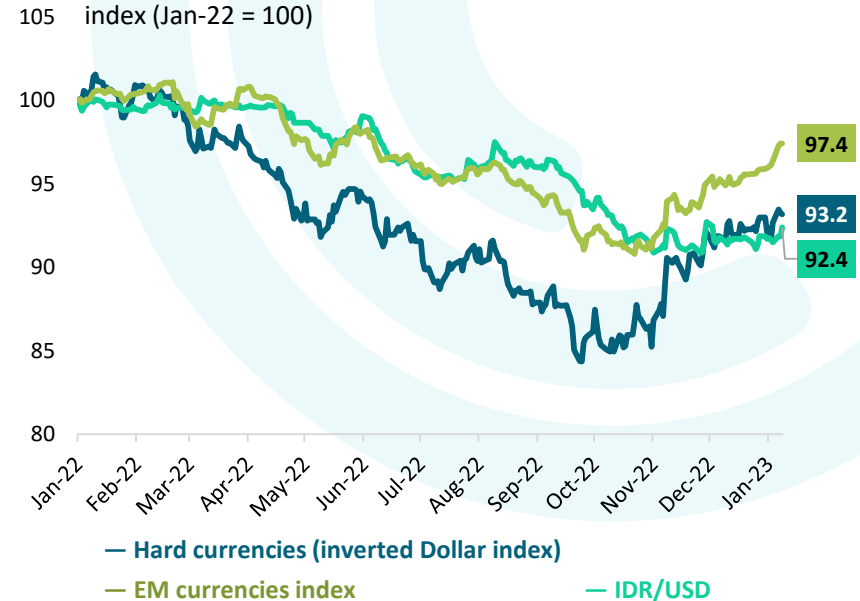
- As mentioned, the commodity boom worked to Indonesia's advantage, which despite being a net importer of oil is still a leading exporter of coal, gas, CPO, nickel, tin, and many others. The trade surplus reached record highs, and the same was true for foreign direct investment (FDI) as investors scramble for a piece of Indonesia's resource riches.
- But domestic consumption remains the main growth engine, and this was visible from our two big data indices – BCA consumer spending index (Intrabel) and BCA business transaction index (Intrabiz) – which are derived from real-time transaction data on our platform.** Both indicators tracked the strong GDP growth since the end of the Delta variant wave in Q3-21. However, the momentum noticeably slowed since Sep-22, around the same time as the fuel price hikes, which finally brought retail fuel prices closer to – albeit not fully in line with – global prices.

Chart I-4. Fed hikes had been anticipated for a while, but BI only started hiking as global rate outlook accelerated ...



Source: Bloomberg

Chart I-5. ... which weakened the Rupiah following a relative over-performance in the first half of 2022



Source: Bloomberg

- Meanwhile, BI had to hike its benchmark 7-Day Repo Rate to curb the impact of rising global interest rates on the Rupiah. BI was initially rather slow to hike, banking the Rupiah's stability on the trade surplus and equity inflows into Indonesia's energy sector. **But as the Fed became increasingly hawkish and energy prices peaked, pressure started to build – resulting in sharp depreciation in September and October.** It is in response to this, as well as anticipating fuel hike-induced inflation, that BI began tightening policy – starting with one 25 bps hike in August and followed by three 50 bps hikes in subsequent months, before slowing down to 25 bps again in December.

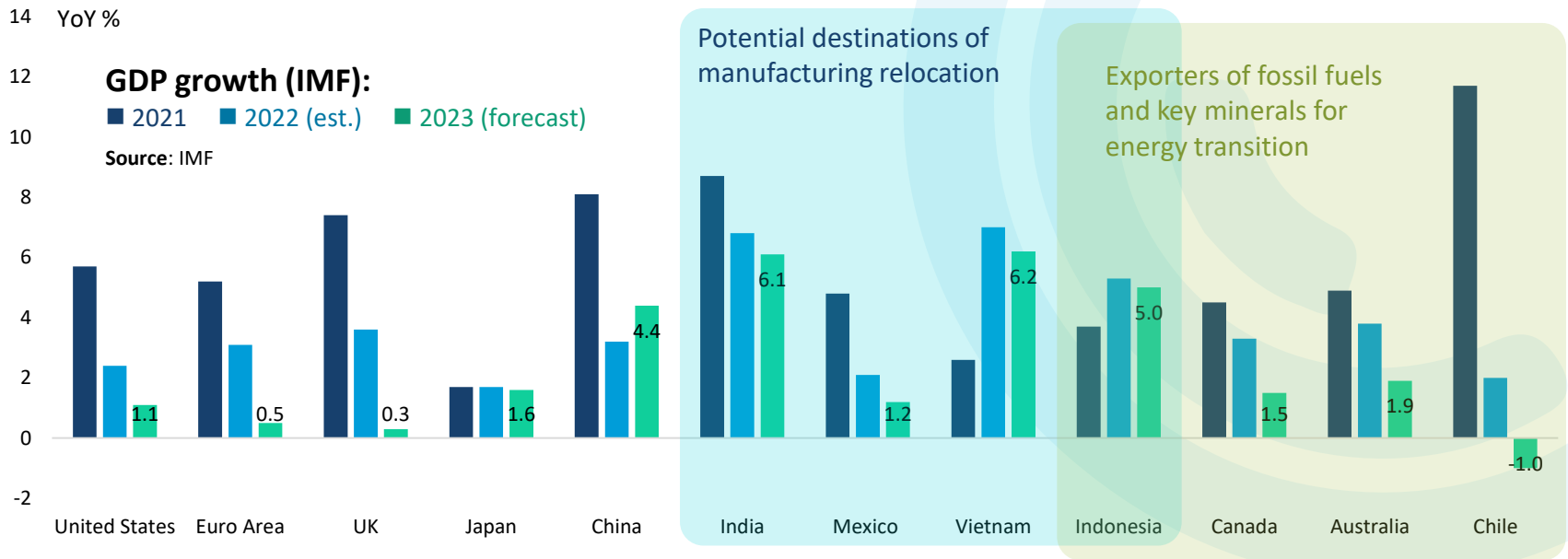


# #2: Consumption and trade

## The old mainstays holding strong

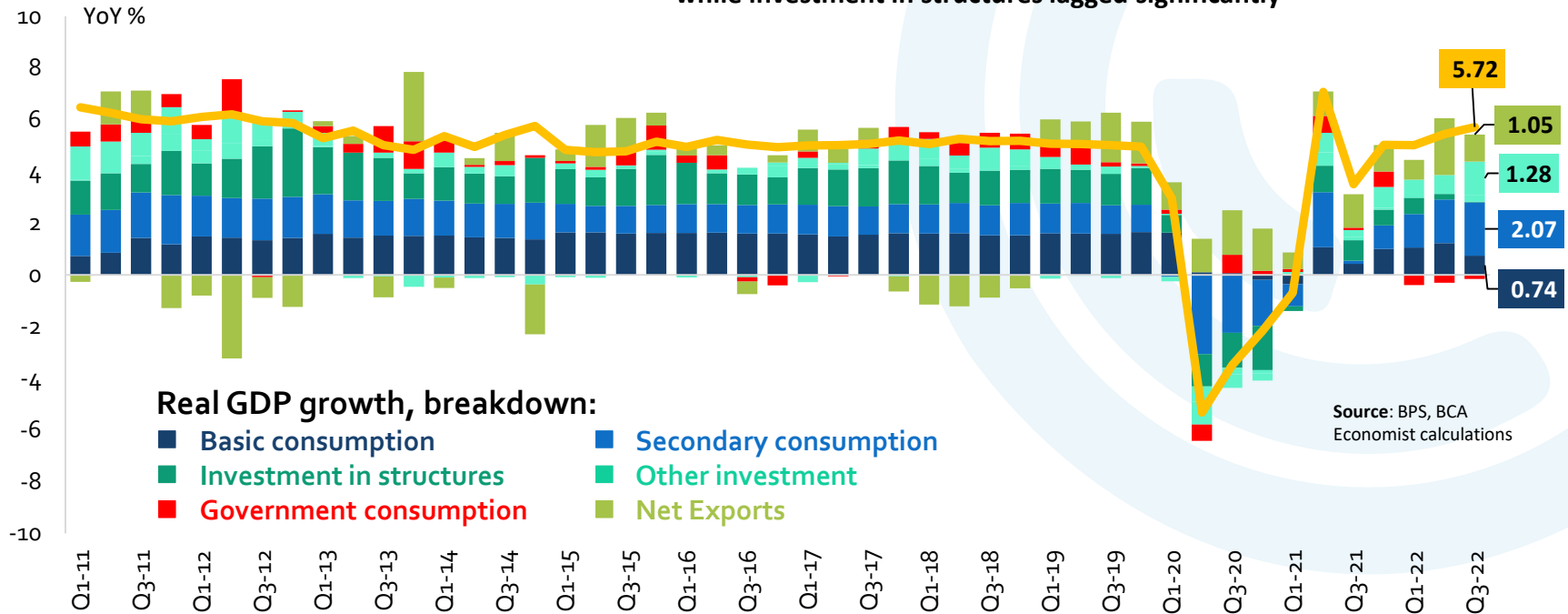
Indonesia's relative resilience during global crises is predicated, then as now, on its robust (and quite insulated) domestic market, and its commodity-centric productive sectors that benefit from global stagflations. Both of these should hold true in 2023, but with some caveats. Saving rates, especially for low-income households, have declined markedly while foodstuff inflation could return if not managed carefully – both potentially hindering future consumption growth. And while commodity exports are likely to remain strong thanks to China's reopening, the more export-oriented manufacturing sectors (like textiles or footwear) could wither due to weak demand from their (primarily) Western markets.

Chart II-1. Indonesia is seen to benefit from two post-pandemic, post-Ukraine growth stories



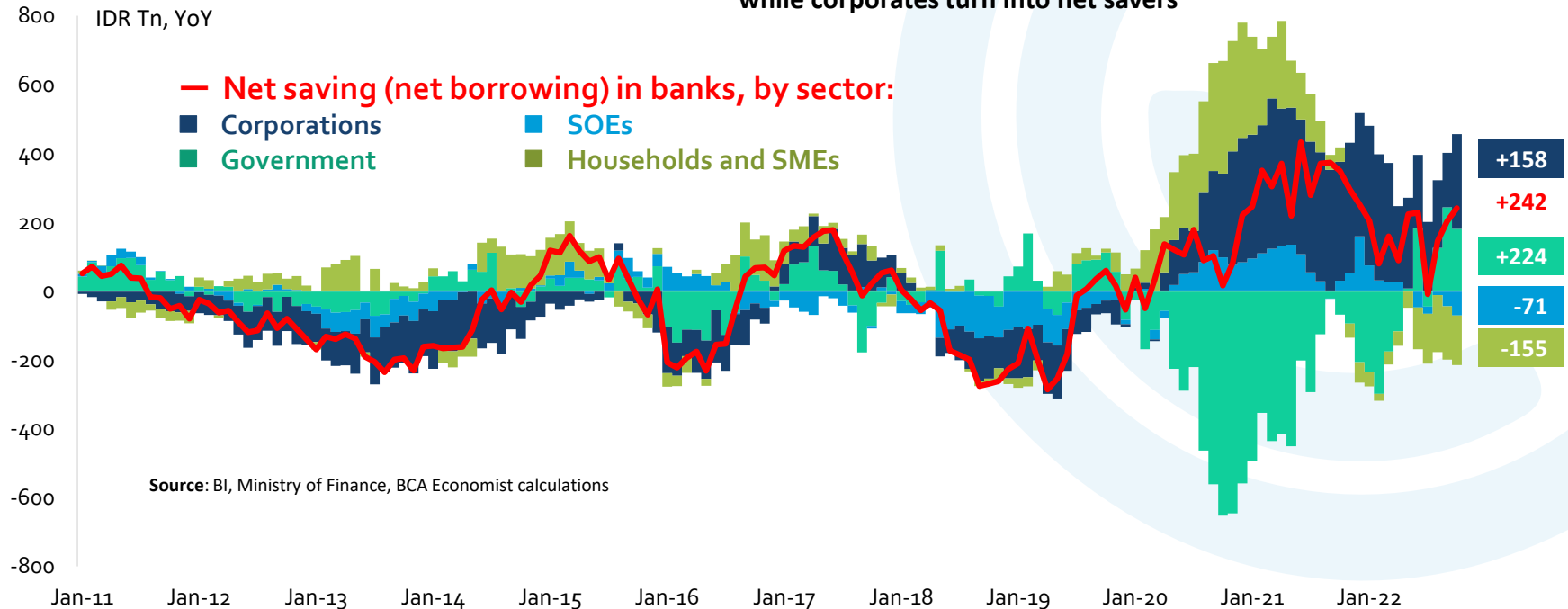
- Indonesia is widely expected to be one of the world's best-performing economies in 2023 – a haven of growth amid the storm of global recession. There are three theses for this resilience. **The first is Indonesia's large and robust internal market, insulating it from the vagaries of global demand. The second is its status as a major exporter of commodities, which puts it in an advantageous position during a tight commodity market.** Both hypotheses have been borne out by past global crises such as the 2008 GFC; the question – which we will discuss in this chapter – is simply whether it would be replicated in the coming global slowdown.
- The third, and perhaps less historically-supported thesis, is that the country would benefit from strong investment growth.** There are several arguments in favor: on the private side, Indonesian corporates have been enjoying bumper profits after two lean years, while FDI numbers have swelled especially by investment into metal processing for batteries. Meanwhile, on the public side, there are multiple outstanding infrastructure projects awaiting completion after having been postponed during the pandemic. These arguments would be examined more closely in **Part 3**.

Chart II-2. Growth in 2022 had been mostly driven by consumption and exports, while investment in structures lagged significantly



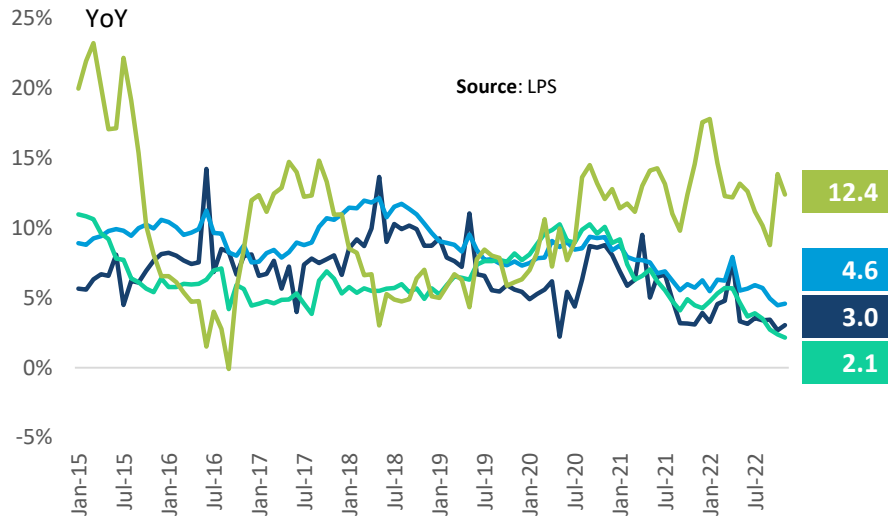
- Support for the first two narratives (rather than the third) comes from the recent composition of GDP growth. It used to be the case, at the height of the pandemic, that growth was sustained almost entirely by fiscal stimulus and the decline in imports. **Since mid-2021, however, consumption has returned once more as the main growth driver, while exports boomed alongside high commodity prices.** On the flip side, investment growth has remained subpar, whereas fiscal contribution to GDP growth turned negative as the stimulus ended.
- However, this growth model is likely to meet diminishing returns. Exports may not reach the same heights if commodity prices normalize from its 2022 heights, while consumption might be maxed out – seeing as it rarely contributed more than 3% GDP growth even during the “middle-class consumption boom” in the early 2010s. **Investment growth, then, is key if Indonesia is to attain strong growth (at 4.5% or higher) in 2023.**

Chart II-3. A paradoxical situation: Households are becoming net borrowers, while corporates turn into net savers



- The difficulty of relying on consumption can be seen from the saving-investment (S-I) gap data, which is of course a reflection of the current account (CA) balance. **The commodity boom has bolstered the CA surplus, and this has accumulated mostly in the form of corporate savings.** The government, meanwhile, has also vastly improved its cash flow situation thanks to increasing revenue from taxes and commodities.
- What is striking, however, is the shift in households' finances (which in BI data is not separated from SMEs). **They were massive savers during the pandemic, but have been net borrowers for a year now. The deterioration in household finances might be even starker than this indicates, as the savings have been devalued by inflation.** There is also a distributional aspect: much of the savings are probably driven by high-income households, while the new borrowings – other than SME loans which are encouraged by the RPIM (inclusive lending ratio) policy – probably skew lower-income.

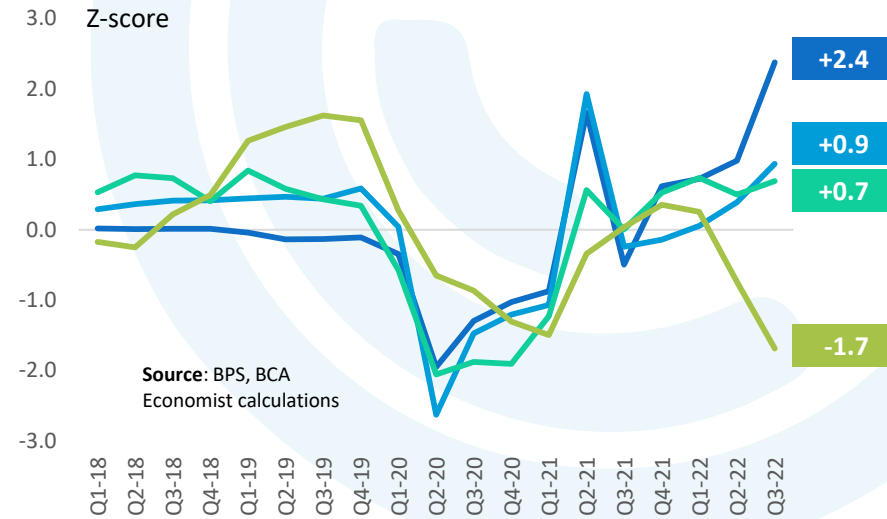
**Chart II-4. Large accounts (corporates, high-income individuals) have shown less growth decline throughout 2022**



**Deposit balance, by size:**

- Less than IDR 100 Mn
- IDR 100 - 500 Mn
- IDR 500 Mn - 2 Bn
- More than IDR 2 Bn

**Chart II-5. Big-ticket and “frivolous” spending, other than real estate, have recovered very strongly**

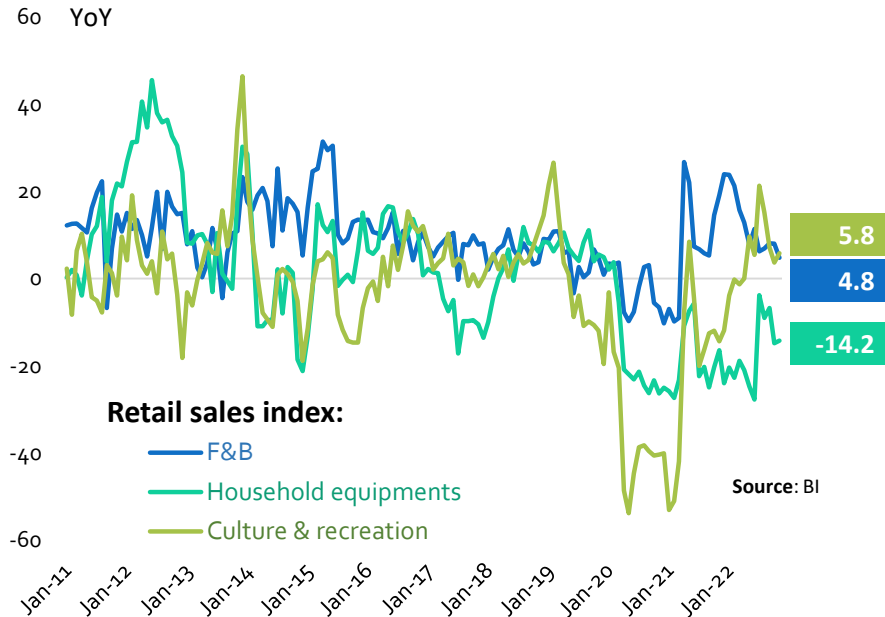


**Sectoral GDP growth:**

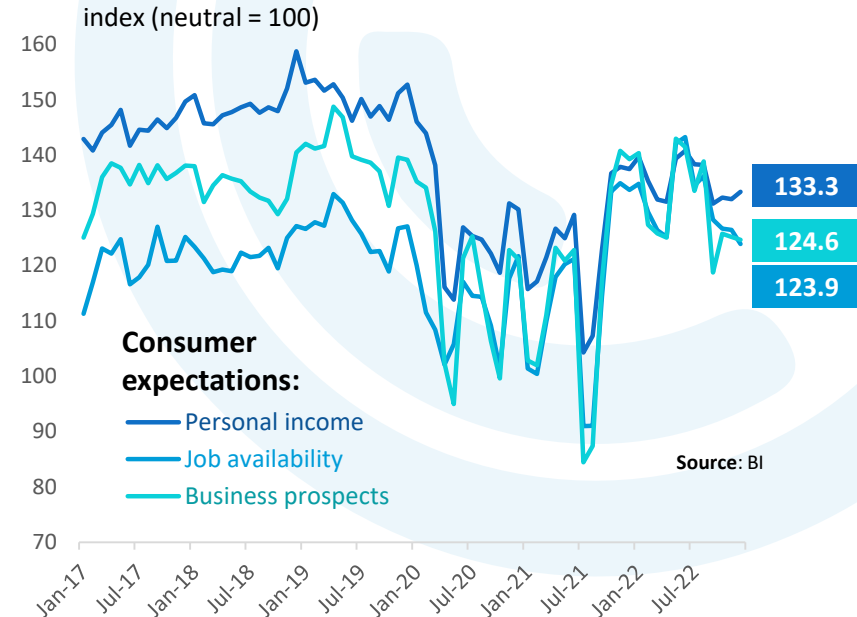
- Hotels
- Restaurants
- Auto sales & repairs
- Real estate

- This distributional effect is apparent when we look at the LPS deposit data, where the largest-denomination deposits – i.e. corporates and the very richest households – seem to have continued their pandemic-era growth trend, while the smaller segments have slowed markedly in 2022. **This strengthens our argument that consumer demand may not grow as fast in 2023, given the lack of savings to tap on.**
- **One area where we can still expect more robust consumption growth, then, are big-ticket and “frivolous” items, which are naturally dominated by high-income households.** This is apparent from the reinvigorated revenue growth for the hospitality sector (hotels and restaurants) as well as motor vehicles. However, this does not seem to extend to the real estate sector, where pre-pandemic oversupply, price inflation for building materials, rate hikes, and the drying up of speculative money all combine to hamper growth.

**Chart II-6. Demand for services and basic goods remains robust, but things are much less rosy for discretionary goods**

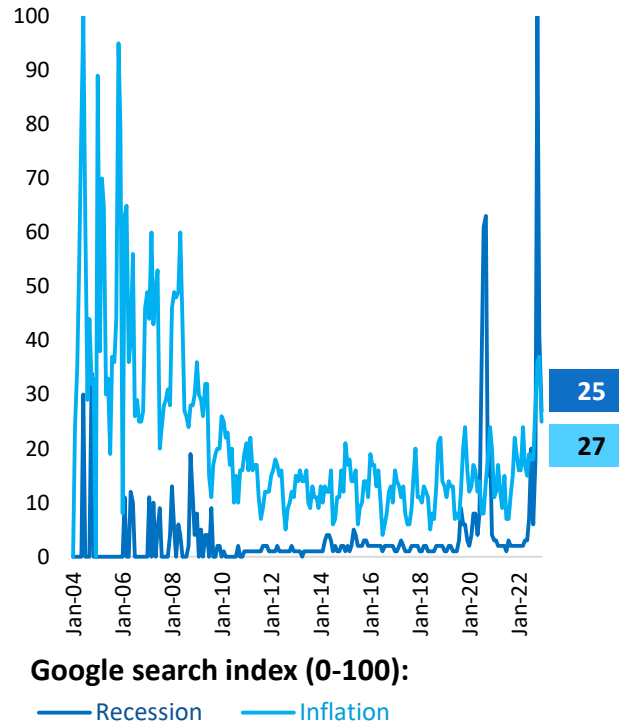


**Chart II-7. Job expectations are softening after a strong recovery, but income expectations are still holding up**



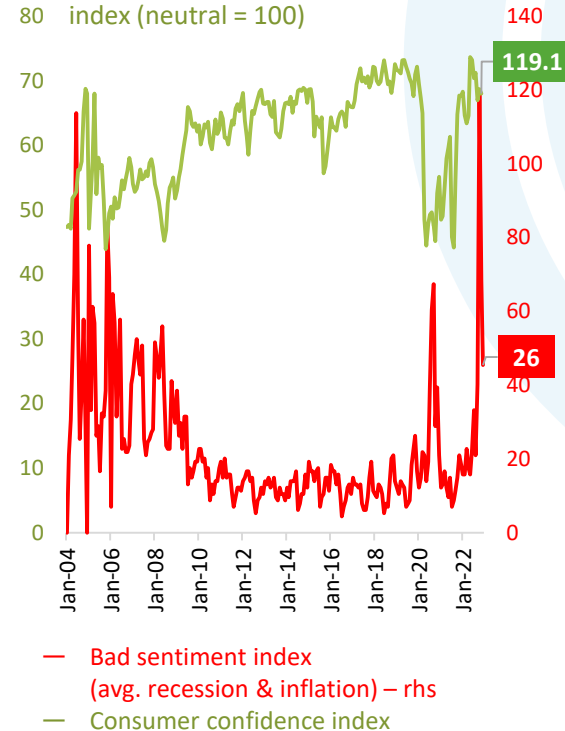
- The less rarified consumption, meanwhile, are softening following a high peak in mid-2022 – as apparent from both BI’s retail survey and our very own BCA Intrabel data. **Nevertheless, this slowdown has not morphed into an outright contraction, and any potential decline would be limited by several factors.**
- The first is the still-strong state of household income. The labor market appeared to have made up for lost times from the pandemic, and while there are clear scarring effects in certain industries such as textiles, overall job availability did recover to a level slightly higher than the pre-pandemic average. Expectations regarding the labor market has indeed turned slightly south in recent months amid global slowdown, **but expected income has not done so – thanks in part to an increase in minimum wages that keeps up in relative terms with inflation.**

**Chart II-8. Recession fears have risen lately, exceeding the usual inflation fears ...**

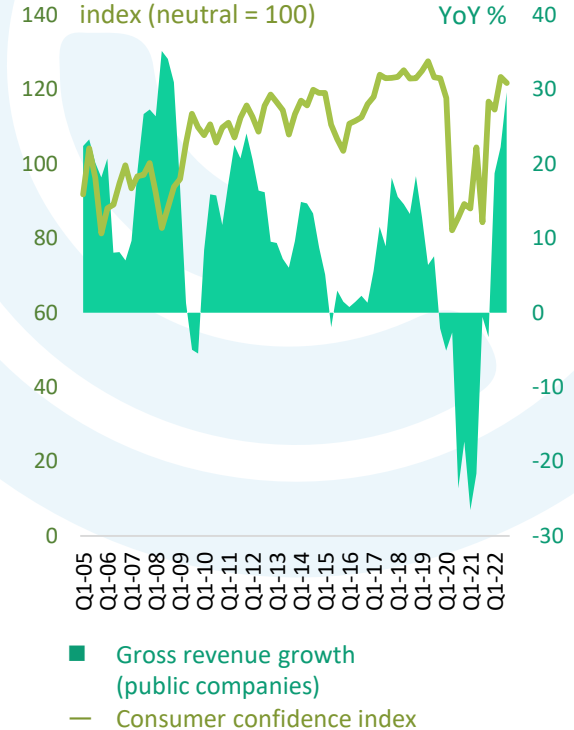


Source: Google Trends, BI, Bloomberg, BCA Economist calculations

**Chart II-9. ... which fortunately has only marginal effect on consumer confidence ...**

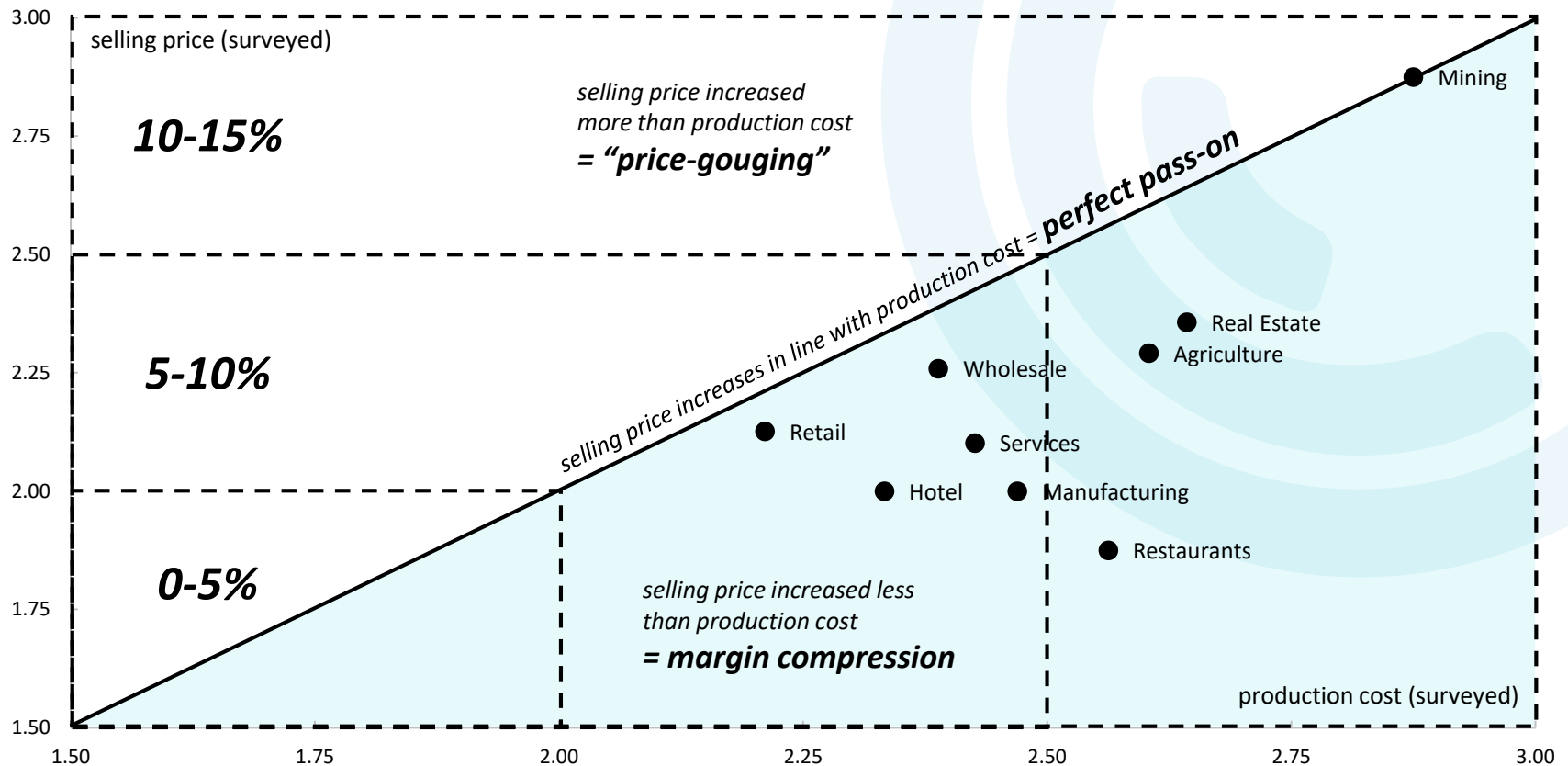


**Chart II-10. ... and in turn limiting its impact on corporate revenue**



- The other factor is the moderate inflation, even after September's fuel price hike. **Indonesian consumer sentiment tends to be more sensitive to inflation, especially that of basic necessities, rather than recession or unemployment – and this is even truer for low-income households, who tend to be employed in the informal economy.** As such, while recession fears seem to be at an all-time high – not helped, of course, by breathless discussions in the traditional and social media – the impact on consumer confidence is more muted compared to past fuel hikes (2005, 2008, 2013-14) or the Covid-19 lockdowns which disproportionately affected the informal sector.

Chart II-11. Businesses are still mostly reluctant to pass on their cost increase to customers

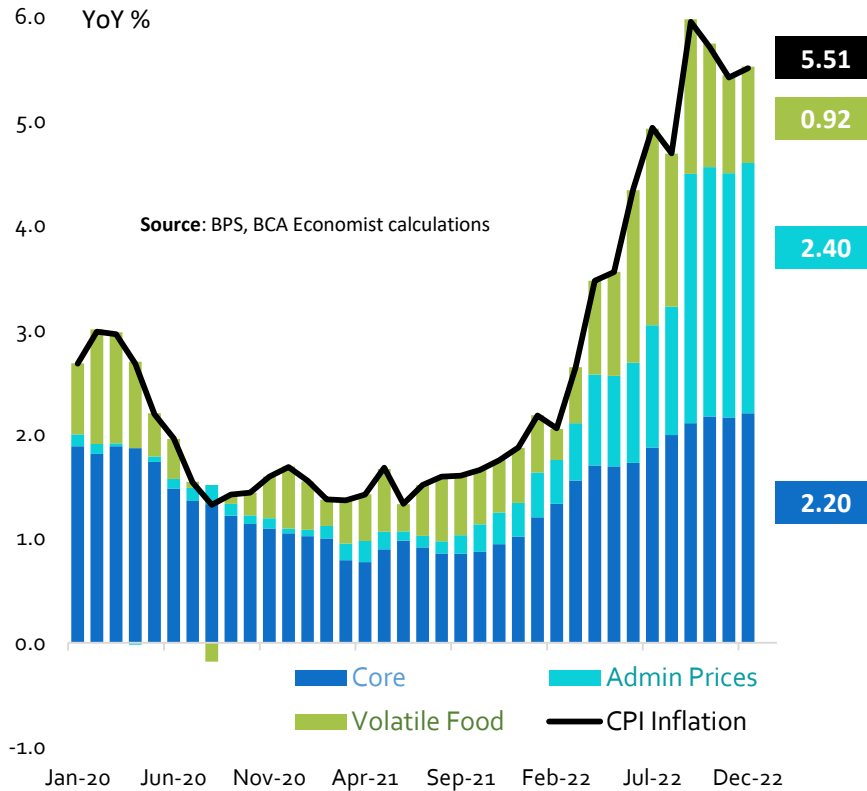


Source: BCA Business Survey, BCA Economist calculations

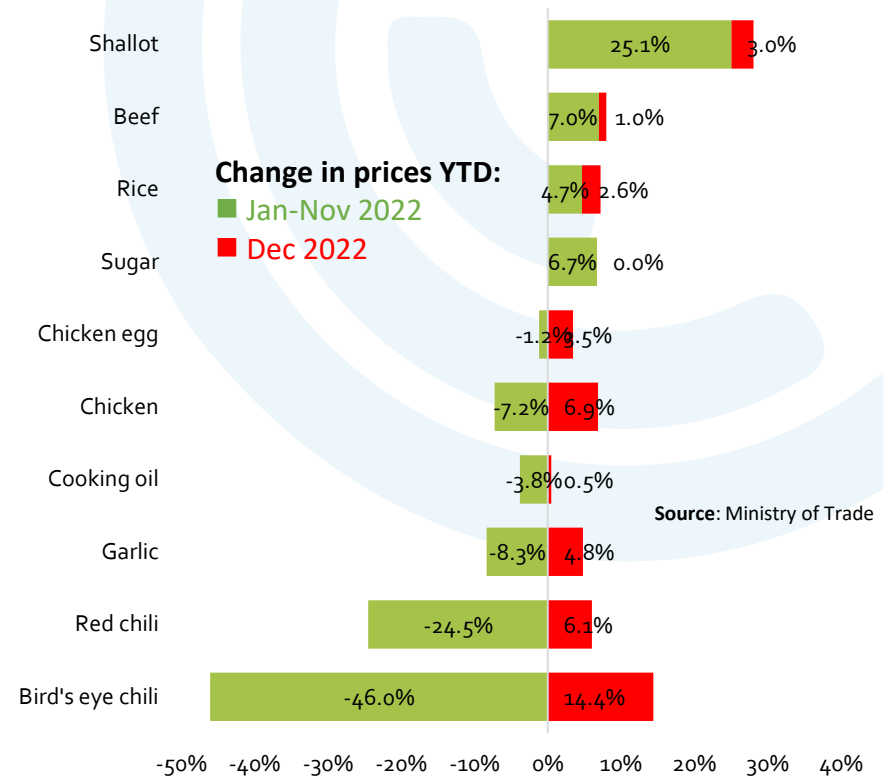
- One thing that helps suppress inflation is the relative reluctance of sellers to pass their rising cost on to consumers. **Our survey of BCA clients found that, on average, businesses faced around 8.9% increase in their cost structure between H1 and H2-22, but only raised their selling prices by 6.5%.** This is partly a tactical choice on the part of the companies – sacrificing margins for greater volumes amid the recovery – and one that is also enabled by the healthy savings buffer that it has enjoyed since the start of the pandemic.



**Chart II-12. The impact of fuel price hike had been cushioned by food deflation, but this might be changing soon ...**



**Chart II-13. ... as the prices of many foodstuffs, particularly rice, began to rebound**



- The lower-than-expected inflation is also the product of a food deflation in H2-22, which offset the impact of the fuel hikes. **While many parts of the world struggled with droughts and other weather anomalies, La Nina's impact on Indonesian agriculture had been less malign** – only shallot, which favors drier conditions, saw marked disruption. Unfortunately, this situation is starting to reverse late in the year, as food stocks thin out and rising production costs (especially for fertilizer) are becoming more acutely felt, none more so than for the all-important commodity of rice.

Chart II-14. Global disinflation is starting to take hold, as evidenced by the sharp decline in imported prices ...

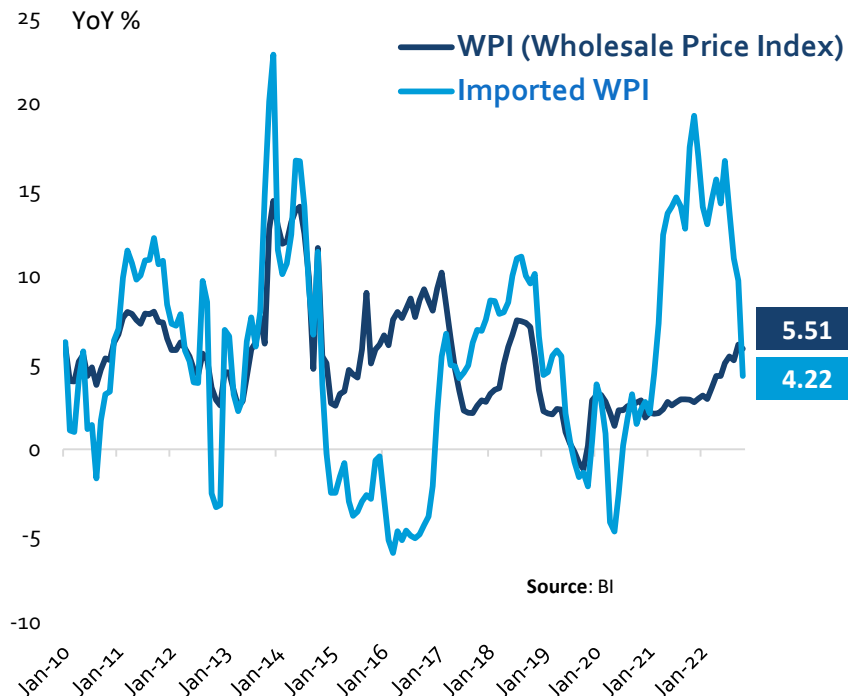
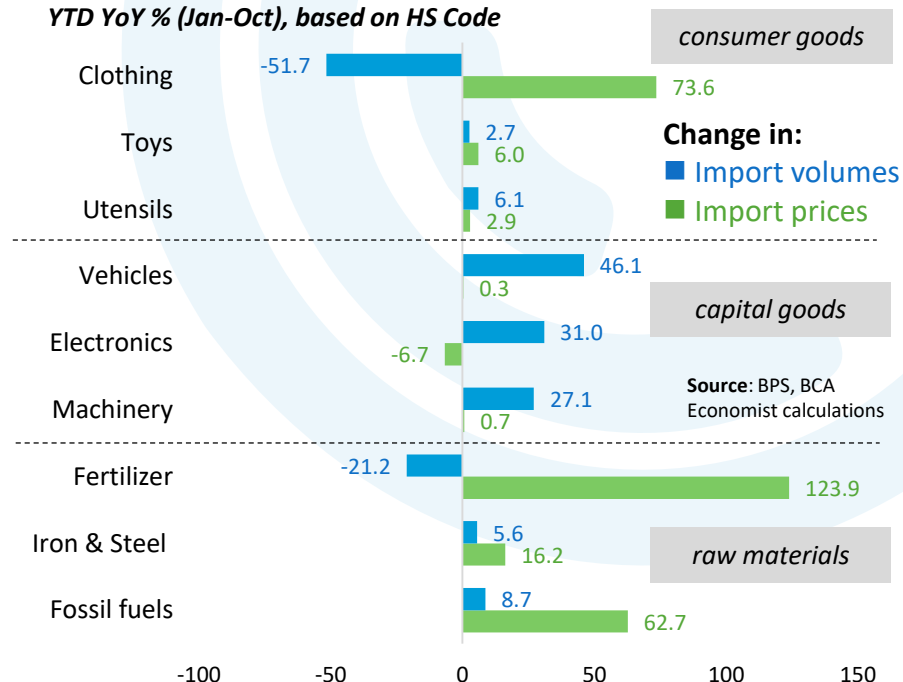


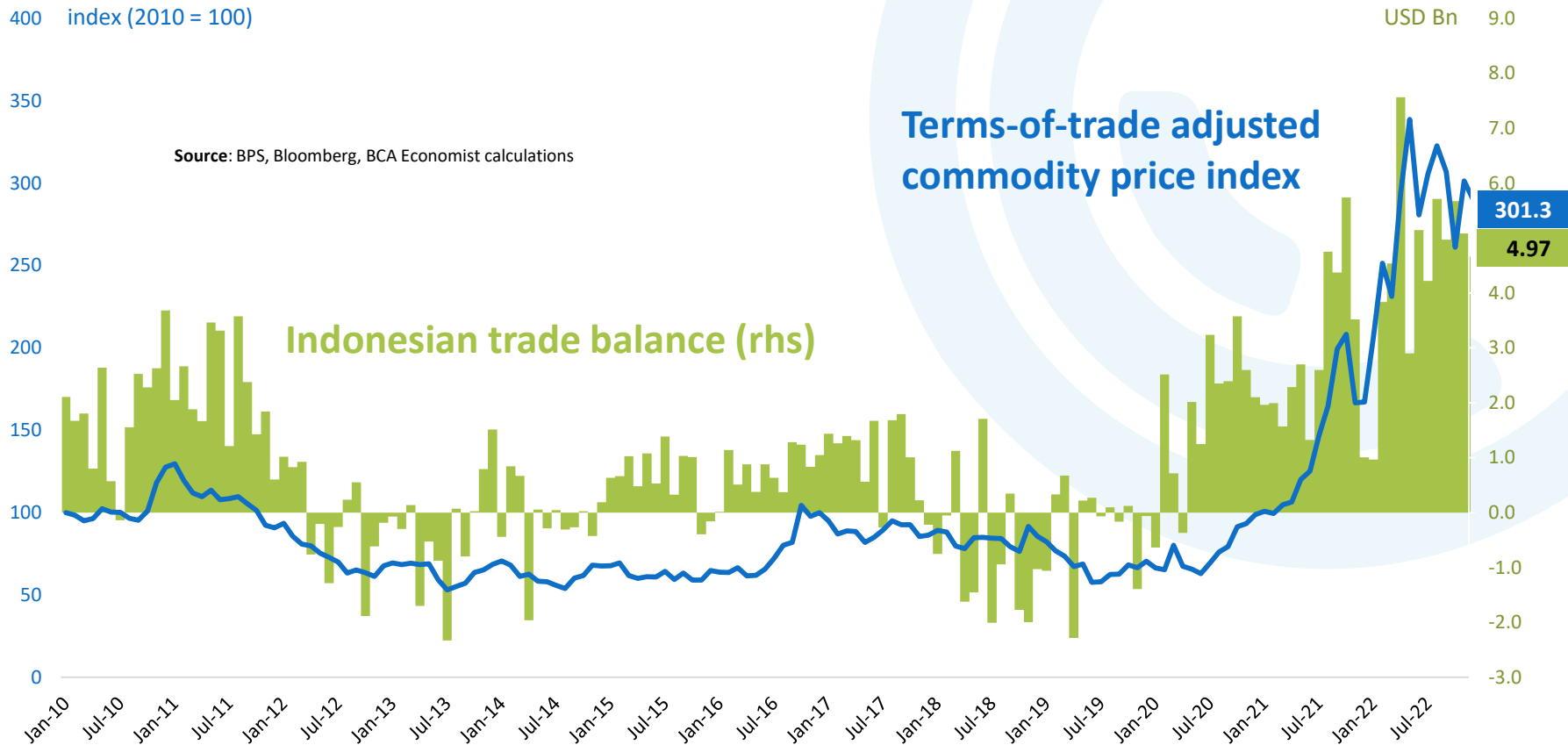
Chart II-15. ... particularly for consumer and capital goods, whereas prices of raw materials remain mostly elevated

YTD YoY % (Jan-Oct), based on HS Code



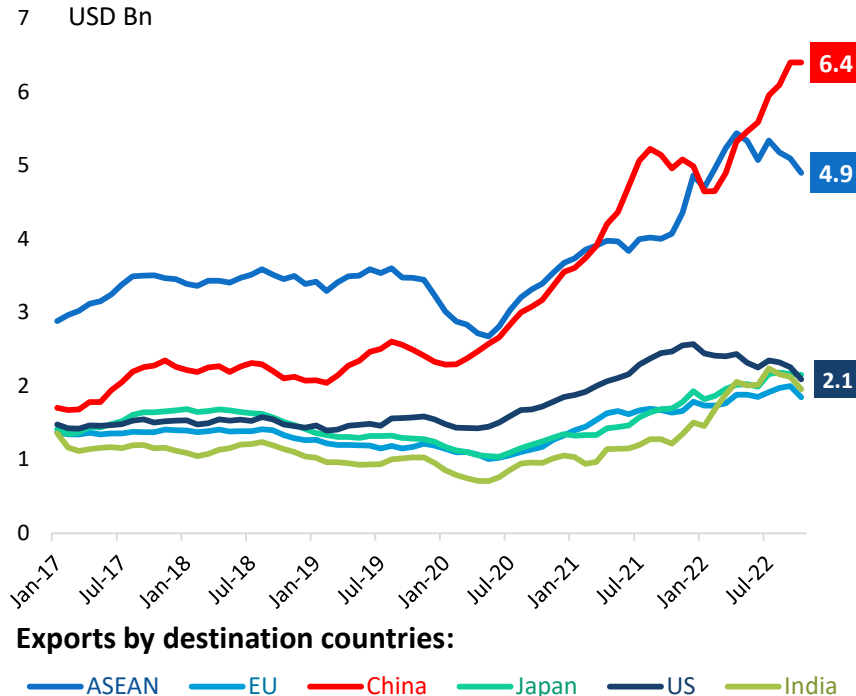
- But even if margin compression and food deflation may be reversed, there is one more factor that should help curb inflation in 2023, namely the ongoing global disinflation. Imports have begun to decline, and much of it is driven by lower prices rather than lower volumes. In fact, much of the fluctuations in import values during the past two years (particularly for raw materials) have been price-driven, while volumes have been steadier – meaning that the recovery in 2022 had been less dependent on imports compared to previous booms. Still, **the fact that consumer goods imports are declining faster, volume-wise, relative to capital goods, comport with our view that investment – rather than consumption – is the one key part of the GDP that still has room to accelerate in 2023.**

Chart II-16. Prices of commodity exports rise more than imports, continuing the trade surplus trend



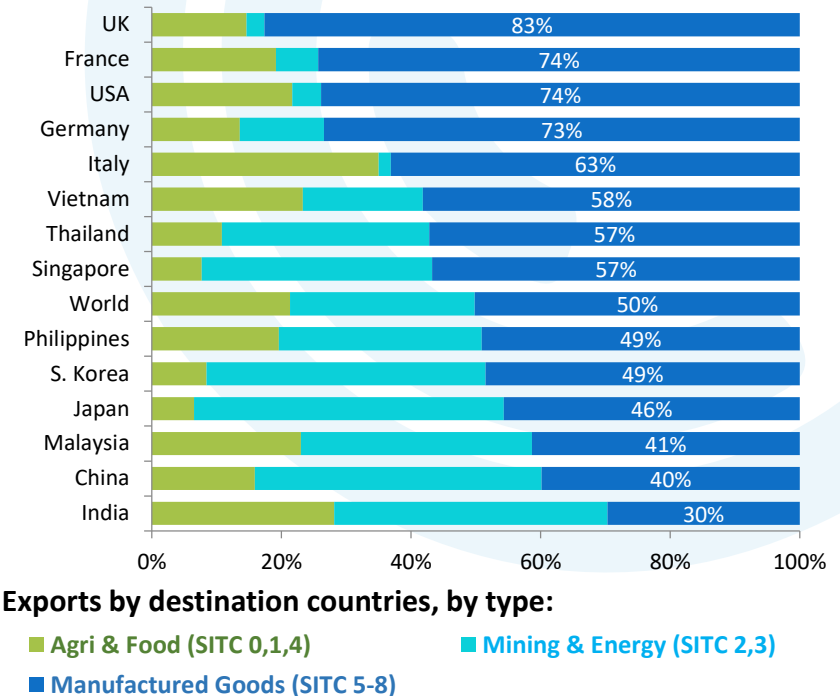
- If prices were the main determinant of import growth, the same is also true for exports – and so declining commodity prices as the global economy slows is also liable to depress exports. **However, this decline does not necessarily mean that the massive trade surpluses in 2021-22 would evaporate, especially if coal price remains elevated while CPO and nickel potentially stage a recovery as Chinese demand returns.** All in all, we think net exports may well contribute negatively to *real* GDP growth in 2023, but the trade surplus is likely to remain albeit at a narrower level.

**Chart II-17. Indonesian exports are increasingly directed towards China, India, and other ASEAN countries ...**



Source: BPS

**Chart II-18. ... which unfortunately also means greater reliance on exports of commodities**



Source: UN Comtrade, BCA Economist calculations (percentage excluding SITC 9)

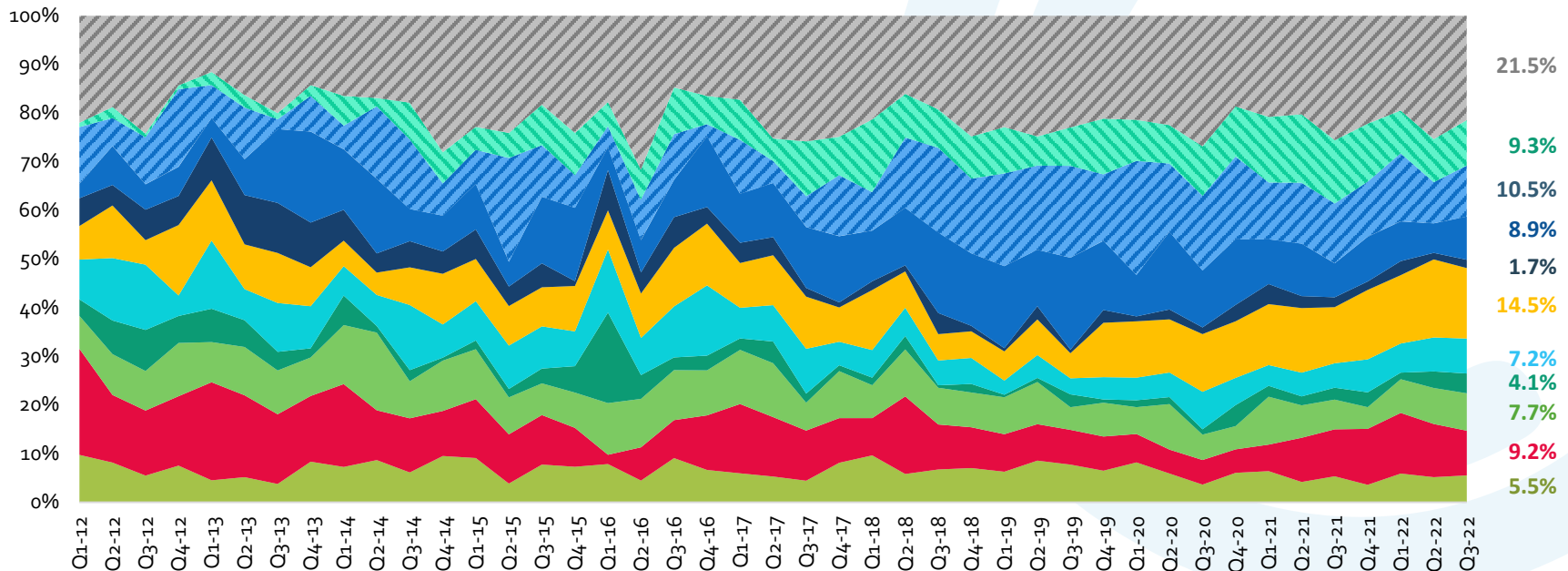
- There is, however, a real risk that Indonesia's exports would become even more reliant on commodities in 2023. Of the major export destinations, demand from Europe will probably contract the furthest, but the US and other advanced economies may not be far behind. However, it is precisely these countries that import more manufactured products from Indonesia, whereas countries like India and China that are expected to support global growth in 2023 purchase mostly raw materials from Indonesia. This is something that we should keep in mind as we discuss investment outlook in the next chapter.

# #3: Investment and fiscal policy

## High hopes, low ceiling?

The Jokowi administration's hopes to transform the Indonesian economy rest on strong investment growth, whether public, private, or foreign. After the Covid-19 interruption, investment growth is set to rebound, but is bumping up against multiple constraints. Fiscal policy as a motor of CAPEX is now weaker as subsidies and debt service burden grew, while the private sector (other than the flourishing commodity sectors) are more cautious after the financial hit from the pandemic. Investment growth, then, would rely on the supercharged FDI and DDI into commodity-related sectors, while Indonesia may struggle to benefit from the wave of industrial relocation from China.

Chart III-1. The recent investment boom has been fueled by mining and metals



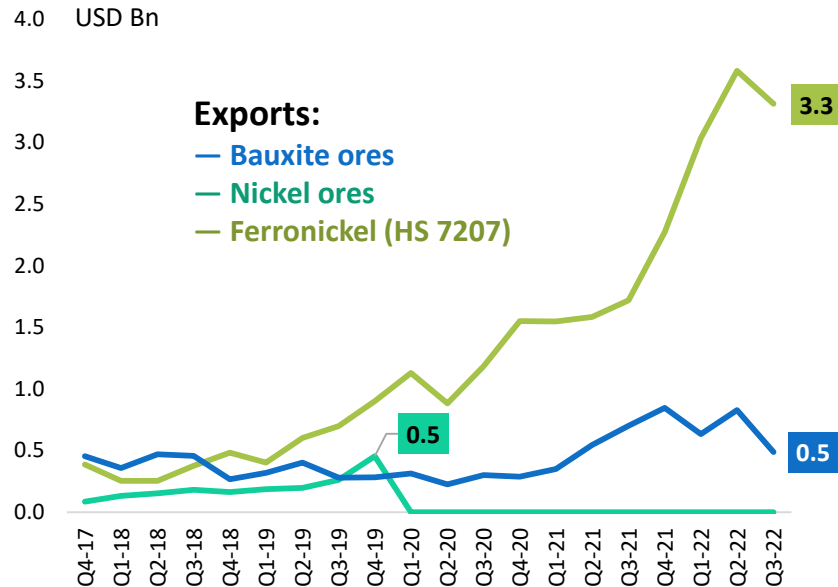
## Investment (FDI &amp; DDI), by sector:

Source: BKPM



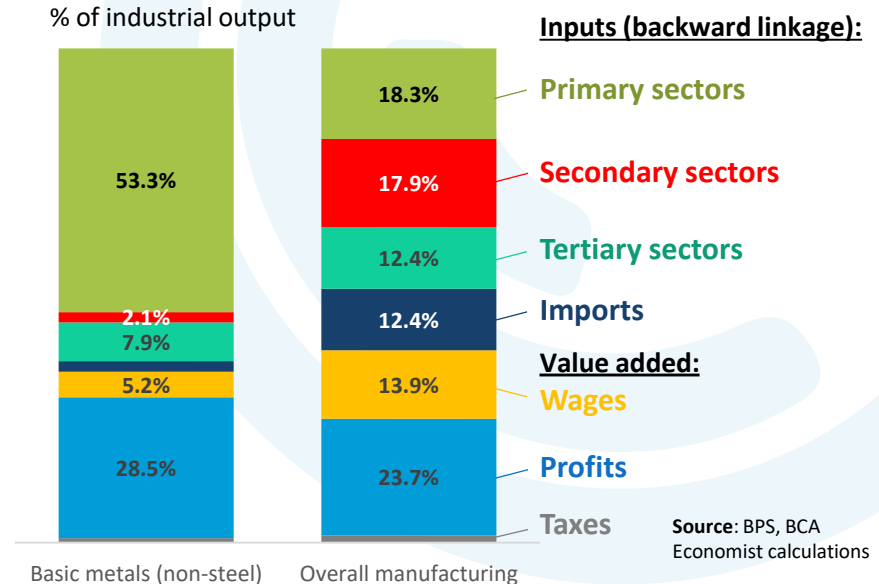
- Investment presents an interesting case: despite the all-time high FDI numbers, actual contribution of investment to growth has been rather limited, and was notably weak for structures/buildings which typically makes up most of investment in previous years. The answer to this lies in the changing sectoral composition of the investment.
- While the bulk of investment growth during “peak Jokowiomics” years were DDI into the utilities, logistics, and real estate sectors (all structures-based), recent investment are driven more by FDI into mining and metal processing (more machinery-based).** There is also a substantial gap between the FDI figures as reported by BKPM and actual monetary flows reported by BI, which could be a sign of a delay between when investment deals are signed and when they are executed – and these delays are becoming longer amid rising global uncertainty.

Chart III-2. The government's ban on nickel ore exports has successfully increased export value (but mostly nickel pig iron)



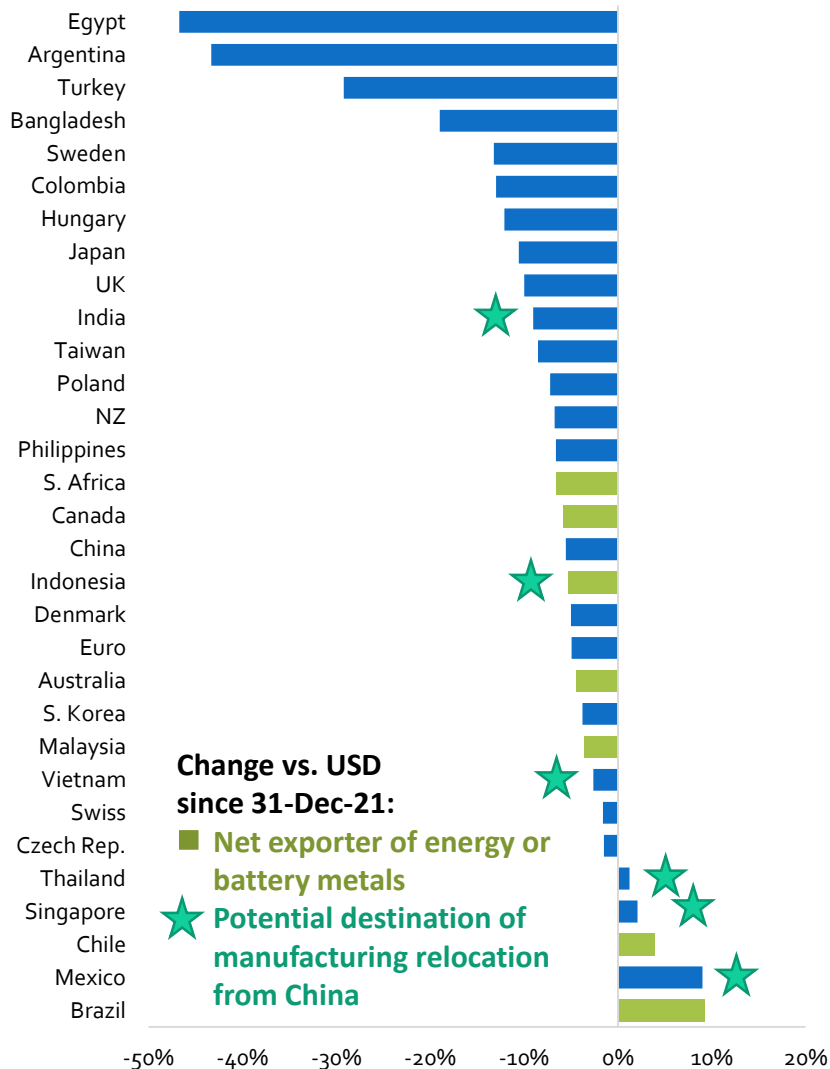
Source: BPS

Chart III-3. But the burgeoning base metal industry has little impact on workers' income and other domestic industries



- As such, the government's ambition to create an "electro-state" that benefits from the global energy transition – while astute in the long-run – may not be enough to offset the effects of the global slowdown in the short-run. **Furthermore, while its impact on GDP growth is clear, Indonesia's base metal sector has limited backward linkages with other domestic industries, and it also returns relatively small share of its surplus value to workers (instead of shareholders who may repatriate it abroad), meaning that the spillover to the domestic economy could be limited as well.**
- The benefit from this sector, then, comes mainly in the form of FX inflows, both from the initial FDI and the extra value-added from processing the metals rather than exporting the raw ores. The former has worked beautifully as noted, as has the latter in the case of nickel – but it would entail some sacrifice in the short-term as the government plans to ban bauxite exports in a bid to replicate the success with another metal (aluminum).

**Chart III-4. Energy exporters and countries that benefit from industrial relocation had been more resilient against the Dollar in 2022**

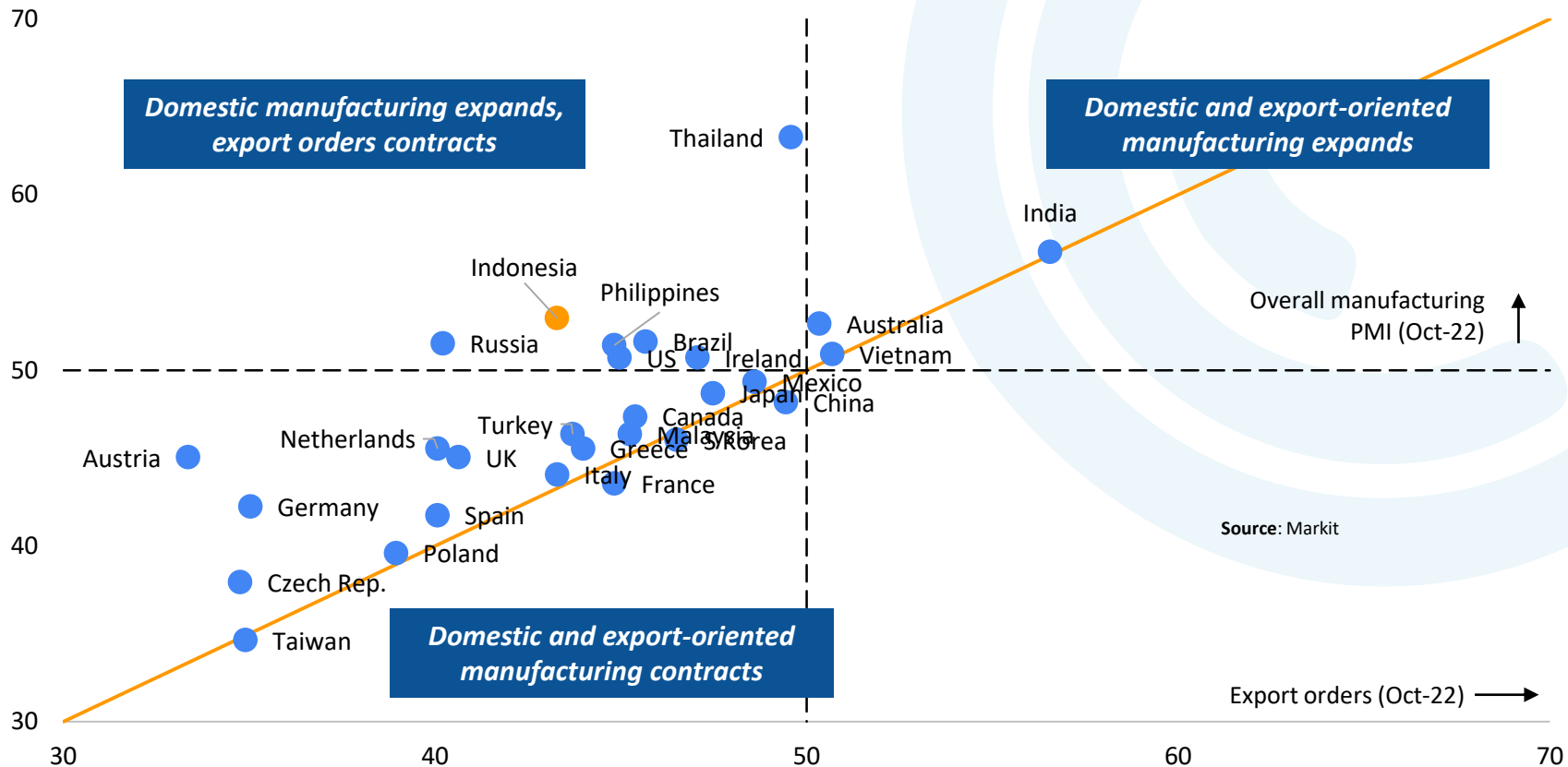


Source: Bloomberg (data per 16-Jan-23)

- The other transformation story, aside from battery metals, is the creation of new manufacturing hubs in several emerging markets, as Western economies (particularly the US) hastens their decoupling with China. There have been slow-but-steady reports of companies shifting part of their supply chains to India or Vietnam, and this appears to have helped these countries' currencies amid the USD onslaught in much of 2022.
- **On paper, Indonesia could become a contender in this “relocation sweepstakes”, as it was an emerging manufacturing hub before the 1998 Asian crisis and the entrance of China into WTO.** This is also a big rationale behind the Omnibus Law on Job Creation, which unfortunately hit a snag last year on technical grounds. While the law has indeed been revived as a Perppu (government regulation in lieu of bill) and the regulations stipulated in it – including those on labor compensation – have stayed in place, the uncertainty in the interim did little to quell concerns about the regulatory climate in Indonesia.



Chart III-5. Indonesian manufacturing activities are held up by domestic demand, but it is missing out on the “industrial relocation sweepstakes”



- The proof, unfortunately, is in the pudding that Indonesia is hardly benefiting from industrial relocation. The recent Indonesian manufacturing PMI data showed that – while the headline numbers have stayed above 50 – export orders have shown sharp decline, nearly on par with Russia or the European countries suffering from energy crisis. This is a far cry from India and Vietnam, or indeed Thailand and Mexico, which have also emerged as prime relocation candidates. **It is clear, then, whatever is benefiting Indonesian exports, it is not manufacturing (but rather commodities); and whatever is driving the manufacturing sector, it is not global demand (but rather domestic demand).**

Chart III-6. Corporate earnings have recovered, but CAPEX seems to be slowing again ...

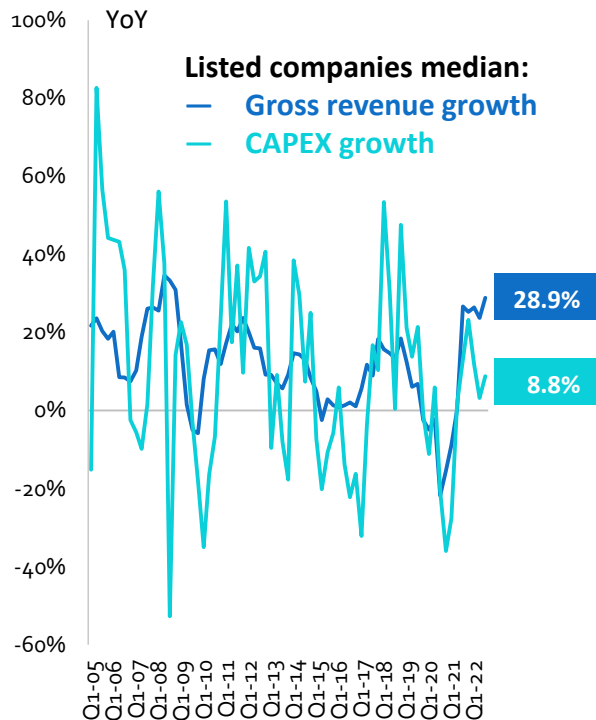


Chart III-7. ... as companies tend to adopt a more cautious balance sheet posture ...

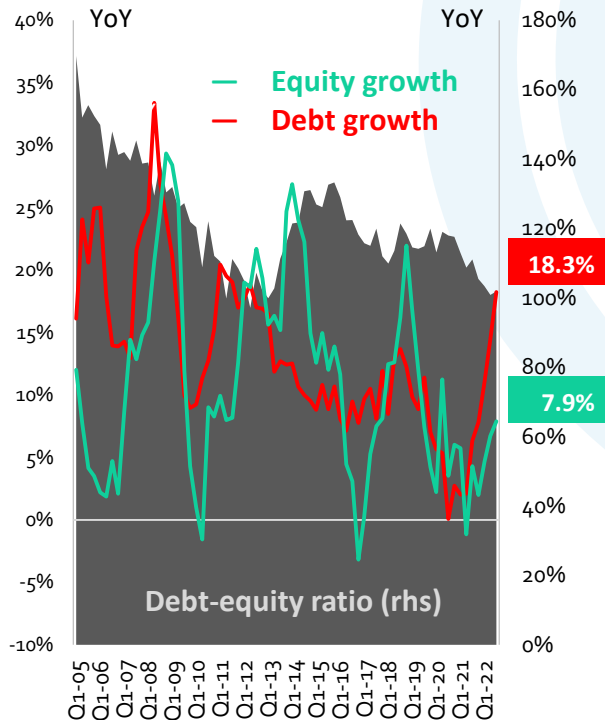
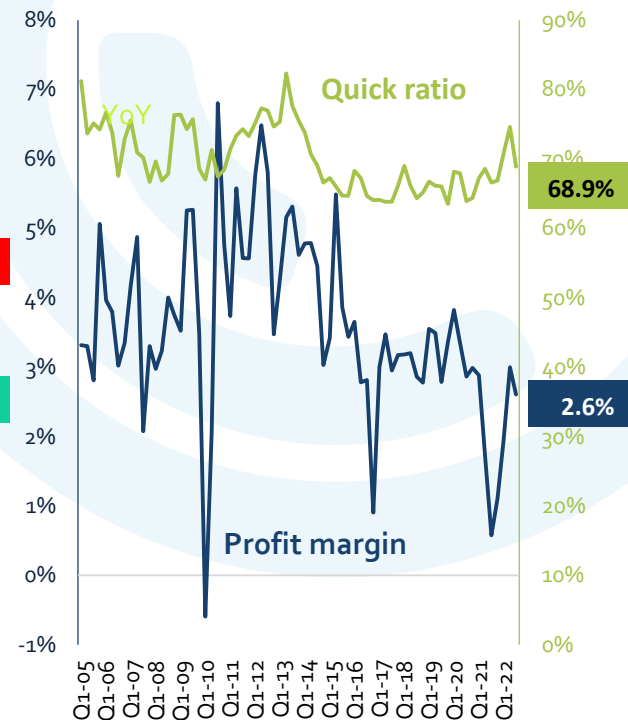


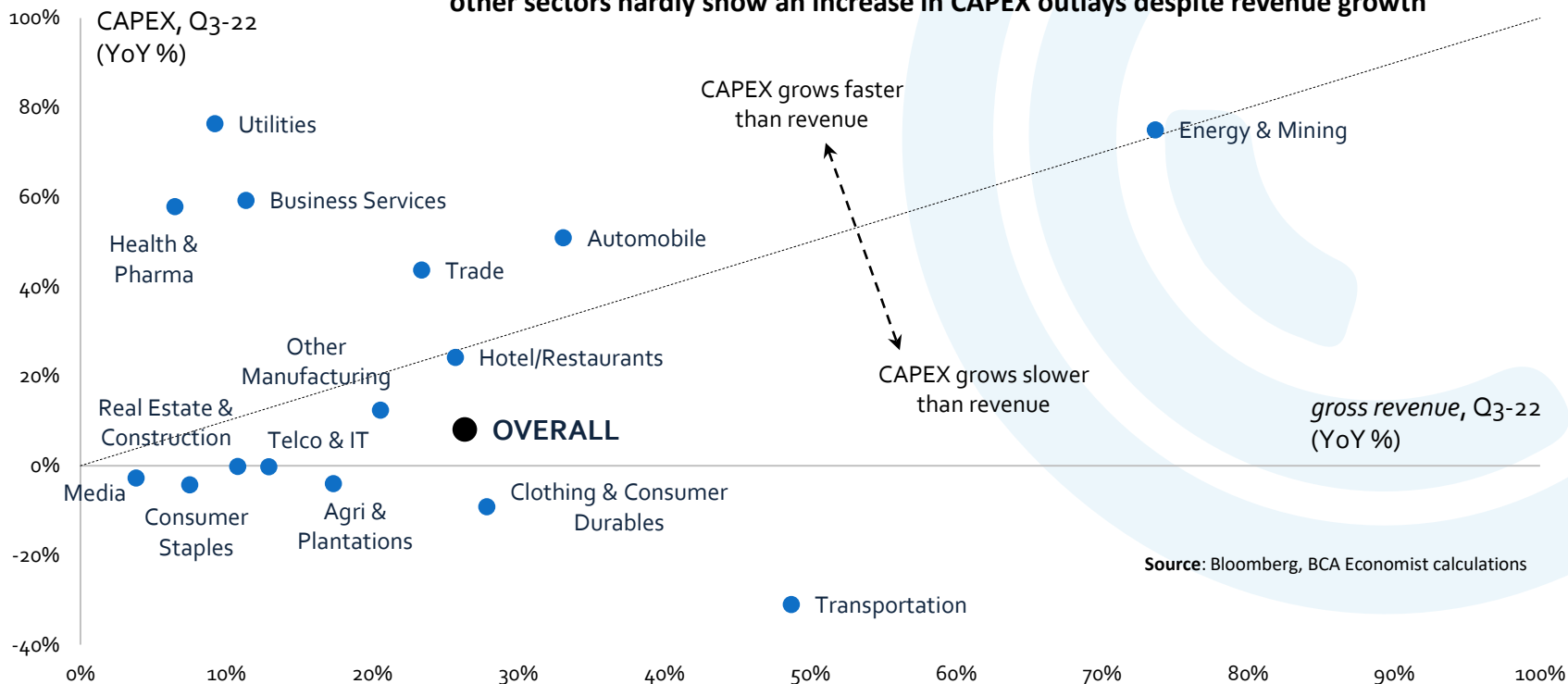
Chart III-8. ... despite their profitability and liquidity having normalized



Source: Bloomberg, BCA Economist calculations

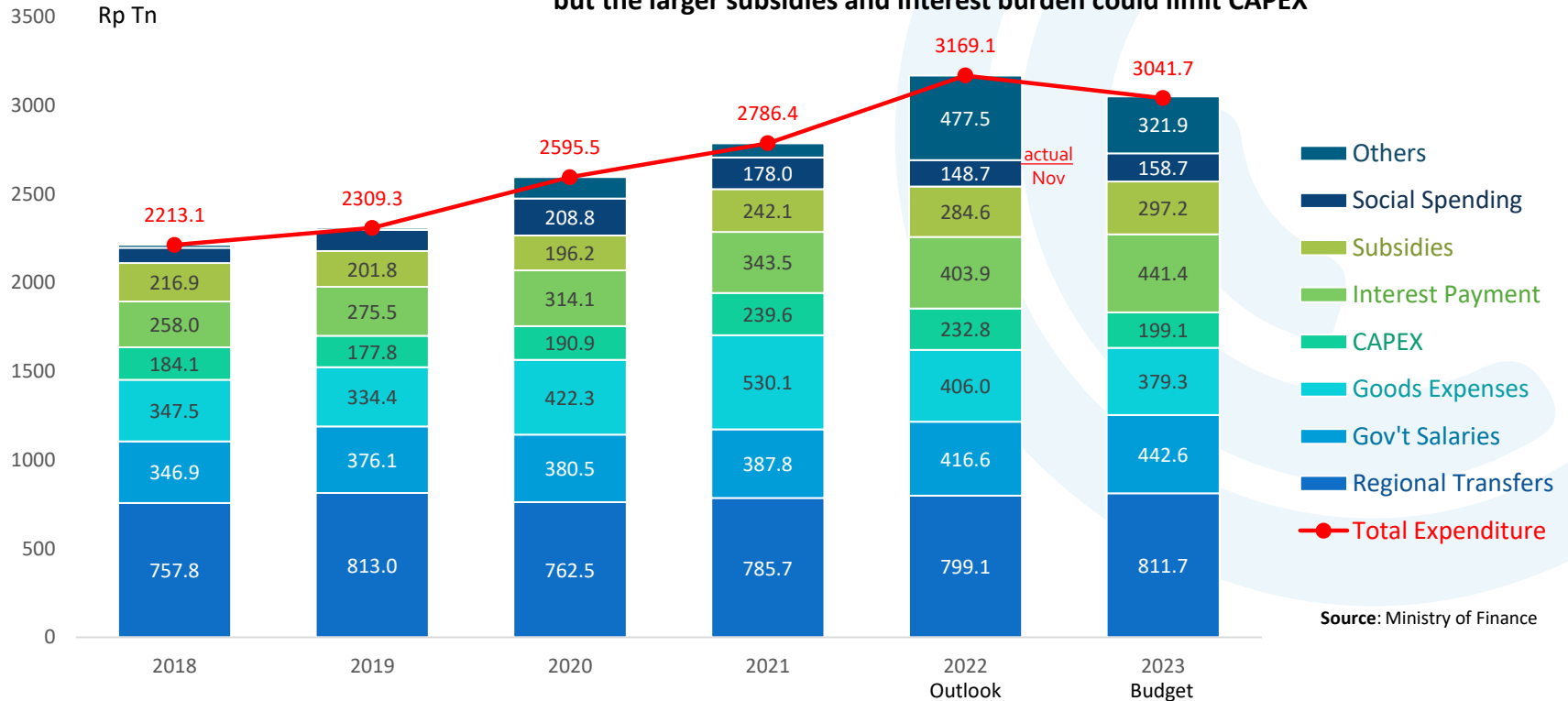
- Moving on to domestic investment, we can see that CAPEX growth has slowed down since the start of the year, even as revenue growth has stayed robust. **Corporate financial data as a whole paint a picture of a rather conservative stance, with equity growing faster than debt – and this reluctance to take on new debt would only be strengthened as BI rate hikes are gradually transmitted into higher loan rates.** On the flip side, the declining leverage as well as improving profitability and liquidity indicators imply that credit risk should remain manageable, and the risk of a systemic problem in the financial sector remains remote – even accounting for the impact of an incipient global recession.

**Chart III-9. Investment growth is driven mostly by energy/mining, while many other sectors hardly show an increase in CAPEX outlays despite revenue growth**



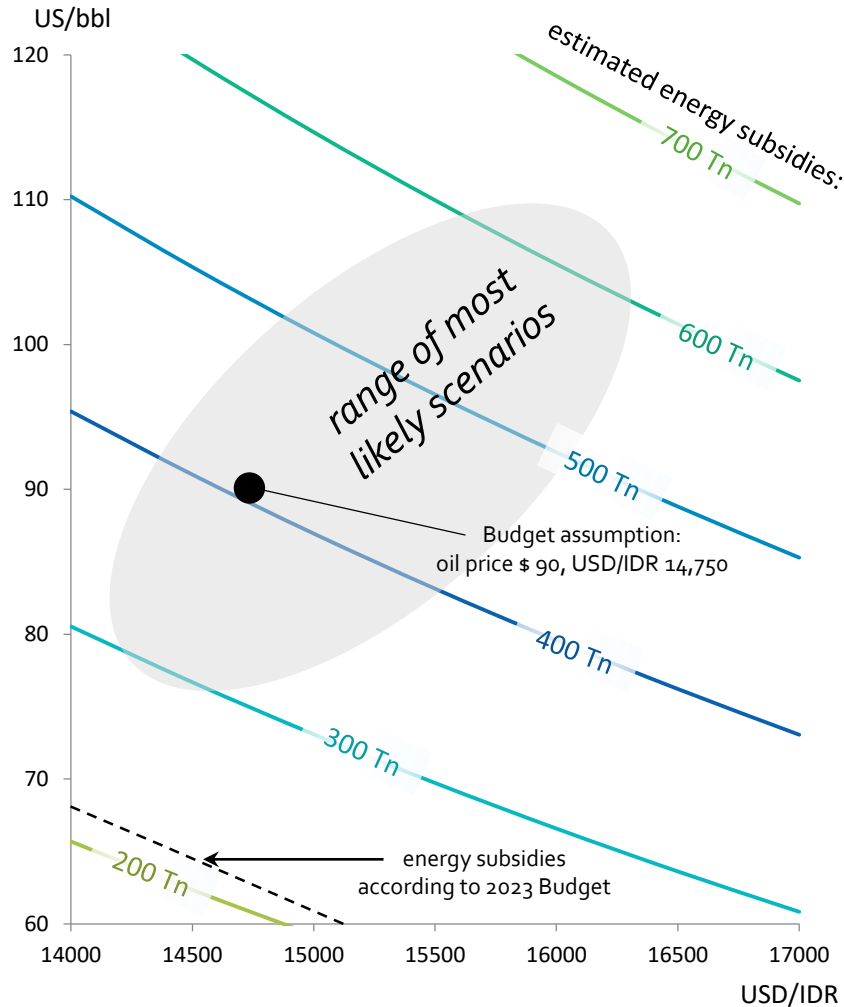
- Interestingly, while it is the primary sectors that have fueled the current account surplus (and therefore net savings), the appetite for CAPEX is more markedly weaker in non-commodity sectors, many of which are still prioritizing **balance sheet repair rather than expansion**. Fluctuating prices (esp. for CPO) and rising input cost (esp. for transport) are also likely to affect businesses' decision to delay investment.
- Even the strong investment growth in mining/energy should not be seen as a simple matter of expanding capacity (say, opening new mining sites). Rather, it is part of a broader, long-term strategy to adapt to the new realities of the global energy/commodity market – ore exporters investing in smelters, or coal companies investing in renewable energy. **This new approach implies less immediate returns – “less bang for the buck” – despite the long-term potentials.**

Chart III-10. The government is reining in its pandemic-era spending, but the larger subsidies and interest burden could limit CAPEX



- If private investment is limited more by appetite than by finances, then public investment is the opposite. After a three year period where the government enacted extraordinary measures to deal with Covid-19 – budget deficit over 3% of GDP, BI absorbing government bonds (SBN) at below-market rates as part of “burden sharing” – 2023 will mark a return to budget normalcy.
- Unfortunately, the legacy of the pandemic means that interest payment is now taking a bigger bite out of the budget (from 1.7% of the GDP in 2019 to 2.0-2.1% in 2023), while higher energy prices implies the same with subsidies (from 1.3% to 1.4-1.5%). Both these leave **less room for discretionary spending, including CAPEX**, whose share of the GDP is thus slated to decline (from 2.1% to 1.7%).

**Chart III-11. The energy subsidies (fuel, LPG, and electricity) will likely exceed what has been earmarked in the State Budget**



Source: Ministry of Finance, Pertamina, PLN, Bloomberg, BCA Economist calculations

- Furthermore, as in 2022, the subsidy budget might underestimate the extent to which the government had to spend to control energy prices. Part of the gap between global and domestic retail prices has been shouldered by the two energy SOEs (Pertamina and PLN), and the government in turn had to compensate for their losses. Adding these to the topline subsidy budget would mean that energy subsidies amount to around 2.5% of the GDP in 2022.
- The picture does not look that different for 2023. Falling prices for oil and gas certainly helps, but this is offset by the Rupiah's depreciation and the expected increase in volumes consumed – to an extent that in order for energy subsidies to stay within the Rp 210 Tn budget, the oil price would have to fall to the unlikely price of USD 60 per barrel or less. **As there is little political sense in raising fuel prices during a slowdown and ahead of an election year, we expect the government to continue bearing the burden.**

Chart III-12. The strong fiscal revenue growth in 2022 was driven both by economic growth ...

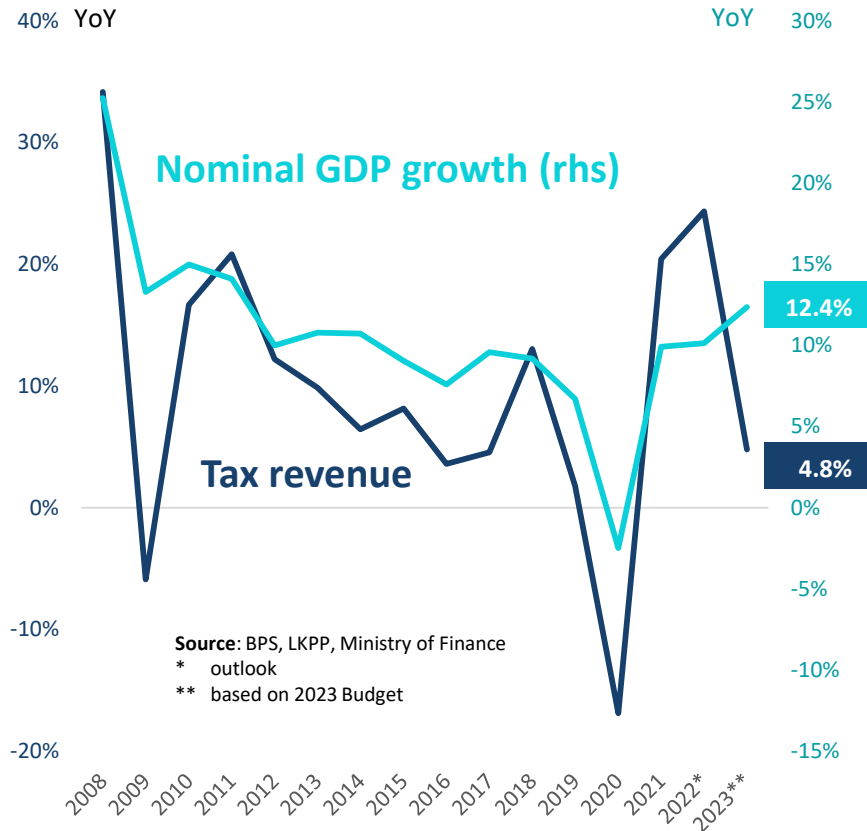
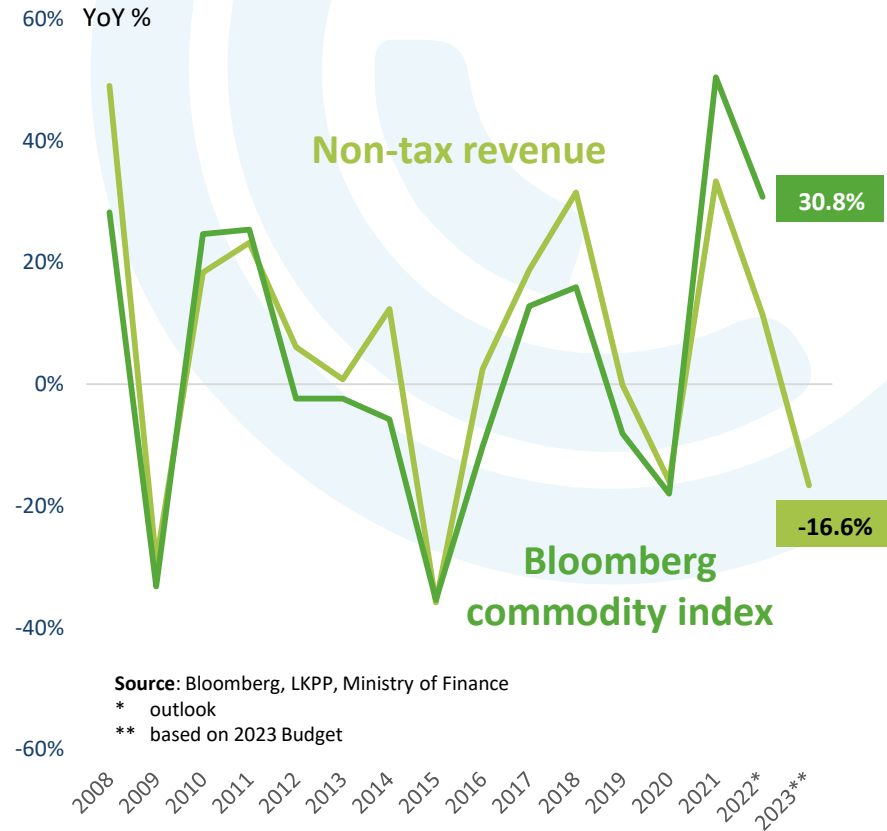
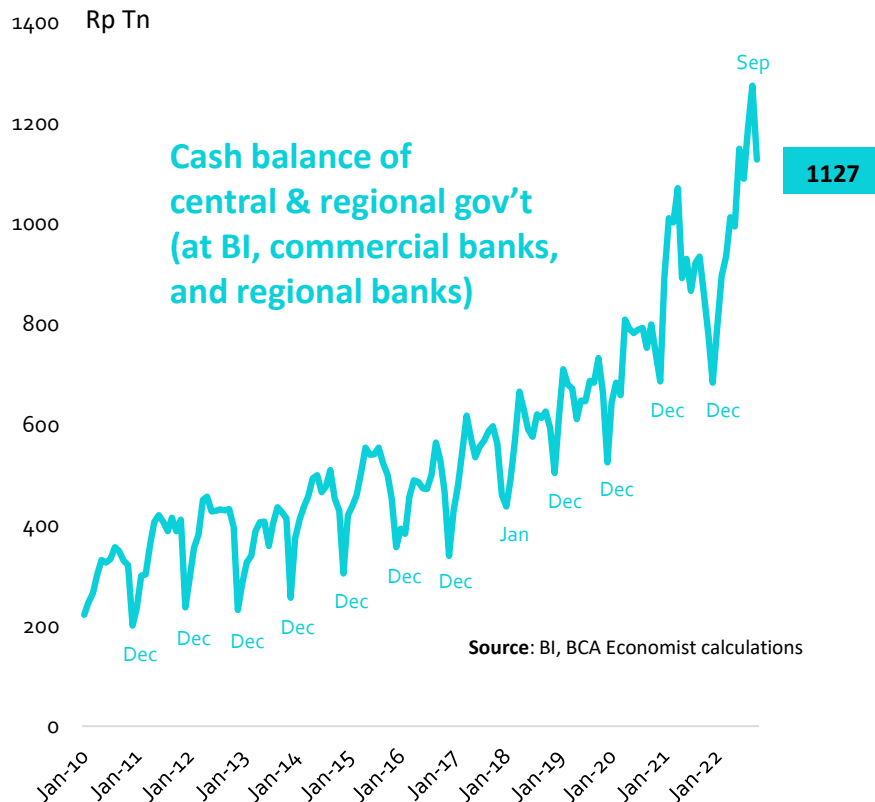


Chart III-13. ... and by rising commodity prices, both of which the government assumes may not be repeated in 2023

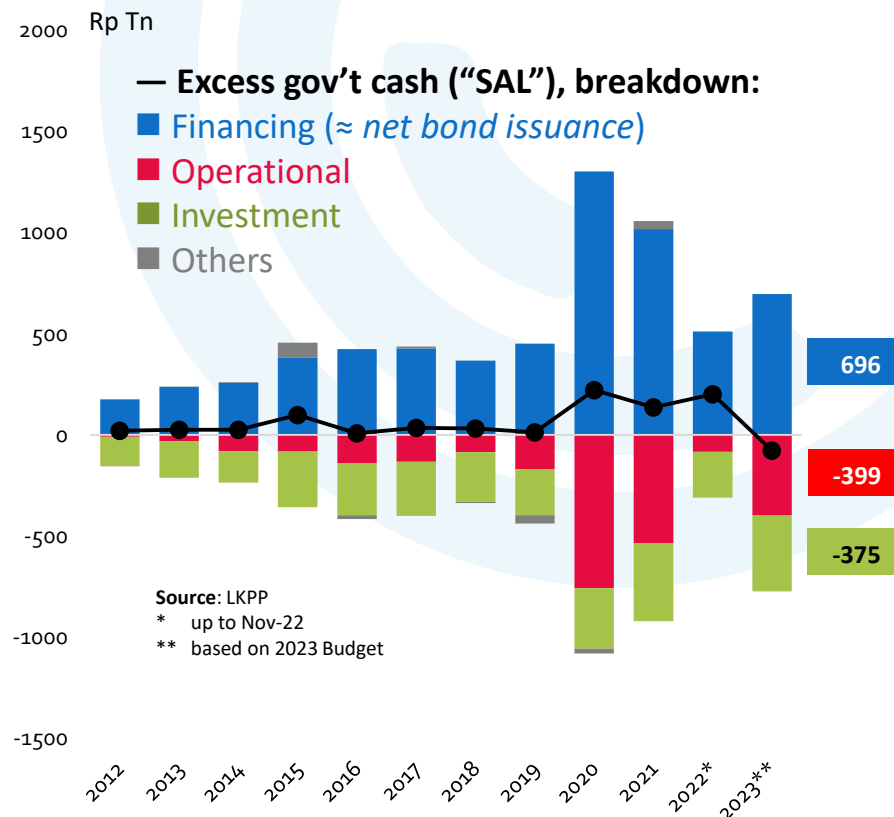


- The government, fortunately, has a few aces up its sleeve. One is the increase in revenue, both taxes and non-taxes, which has helped it reduce the deficit faster in 2022. Tax reform, as outlined in the Tax Harmonization Law of 2021, certainly played a role in getting the tax ratio to its highest level since 2018 – but the big drivers are probably rapid economic recovery and high commodity prices, after all. As such, **the revenue growth in 2023 might not be as strong, as the government has rightly recognized in their 2023 Budget.**

**Chart III-14. The government is flush with cash, which it could either use to stimulate the economy ...**

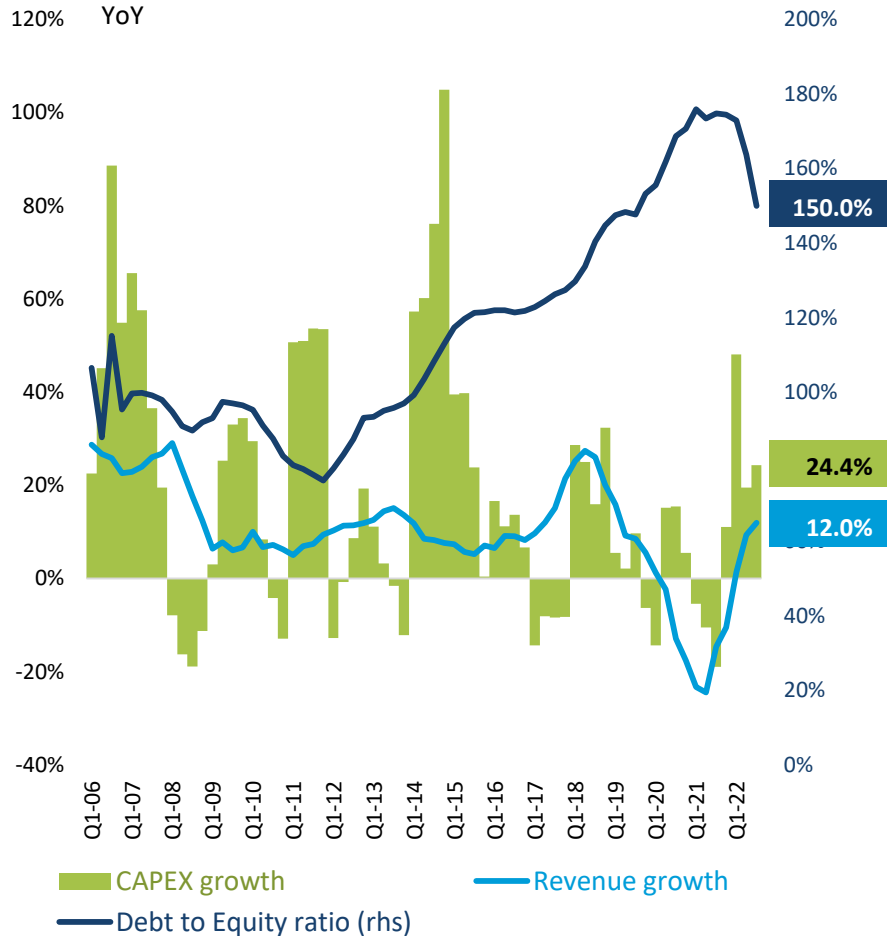


**Chart III-15. ... or to lower net government bond issuance following large debt increase in 2020-22**



- But even if the strong revenue growth in 2022 is unlikely to be repeated, it should still have salutary effect for 2023. The government is flush with cash that it has not fully spent, which could be used either to compensate energy SOEs for the aforementioned losses, or (not exclusively) to drive growth via CAPEX and social assistance. Furthermore, **the sizable cash buffer should reduce the need to issue bonds, therefore reducing the government's exposure to the tighter global financial conditions.**

**Chart III-16. SOE finances have improved in 2022, although debt levels remain rather elevated**



Source: Bloomberg, BCA Economist calculations

- Another factor that could also bolster public sector contribution to growth is **the improvement in SOE finances after the pandemic, with debt/equity ratios in particular improving following a series of capital injections and restructuring**. There are more potential financial resources to be tapped, including from sales of assets to the private sector (or foreign investors via INA-SWF), and there are obvious low-hanging fruits, namely infrastructure projects whose completion had been postponed during the pandemic.
- But beyond that, Jokowiomics-style development may face greater challenges. Perhaps the biggest remaining project in the President's agenda is the new capital city (Nusantara) in Kalimantan, which requires considerably more resources to proceed. Meanwhile, one of the signature achievements of his administration, the 35 GW power generation project – of which ~83% are operational or under construction per Q3-22 – could be hampered by the more recent commitment to phase out coal-fired power plants.

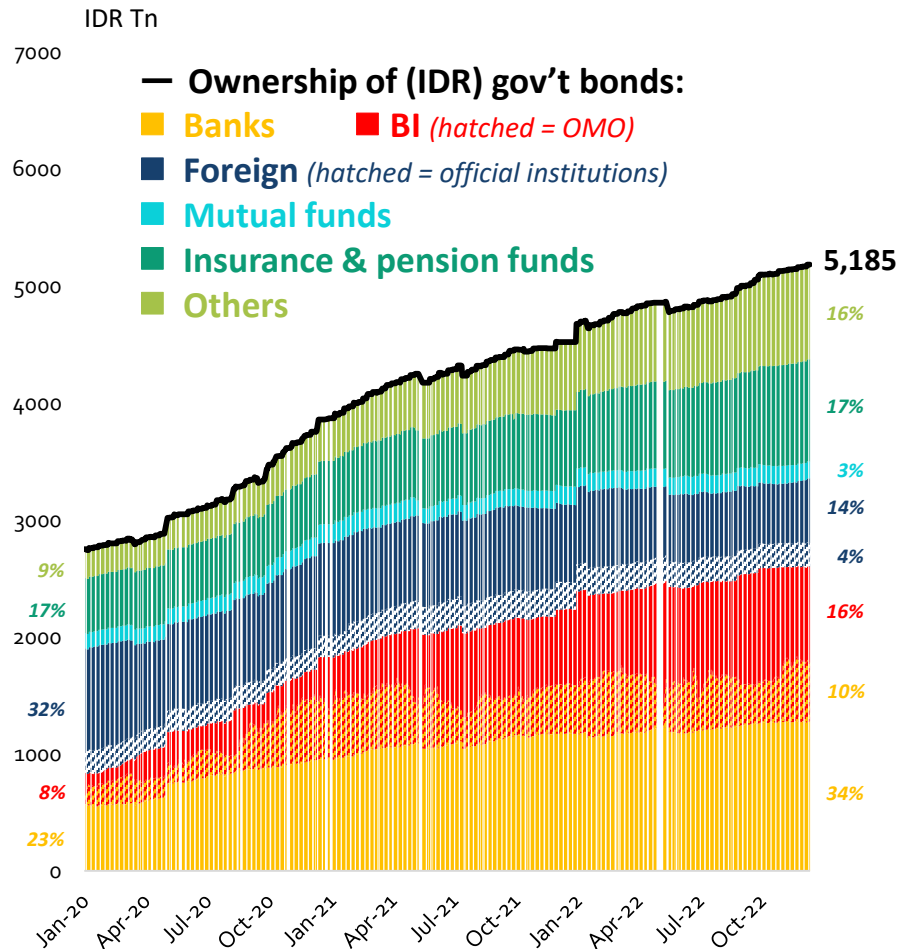


# #4: Monetary policy

## Steadier for longer

With the global outlook in flux, Indonesia's all-around robust macro fundamentals mean that it could emerge as a pole of stability – ergo, lower risk premia and better valuations versus other emerging markets. This does not necessarily imply a return to a strong Rupiah and low interest rate regime circa the pandemic. More likely, it means an early end to BI's rate hike cycle, but only partial restoration for the Rupiah and the bond/equity markets if the Fed maintains a higher-for-longer posture.

**Chart IV-1. As demand from traditional buyers and BI plateau, NBFIs and individuals are becoming the main buyer of bonds**



Source: Ministry of Finance, BCA Economist calculations

- The reduction in fresh supplies of government bonds – as discussed in Part 3 – comes at an opportune time, given limitations on the demand side. Banks, by far the biggest buyer of SBN, have been rerouting their liquidity to loans and to fulfill BI's higher (9.0%) reserve requirement. Meanwhile, foreign demand for SBN is returning after the previous exodus, but the extent to which this happens remains dependent on Fed policy outlook. If the Fed sticks with its plan to keep high nominal rates for the medium-term, these inflows is unlikely to restore foreign bond ownership back to pre-Covid levels.
- At the same time, BI's role in smoothing out the ups-and-downs of bank/foreign demand throughout the pandemic is diminished with the end of its "burden sharing" agreement with the Ministry of Finance. This leaves non-banks (insurance, pension funds, mutual funds, and private individuals) as the most reliable buyer of government debt, at a time when household saving rates are declining. **Thus, even with the end of the Fed's (and BI's) rate hike cycle, there is a clear limit as to how much bond valuations may improve this year.**

Chart IV-2. The inverted US yield curve means yield spreads are wider in the longer-end and narrower in the shorter-end ...

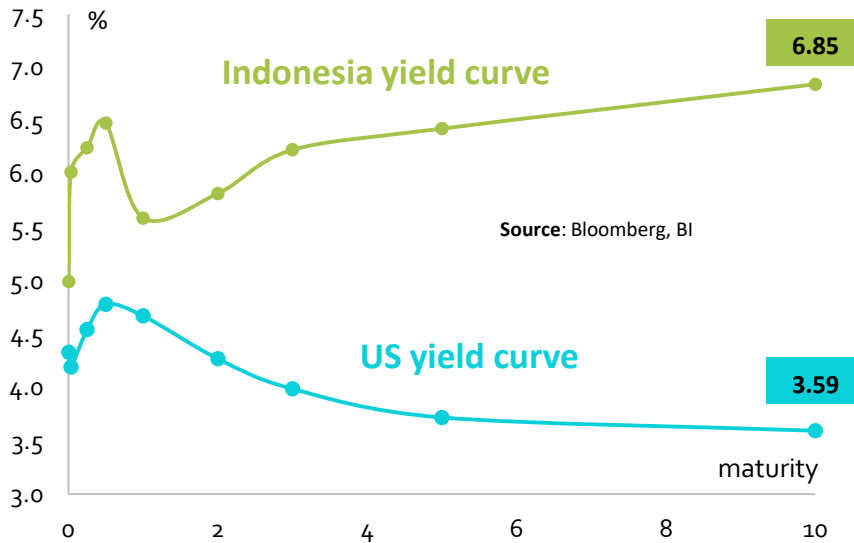
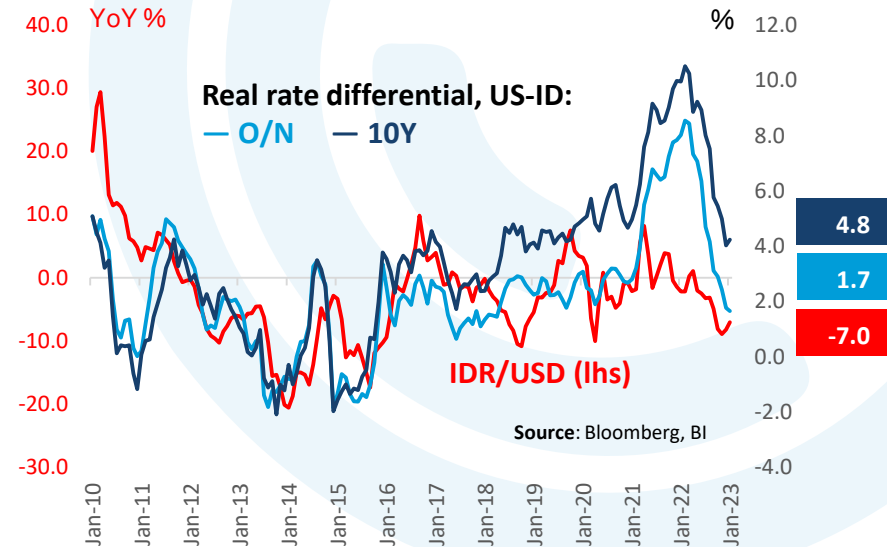


Chart IV-3. ... but IDR/USD has been less dictated by rate differentials recently, but rather by expectations



- This relative weakness in SBN demand contributes to Indonesia's still-positively sloping yield curve – which, however, could also be read as a sign of optimism on growth outlook. When set against the inverted yield curve for the US, this means a narrow nominal (and real) spread in the short-end, but a wider spread in the longer-end. It is this discrepancy that has prompted BI to undertake a kind of “Operation Twist” – a balance-sheet neutral operation whereby BI sells shorter-dated SBN and buy longer-dated ones.
- This is, on paper, a clever maneuver as it widens short-term spreads (which is more closely correlated with the Rupiah) while also bringing down the longer yields (which dictates lending rates). **In practice, however, its impact is rather more limited, and yield spreads – nominal or real – has not been a good predictor of the exchange rate. Indeed, the recent intensifying of the Fed pivot narratives has been more effective in bolstering the Rupiah, despite actually narrowing yield spreads.**

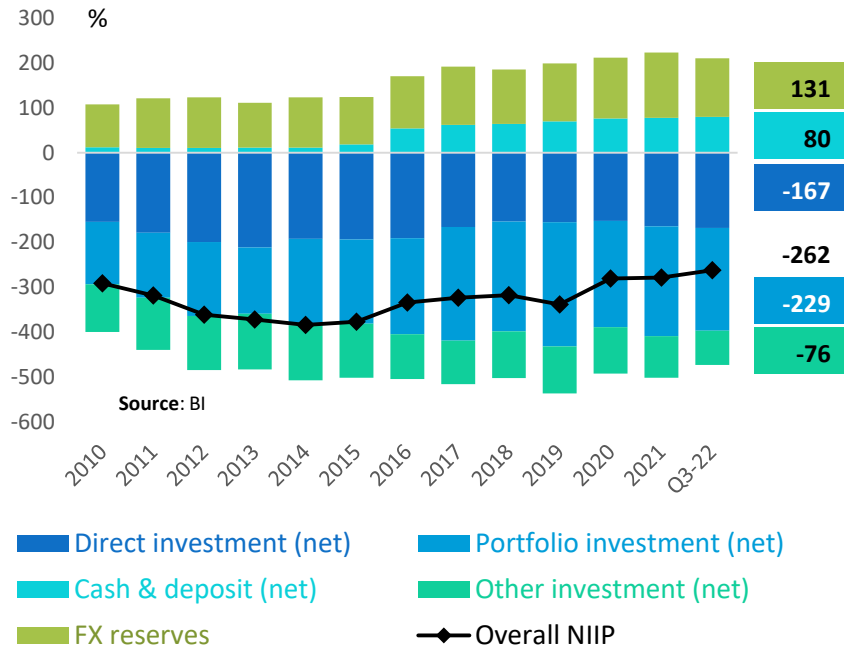
**Chart IV-4. Indonesia has one of the most consistently healthy macro indicators among emerging markets**

(position at end of 2022 unless stated otherwise)		ASEAN Countries				Other Emerging Markets						
		ID	MY	TH	PH	IN	CN	BR	MX	PL	TR	ZA
<b>Market Indicators</b>												
<b>CDS 5Y</b>	bps	99.6	78.7	61.4	97.1	107.8	72.8	254.4	130.1	115.0	512.3	249.8
	YoY bps	25.0	33.4	28.4	41.0	21.9	32.7	49.1	40.0	75.4	-51.3	46.5
<b>Currency</b>	YoY %	-8.4	-5.4	-3.5	-8.5	-10.1	-7.9	5.6	5.3	-7.8	-28.9	-6.5
<b>Gov't bonds 10Y</b>	YoY bps	55.4	45.1	67.9	74.1	87.1	6.3	185.0	146.6	32.0	-1229.5	98.9
<b>Stock index (USD)</b>	YoY %	-3.5	-9.2	1.9	-13.2	-6.9	-26.0	0.3	-5.2	-30.2	96.9	-5.8
<b>Macro Indicators</b>												
<b>GDP growth</b>	YoY % (Q3)	5.4	9.4	3.1	7.8	8.0	3.3	3.2	2.8	6.0	6.4	0.9
<b>Inflation</b>	YoY %	5.5	4.0	6.1	8.1	5.8	1.8	5.8	7.8	16.6	72.0	7.2
<b>Real policy rates</b>	%	0.1	-1.3	-4.3	-2.5	0.8	0.4	7.9	2.7	-10.0	-75.4	-0.4
	YoY	-1.6	0.2	-2.6	-1.4	2.1	-0.3	8.7	4.6	-3.0	-53.0	1.8
<b>FX reserves</b>	mths of imports	7.9	4.7	6.0	9.5	11.4	14.4	18.3	4.7	0.6	2.8	7.9
	YoY %	-5.3	-1.4	-13.0	-11.8	-11.2	-3.8	-10.4	-1.6	0.4	14.3	5.2
<b>Current account</b>	% of GDP (Q3)	0.8	2.1	-4.0	-5.8	-2.7	2.5	-3.4	-0.7	-3.5	-4.6	0.7
	YoY	0.6	-1.7	-2.4	-6.1	-2.3	0.6	-1.1	-1.4	0.0	-3.0	-3.7

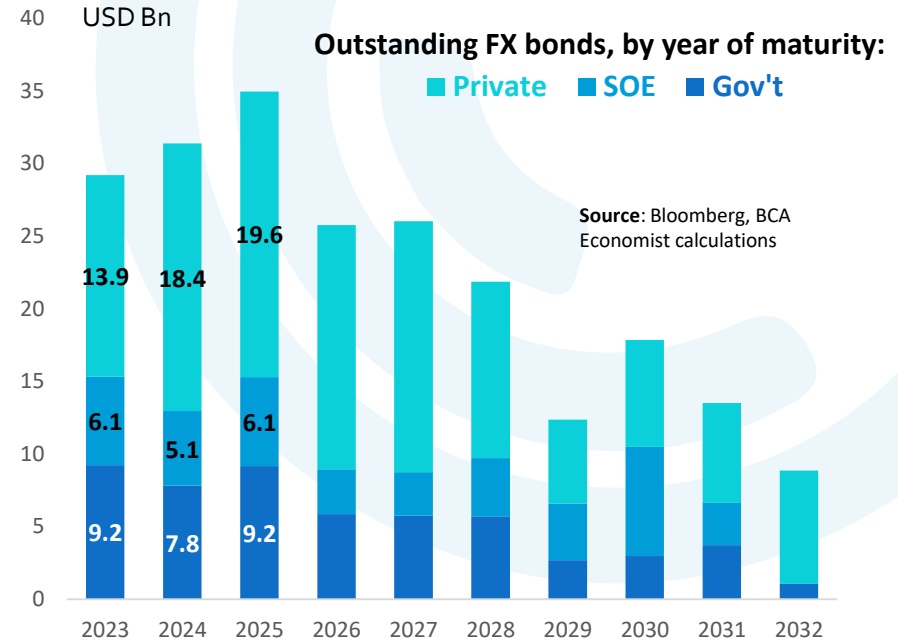
Source: Bloomberg

- But regardless of Fed policy outlook, we can be confident that Rupiah and SBN would over-perform relative to most of their respective emerging market counterparts, thanks to Indonesia's relatively clean bill of macro health. Given the aforementioned robust growth outlook, relatively low inflation, and a current account that benefits from the tumult in commodity markets, it is not surprising that Indonesia has performed much better compared to recent Fed tightening cycles in 2013-19. At that time, Indonesia was grouped together with India, Brazil, Turkey, and South Africa as the "Fragile Five" emerging nations. At present, however, Indonesia and India have clearly broken from the rest of the pack, and this has been duly recognized by the market as seen from the narrower credit default swap (CDS) bases.

**Chart IV-5. Bond outflows and current account surpluses during the pandemic have improved the NIIP ...**

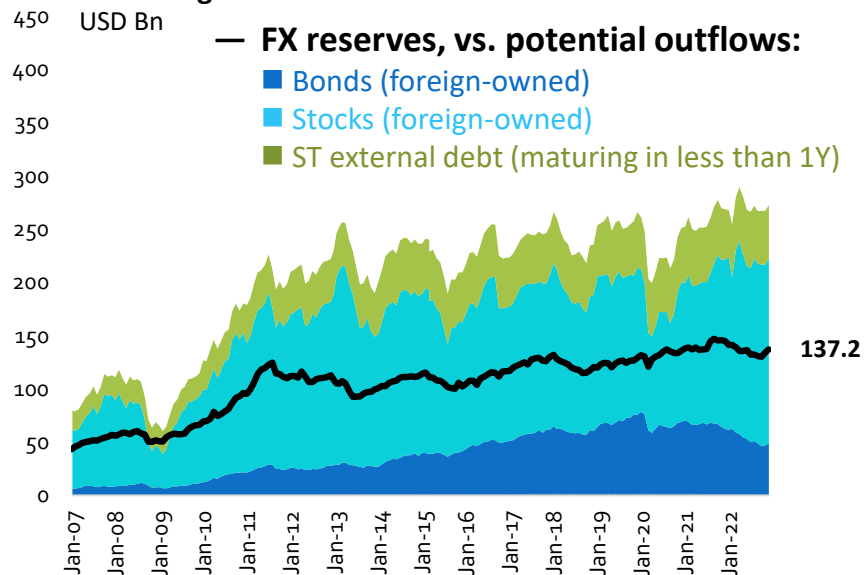


**Chart IV-6. ... but Indonesia does face a substantial need for repayment/refinancing of FX-denominated bonds**



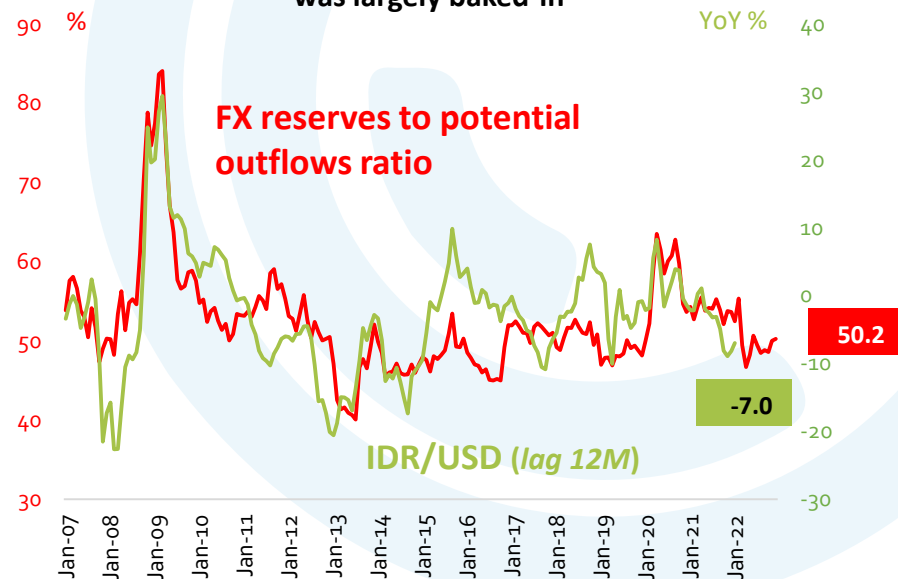
- The other point that reduced Indonesia's vulnerability is the improved net international investment position (NIIP). **This is of course a "blessing in disguise" due to the foreign bond outflows, and also thanks to the current account surplus of the past two years.** The portfolio outflows also increased the share of direct investment to 39% of total liabilities (up from 34% in 2019), thus significantly lengthening the holding period and reducing the risk of short-term flux.
- Nevertheless, Indonesia does have significant FX-denominated liabilities maturing in the short-term, both on the public and private sectors' side – a legacy especially of borrowing during the infrastructure boom of the late 2010's. Indeed, since about 2019, we have identified 2023-26 as a time when large tranches of FX loans would need to be refinanced. This refinancing may have to be done at higher rates if the Fed persists with its stance, and this is another factor that could hinder CAPEX except for certain sectors like mining that enjoys FX revenue streams.

Chart IV-7. Before recent recovery, FX reserves had been declining faster than short-term external liabilities ...



Source: BI, KSEI, Ministry of Finance, BCA Economist calculations

Chart IV-8. ... which meant that the depreciation in H2-22 was largely baked-in



Source: BI, KSEI, Ministry of Finance, Bloomberg, BCA Economist calculations

- Overall, even if the pressure on the Rupiah is likely to ease going forward (probably due to a flat/weaker Dollar), it does not mean that it would rebound to its previous levels (between 14,000-15,000). **In our view, the depreciation between September-November – while proximately driven by the Fed's relentless tightening and normalizing coal prices – were largely baked-in from the start.**
- For one, we find that the ratio between BI's FX reserves and short-term FX liabilities (which includes foreign portfolio ownership and external debt maturing in less than one year) to be predictive of the USD/IDR exchange rate by up to one year ahead, and a ratio of about 55% is historically needed to stabilize it. In the course of 2022, this ratio has fallen to 50% or less as the decline in reserves outpaced that of short-term liabilities – largely due to slight inflow to equities. The recent recovery in FX reserves has stabilized things somewhat, but not fully, as it is accompanied by a large-scale return of bond inflows as well.

Chart IV-9. Demand for FX loans have increased strongly, a sign of FX liquidity shortage ...

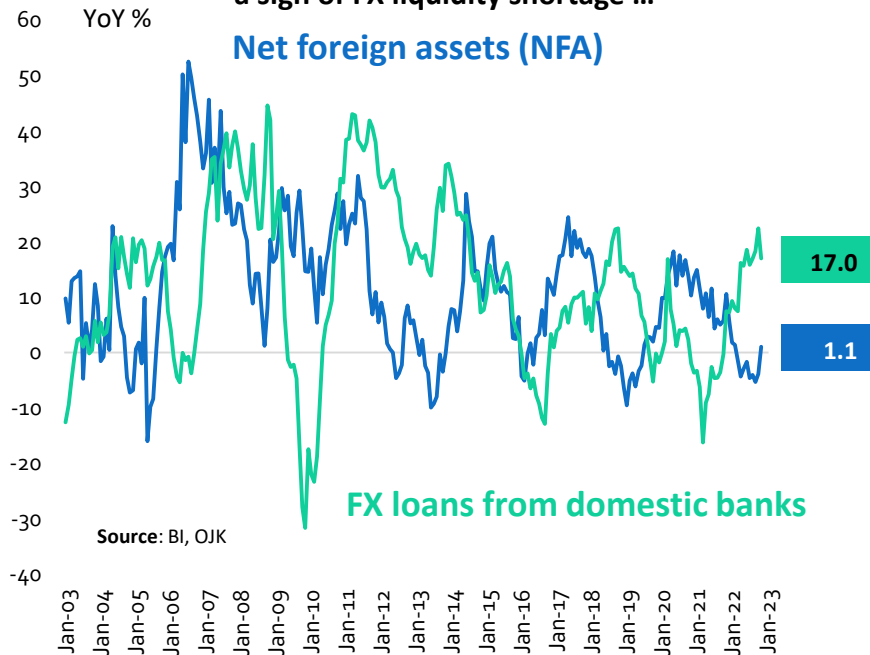
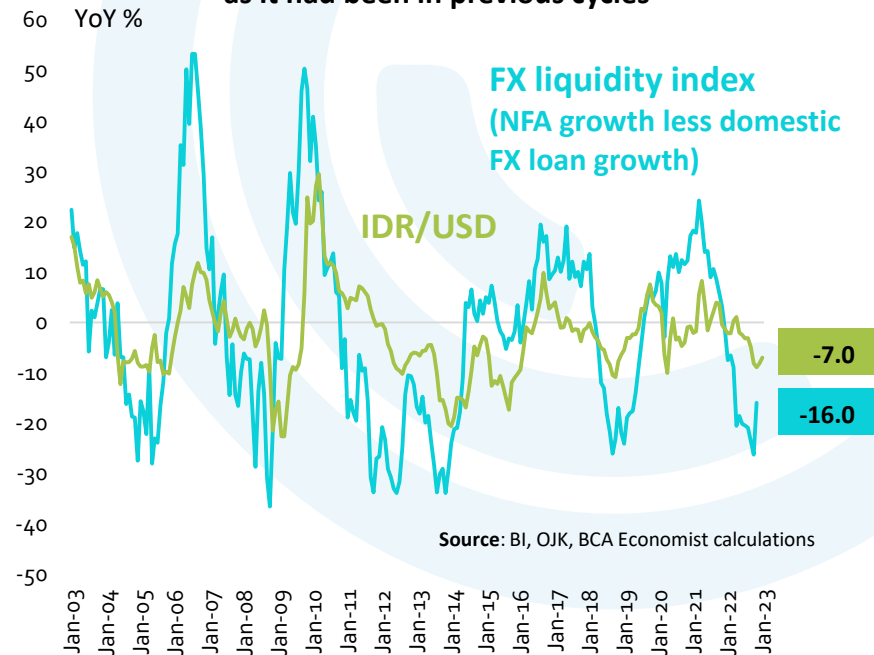


Chart IV-10. ... which also predicted the Rupiah's weakness as it had been in previous cycles



- The other indicator that strongly predicts the USD/IDR movement is the gap between the growth of domestic FX supply – net foreign assets (NFA) – and FX demand, for which we use FX loan growth from domestic banks as proxy. Such loans provide an indication of FX demand independent of supply from abroad – unlike the issuance of FX bonds or loans from foreign banks, whereby demand is directly matched by supply.
- With that in mind, we can see the still-strong demand for domestic FX loans as another sign that the Rupiah is unlikely to fully recover the ground it lost. **The reason behind this strong demand are things we have mentioned – maturing FX liabilities and continued lossmaking by energy SOEs due to low(er) retail prices at home.** Indeed, the latter had been a major driver of FX loan growth in 2022, as the SOEs borrowed to bridge the gap between the short-term losses and the disbursement of subsidies and compensation funds from the government.

Chart IV-11. Before the recent recovery, FX liquidity had been declining despite the large trade surplus ...

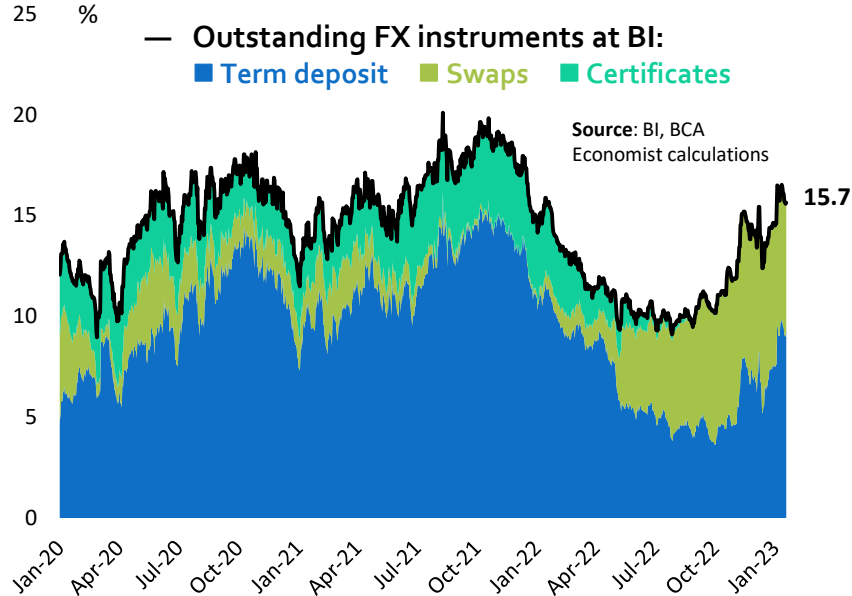
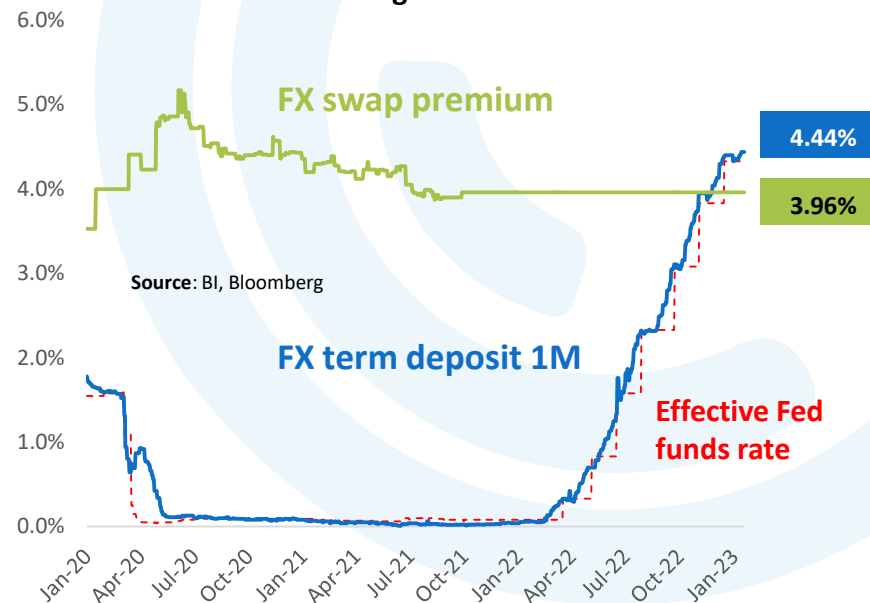


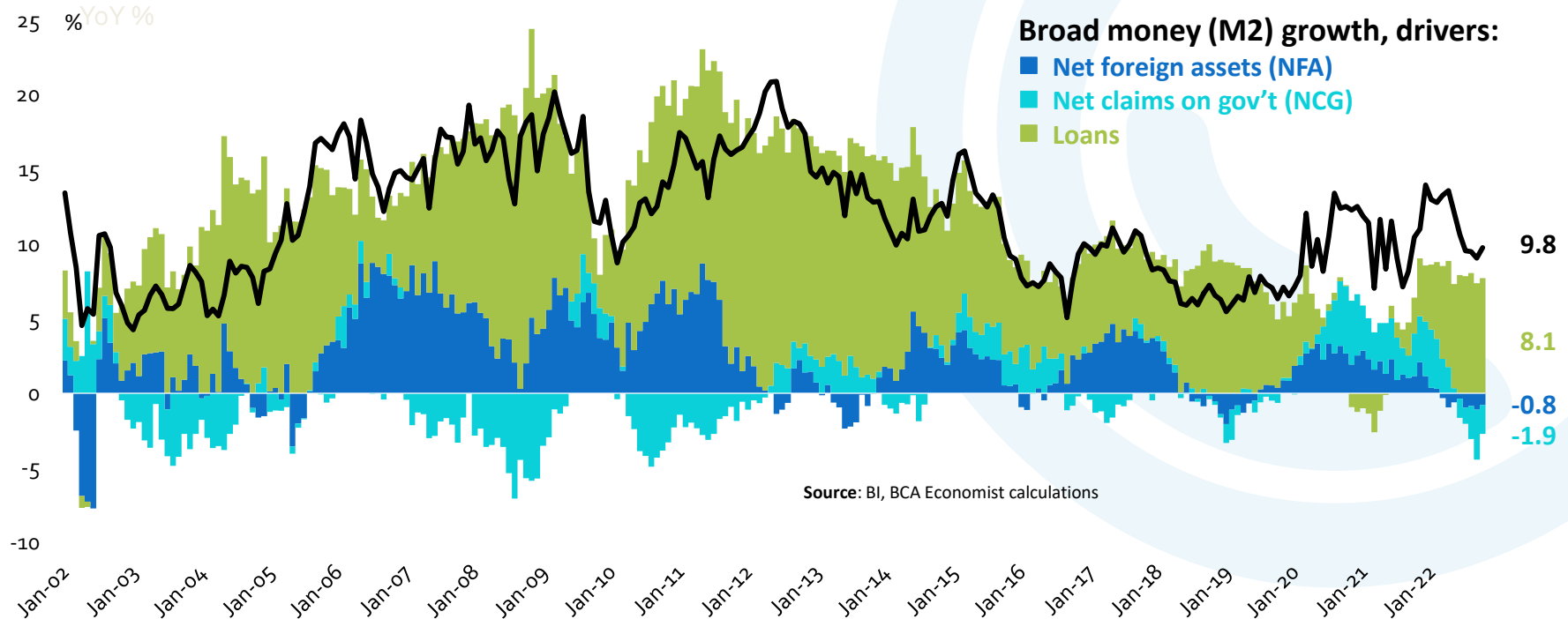
Chart IV-12. ... partly as the return on excess FX liquidity has not been much higher than Fed funds rate



- The private sector as a whole seem to be in a better place as far as FX liquidity is concerned, thanks to the commodity-driven net savings. **However, getting this “source” to finance the “use” of FX (in flow-of-funds parlance) is trickier, since a sizable proportion of the export proceeds are not repatriated.** There are multiple reasons why companies retain these funds abroad, but part of this seems to be the low yields offered at domestic banks vis-à-vis abroad, which is apparent from the decline in banks’ excess FX liquidity as the Fed raised interest rates.
- **BI has acknowledged this problem, and is trying out a new scheme that offers more incentive for banks to place their excess FX liquidity with BI,** as compared to the yields that they are currently getting from term deposits and swaps. If this works as intended, banks would then pass on the yields to their exporter clients, thereby incentivizing them to put their FX funds domestically. This bigger “carrot” will also be combined with a bigger “stick”, i.e. stricter regulations on export receipts, and stronger enforcement thereof.



Chart IV-13. Recent monetary growth has been driven entirely by credit growth



- So with NFA growth set to recover, albeit slowly, while net claims on government (NCG) continuing to decline amidst limited SBN issuance, the monetary landscape – at least in early 2022 – is set to be a continuation of mid- to late 2022, whereby most of the money growth is driven by inside money (i.e. loans). This situation naturally means higher loan-to-deposit ratio (LDR) and a declining CA surplus, which may seem broadly similar to prior balance-of-payment (BoP) crises in 2004-05, 2012-13, and 2018-19.
- It is quite clear, however, that the current situation is much more benign than those episodes, with the favorable terms of trade providing the necessary cushion. **We should also remember that such episodes are typically resolved by some combination of BI rate hikes, fuel price hikes, or monetary easing by the Fed. Even if the latter may not happen in the short-term (see Part 5), the domestic adjustments have also happened much earlier in the cycle.**

Chart IV-14. Excess Rupiah liquidity has recovered following BI's rate hike cycle ...

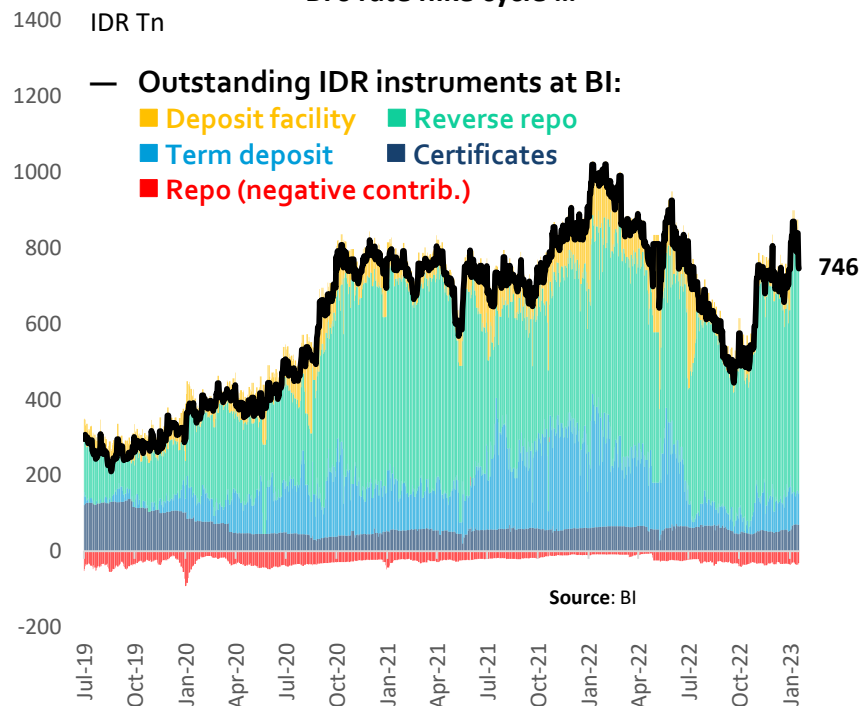
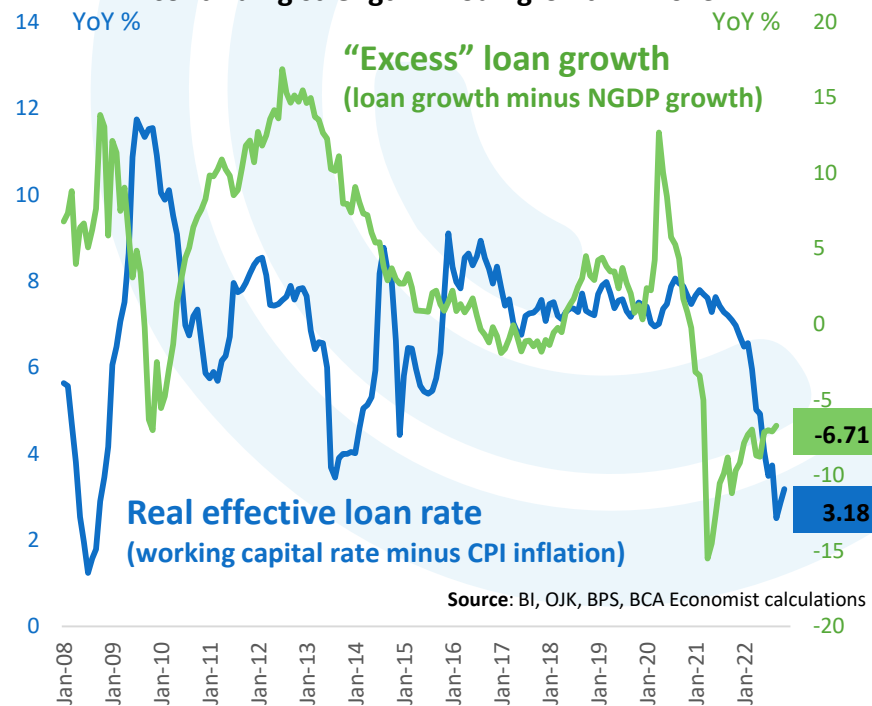


Chart IV-15. ... but the low real rates may imply continuing strength in loan growth in 2023



- **The upshot of all these is that BI's rate hike cycle may be nearing its end.** Unless there is a major surprise by the Fed – perhaps a fresh inflationary shock that would leave its terminal rate higher than the 5.00-5.25% currently expected – BI may only need to raise rates by a further 50-75 bps in order to stabilize the Rupiah and the external balance.
- **Fortunately, this still leaves sufficient room for banks to spur growth.** After falling during Q3-22, banks' excess liquidity has recovered strongly, as the Rupiah's new level finally attracted sufficient foreign flows (and sufficient conversion into IDR liquidity). BI is also under no real pressure to end its accommodative macroprudential policies, like the RPIM and the relaxation of loan-to-value (LTV) ratio, even though both of these would necessarily means a continuation of the current growth pattern – driven more by consumption than by private investment.

# #5: Scenario analysis

Fortress Indonesia

# The Global Economy Venn Diagram, 2023

(graphics elements  
taken from Flaticon)



## Baseline scenario (50%):

- Soft landing (mild or no recession)
- Moderate commodity prices
- Moderately accommodative Fed policies:  
~5% terminal rate & slow(er) QT

## Higher for longer (25%):

- Inflation flares up again
- High commodity prices
- Tighter Fed policies



## Deeper crisis (5%):

- Either stagflation, or Fed policy mis-timing:  
financial shock (possibly peripheral) & Fed reacts too late

## Pivot (20%):

- Hard landing
- Low commodity prices
- Fed policy pivot (rate cut,  
end of QT)



- The outlook for the Indonesian economy, as we have outlined, does not include much uncertainty from the domestic side. This is because the policy outlook is largely conservative and predictable: BI should continue its mix of prudent and accommodative policies, while the government is both very unlikely to stray from fiscal normalization and at the same time would prioritize price stability (through subsidies and market interventions). Likewise, the structural themes – robust consumption, strong appetite for investment in commodities but less so in manufacturing – are also unlikely to deviate much in the short-term.
- **As such, there is not much variance to be expected with respect to Indonesia's macro variables, except those induced by global shocks** – which is what our scenario analysis mainly deals with. The variance is arguably lowest for GDP growth, which is dominated by domestic factors; somewhat higher for inflation and rates, which are more policy-dependent; and highest for the USD/IDR and trade/CA balance, which are greatly influenced by global factors.

## Baseline scenario: Soft landing

Probability:

**50%**

**Why 50%:** The reasoning here is still essentially the same to the baseline scenario in our global outlook, and it hinges on two key factors. **One is China's reopening, which – when coupled with stimulus to its troubled real estate sector – should bolster both the supply and demand sides of the global economy.**

The other factor is a continued moderation of energy prices, which would ensure that further demand destruction would not be needed in advanced economies. This has been made easier by the G7 price cap on Russian oil, although Russia may yet wiggle out of this restraint if it could coordinate a consistent output cut with OPEC.

- **Growth outlook:** China's reopening and recovery is a biggie for Indonesia, since its growth (and its demand for Indonesian commodities) have traditionally been a major determinant of our GDP growth. Furthermore, the current commodity prices – as it stands around Dec-22/Jan-23 – seem to be a “sweet spot” for Indonesia: high enough to spur exports and FDI, but not high enough to prompt fuel hikes, export bans, or other such disruptive interventions. As such, GDP should grow at 4.7-4.8%, with some potential for even faster growth rates.
- **Inflation and rates:** The current market view (terminal Fed rate at 5% before a gradual pivot) is not at all a challenge for BI, as seen from the recent inflow into Indonesian bonds. As long as inflation stays within the expected range by year-end (roughly 4.0-4.5%), BI should end its rate hikes by February/March, and then set policy to cruise control.
- **External balance:** More moderate commodity prices imply more modest trade and CA surpluses, with the latter likely tending towards neutral or even slightly negative territory, especially if growth over-performs. This is not a big problem for the Rupiah so long as bond inflows continue, but we nonetheless think that the latest levels (of 15,000 or lower versus the USD) represent an overshoot, and should revert to more sustainable levels (15,300-15,800) given the aforementioned fundamentals.

## Alternative #1: Higher for longer

Probability:  
**25%**

**Why 25%:** While energy markets seem to be a buyer's market for now, it is not hard to foresee situations in which suppliers could regain the upper hand. Geopolitical tensions could flare up, OPEC could join forces with Russia to cut oil production, gas storage in EU may dwindle again as the next winter approaches, and China's reopening may upset the Fed's careful plans to limit demand.

In the latter case, strong Chinese demand should support global (and particularly Asian) growth, which means that the Fed may contemplate further demand destruction. **This scenario is unlikely to kick in immediately (the disinflationary momentum is still too strong in H1-23), but our soft landing baseline might yet turn into this situation later in the year.**

- **Growth outlook:** Indonesia is a beneficiary of Chinese growth and commodity booms, so this is another situation where GDP growth would remain relatively strong. The problem here would be inflationary pressures, which could affect consumption and may – with low probability but fairly large impact – force the government to adjust prices or halt exports (or both), both of which would be rather growth-negative.
- **Inflation and rates:** The playbook here may be similar to 2022: higher inflation, bond outflows, rate hikes. But while 2022 saw an increase in the shorter-end, here it may happen more towards the longer-end (bear steepening), as it becomes clear that inflation would be a persistent (structural) global problem.
- **External balance:** As ever, Indonesia's trade and CA outlook depends on the overall commodity terms-of-trade (ToT): coal gaining means higher surplus, while oil gaining means lower surplus. Indonesia's diverse commodity portfolio means that it is still likely to come out ahead in this situation – as indeed in 2022 – but the impact on Rupiah is more ambiguous and may well be less positive. Our experience in 2022 shows that the Rupiah benefits more from capital inflows than trade inflows, and this would remain the case unless BI could quickly plug the “leakage” of Indonesia's export receipts.

## Alternative #2: Pivot

Probability:

**20%**

**Why 20%:** The opposite scenario to higher-for-longer is a Fed pivot. This is something that would probably be necessitated by a deep recession, or a financial shock that would necessitate liquidity provision by the Fed. Obviously, this would be made easier if inflation also declines, and this could happen if China's recovery leads to supply-side rebound without a commensurate demand-side recovery.

**Such possibility is arguably both overestimated and underestimated by the market.** The former, because the market is already pricing in some pivot in late 2023/early 2024, even though at the same time the consensus is still for a soft landing in the US. And the latter, because a recession later in the year is still quite probable in spite of the still-strong state of labor market, given that leading indicators have continued to deteriorate.

- **Growth outlook:** A global recession, coupled with low commodity prices, would certainly lower Indonesian growth, probably towards 4.3-4.5%. However, if the Fed cut rates quickly enough, it could provide extra push for investment into sectors like renewable energy and electric vehicle, which would spill over into Indonesia's commodity sectors.
- **Inflation and rates:** Inflation would certainly decline in this scenario, with food inflation being the only wildcard. This would pave the way for BI to cut rates below 5%, possibly even lower, as there is sufficient room for it with regards to real rates, rate differentials (vis-à-vis US), or the Rupiah's trajectory.
- **External balance:** Lower commodity prices generally means lower ToT and lower trade/CA surplus. Indeed, the fact that Indonesia grows faster than most economies – especially with the aforementioned investment growth – means its CA should deteriorate towards negative territories. This would be counterbalanced by capital inflows particularly towards bonds, while the outlook for Indonesian equities – whose rally in 2022 has been partly driven by commodity sectors – is more mixed.

## Alternative #3: Deeper crisis

Probability:

5%

**Why 5%:** This is the most damaging situation whereby the global economy falls into a deep recession but the Fed is in no position to help boost global liquidity. **It is not a very likely scenario, as the Fed (and its counterpart the Chinese authorities) have the playbook and willingness to respond to most global shocks, after all the tumultuous years since 2008.**

There are two types of scenarios where this could happen. The first is an acute stagflation, where the commodity shock in #3 occurs despite still-weak global demand – perhaps due to an outright geopolitical conflagration. The second is if there is a systemic financial shock at the peripheries of the USD system – perhaps in emerging markets, but possibly also in Europe or Japan – where the Fed is not ready to play its de facto role as the global lender of last resort. In this case, the shock could work its way through the global economy before the Fed pivots.

- **Growth outlook:** The scale of the shock here might be more comparable to the 2008 – that is to say, substantial – but even then Indonesia was well insulated and the sectors geared towards domestic consumers remained intact. Still, growth did slow down by ~1% below its pre-crisis average, which in our case could be closer to 4.0-4.1%.
- **Inflation and rates:** The outlook would greatly depend on whether the trigger is an acute stagflation or a financial crisis. But whether due to inflation or volatility in the market, risk premia are likely to increase, translating therefore to higher yields both on the short (BI monetary policy) and longer-end (SBN yields).
- **External balance:** Again, the outcome depends on the trigger, but tumult on the capital account is to be expected due to flight towards liquidity – which for the moment still means USD and UST. The impact on trade/CA is rather ambiguous, but a sharply weaker Rupiah (due to the flight) would eventually “enforce” improvement in Indonesia’s CA via lower goods and services imports.



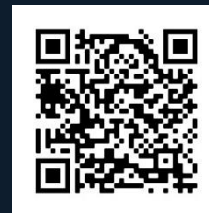
## Projections of macroeconomic indicators

	2018	2019	2020	2021	2022	2023E
<b>GDP growth</b> (% YoY)	5.17	5.02	-2.07	3.69	5.23 (E)	4.74
<b>GDP per capita (USD)</b>	3927	4175	3912	4350	4646 (E)	5011
<b>CPI inflation</b> (% YoY)	3.13	2.59	1.68	1.87	5.51	4.31
<b>BI 7-day Repo Rate (%)</b>	6.00	5.00	3.75	3.50	5.50	6.00
<b>10Y government debt yield (%)</b>	7.98	7.04	5.86	6.36	6.92	6.79
<b>USD/IDR exchange rate</b>	14,390	13,866	14,050	14,262	15,568	15,647
<b>Trade balance</b> (USD Billion)	-8.5	-3.2	+21.7	+35.3	+54.5	+43.2
<b>Current account balance</b> (% of GDP)	-2.94	-2.71	-0.42	+0.28	+0.90 (E)	-0.19

Source : BPS, Bloomberg, BCA Economist calculations

Notes:

- BI 7-day Repo Rate, 10Y yield, and USD/IDR exchange rate refer to end of year position
- 10Y yield and USD/IDR exchange rate projections refer to fundamental values; actual market values may vary depending on sentiment and technical factors



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