INDONESIAN ECONOMIC OUTLOOK 2022

Boom time, at last?

Bank Central Asia – Economic, Banking, & Industry Research

Executive Summary

- Following the Delta wave in mid-2021, the Indonesian economy has staged a rapid comeback, driven by pent-up demand, increased mobility, and an export boom thanks to high commodity prices.
- The momentum will carry over into 2022, paving a way for a broad-based recovery across most economic sectors (instead of a bifurcated "*K-shaped recovery*" in 2021) and growing business investment, as corporate Indonesia (with some exceptions) has remained in decent financial shapes.
- The commodity windfall has loosened the conventional tradeoff between growth and depreciation, but only slightly. The prospects of global monetary tightening and partial normalization of commodity prices mean that a growth rate of about 5.4% or more might still increase depreciation risk, leading to faster rate hikes by BI.
- Inflation is due for an increase alongside demand and loan growth. Energy prices are the biggest wildcard since they have been kept low relative to global levels. While the fiscal risk from energy subsidies is now relatively contained, the cost to SOEs means that energy prices may be adjusted if global prices stay high 6 – 12 months from now.
- Strong revenue growth from both taxes and commodities help narrow the fiscal deficit relative to prior expectations. This should reduce the financing gap for government bonds amid potentially weaker appetite from banks and foreign investors.
- Whilst Indonesia's short-term macro fundamentals are arguably the best among emerging markets, its long-term prospects are clouded by the uncertain prospect of its structural reforms. Its rapid wage growth relative to productivity could remain a hindrance for it to partake in post-pandemic reconfigurations of the global supply chain.

Table of Contents

List of Exhibits

Riding the Fourth Wind

Commodity booms, past and present

- The year 2021 had been a topsy-turvy one. The economy recovered at a remarkable speed from the carnage of the initial Covid-19 wave, but it was interrupted by the spread of the Delta variant in the middle of the year, which took massive human and economic tolls on Indonesia.

- Things improved again as the Delta wave died down in September, but by that point the global economy was facing additional threats: supply chain disruptions and inflationary surge across multiple countries. The latter – an ancient dragon which central bankers thought they had slain – was particularly troubling to the capital markets, which grew more volatile towards the end of the year.

- But while much of the world views inflation and supply-chain disruptions with apprehension, these developments are not necessarily negative from Indonesia's point of view, accompanied as it is by an increase in commodity prices (***Exhibit 3***). Being a diversified commodity exporter – instead of a single-commodity economy like Zambia (copper) or Saudi Arabia (oil) – Indonesia tends to do well when commodity prices are elevated, regardless of which commodity was performing the best. But the present boom is indeed highly skewed in Indonesia's favor, with export commodities showing larger price gains compared to imported ones (***Exhibit 2***).

> ***Indonesia has historically done well whenever global commodity prices are elevated***

- The question, then, is not so much whether Indonesia will grow strongly in 2022 – chances are, it will – but *to what extent could it grow*, *at what risks*, and *whether or not the momentum could be sustained when real commo-*

dity prices inevitably regress. Historically, there had been three periods in the past when Indonesia benefited from high commodity prices (***Exhibit 1***):

- The rubber boom of 1950 – 1952

  Newly-independent Indonesia failed to gain lasting benefits from this brief, Korean War-driven boom, but it did give a window for reform-minded politicians to adopt tough stabilization policies (in contrast to the more chaotic and populist era that followed).

- The oil/gas boom of 1973 – 1981

  The windfall from oil and gas, plus the accompanying FDI boom, allowed the New Order regime to embark on ambitious infrastructure and social development programs that would pay dividend in later years. But the fixed exchange-rate and import-substitution policies sustained by this windfall did not pan out, leading to severe (albeit successful) adjustment when oil price fell in the early 1980's.

- The coal/CPO boom of 2004 – 2013 (briefly interrupted by the GFC)

  The boom initially led to a brief negative shock when the government had to hike gasoline prices in order to curtail fiscal and current account (CA) deficits – since Indonesia was no longer a net oil exporter by this point. Once over that hump, however, there was a long period of rapid growth led mainly by consumption and services, while manufacturing languished. This growth model stalled when rising global yields and falling commodity prices meant that Indonesia was no longer able to afford the import growth required to sustain the rising consumption.

The 2004-13 boom ended when Indonesia could no longer afford the imports needed to sustain the rising consumption

- As we can see, the outcome of each boom depends on a complex set of factors, including the length of the boom, global interest rates, exchange-rate regimes, domestic energy prices, and other policy responses. These would certainly hold true for the fourth (and current) boom as well, but not all of them will be covered in this ***2022 Domestic Outlook***, which – by its very name – focuses only on the near future (but see ***Epilogue***).
- The global factors, meanwhile, are covered more extensively in our ***2022 Global Outlook***. A few key takeaways that are relevant here are as follows:

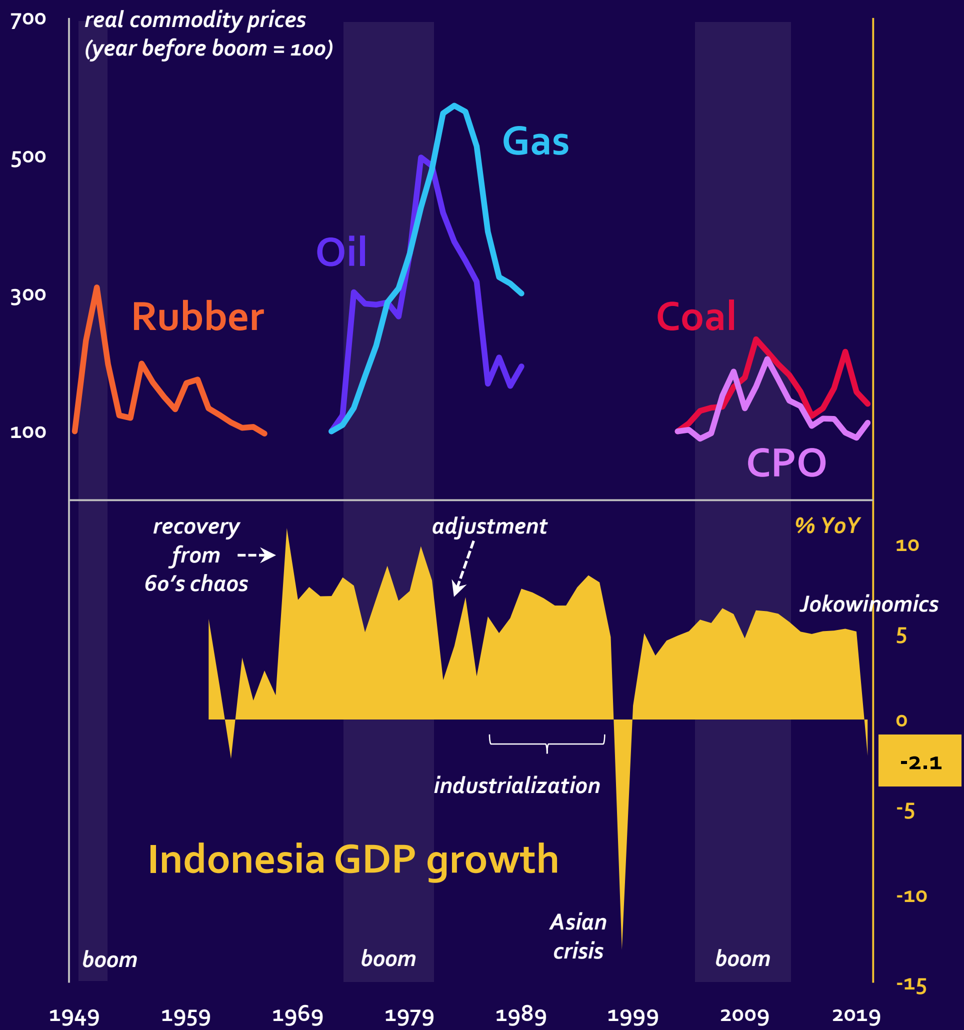
The potentially accelerated global monetary cycle means that we cannot assume a prolonged boom à la the 1970's and 2000's just yet

  - In spite of its apparent persistence, global inflation is still caused largely by pandemic-related anomalies, i.e. supply chain disruptions and demand imbalance, with demand for goods much higher than that for services. On the other hand, high absolute demand (due to overly-large stimulus) and structural tightening in the labor market ("the Great Resignation") are playing comparatively smaller roles, at least for the moment. This means commodity prices could begin to normalize as the pandemic subsides, and inflation may yet prove to be transitory – even if it means a timeline of 2-3 years rather than 2-3 months.
  - In the same vein, there are several factors that could lead to weaker demand for commodities in 2022, namely (1) the continuing slowdown and deleveraging in China, and (2) the Fed hiking rates faster in order to combat inflation. Both of these scenarios also imply greater risks of rising global yields and capital outflows.

- Finally, real energy prices may follow their own separate logic and stay elevated for longer, as had happened historically. Aside from the usual supply and geopolitical volatility surrounding OPEC+, we are also concerned that fossil fuel production might not respond to the incentive of higher prices as it typically did in the past, given the growing trend towards ESG investing as well as public policies across the world that may constrain investment in this industry.

- Given these considerations, our baseline scenario for the global economy remains optimistic, but less notably so compared to the situation at the tail end of 2021. Indonesia is riding a strong momentum into 2022, but the added uncertainty of the pandemic and the potentially accelerated global monetary/business cycle means that we should not pencil in a long boom *à la* the 1970’s and the 2000’s just yet.

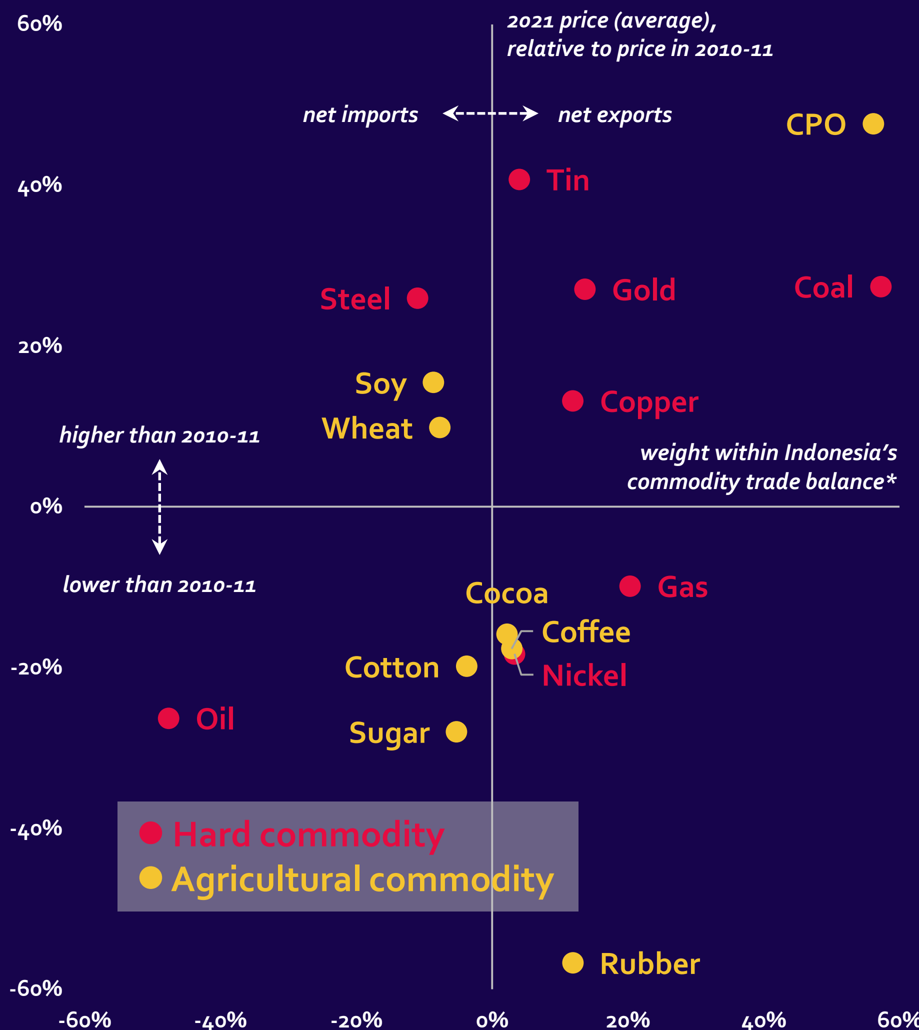
Indonesia had benefited from commodity booms on three previous occasions since independence



Source : *World Bank, Jacks, D.S. (2019) – "From Boom to Bust: A Typology of Real Commodity Prices in the Long Run" – Cliometrica 13(2), 202-220, BCA Economist calculations*

Exhibit 2

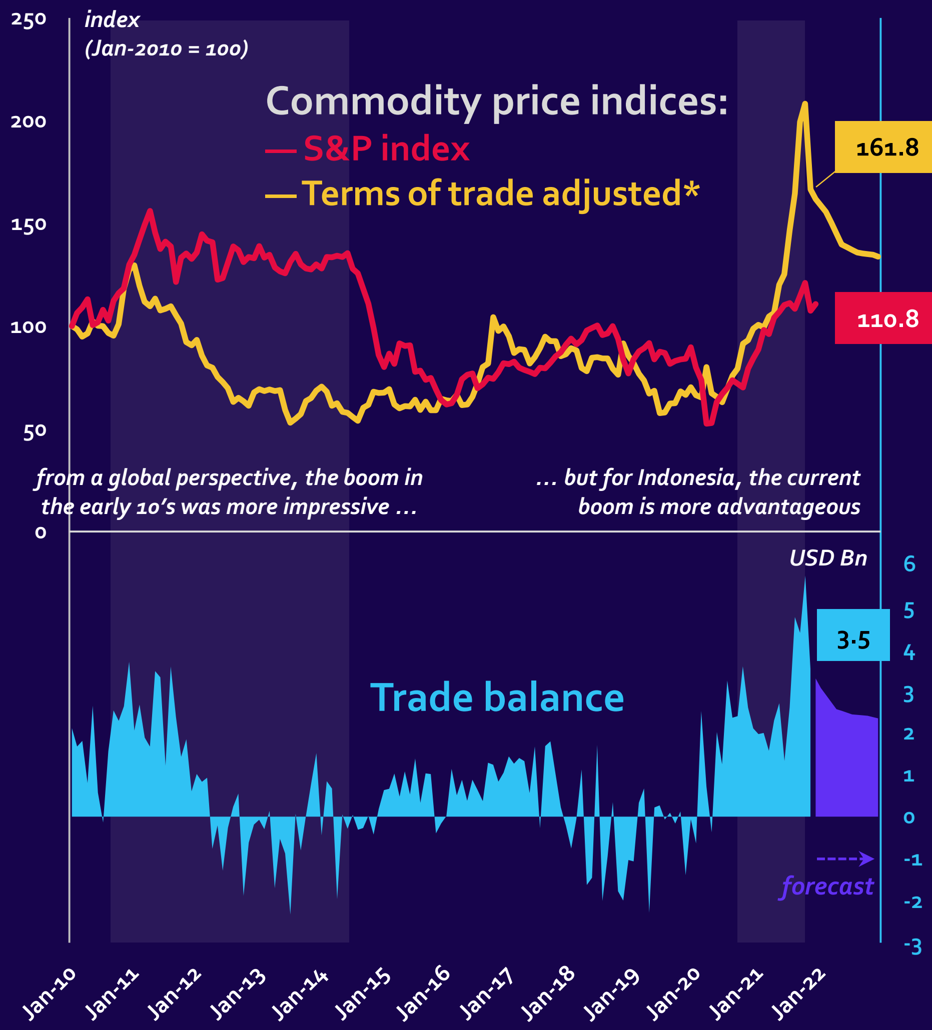
The current boom is especially beneficial as export prices have risen more than import prices ...



Source : *Bloomberg, UN Comtrade, BCA Economist calculations*
** The trade balance after removing all but the major commodity exports/imports*

Exhibit 3

... resulting in a string of massive trade surpluses which may continue into 2022



Source : *BPS, Bloomberg, BCA Economist calculations*

** Adjusted by each commodity's weight within Indonesia's commodity trade balance*

Loosening the Straitjacket

Weighing growth versus vulnerability

- The story of past booms told us that there is a point at which growth starts to hit a wall, typically signified by rising inflation and/or exchange-rate depreciation. For Indonesia, the biggest such moment in recent memory was the "taper tantrum" in 2013, when it was memorably grouped alongside India, Turkey, Brazil, and South Africa as the "Fragile Five" countries that are most vulnerable to US monetary tightening. Growth is therefore indirectly limited by "vulnerability", however it is defined.

- A common method to estimate this limit is the so-called potential growth rate, above which growth could lead to accelerating inflation. But this may not be terribly useful in the Indonesian context, for two reasons. Firstly, the government controls inflation by fixing energy prices, making it a poor measure of true excess demand.

More than inflation, depreciation risk seems to be the main factor that dictates monetary policy and caps potential growth in recent years

- Secondly, inflation is not the only – or even the most important – determinant of monetary policy. In fact, it could be argued that the exchange rate is the more crucial factor in recent years, as evident from Bank Indonesia's rate hikes in 2018 in the absence of a significant rise in inflation, and its maintenance of positive real policy rates ever since (***Exhibit 6***). This may be evidence of BI's "fear of floating", i.e. its reluctance to let the Rupiah float freely at the whims of the market, which is understandable considering Indonesia's negative net international investment position or NIIP (***Exhibit 10***) and its high dependence on imports, both for consumption and particularly for investment (***Exhibit 8***).

- As such, we need to calculate an alternative, non-depreciative potential growth rate (***Exhibit 9***) – if actual GDP growth exceeds it, then the Rupiah is fundamentally expected to weaken versus the USD, and vice versa. Our estimation is based on the balance between external FX supply (a function of trade and capital flows) and internal FX demand.

- As it turns out, Indonesia's non-depreciative potential growth had drifted downwards in the past decade – bottoming out at just below 4% in 2017-18 – before rising again just before the pandemic. This decline was driven in part by commodity prices, but it also reflected a growing dependence on imports, spurred on by the growth of e-commerce as well as massive investment projects under Jokowinomics. Small wonder, then, that Indonesia's rapid growth during the past decade (averaging 5.4%) had been "paid back" by periodic bouts of Rupiah depreciation.

- The present commodity boom has lifted the potential rate to about 5.4% for Q3-21, but – despite an even more favorable terms of trade – it does not quite reach the heights of 2010-11, due to the aforementioned drift. The twin risks of Fed rate hikes and China slowdown is likely to curtail this potential in the short-term, meaning that the GDP may grow "safely" only at 4.8 – 5.2% in 2022, or at the lower end of the government's target range of 5.0 – 5.5%. This boom, in other words, has not let Indonesia out of its growth versus depreciation tradeoff – it has merely slightly loosened the straitjacket.

Indonesia's growth potential had drifted lower, but is now back above 5% amid the commodity boom

- But while growth might not return to the halcyon days, Indonesia has indeed broken out of the "Fragile Five" pack with respect to its vulnerability indicators (***Exhibit 4 – upper panel***), thanks largely to its improving CA and its hitherto low inflation rate. This has not gone unnoticed by the market, which has rewarded Indonesian assets with one of the strongest recent performances among EMs (***Exhibit 4 – lower panel***). Furthermore, we also think that there could remain some upside to Indonesian equities given the growth momentum, whereas bonds and the Rupiah seem to be quite in line with their macro fundamentals.

- These improvements should allow BI to stick closer to its intended timeline for monetary normalization at H2-22, as opposed to other EMs (Mexico, Russia, Brazil, South Africa) which had been forced to hike rates in 2021 – plus Turkey, which has defied monetary policy logic despite its inflation and depreciation problems. BI's timeline, as it stands, lags slightly behind the current consensus about the Fed's own liftoff timeline (Q2-22), which is a far cry from BI's rushed tightening in 2013. This is definitely a testament to Indonesia's reduced vulnerability, although there are two major caveats that we will discuss in subsequent chapters.

Exhibit 4

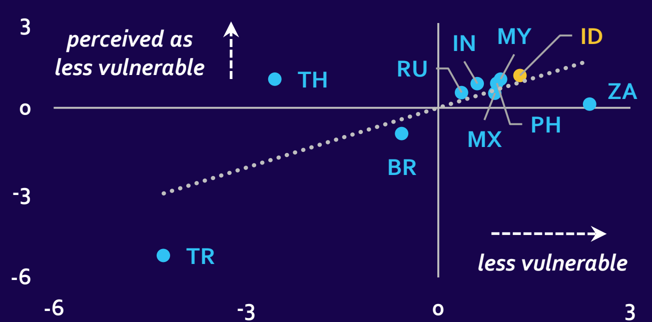
Indonesia has broken away from the "Fragile Five" pack, and the market has rewarded it accordingly ...

			ASEAN Peers			Other Fragile Five				Other EM	
		ID	MY	TH	PH	IN	BR	TR	ZA	MX	RU
MARKET INDICATORS											
CDS 5Y	bps	75.4	48.3	34.5	56.5	90.1	221.8	495.6	221.4	102.2	106.4
	chg YTD	7.6	10.8	-2.3	20.9	25.7	79.0	189.5	17.5	20.7	20.4
Currency	% YTD	-2.2	-4.6	-11.0	-4.6	-3.6	-6.9	-46.6	-8.3	-5.1	0.7
10Y Sov Bond	bps YTD	43	91	65	105	50	377	802	122	182	263
Stock Index	% YTD	11.3	34.4	11.7	0.7	23.1	-10.7	37.6	20.7	16.3	16.8
MACROECONOMIC INDICATORS											
GDP	% YoY	3.5	-4.5	-0.3	7.1	8.4	4.0	7.4	2.9	4.5	4.3
Inflation	% YoY	1.8	2.9	2.7	4.2	4.5	10.7	21.3	5.0	7.4	8.4
Policy Rates (Real)	%	1.8	-1.2	-2.2	-2.2	-0.5	-1.4	-6.3	-1.3	-2.4	-0.9
	chg YTD (bps)	-32	-430	-298	-70	7	110	-871	-165	-347	-27
Reserves	import mths	10.4	5.8	5.8	11.9	16.1	25.3	4.2	8.6	5.3	27.4
	% YTD	8.1	2.8	-9.0	-3.2	10.0	3.7	60.5	3.7	1.3	4.3
Current Account	% of GDP	0.2	3.8	-1.9	1.9	0.4	-1.5	-2.3	4.1	2.9	3.3
	chg from '19	3.1	0.7	-7.6	3.2	2.1	1.5	-2.9	6.8	4.0	-2.4
NIIP*	% of GDP	-24.1	7.5	7.9	-6.0	-11.7	-40.7	-37.4	24.9	-45.9	30.0
	chg from '19	6.0	10.1	7.9	4.2	3.5	1.6	3.5	16.9	2.9	9.0

MACRO-BASED INVULNERABILITY SCORE** (*x-axis*)

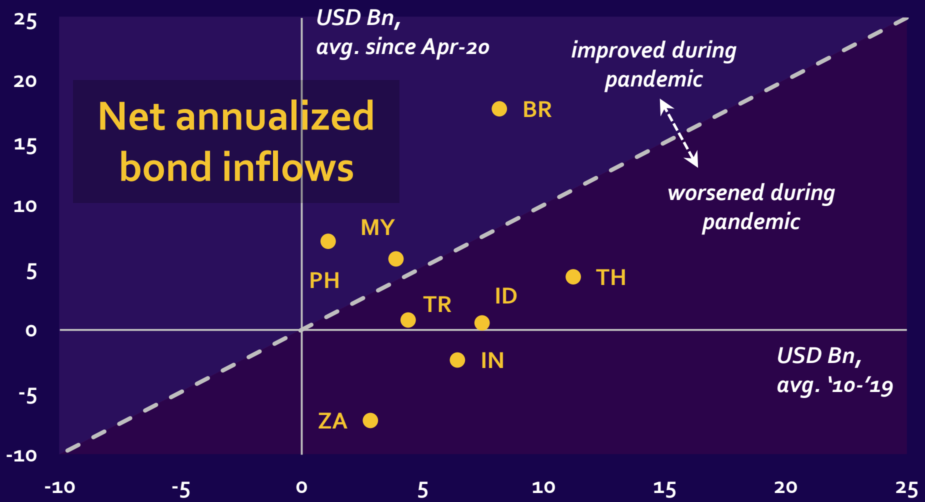
vs.

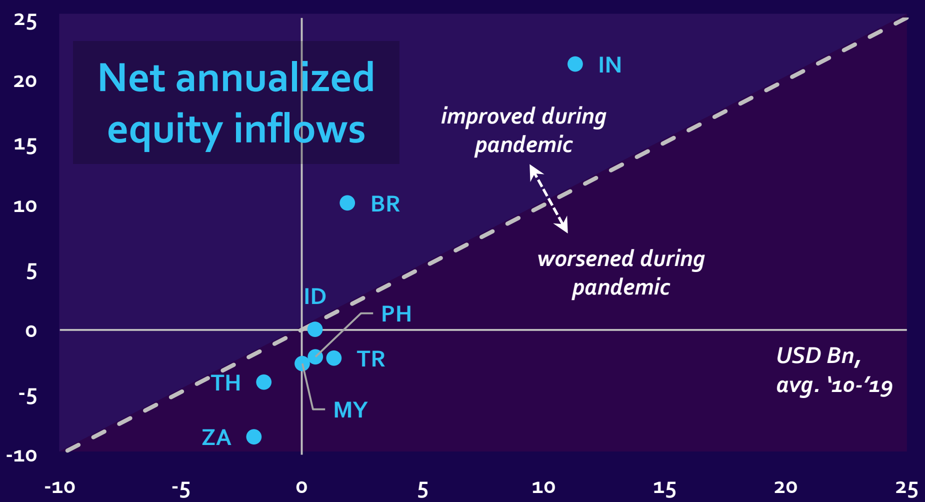
MARKET-BASED INVULNERABILITY SCORE** (*y-axis*)



Source : *Bloomberg, IMF, BCA Economist calculations*
** Net international investment position* *** Estimated by principal component analysis*

... but portfolio inflows to emerging markets have not quite been the same since the start of the pandemic

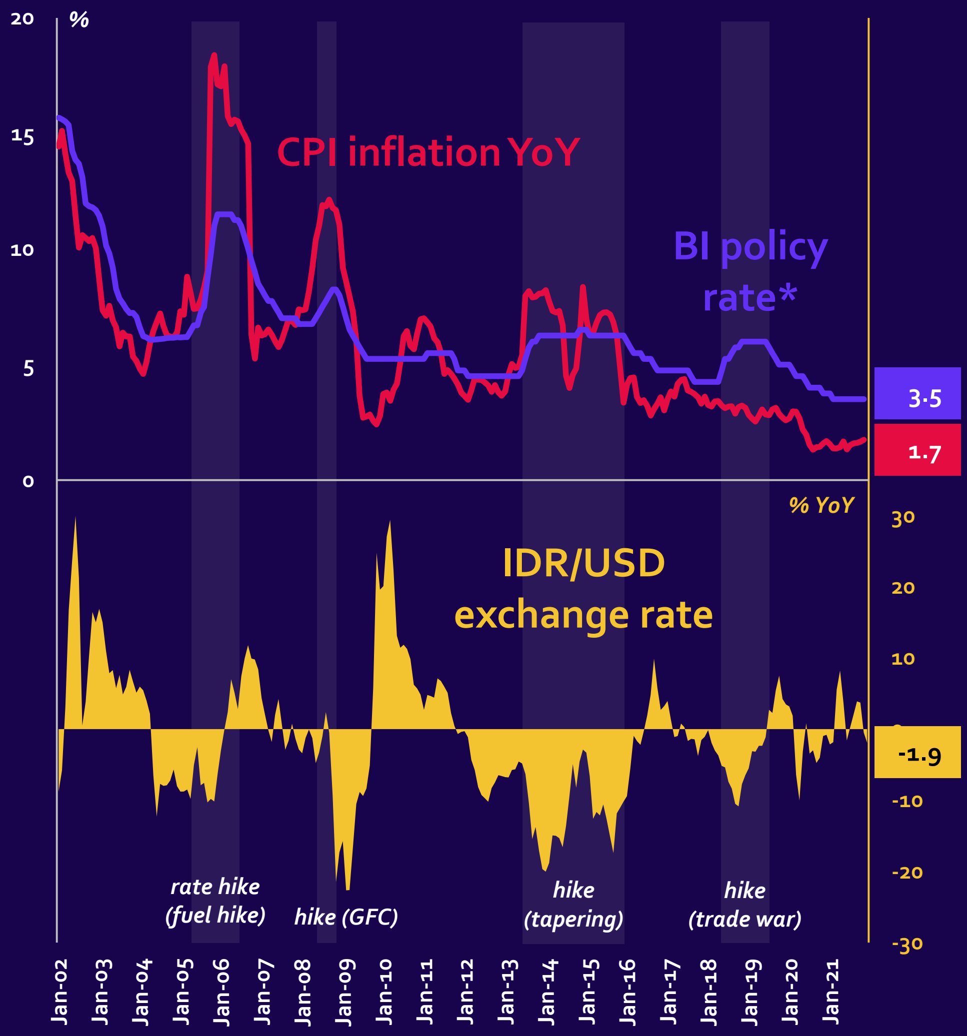




Source : *Bloomberg, BCA Economist calculations*

Exhibit 6

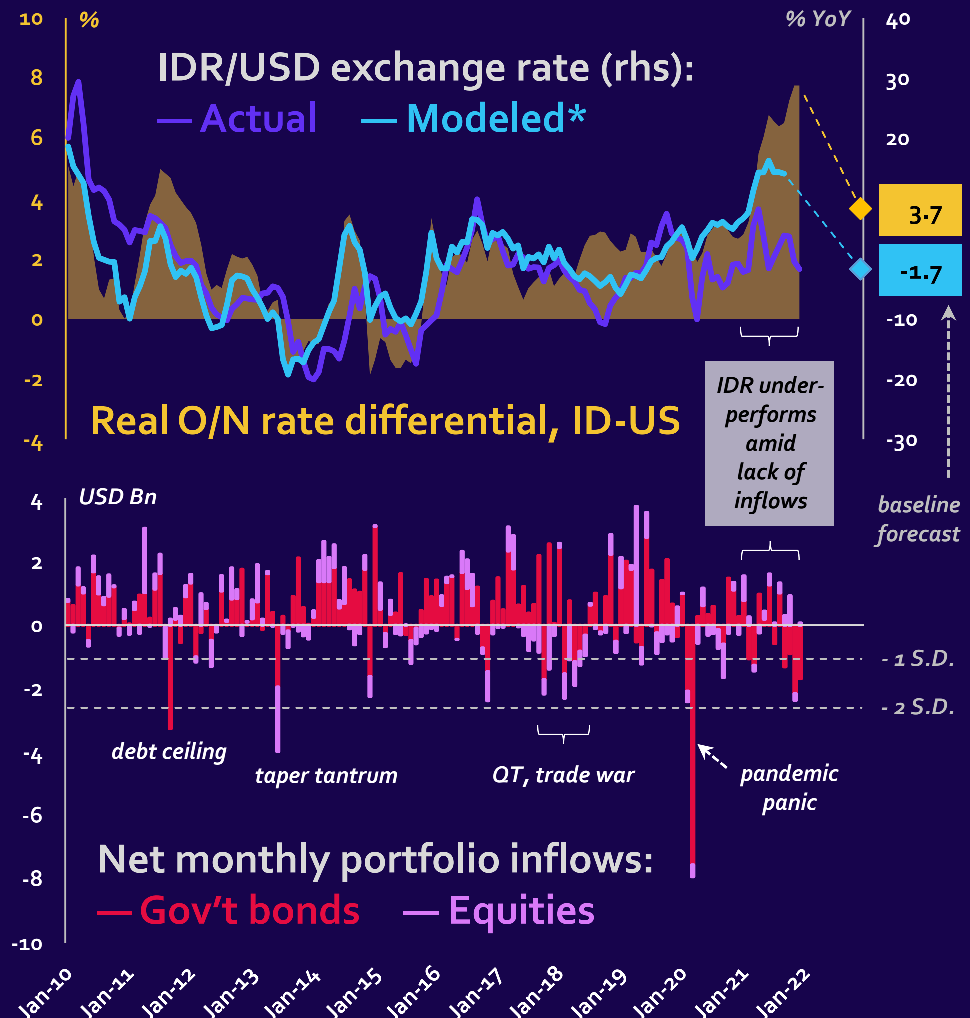
Since 2018, BI has maintained positive real policy rates as a buffer against depreciation risks ...



Source : *BPS, BI, Bloomberg, BCA Economist calculations*

** Merged across three policy regimes: SBI auctions (to Jun-05), BI Rate (to Jul-16), and 7-day Repo Rate*

… but the relative weakness of foreign inflows recently has capped IDR strength nonetheless

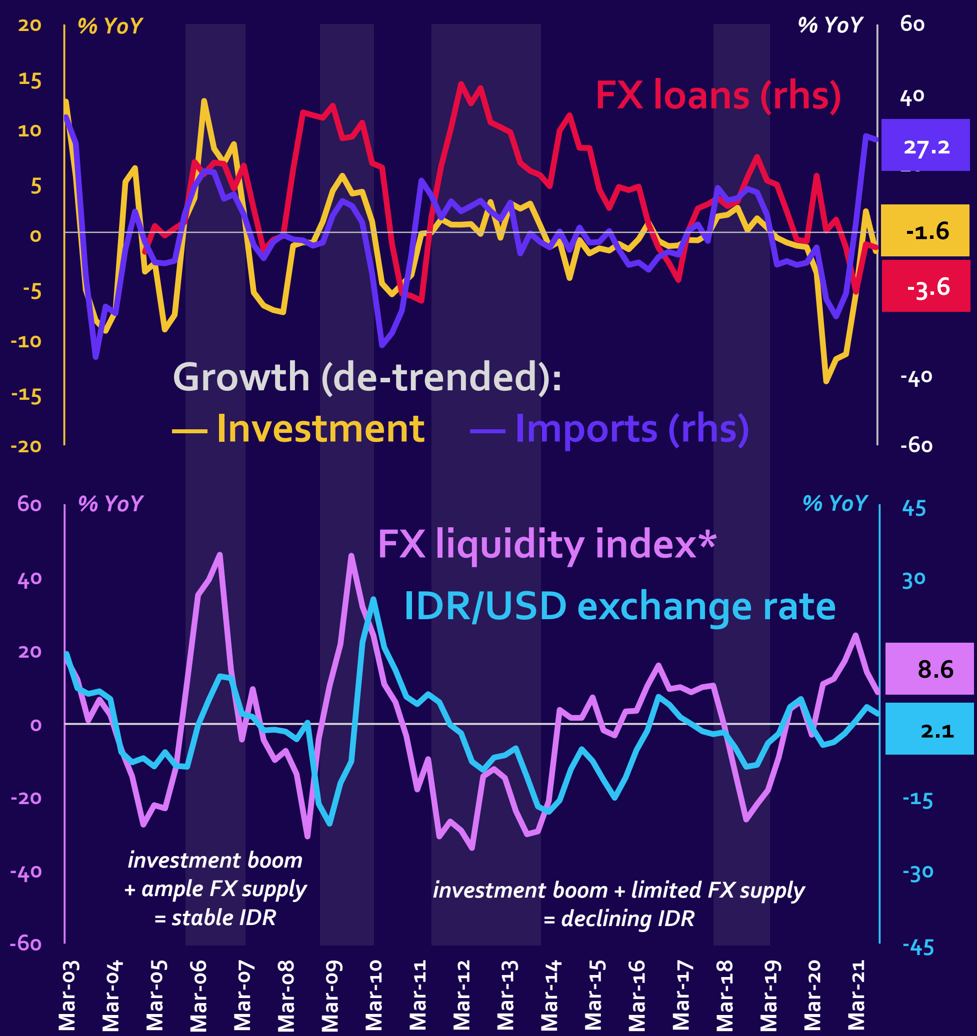


Source : *Bloomberg, BCA Economist calculations*

** Estimated based on real interest real differentials and FX liquidity index (see Exhibit 8)*

Exhibit 8

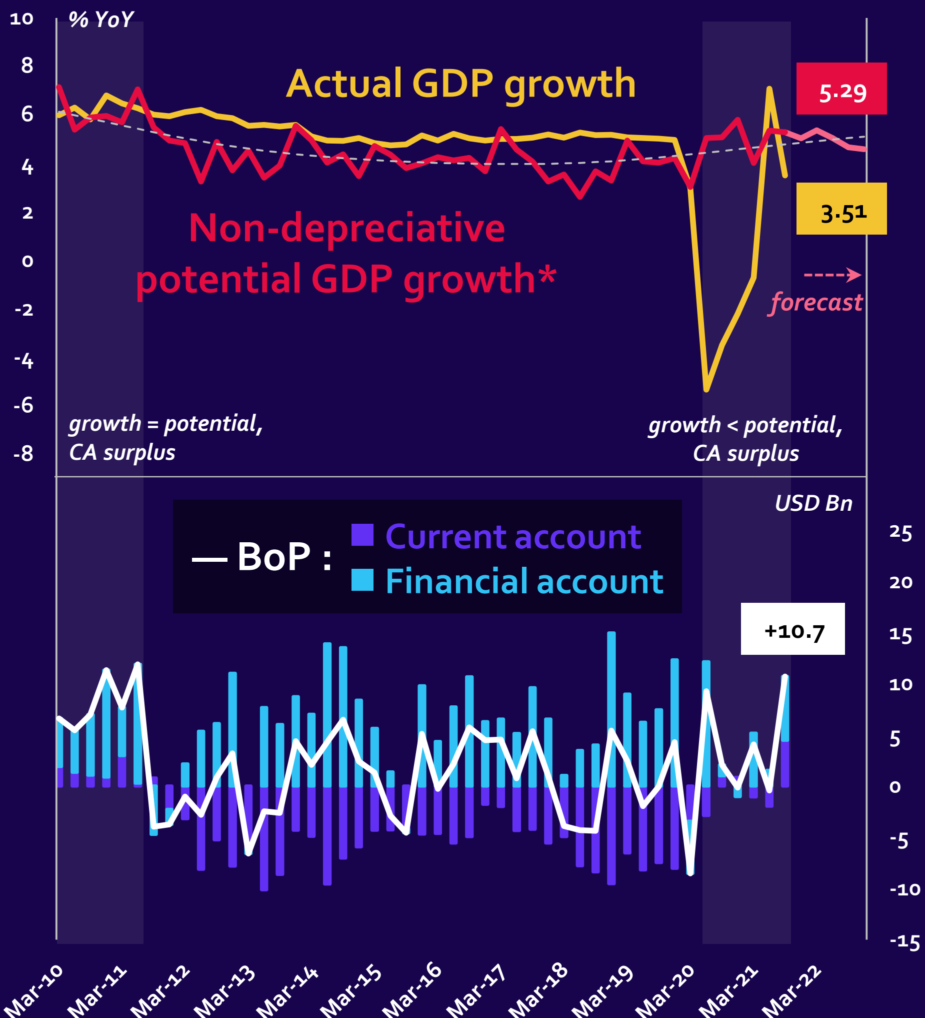
Every investment boom in recent history has been limited by the availability of foreign exchange ...



Source : *BPS, BI, OJK, Bloomberg, BCA Economist calculations*

** Net foreign asset growth YoY (FX supply) minus FX loan growth YoY (proxy for FX demand)*

... meaning that the current commodity boom has lifted Indonesia's potential growth rate



Source : *BPS, BI, OJK, Bloomberg, BCA Economist calculations*
** The growth rate at which FX supply growth is comparable to FX demand growth*

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Turning Outside In

Exit from pandemic-era stimulus

- A common narrative that has emerged recently is that Indonesia has got rid of a key vulnerability: the high level of foreign ownership in its sovereign bonds, which has declined from almost 40% prior to the pandemic to about 20% (***Exhibit 12***). However, these figures obscures a few underlying risks, and the fiscal stimulus of the past two years is not quite the "free lunch" that this narrative seems to suggest.

- Firstly, the oft-cited statistic on foreign ownership concerns tradable IDR bonds only, whereas the government has recently issued more FX debt (***Exhibit 11***) – no doubt taking advantage of low global yields. This explains why net bond liabilities have actually widened, in contrast to the overall improvement of the NIIP (***Exhibit 10***). Fortunately, the increase in FX debt is not as risky as it may appear amid a strengthening Dollar environment, as the FX composition of these new debts is quite well-diversified.

- Secondly – and more crucially – the banking system (i.e. BI and commercial banks) now holds half of tradable IDR bonds, to make up for the declining foreign portion. Commercial banks took the lead in 2020, as declining loan growth coupled with high private saving rates left it awash with liquidity. But as loans began to grow back in 2021, banks' capacity to absorb these bonds declined, forcing BI to increase its share. As a result, the monetary base (M0) is growing rapidly, precisely at a time when money velocity is starting to pick up along with economic recovery (***Exhibit 13***).

The reduced vulnerability to bond outflows comes at the cost of an expanding money supply, which could turn inflationary

- To put it another way, the growth of outside money from the stimulus was once needed to offset the collapse of inside money from lending, but is now growing alongside it (***Exhibit 14***). In essence, then, the reduced vulnerability to foreign bond outflows comes at the cost of an expanding money supply, which could turn inflationary under some circumstances.

- But there are two other ways to resolve this situation. The most desirable scenario is for foreign investors to return and reclaim their share of ownership in Indonesian sovereign bonds. However, the chances of this happening is rather slim, not only due to the Fed's upcoming rate hikes, but also because investors' appetite for EM bonds – not just Indonesia's (***Exhibit 7***) but EMs in general (***Exhibit 5***) – is not what it used to be prior to the pandemic. This might have to do with the US' large-scale fiscal stimulus, its widening CA deficit, and the corresponding increase in capital inflows *towards* the US, meaning that the "pandemic QE" is less of a positive force for EM compared to the old post-GFC QE (2008-14).

The exit from stimulus cannot rely on the return of foreign bondholders, meaning that it would take an actual reduction in government spending

- The other alternative is to reduce government debt issuance – essentially phasing out the growth of outside money. Government revenue growth in 2021 has been unusually strong, and the deficit likely falls below 5% of the GDP, much better than the mid-year outlook (5.8%). More encouragingly, this growth has been driven by natural resource revenues *as well as taxes*, and that the multi-year decline of Indonesia's tax/GDP ratio seems to have been arrested at last (***Exhibit 15***).

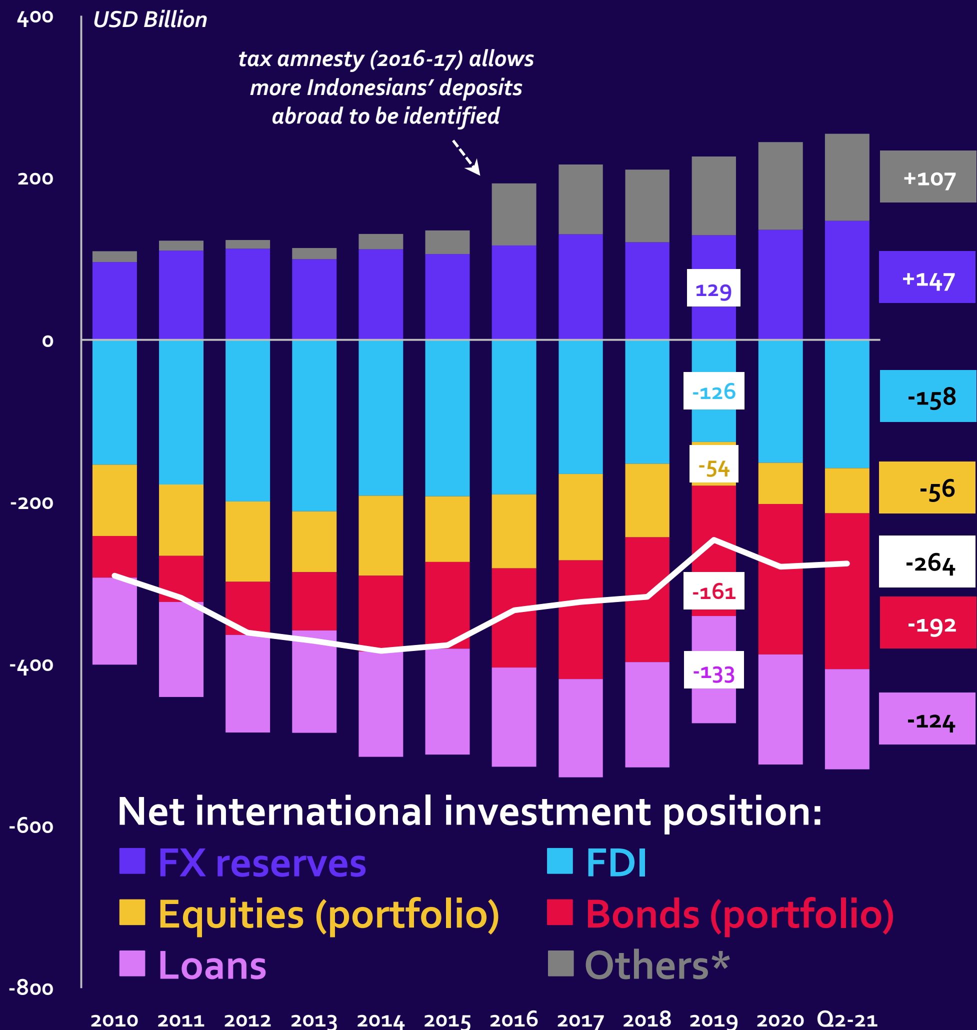
- All these bode well for 2022, where the government is already planning to implement several measures to raise revenue as part of the Tax Harmonization Act, including (1) an increase in VAT rate from 10% to 11%; (2) introduction of a top personal income tax bracket at 35% marginal rate; (3) a carbon tax scheme; and (4) a fresh round of tax amnesty. Paired with a rather conservative spending target, these may push the deficit closer to 4% of the GDP – not quite a return to normalcy, but a somewhat faster exit from stimulus compared to what was envisioned even in the 2022 Budget (which, we should recall, was issued in August 2021, i.e. prior to the big explosion in commodity prices).

The chronic decline in tax ratio has been arrested at last, and may reverse in 2022 thanks to the Tax Harmonization Act

- This lower deficit outlook should afford the government some flexibility with regards to its financing, in a year which could see significant uptrend and volatility in yields. In particular, we note that the fiscal deficit is not that far off from the size of the private sector's savings that we estimate for 2022 (***Exhibit 19***). This implies that (1) the CA balance would probably end up close to neutral (i.e. 0% of the GDP); and (2) the fiscal deficit could be largely financed by the financial sector (both banks and non-banks) as well as private individuals, without depending too much on foreign inflows or BI intervention.

- As such, while BI retains the option to purchase government bonds at sub-market rates ("burden sharing") to a tune of Rp 224 Tn, this appears to be simply an additional tool to manage financing costs rather than an absolute lifeline for the government. Indonesia is therefore far removed from the danger of fiscal dominance – whereby monetary policy is forced to stay loose for an extended time to help finance fiscal deficits – and this should help maintain a strong sovereign risk outlook going forward.

Despite overall NIIP improvement, net gov't bond liabilities have widened since the pandemic ...



Source : *BI, BCA Economist*

* *Mainly consisting of cash, bank deposits, and trade loans*

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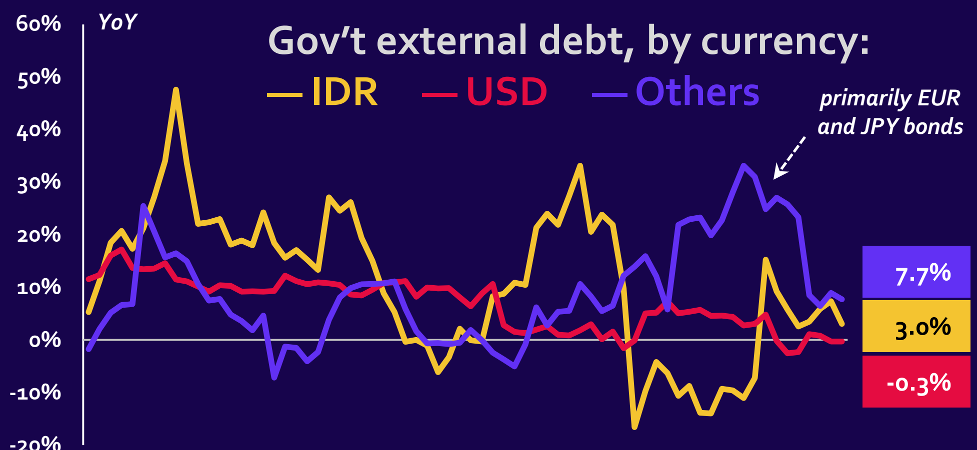
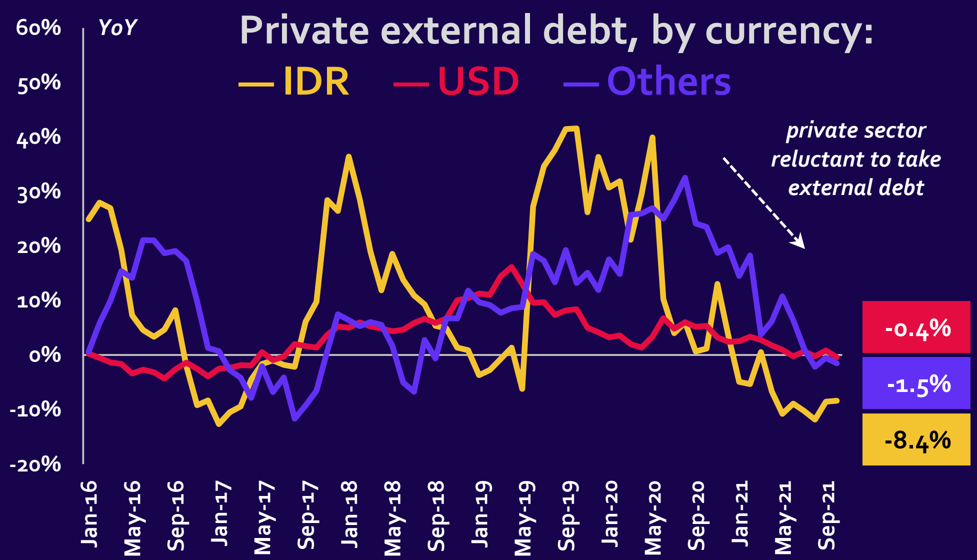
Exhibit 11

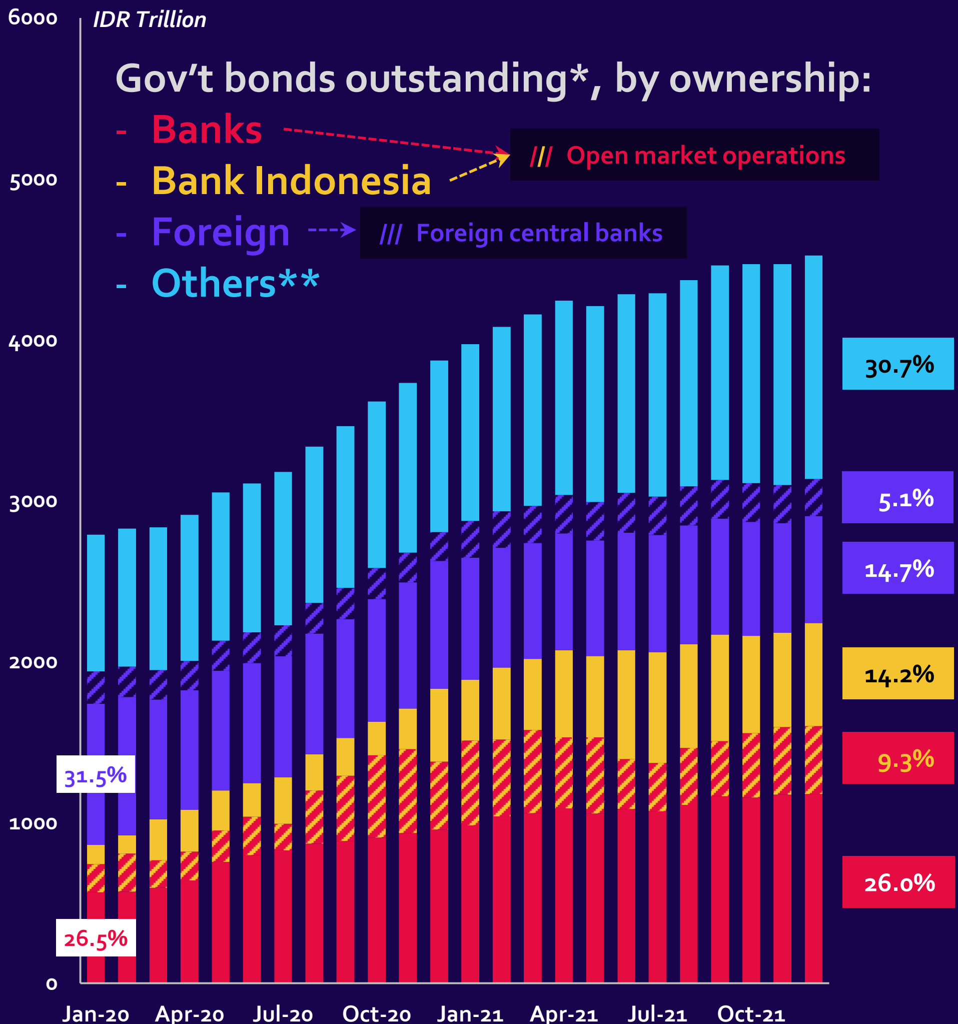
… as the gov't issued large amounts of FX bonds, although external debt risks remain under control





Source : *BI, BCA Economist*

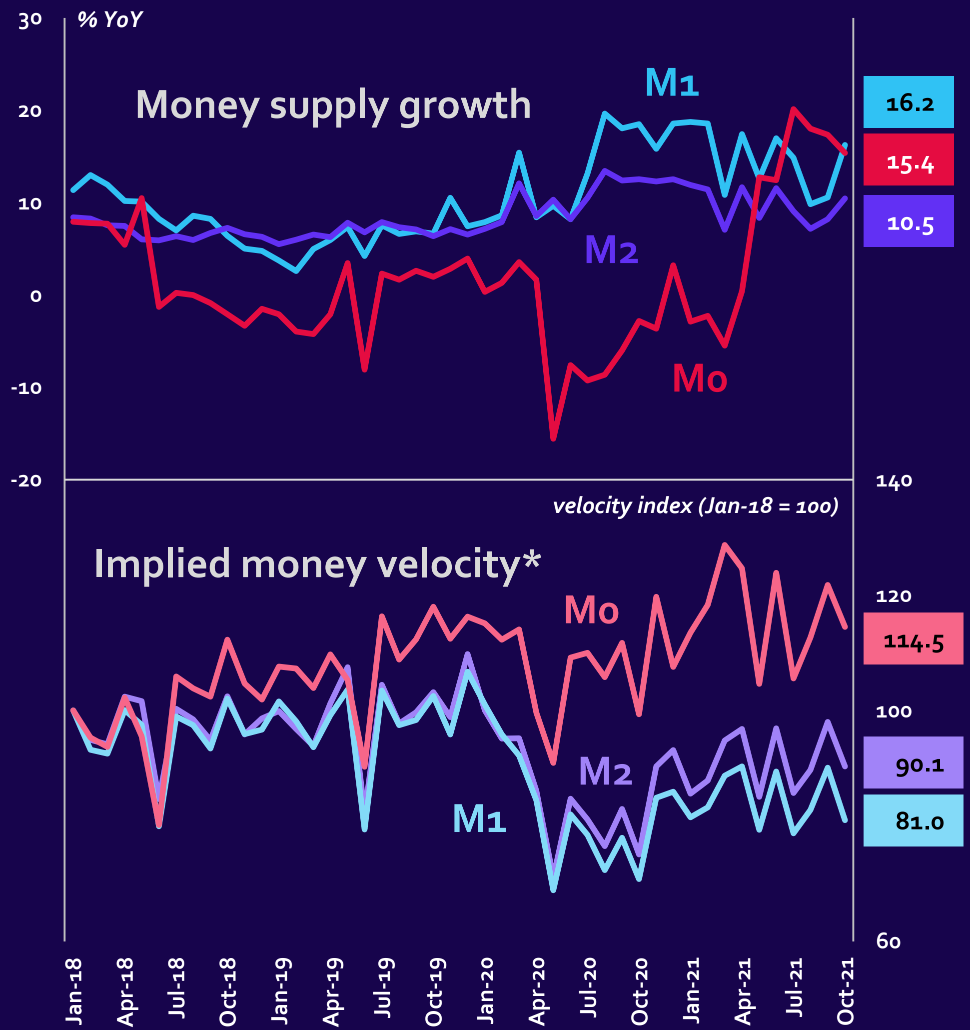
BI increasingly takes the lead in buying gov't debt amid reduced demand from banks and foreigners ...



Source : *MoF, BCA Economist*

** Tradable IDR bonds only* *** Insurance, pension funds, private individuals, and other institutions*

… resulting in rapid base money growth while money velocity is gradually picking up

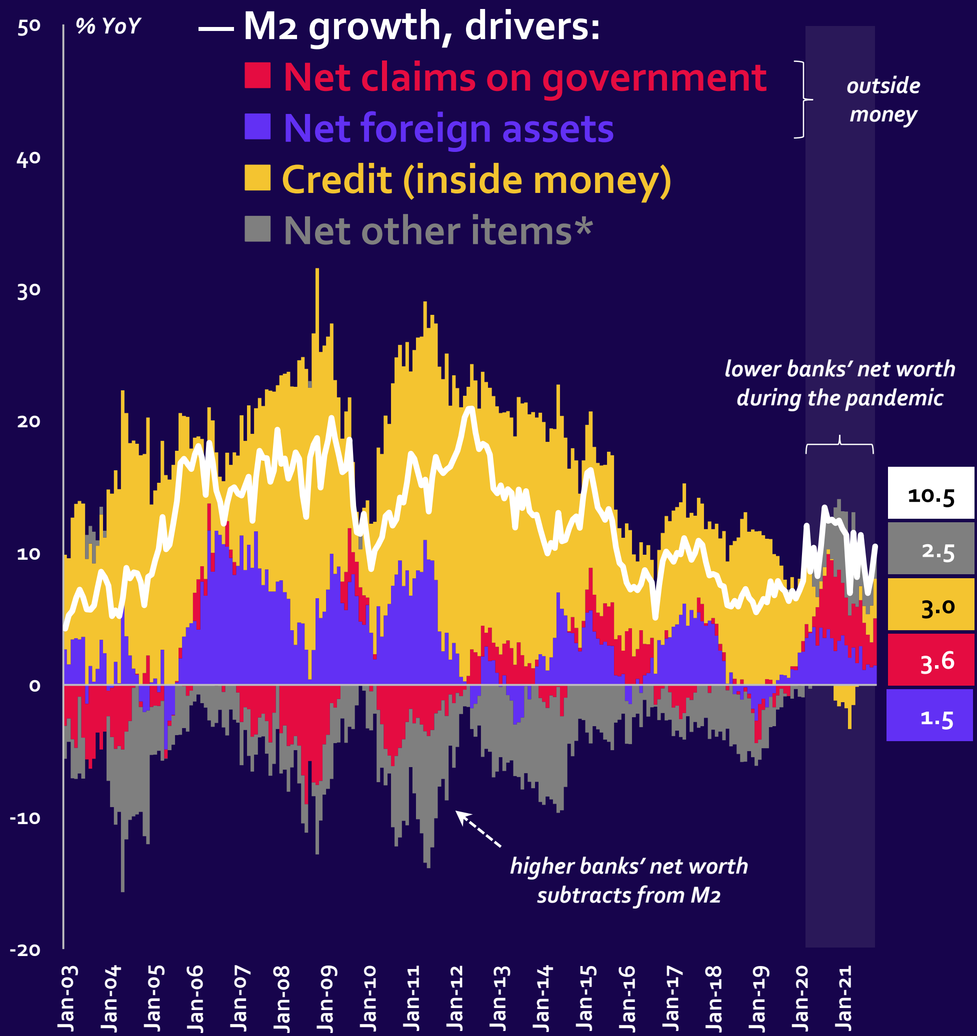


Source : *BI, BCA Big Data, BCA Economist calculations*

** Calculated based on BI money supply data and BCA transaction activities data*

Exhibit 14

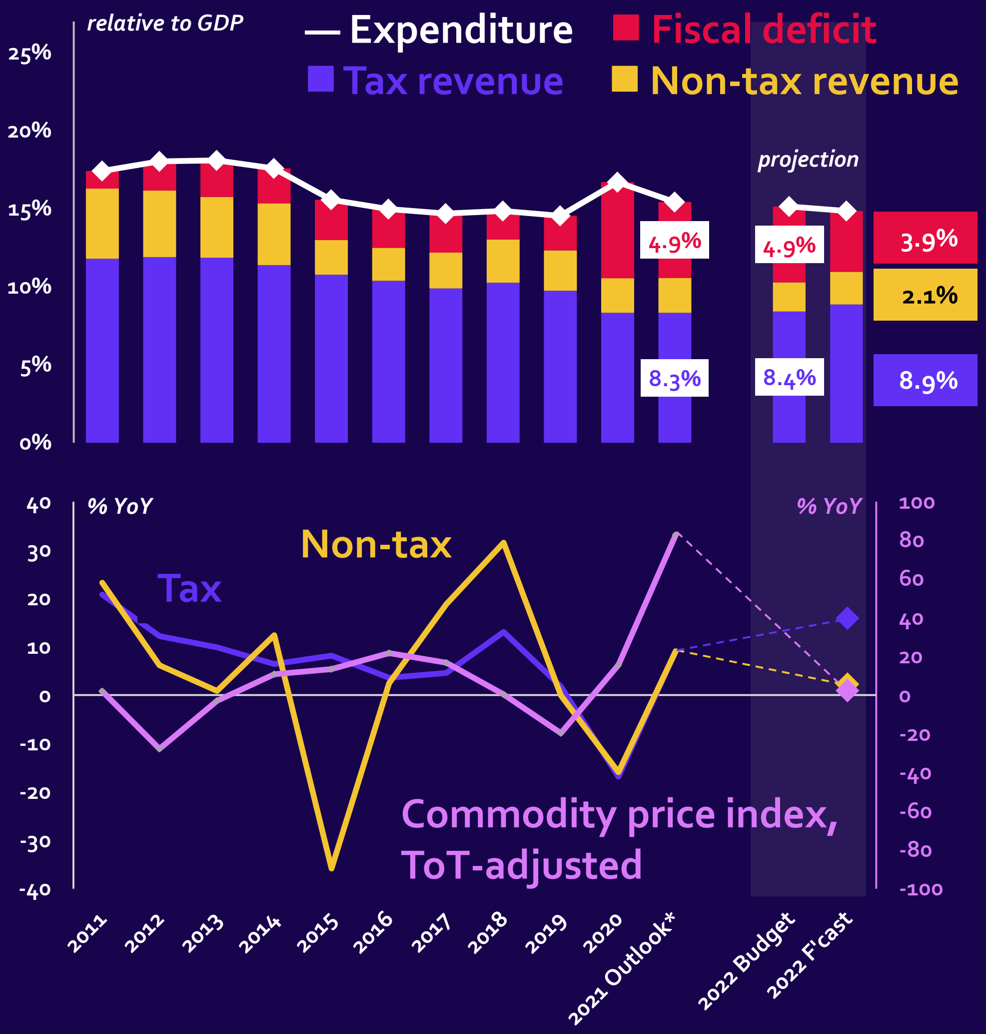
Stimulus was needed to offset loan contraction, but will have to wind down as credit expands again



Source : *BI, BCA Economist calculations*

** Reflects equities, physical assets, impairments, and other items in banks' and BI's balance sheet*

Strong revenue growth and tax reforms could drive fiscal normalization slightly ahead of schedule



Source : *MoF, BPS, Bloomberg, BCA Economist calculations*
** Extrapolated to full year from the latest interim MoF data (November 2021)*

Waiting for the Starting Gun

The lurking threat of inflation

- A smooth exit from stimulus alone, however, does not guarantee low and stable inflation. As mentioned earlier, inside money growth (i.e. lending) is starting to pick up, and this is historically associated with an increase in core inflation (***Exhibit 16 – lower panel***). The correlation between the two goes both ways – lending expands money supply, while inflation reduces real interest rates and thereby incentivizing borrowing. The fact that core inflation has stayed low, then, appears to be an anomaly that may snap back to normal in the next few quarters.

Fixed energy prices has shielded Indonesia from the global inflationary trend, but inflation may accelerate in 2022 alongside demand

- One common "folk hypothesis" as to why inflation has not accelerated is that businesses are essentially locked in a "waiting game" with each other. The first one to hike their prices risks losing customers – particularly when demand has not quite returned to form – so most opt for volumes while sacrificing margins amid rising prices of imported inputs.

- This is quite a plausible – albeit simplified – scenario, and it suggests two ways that inflation could "catch up" to the elevated global norms. The first is in monopolistic or oligopolistic industries, where corporations have substantial pricing power. The second is via some signal that allows businesses to increase prices in a semi-coordinated fashion – a "starting gun" of sorts.

- The new year of 2022 may serve as such a signal to some extent, but the most potent starting gun remains the increase in energy prices, which is largely fixed by the government (hence administered prices). In the past, global inflationary pressures only translates to domestic inflation insofar as administered prices allow them to (***Exhibit 16 – upper panel***).

- The political decision to hike (or not to hike) energy prices thus affects the transmission of both supply-side and demand-side inflation, making the outlook for inflation – especially for 2022 – highly uncertain. The government's choice to keep energy prices low so far is meant to not jeopardize consumer demand amid the incipient recovery, especially given the possibility that global energy prices might ease in the future.

- It is also no longer as costly for the government to maintain the price gap between global and domestic energy prices. Unlike in the past, when the fuel price policy could plainly affect sovereign ratings, the burden of subsidizing energy prices is now shouldered mostly/partly by the respective SOEs (***Exhibit 18***) – Pertamina for liquid fuels and household LPG, and PLN for electricity. Plus, under the domestic market obligation (DMO) rules, coal producers also bear some opportunity loss, as they have to sell to PLN at only USD 70/MT (versus the average of USD 181/MT during H2-21).

The fuel price gap is now shouldered by SOEs instead of government budget, but adjustment may still be necessary if oil/coal prices stay high through H2-22

- The question, then, is about timing. Energy prices, as we mentioned in the beginning, have a knack of staying higher for longer compared to other commodities, whereas the two SOEs have a finite capacity to sustain these losses. So while energy prices stay unchanged for now (other than non-subsidized items), the odds of an adjustment may rise if oil/coal prices stay high through H2-22. Kicking the can further to 2023 is possible, but it might come too close for (political) comfort to the 2024 Elections.

- Even in the absence of energy price adjustment, inflation is very likely to increase, albeit much less abruptly. Aside from the aforementioned loan growth, imported inflation, and increase in the aggregate demand, there is also the wildcard of food prices. Unlike energy, the government's control over food prices is less direct, and consequently consumer prices tend not to deviate too sharply from producer prices (***Exhibit 17***).

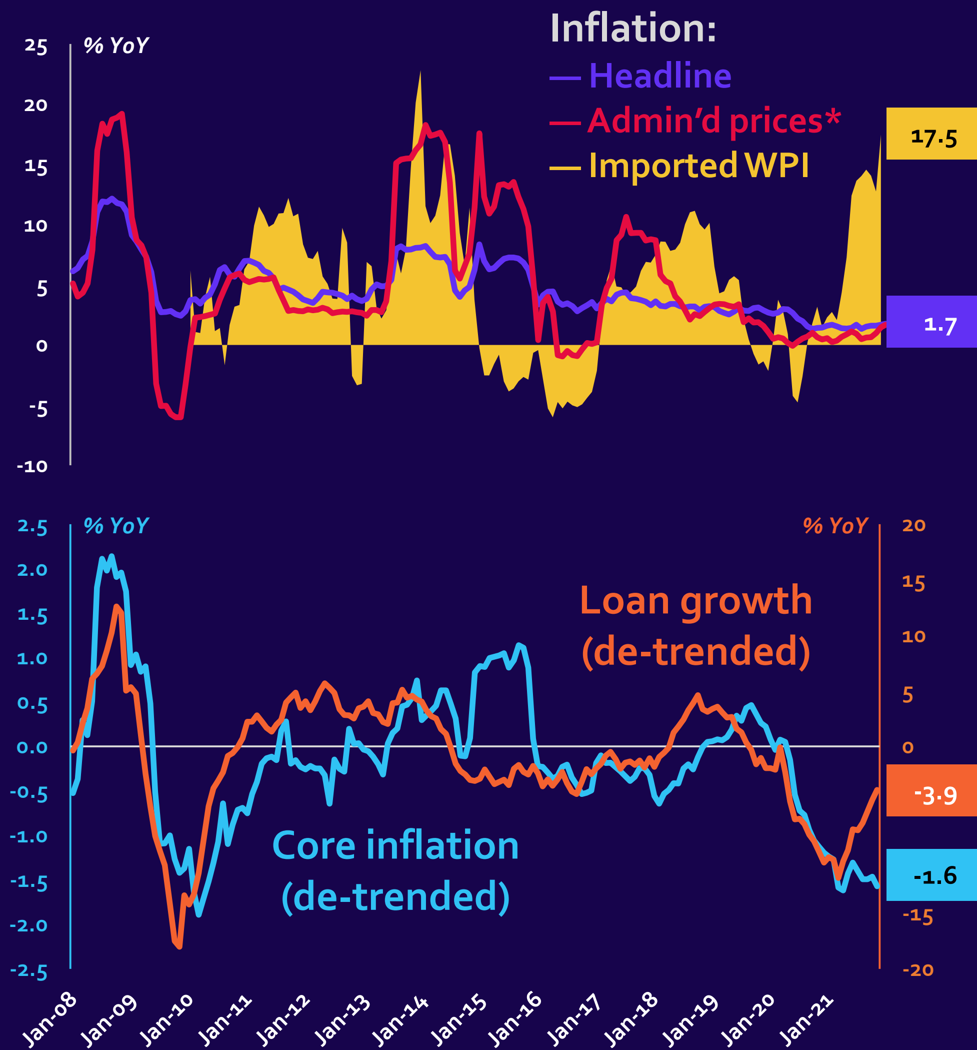
- Compared to other countries, Indonesia has been quite fortunate so far in that it has seen declines in producer prices for several key foodstuffs (rice, onions, poultry/egg at several points) during the pandemic. But the La Nina weather anomaly to start the year seems to be affecting the production of several food commodities such as CPO and chili peppers.

Indonesia has benefited from low food inflation, but this may change due to weather factors and the return of migration to cities

- Furthermore, economic recovery will also attract migrant workers back to the big cities after spending 1-2 years in their home villages, which may cause inflation in two ways. Firstly, the higher earnings in the cities would lead to an increase in aggregate demand. Secondly, inasmuch as these workers assisted in agricultural work during their time in the villages, their move to the cities could also alter the balance between food supply and demand in favor of higher food prices.

Exhibit 16

Inflation has been kept in check amid global pressures, but it is likely to increase alongside loan growth

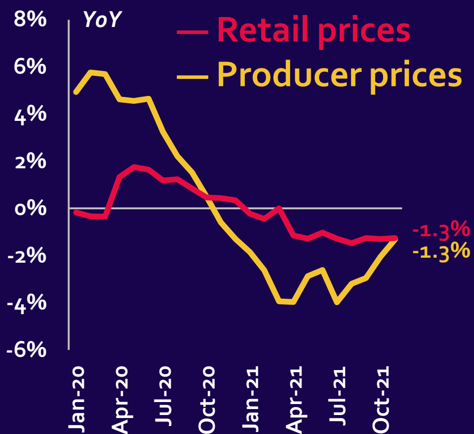


Source : *BPS, BI, OJK, BCA Economist calculations*

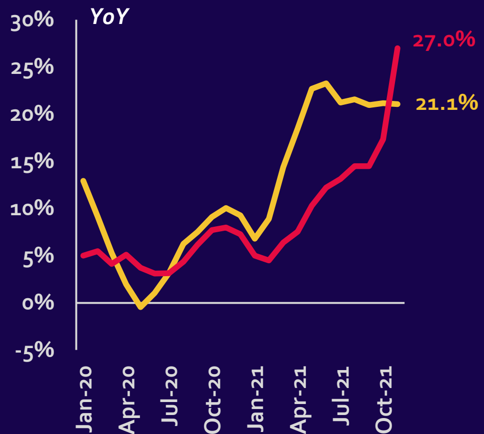
** Prices under government control, mainly energy but also cigarette excise, airline tariffs, etc.*

Food prices have moved in line with producer prices, implying relatively limited role of gov't intervention

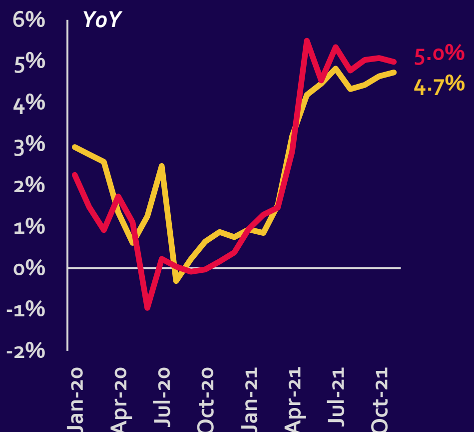
RICE



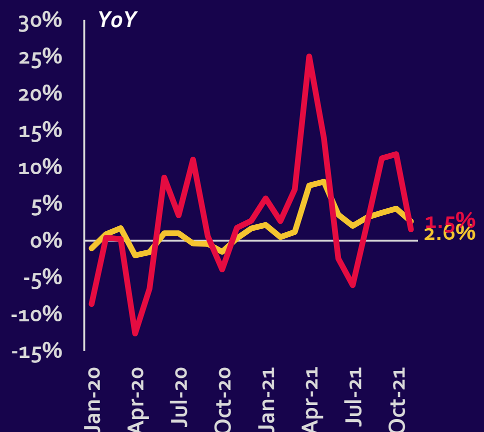
CPO*



BEEF



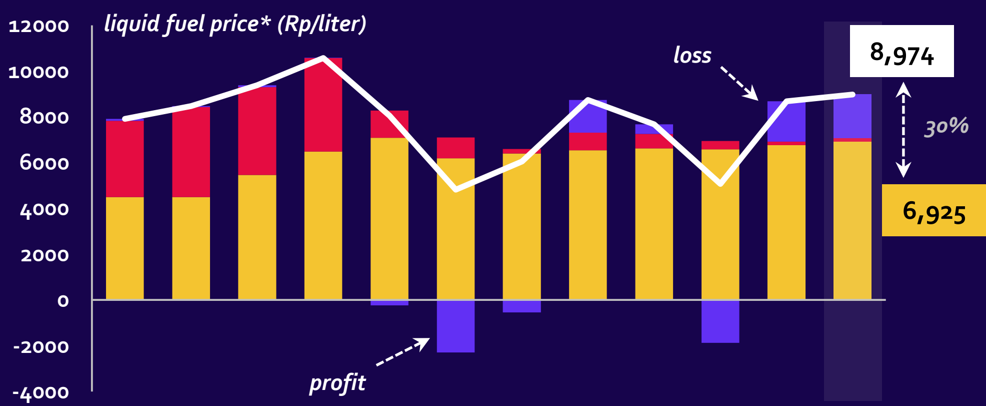
POULTRY



Source : *BPS, Ministry of Trade, BCA Economist*

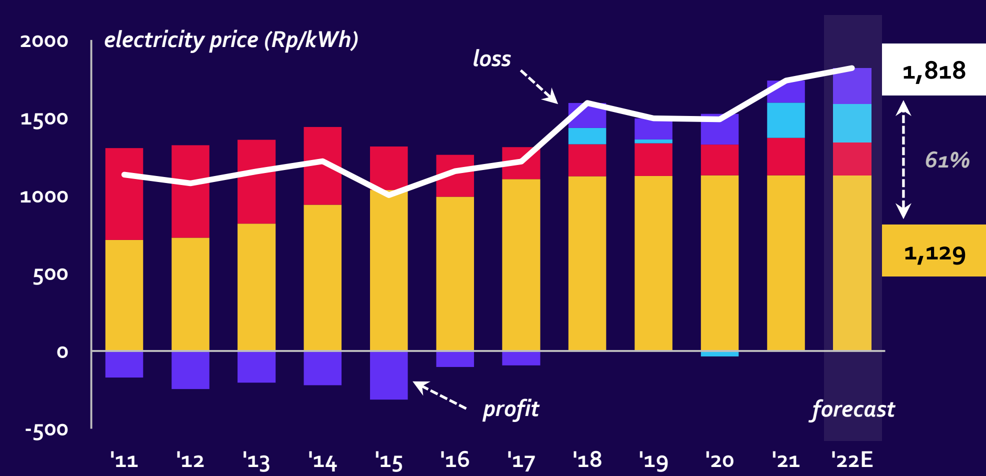
** CPO producer price refers to the price received by plantation crop farmers in general*

Misalignment of local energy prices (vs. global) poses little fiscal risk, but could be costly to SOEs



Who's paying for energy?

Customers
Gov't subsidies
SOE (Pertamina/PLN)
Coal producers (DMO)

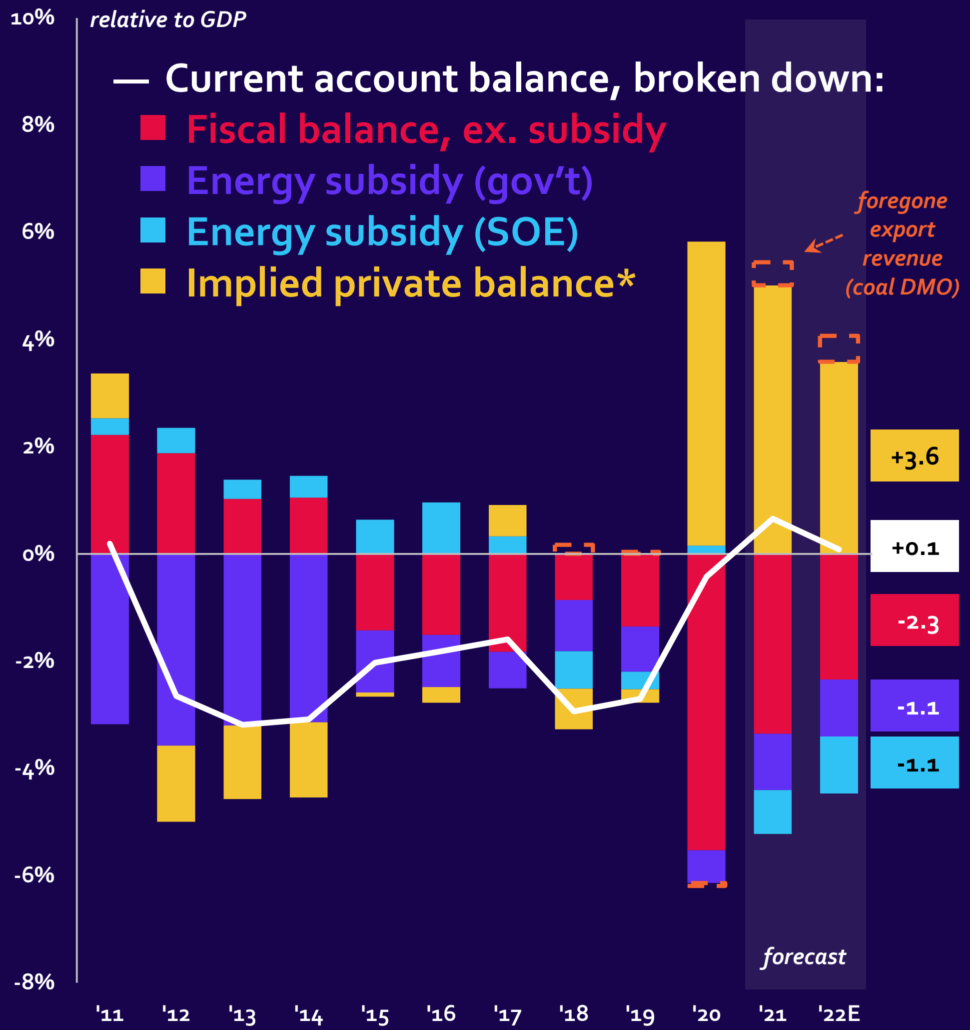


Source : *MoF, Pertamina, PLN, Bloomberg, BCA Economist calculations*

** Mix of Pertalite and DMO fuels (Premium and subsidized Solar), weighted by consumption volumes*

Exhibit 19

Energy subsidy and commodity boom contribute towards the private sector's substantial net savings



Source : *MoF, Pertamina, PLN, Bloomberg, BCA Economist calculations*
** Private businesses, households, plus SOEs outside of energy subsidies*

All Together Now

A more broad-based recovery

- Given the commodity boom, the rising growth potential, and the broadly-reduced vulnerability that we have seen, it is indeed likely that Indonesia will finally return to the 5%-plus growth that it is accustomed to in 2022. And while inflation and BI policy rate are both likely to increase during the course of the year, their effect on growth will only be fully felt after a few quarters. For illustration, growth during the tantrum year of 2013 was 0.5% lower than 2012, but the major drop-off to sub-5% growth did not occur until 2014-15 (***Exhibit 20***) – and even then, it was mixed up with the impact of falling commodity prices.

- That recovery is proceeding well is clearly apparent from BCA's transaction data, whether on the businesses' side or the consumers' sides (***Exhibit 21***). Indeed, the pace of transaction growth in Q4-21 is consistent with a GDP growth rate of more than 6% YoY, although we expect this momentum to cool off somewhat in 2022.

The economic impact of successive Covid waves seem to be diminishing, as the economy adapts and moves online

- It is also quite striking how short-lived and limited the impact of Delta was on economic activities, even though it drastically curtailed mobility. This shows how much of the economy have moved online – in fact, our offline-only consumption index has only belatedly returned to its pre-pandemic levels, thanks to a rapid rise in mobility. It also points to (fingers crossed) diminishing economic impact of successive Covid waves, especially considering that the majority of cases and deaths in Indonesia happened during the Delta wave.

- Such rapid growth is inevitably rather broad-based, and we are likely exiting the period of "K-shaped recovery", when only a handful of industries are growing. From 2020 up to the early 2021, this include all the expected ones i.e. basic consumer staples, healthcare, pharmaceuticals, as well as the commodity sectors.

Most sectors are on their way to recovery, even some like hotels and transportation which had seen large scarring effects

- For 2022, then, the recovery would extend to the sectors on the left-hand side of ***Exhibit 27***. These are all industries that have seen output losses – i.e. their nominal output in the past two years have been markedly lower than what would be expected given their growth trajectory prior to the pandemic. We use this output loss as a proxy for the so-called "scarring effect" that each sector has experienced, be it in the form of layoffs, financial losses, business closures, or non-performing loans.

- The vast majority of these sectors have begun to recover through Q3-21, although not quite at their normal pace. This includes such central sectors as retail, banking, real estate, and utilities, which are all certainly lifted by the post-Delta momentum. Others, the automobile industry in particular, actually saw outsized growth 2021, thanks to the government's tax incentives. As such, the recovery in vehicle sales are way ahead of schedule, but durable goods in general are probably not far behind, given the strength of consumer confidence since October (***Exhibit 22***).

- This leaves us with just a handful of edge cases. On one hand, there are sectors that have suffered from extreme output loss during the pandemic, namely transportation and tourism, which have nonetheless begun a slow recovery in spite of the on-again/off-again mobility restrictions. The pandemic probably "killed off" many of the weakest/least efficient players in these industries, but this also opens new opportunities when international travel resumes a few quarters/years down the road.

- A few other industries such as textiles, paper, and electronics are showing negative real growth in 2021, which might have to do with the logistical logjam that affect manufacturing industries across the globe. The case of textiles is nonetheless quite concerning given the scarring effect that the industry had experienced – and this could be a prelude to a further decline in competitiveness down the road.

- With consumer demand and business revenues (for most sectors) riding a hot streak into 2022, the one thing that remains in flux is business spending, i.e. investment in physical or intangible assets. Throughout 2021, our big data observations indicated that businesses were still quite reluctant to spend, resulting in a significant increase in their cash reserves. This was especially true for commodity sectors such as coal, perhaps due to the uncertainty as to whether the current boom turns out to be short-lived.

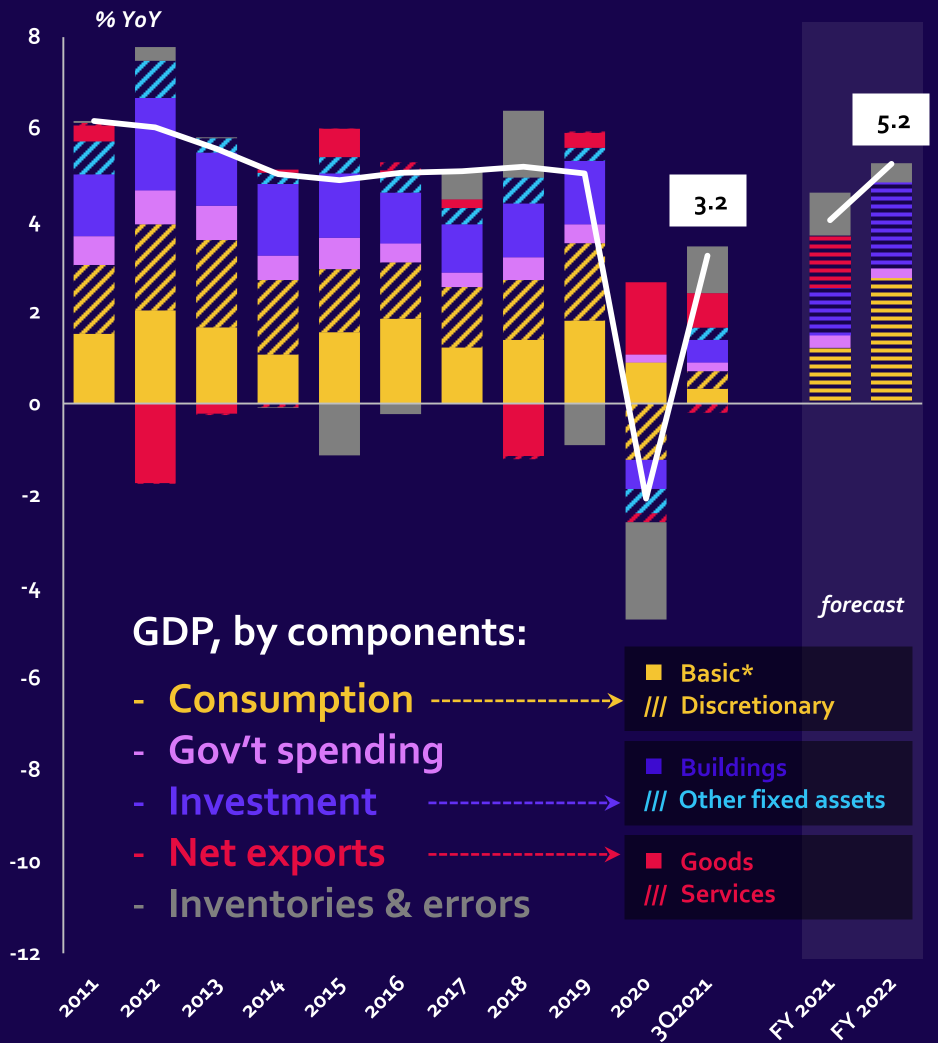
Investment have been lagging behind during the initial recovery, but high capacity utilization and stable financial indicators among corporates could facilitate it in 2022

- Other indicators such as the growth of investment loans have also remained subpar, as have capital goods imports, whose growth lags behind those of consumer goods and raw materials (***Exhibit 23***). A closer look at the data, however, reveals that the gap may have been partly an artefact of global inflation, as prices of machinery, electrical equipment, and the likes have risen more slowly than other imported goods. We are also seeing a sharp increase in reported job availability (***Exhibit 22***) – a sign that at least certain industries are starting to expand and recruit workers in response to the burgeoning demand.

- An investment boom – or at least above-trend investment growth (***Exhibit 8***) – is thus potentially closer than it might seem. Before Delta hit, capacity utilization in manufacturing industries was already close to pre-pandemic norms, and the sharp increase in PMI after Delta could lead to even higher utilization rates (***Exhibit 24***). Indeed, it is quite striking that several manufacturing industries have seen positive investment growth (FDI and DDI) amid the pandemic (***Exhibit 25***), which is perhaps driven by many of the same factors that have inflamed global inflation recently – supply-chain disruptions and greater demand for goods vis-à-vis services. These issues would also make investment in logistics – from shipping to last-mile delivery – highly attractive in the medium-term.

- The average Indonesian corporation also seem to have emerged from the pandemic in decent financial shapes (***Exhibit 26***). In addition to the strong revenue growth and recovering profit margins, the median debt/equity ratio of listed companies has also stayed remarkably stable throughout the pandemic – neither a debt overhang nor a deleveraging trend that could both impede growth. The stage is thus set for a "comeback year", in which growth would finally become less dependent on exports and stimulus, but instead on a broad-based recovery in both consumption and investment (***Exhibit 20***).

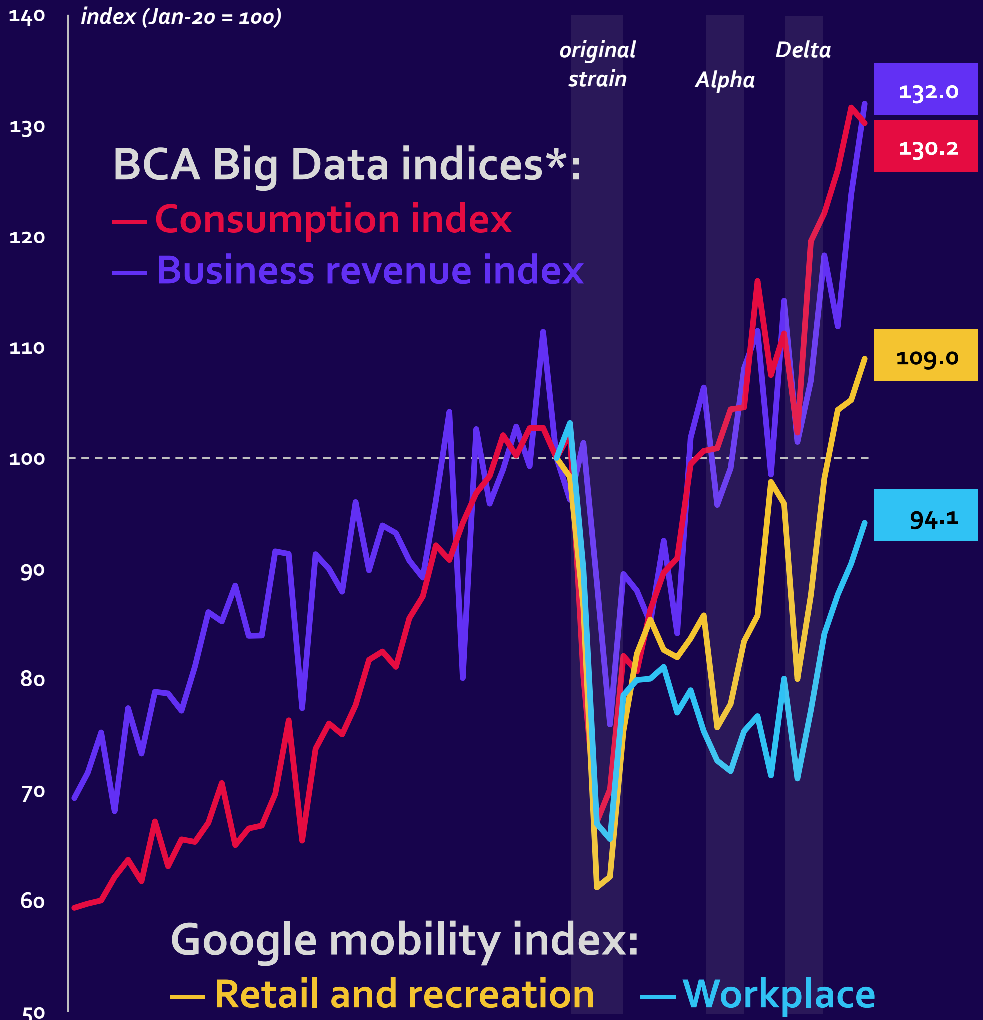
Growth has hitherto been led mostly by exports, but domestic demand is regaining the initiative



Source : *BPS, BCA Economist calculations*

** Food and beverages (other than restaurants), clothing, healthcare, and education*

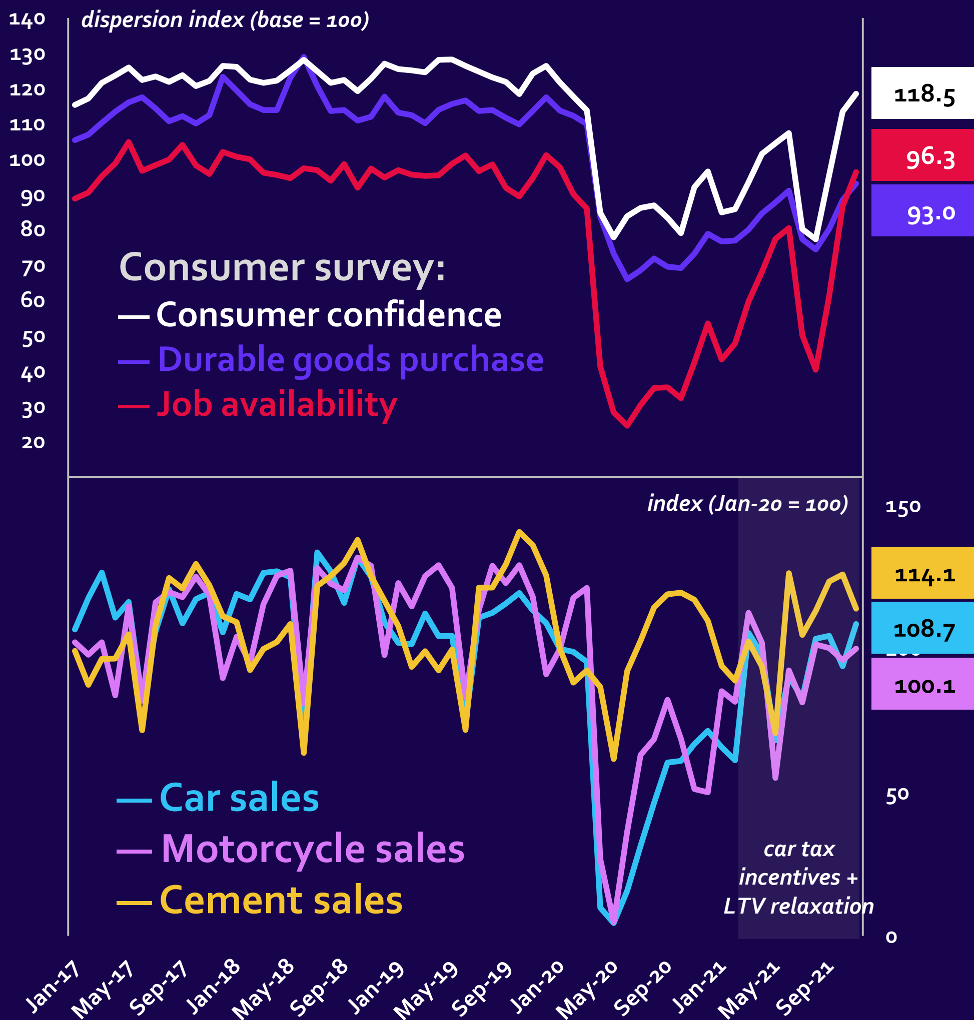
Consumer spending and business revenue have rallied after Delta, as have mobility to a lesser extent



Source : *BCA Big Data, Google, BCA Economist calculations*

** Reflects aggregated BCA transaction data, averaged for each month*

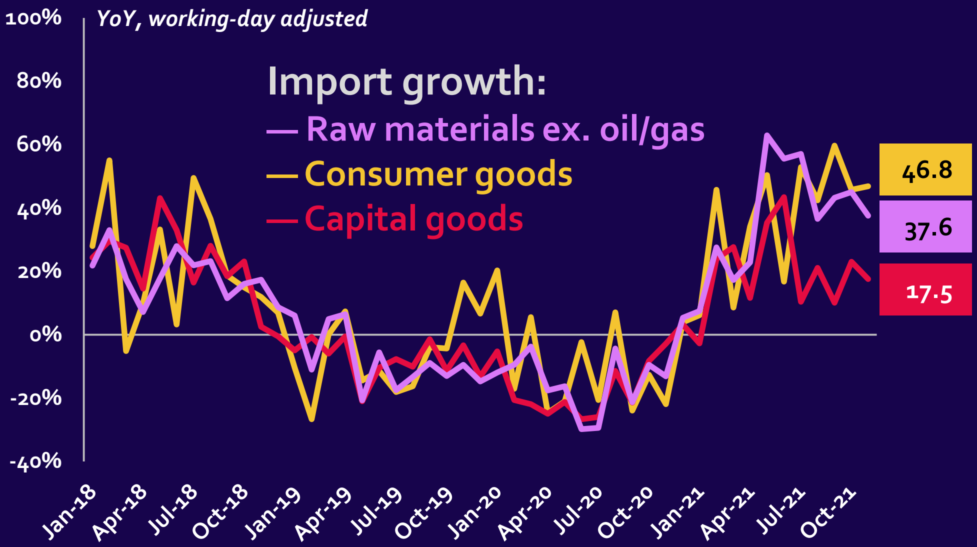
Consumer optimism is starting to spill over into big-ticket purchase, independent of gov't incentives

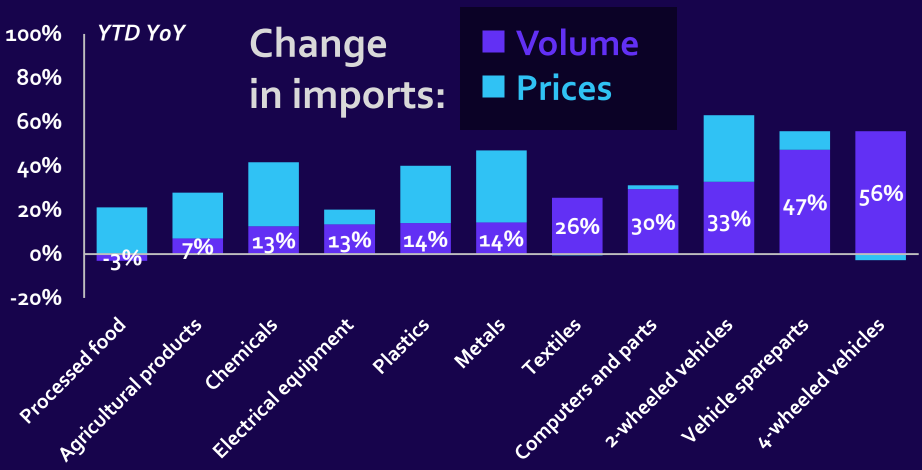


Source : *BI, Gaikindo, AISI, PT Semen Indonesia, BCA Economist calculations*

Exhibit 23

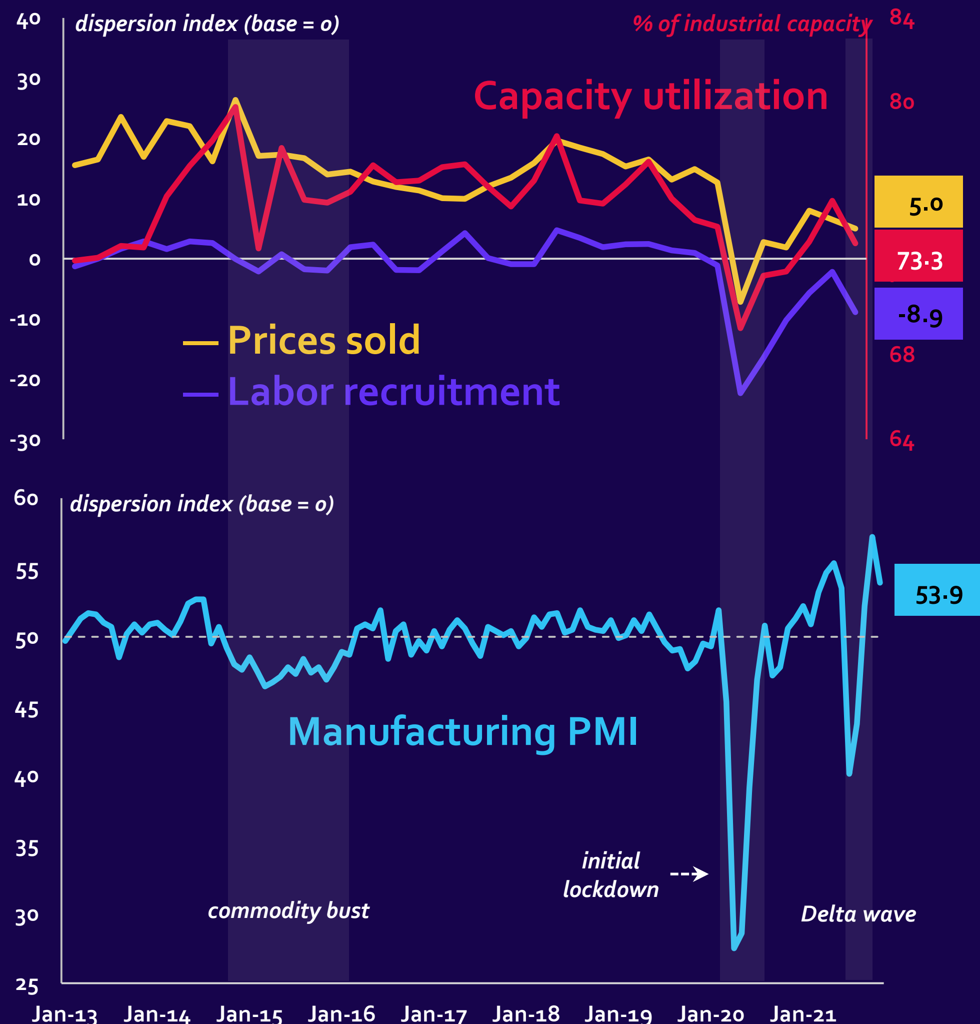
Capital goods imports have been lagging behind, but it is partly an artefact of inflation differentials





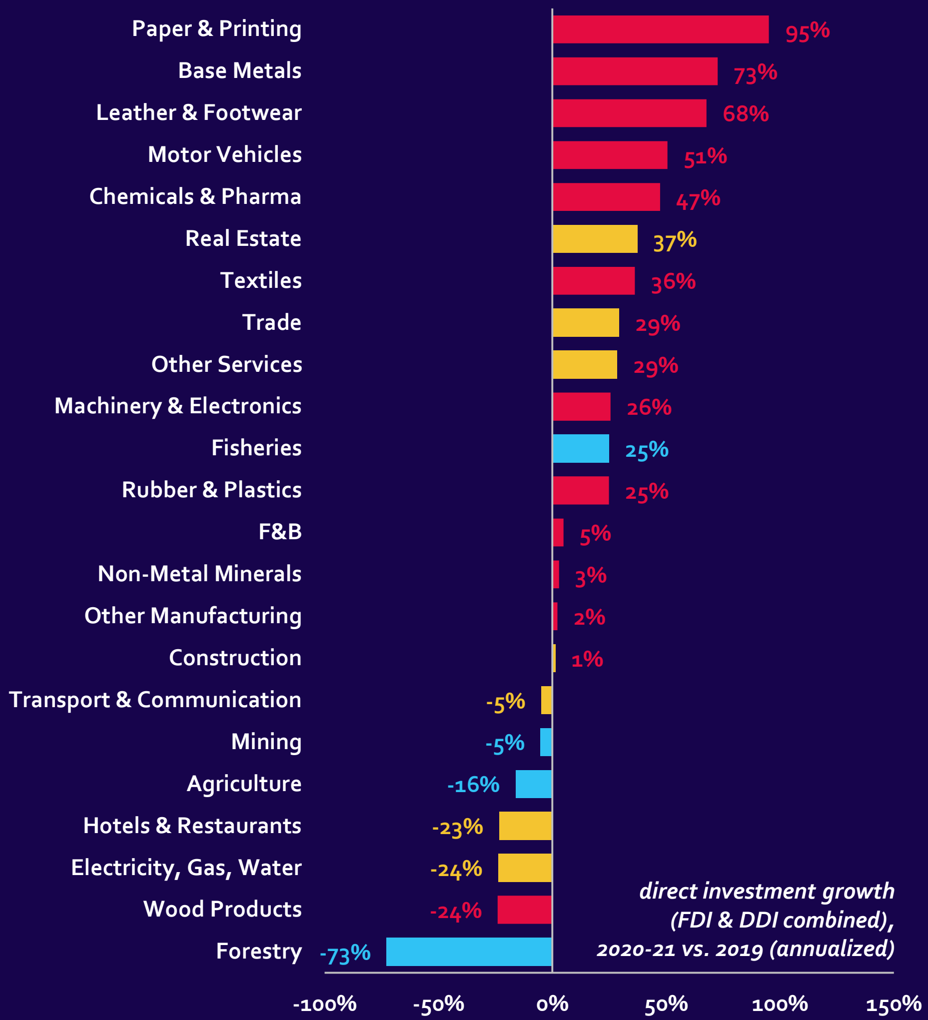
Source : *BPS, BI, BCA Economist calculations*

Capacity utilization and recruitment was near-normal before Delta hit, and may bounce back even stronger



Source : *BI, Bloomberg, BCA Economist*

Manufacturing sectors have actually seen an increase in investment during the pandemic

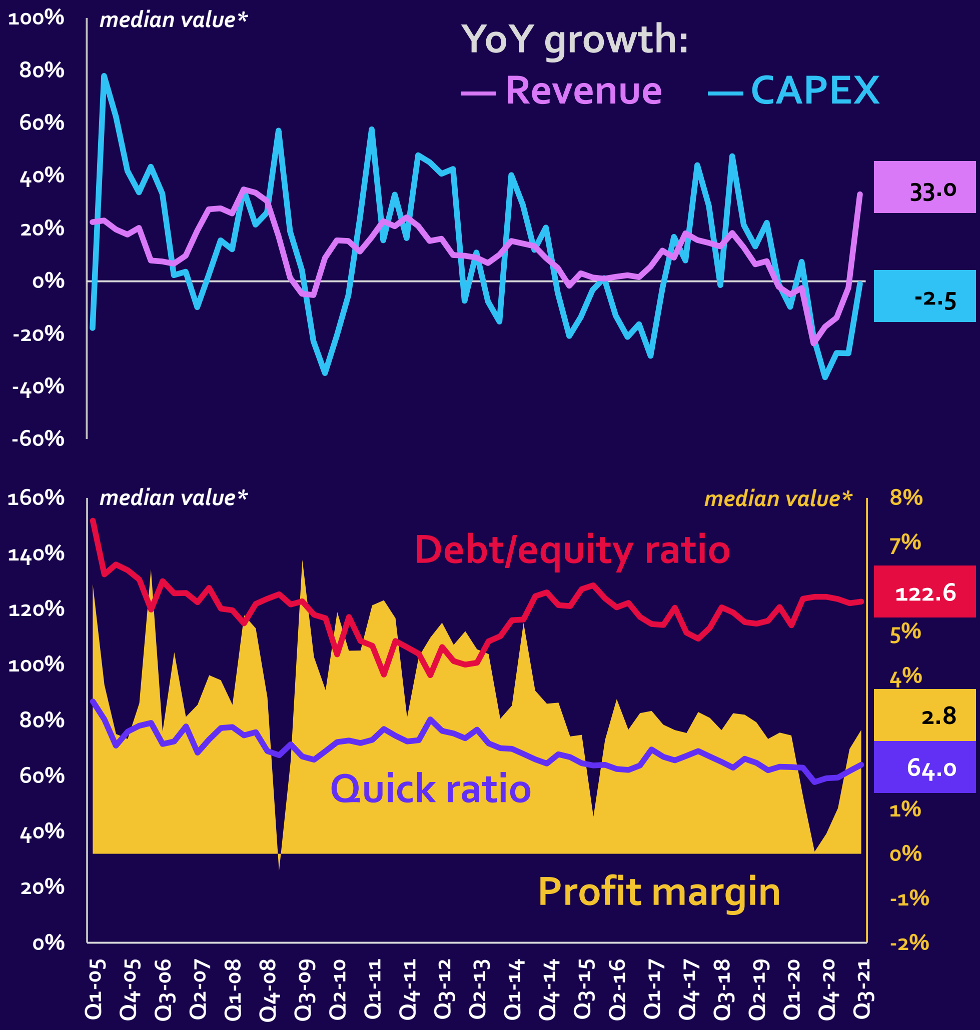


Source : *BKPM, BCA Economist*

* ***Light blue*** *= Primary sectors,* ***Red*** *= Manufacturing,* ***Yellow*** *= Tertiary sectors*

Exhibit 26

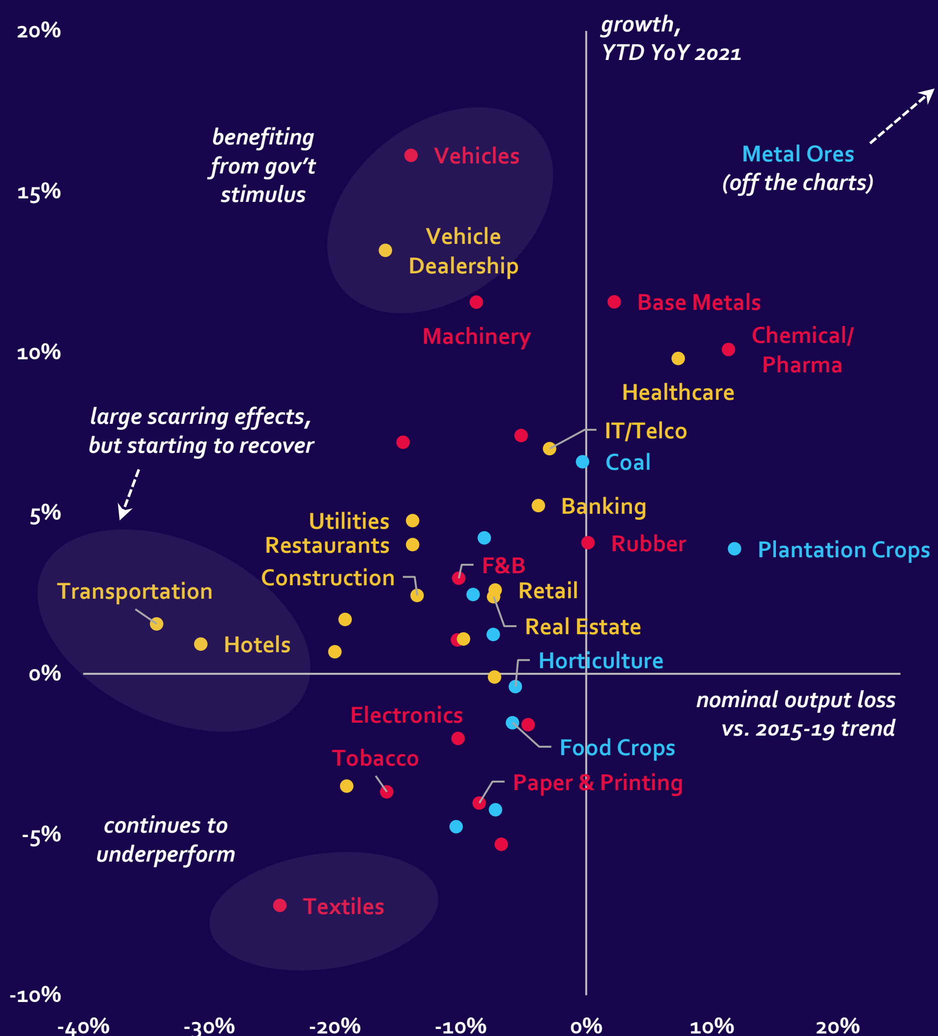
Corporate Indonesia (by and large) retains healthy balance sheets, paving the way for future expansion



Source : *Bloomberg, BCA Economist calculations*

** Non-financial companies listed on the Indonesia Stock Exchange*

Despite large scarring effects on a few sectors, most industries are on track towards recovery



Source : *BPS, BCA Economist calculations*

* *Light blue = Primary sectors, Red = Manufacturing, Yellow = Tertiary sectors*

Epilogue: Over the Rainbow

Looking beyond the boom

- Boom time is here at last after two difficult years, but what lies beyond that is *terra incognita*. The massive dose of stimulus that has been given to the world economy may fuel a decades-long boom, but it could just as well lead to a compressed global monetary/business cycle whereby the sugar rush quickly turns into a hangover – if the flattening UST yield curve (a portend of upcoming recession) is any guide.

- Indonesia's luck with high commodity prices may not last, and it has been clear for a while now that it needs to upgrade its economic capabilities so as to export more complex products with higher value-added. In theory, the country has one of the widest ranges of option available to expand its capabilities (***Exhibit 28***), but in practice it has scarcely made any progress since 2000 (***Exhibit 29 – upper panel***).

- The problem is, as much as Indonesia tops the short-term invulnerability league table at the moment (***Exhibit 4)***, it languishes when it comes to the long-term productivity table (***Exhibit 29 – lower panel***). What it needs are pretty clear: domestic innovation to boost total factor productivity (TFP), physical investment (especially infrastructure), and FDI to bring in outside capabilities. The Joko Widodo administration has made significant progress addressing the latter two under the banner of Jokowinomics, but the momentum appears to be stalling.

In the last two decades, Indonesia has struggled to diversify away from low value-added commodities despite its vast potential to upgrade its capabilities

- The first plank, infrastructure, runs into delays partly due to the pandemic, while the sudden thrust of climate issues calls into question the coal-heavy energy master plan that the administration had been pursuing. However, the main constraint at the moment is largely about financing.

The setbacks faced by the Job Creation Act could threaten efforts to align wage growth with productivity growth

- As part of its exit plan from the pandemic-era stimulus, the government has reduced its infrastructure outlay by 7% for 2022. Meanwhile, several SOEs which own, build, and operate many of the major projects seem to be maxing out their financial capacity as debt service growth surpasses income growth. At the moment, the proposed solution to this issue seem to involve a combination of capital injection from the government, the divestment of SOE assets, and external financing delivered via the new Indonesian Investment Authority (INA).

- On the FDI front, the government made a major breakthrough in 2020 by advancing the Job Creation Act, which – among others – addresses major sticking points with regards to labor-employee relations. But the Act has recently been ruled (conditionally) unconstitutional by the Constitutional Court, forcing the government to make the appropriate amendments in two years' time or risk having it thrown out altogether – even if the Act and the regulations that derive from it stays in place for now.

- At about the same time, the issue of minimum wage – which had receded from view in recent years – flares up again, thanks to the decision by the Jakarta mayor Anies Baswedan to raise it much faster than the predetermined formulae based on the Job Creation Act. It is easy to surmise political motive here given his status as a leading presidential contender for

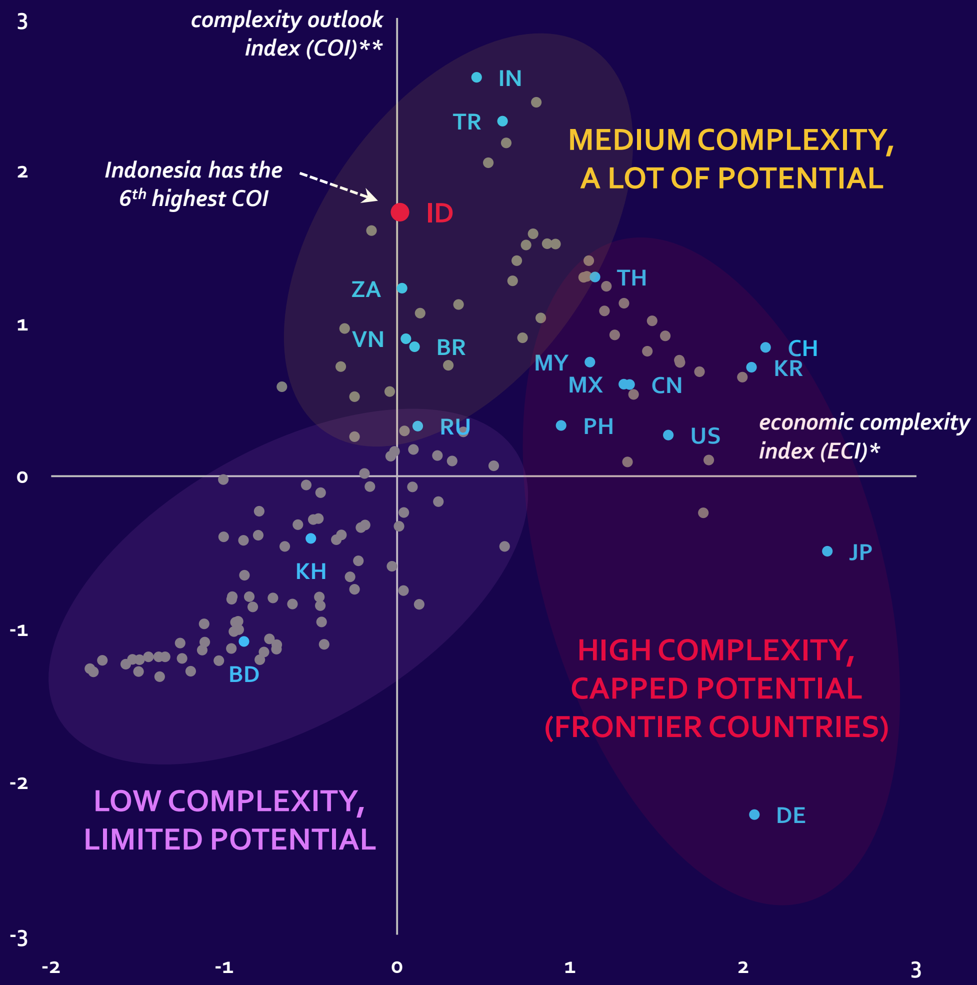
2024, and this might thus revive the specter of populist wage hikes, which was especially rampant in the period of 2010-13 and again in 2016 (***Exhibit 30 – upper panel***).

The government seems to have had better success doing targeted "downstreaming" industrial policies rather than broad structural reforms

- These developments are particularly unfortunate given the new opportunities accorded by both the pandemic and the escalating US-China rivalry. With global supply chains now exposed as often being too fragile and too reliant on China, manufacturing relocation has become a growing proposition. But Indonesia's low labor productivity growth, especially compared to its wage growth (***Exhibit 30 – lower panel***), undercuts its competitiveness in this regard. One piece of evidence is Indonesia's rather lowly rank as future sourcing option for US fashion companies (***Exhibit 31***) – fashion/ textiles, of course, being the prototypical footloose, labor-intensive industry *par excellence*.

- But not all hope is lost – if it proves too difficult for Indonesia to leverage its abundant workforce, it could always leverage its natural endowments. It seems that targeted industrial policies aimed at developing downstream industries ("downstreaming") from Indonesia's export commodities – e.g. cocoa under the SBY administration, nickel under Jokowi's – have been easier to implement than broad-based reforms like the aforementioned Job Creation Act. Strong FDI growth into the metal and automobile (i.e. EV battery) industries during the pandemic (***Exhibit 25***) seems to support this point. It is thus not necessarily a sin, nor a curse, to be a commodity-based economy, so long as we can derive ever greater downstream value from those raw materials.

Indonesia has the potential to diversify away from low-complexity (commodity) exports ...

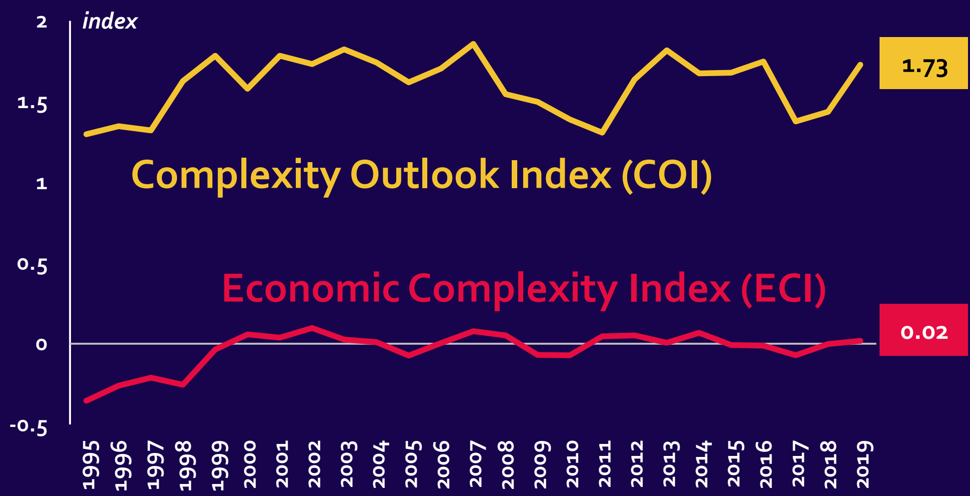


Source : *Atlas of Economic Complexity, BCA Economist*

** ECI reflects the overall level of complexity/value-added of the products that a country exports*

*** COI reflects the potential range of higher-complexity products that a country can expand its capabilities into in the future*

... but it has not capitalized on that potential due to weak productivity growth

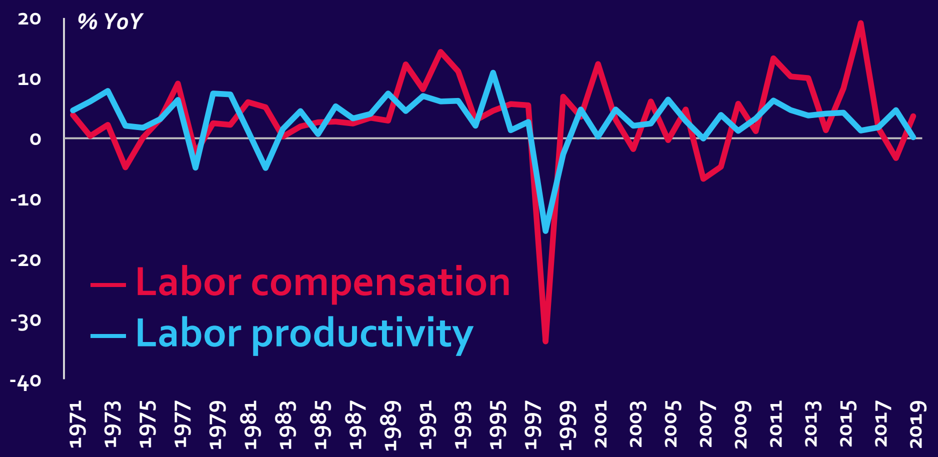


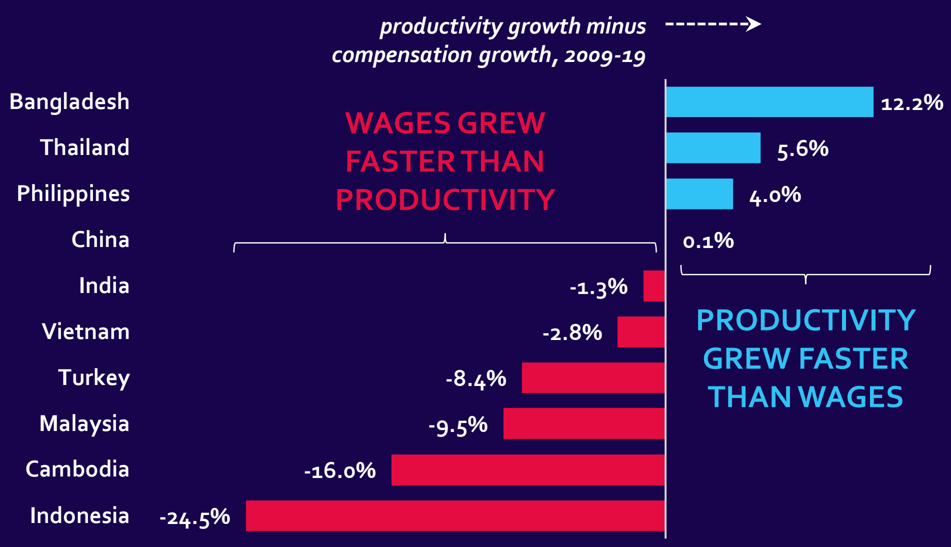
	ID	MY	TH	PH	VN	IN	CN	TR	BD	KH
Economic Complexity Index (ECI), change 2009-19	0.09	0.38	0.26	0.46	0.16	0.27	0.37	0.14	-0.07	0.43
Labor productivity, % change 2009-19	39.9	27.3	59.1	48.8	76.7	76.6	94.0	58.9	53.8	34.9
Total factor productivity, % change 2009-19	-10.7	10.2	12.3	12.0	17.3	24.7	12.6	18.7	2.2	-1.4
Capital stock (non-land), % change 2009-19	214.1	107.9	47.9	139.8	191.3	217.9	261.8	291.6	332.3	272.2
FDI/GDP, average 2009-19	2.0	3.1	2.2	1.8	6.0	1.8	2.4	1.5	1.1	12.2

Source : *Atlas of Economic Complexity, Asian Productivity Organization, World Bank, BCA Economist calculations*

Exhibit 30

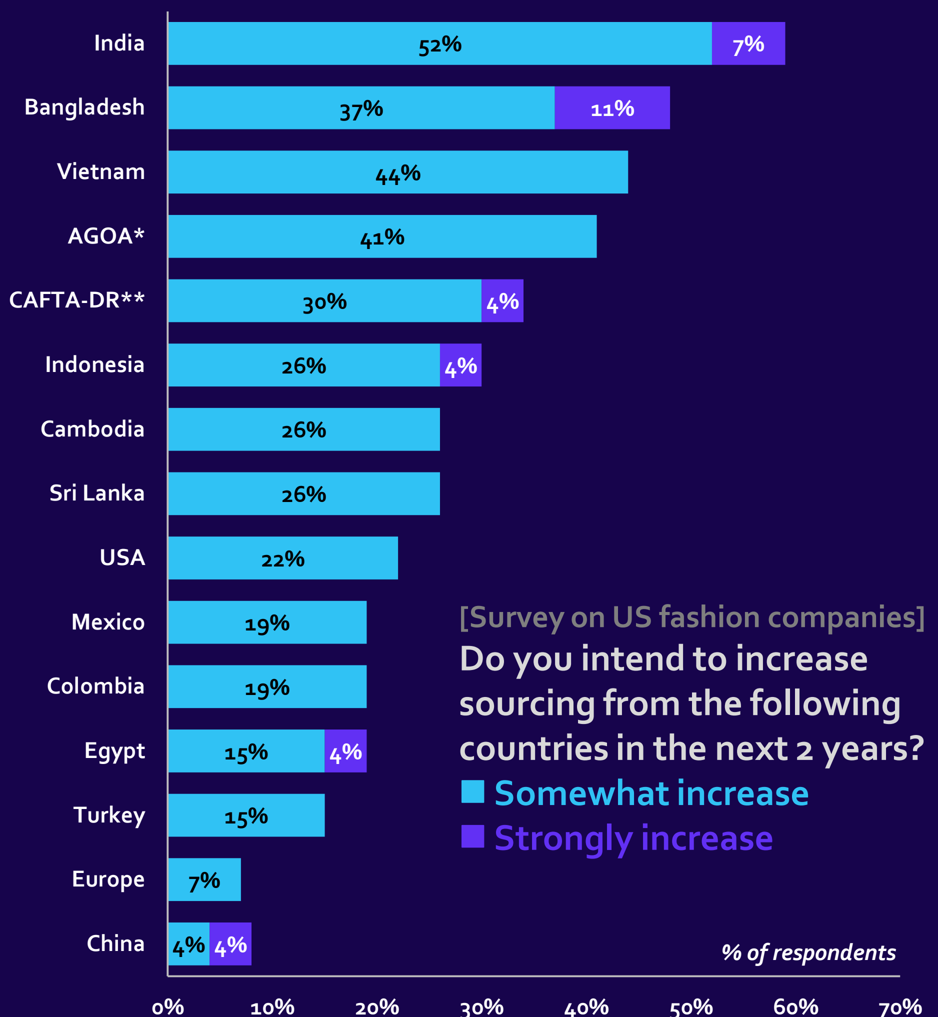
Indonesia had seen rapid increase in wages relative to labor productivity during the past decade ...





Source : *Asian Productivity Organization, BCA Economist calculations*

... and it may consequently be losing out on opportunities from global supply chain reconfiguration



Source : *US Fashion Industry Association, BCA Economist*
** African Growth and Opportunity Act* *** Central America-Dominican Republic FTA*

Projection of Macroeconomic Indicators

	2017	2018	2019	2020	2021	2022E
GDP growth (% YoY)	5.07	5.17	5.02	-2.07	4.02*	5.23
GDP per capita (USD)	3877	3927	4175	3912	4350*	4640
CPI inflation (% YoY)	3.61	3.13	2.59	1.68	1.87	3.31
BI 7-day Repo Rate (%)	4.25	6.00	5.00	3.75	3.50	4.00
10Y gov't debt yield (%)	6.29	7.98	7.04	5.86	6.36	7.09
USD/IDR exchange rate	13,433	14,390	13,866	14,050	14,262	14,660
Trade balance (USD Billion)	+11.8	-8.5	-3.2	+21.7	+36.1*	+30.6
Current account balance (% of GDP)	-1.60	-2.94	-2.71	-0.42	+0.64*	+0.08

Source : *BPS, Bloomberg, BCA Economist calculations*

Notes:

- Numbers marked with asterisk (*) for 2021 are provisional
- BI 7-day Repo Rate, 10Y yield, and USD/IDR exchange rate all refers 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

Odds and Eventualities

Notes on projections and potential scenarios

- Our ***Projection Table*** outlines a baseline scenario for 2022. It is what we call a "moderate-prudent" scenario: assuming a moderately benign global environment and prudent macroeconomic policies which seek to optimize the tradeoff between growth and vulnerability. We forecast GDP growth at **5.23%**, just slightly above its non-depreciative potential, which we estimate at **4.8 – 5.2%**. This translates to a modest weakening of the Rupiah's fundamentals to roughly **14,660** (end of year) versus the USD.

- We expect commodity prices to normalize but remains modestly elevated, while import growth remains strong alongside domestic demand – resulting in an annual trade surplus of about **USD 30.6 Bn**. Note that while this is a step back from the massive surpluses of H2-21, it is still a historically big surplus, in line with what we had in 2011 and between Q3-20 and Q2-21. This would probably translate to a narrow CA surplus at about USD 1.1 Bn or **0.08% of the GDP**.

- Inflation is overdue for an acceleration, with or without energy price hikes, and consequently we project it at **3.31%** – assuming little to no change in administered energy prices. This is within BI's target range (2 – 4%), but BI is still likely to hike rates in line with Fed policy. Nevertheless, Indonesia's relatively strong macro indicators mean that BI can afford to briefly delay hiking rates until H2-22, during which we predict the 7-Day Reverse Repo Rate to be raised twice (25 bps each) to **4.00%**. Finally, assuming that the 10Y UST yields rises to about 2% by year-end, we expect the yield on the 10Y Indonesian government debt to rise to **7.09%**.

- Obviously, these numbers would change if events deviate from our base scenario. Some of the major alternative scenarios are outlined below. Do note that these probabilities do not add up to 100% – *these scenarios can happen in combination, although they may also be relatively incompatible with each other*, as we note below:
    - Global cooling (probability: 40%)

      Fed hikes coupled with China's slowdown might have a chilling effect on global commodity prices. A fall in, for example, coal prices back to pre-pandemic norms (about USD 80/MT) would cut potential growth to 4.6 – 4.9%, but its impact on domestic demand – and therefore actual growth – might be delayed. This gap between actual and potential growth implies a weaker Rupiah by roughly 150 – 300 points (all else being equal) and CA deficit (at 0.9 – 1.2% of the GDP).
    - Overheating (current estimate of probability: 30%)

      Demand growth substantially exceeds potential growth, as post-pandemic euphoria continues deep into 2022. Under this scenario, growth could rise to 5.4 – 5.8% and inflation to 3.5 – 3.9%. As this could lead to higher imports, this might fundamentally weaken the IDR/USD by about 100 – 200 points and lead to CA deficit, which would therefore lead to faster BI rate hikes, possibly towards 4.50%.
    - Energy price hike (probability: 30%)

      The government allows energy prices – liquid fuel, LPG, electricity – to adjust by an average of 20 – 30%, pushing inflation to 5.5% or higher and prompting rates to rise accordingly. This is a disruptive event that the government prefers to avoid unless global energy prices stay high for a sustained period of time, and is therefore incompatible with the global cooling scenario.

- <u>Tantrum redux (probability: 20%)</u>

  Global asset pricing plays catch-up with the Fed's more hawkish thinking, causing declines in global asset prices and sharp outflows similar to taper tantrum in 2013. Thanks to Indonesia's reduced vulnerability, BI might only have to raise rates by an additional 50 – 100 bps relative to our baseline forecast – instead of the abrupt 175 bps hikes that we saw both in 2013 and 2018. The risk of such an event is probably highest in H1-22, and it is also somewhat incompatible with the global cooling scenario.

- <u>Back to quarantine (probability: 5%)</u>

  Covid-19 spawns new variant(s) that are both lethal and highly transmissible, leading to renewed lockdown. As we discussed, the diminishing economic impact of subsequent new variants mean that, for it to alter our forecasts substantially, the threshold of mortality and transmissibility would have to be quite high – hence the low probability.

  Nonetheless, this could certainly become a high-impact scenario, and likely the main one that could depress growth far below our baseline projections. Its effects on interest rates and the Rupiah might nonetheless be relatively benign as it would also delay monetary normalization everywhere in the world.

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