REVIEW OF ECONOMIC DEVELOPMENTS

Slow Growth Rate and Strong Inflationary Pressures

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Economic Growth Report

The Indonesian economy grew at 6.02%--slightly lower than growth in the previous quarter (6.11% yoy recorded at the end of December 2012). Private sector consumption recorded 5.17% (yoy) growth rate—slightly dropped compared to previous quarter (5.36% yoy). The lower growth rate was attributed to strong inflationary pressures during the period. However, private sector consumption kept on expanding—thanks to regional elections taking place in some major areas in Indonesia (Bali, Central Java, etc.). Therefore, although slightly eased off, household/private consumption still contributed as the economy's main engine of growth.

Besides private sector consumption, regional elections also affected government spending in the first quarter of 2013. Last year, government spending booked negative growth rates towards the end of the year (-2.81% in Q3-2012 and -3.34% in Q4-2012) as a result of spending restraints imposed by the government after political meltdown stifled government ability to maintain budget sustainability. At the first quar-

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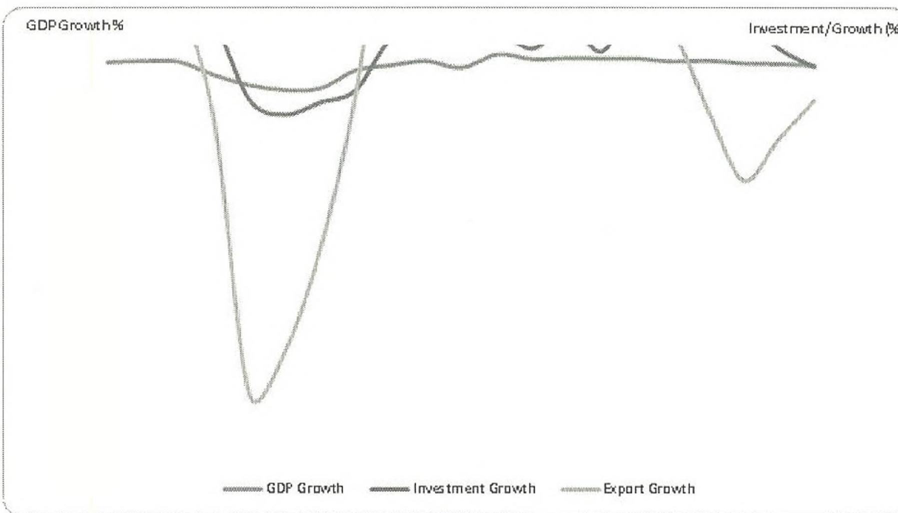
ter of 2013, government expenditure grew 0.42% yoy, slightly improved due to regional elections.

Figure 1. Real GDP, Investment and Export Growth (% yoy), 2008-Q1 2013

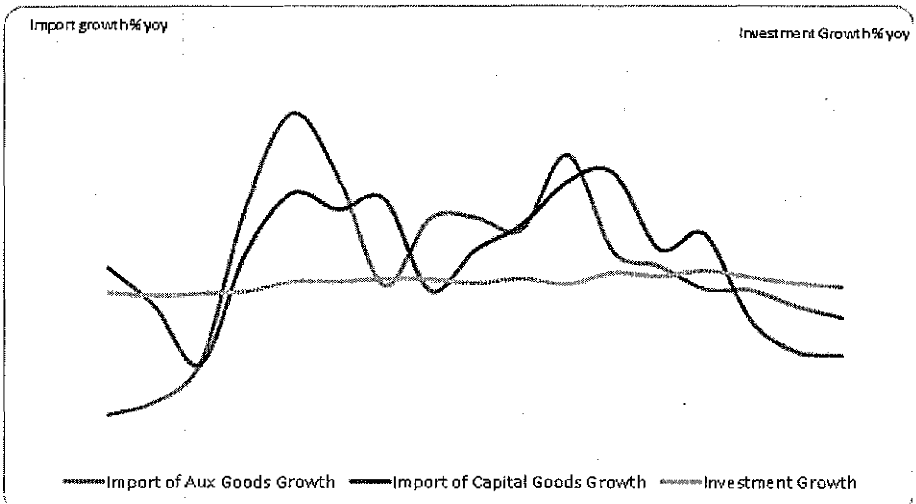


Source: CEIC, Statistics Indonesia

Compared to 2012, investment showed moderate growth during the first quarter of 2013. Investment grew 5.90% yoy in the first quarter of 2013—slowing down from 7.29% yoy in the last quarter of 2012. With estimated time lag of six to nine months after slowing down of capital goods imports, this slowdown has in fact in line with BKPM (Investment Coordinating Body) expectation. Imports of capital goods already started to decline in the third quarter of 2012. With import of capital goods continues to shrink until end of March 2013, it should serve as a caution for the government to anticipate a decline of investment growth towards the end of 2013.

Nevertheless, in the first quarter of 2013, direct investment increased 30.6% (yoy), from IDR 71.2 trillion (Q1 2012) to IDR 93.0 trillion (US $9.58 billion). Of this total amount, about seventy percent (or nominal value IDR 65.5 trillion) is accounted for by foreign direct investment, while the remaining thirty percent came from domestic investors.

Figure 2. Investment, Import of Capital Goods and Auxiliary Goods, 2009-Q1 2013



Source: CEIC, Statistics Indonesia

The biggest investments countries during January-March 2013 were Japan (USD $1.2 billion), USA (USD $0.9 billion), South Korea (USD $0.8 billion), Singapore (USD $0.6 billion), and the United Kingdom (USD $0.5 billion). The largest chunk (64%) of foreign investment was channeled to manufacturing industry, while 24% went to primary sector (in particular to mining sector) and the rest (11%) was directed to tertiary sector of the economy. See Table 2 for more detailed sectoral FDI in the first quarter of 2013.

Table 1. Sectors Attracted Most Foreign Direct Investment in Indonesia (Q1-2013)

Sector	USD billion
Mining	1.4
Chemical and Pharmaceutical Industry	1.2
Metal, Machinery and Electronic Industry	1.0
Transport Equipment and Other Transport Industry	0.9
Paper and Printing Industry	0.6

Source:BKPM

From domestic sources, around 40% of direct investment went to manufacturing industry—notably to food industry and metal, machinery/electronic industry. Only 26% of domestic investment took place in primary sector (most significant was mining sector) and the rest, 33% went to non-tradable sector such as transportation and telecommunication and electricity/gas/water supply sectors. Table 3 provides the breakdown of domestic direct investment in Indonesia in the first quarter of 2013.

Table 2. Five Largest Sector Recipients of of Domestic Direct Investment in Indonesia (Q1-2013)

Sector	IDR trillion
Mining	6.0
Transportation, Storage and Telecommunication	6.0
Food Industry	4.0
Metal, Machinery and Electronic Industry	1.8
Electricity, Gas, and Water Supply	1.7

Source: BKPM

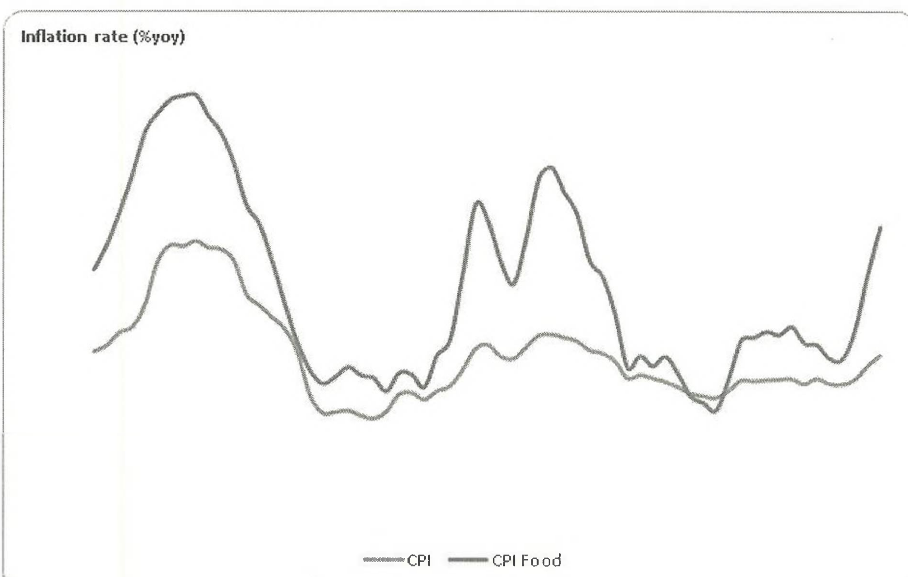
As already mentioned above, on the supply side, all sectors grew steadily except for mining and quarrying sector. Agrictulture sector grew most significantly, compared to other sectors as the first quarter every year is harvesting season—the growth rate went from 1.98% yoy in the fourth quarter of 2012 to 3.7% in the first quarter of 2013. Manufacturing industry expanded by 5.84% yoy, lower than 6.24% yoy growth rates recorded in the fourth quarter of 2012. Out of all tertiary subsectors, transportation and communication still delivered consistent performance of 9.98% yoy—slightly improved than last quarter of 2012 with growth rate of 9.63% yoy. However, other tertiary subsectors had been less impressive—notably construction subsector (growth declined from 7.8% to 7.2% in Q4 2012-Q1 2013) and trade, hotel & restaurants (from 7.8% to 6.52%).

Inflation Report

High inflationary pressure persisted in the first quarter of 2013. Bad weather that hampered distribution of basic foodstuffs, coupled with fruit and vegetables import restrictions introduced by the Government at the same time caused foodstuffs prices to keep increasing. Adding to the pressure was the delay of rice harvesting season and increased meat prices due to restricted imports. Figure 3 showed how general price index movement coincides with foodstuff price index movement since 2008.

In February 2013, the first increase of electricity tariff adjustments (average increase of 4.3%) generated heavy pressures on general price index to move up 0.75% in a month. Added to the pressure was local government decision to raise minimum wage in some cities since the start of the year. In March 2013, limited domestic supply and import restriction on spices, notably garlic and shallots made volatile food price index rose exceeding normal level (2.44% mom or 14.2% yoy).

Figure 3. Inflation Rates (% yoy), 2008-Q1 2013



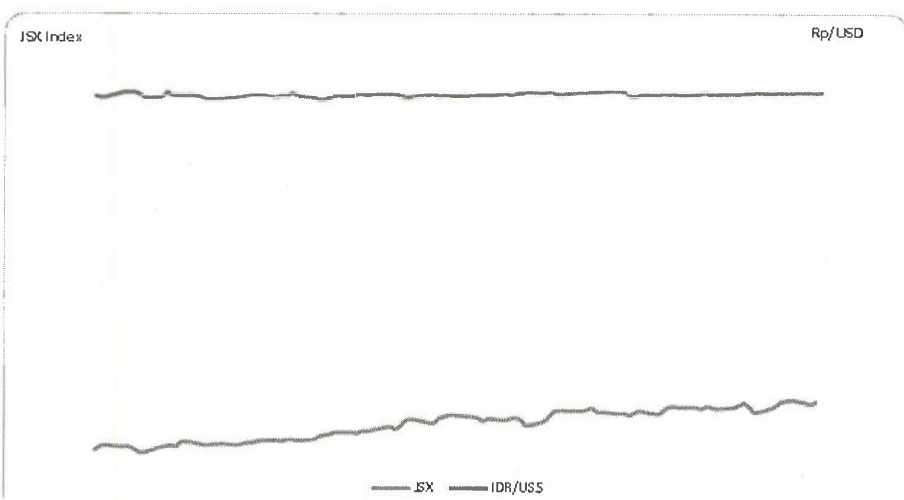
Source: Statistics Indonesia

As the inflation rate soared in the first quarter of 2013, the Central Bank continued to hold interest rate steady at 5.75% which has been fixed since February 2012. Surely, it would be better off to maintain low interest rate to support economic expansion. However, in the very near future, Bank Indonesia will need to make some adjustments as the Government and the Parliament looked set to cut down fuel subsidy by raising fuel prices.

Exchange Rate and Capital Market

In the first quarter of 2013, the Rupiah was under intense pressures to depreciate. On average, the Rupiah value declined 0.7% (qoq) from IDR 9613/US$ to IDR 9680/US$. Some analysts considered Rupiah depreciation as an irregularity, given at the same time, the JSX index scored an all-time high at 4940 before closing for Easter holiday at the end of March 2013. Most recent BOP report (released on May 2013) indicated that foreign capital inflows in private sector equity in the first quarter of 2013 was US$ 2.6 billion (up from US$ 0.6 billion at the end of fourth quarter 2012). At the same time, foreign investors still recorded a net buyer of SUN/government bonds (denominated in Rupiah) in the amount of USD 1.0 billion. Based on DMO data at end of March 2013, foreign investors still held 32.5% of tradable SUNs (slightly down from 32.9% of tradable SUNs at the end of previous quarter, Dec 2012).

Figure 4. JSX Index and IDR/US$ Exchange Rate, January-March 2013



Sources: CEIC

Nevertheless, when one takes a closer look at continued deficits on current account balance since fourth quarter of 2011, Rupiah depreciation seems logical. Sources of deficits on the current account balance came from deficit in the trade balance due to (1) rising gasoline imports both volume and price and (2) declining non-oil/gas export goods—brought about by enduringly low commodity prices. In the first quarter of 2013, current account balanced recorded much smaller deficits due to shrinking overall imports (consumption, auxiliary and capital goods) as domestic consumption and investment slowed down—see economic growth report above.

More pressures on the Rupiah also came from intense inflationary pressures—see inflation report. Another thing related to inflationary pressure is the uncertainty created by discussion and heated debate on whether fuel subsidy would be cut already started earlier in the year up to now. The uncertainty, in turn, caused the rupiah to depreciate further.

Fuel Subsidy Cut is an Urgent Government Agenda

The Government has stipulated few reasons for fuel subsidy cut since last year. Fuel subsidy is inefficient, incorrectly-targeted, not environmentally sound, and could disturb macroeconomic stability. Fuel subsidy is also unproductive since the amount of money allocated for it—IDR 211.9 trillion (63% of total subsidy) would have been much more useful when it is allocated to more productive sectors such as agriculture and infrastructures.

Direct subsidies such as fertilizers, seeds, rice and program credit only need IDR 39.9 trillion or 11.5% of the total subsidy budget. Infrastructure budget is only accounted for 2-3% of GDP which should be increased to at least 5% of GDP. Fuel subsidy is also incorrectly-targeted since almost half of fuel subsidy budget is consumed by the wealthiest 10% of the society, whereas the poorest 10% gets a mere of 2%.

Fuel overconsumption due to its heavily-subsidized cheap price has contributed to environmental damage. Per capital fuel-based CO2 emission in Indonesia is one of the highest in the world, even higher than the ones in India and China. With the cheap fuel price (even compared to the rest of the world) in Indonesia, there is practically no incentive for business sector to shift to renewable energy.

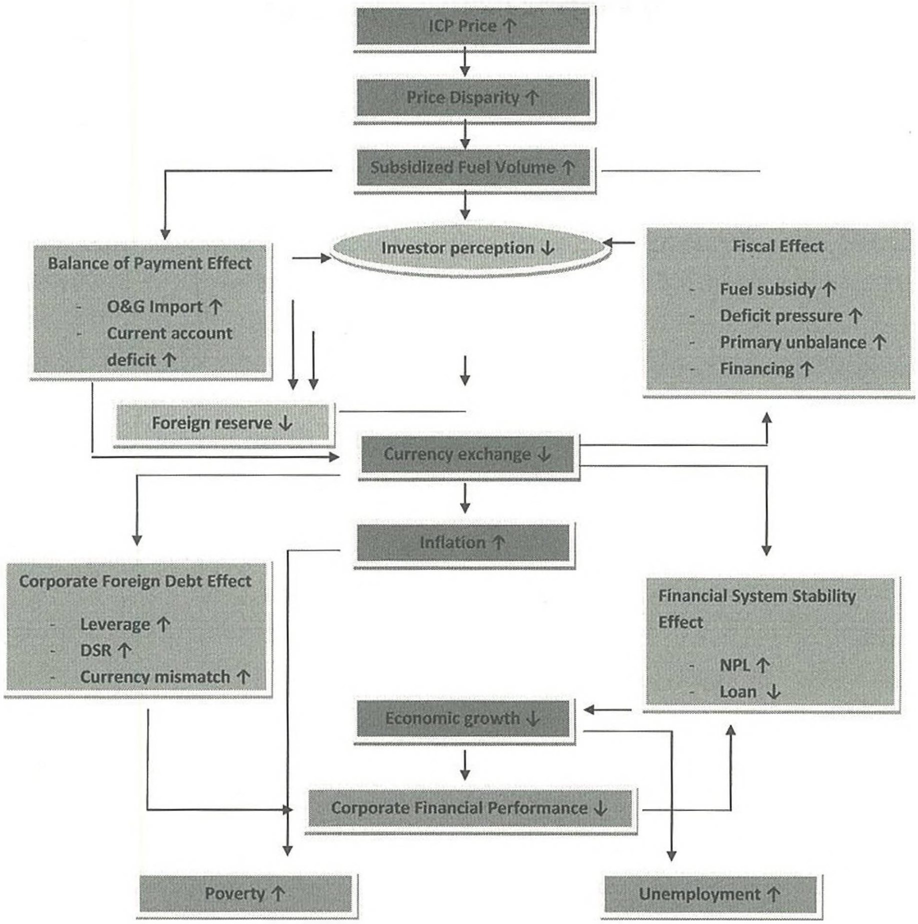
Fuel subsidy can also disturb macroeconomic stability. Cheap price increased fuel consumption tremendously. The increased consumption of subsidized fuel caused double deficits. On one hand, due to declining domestic fuel production, the consumption gap must be met with bigger imports and lead to balance of payment deficit. On the other hand, fuel overconsumption also cause fiscal deficits as bigger fuel needs to be allocated each year.

Widening deficits of balance of payment and worsening fiscal soundness will adversely affect investors' perceptions. In turn, foreign capital inflow starts to decline. At the same time, huge imports that are not matched with improvement of export revenues will reduce foreign reserves and weakened the domestic currency value. Rupiah depreciation would induce four major problems. *First*, it will add burden to private debt payment which will deteriorate corporate financial performance. *Second*, depreciation will drive imported inflation up due to sizable proportion of imports in domestic consumption. *Third*, the declining value of Rupiah will increase government spending for fuel subsidy. *Fourth*, it will directly and indirectly affect financial sector (banking, capital market etc.) performance. Total impacts of those problems would bring on economic growth slowdown, worsening of employment creation, and increased poverty.

In the short run period of time, reduction of fuel subsidy would trigger off higher inflationary pressures. The most recent RAPBN-P (adjusted RAPBN 2013), the government assumes annual inflation rate of 7.2% while the Bank of Indonesia estimated inflation rate would be 8.7%. Inflation will reduce purchasing power of the lowest income group. With number of people in the near-poor category is quite large, higher inflation rate would drive them down into the poor category. The number of poor will increase significantly.

To anticipate the short-run impact of fuel subsidy cut, the Government will disburse direct cash transfer to approximately 15 million poor households. If the average poor household consists of 4 family members, the number of people who would be supported by BLSM is around 60 million people. Direct cash transfer will be given in the amount of IDR 150.000 for each of the four-month period.

Figure 5. Fuel Subsidy and Its Effects



Source: Financial Note and Draft of State Budget 2013, http://www.anggaran.depkeu.go.id/dja/acontent/Nota%20Keuangan%20RAPBN%202013.pdf

In 2013, the government does not need parliament approval to cut fuel subsidy and raise fuel prices. However, parliament approval is still required to disburse BLSM. Government policy was supported by five political fractions PD, Golkar, PAN, PPP and PKB, while four other political parties PDIP, PKS, Gerindra and Hanura decided against. Finally after hard debate and intense lobbying process, the parliament voted off and the disbursement of BLSM was approved.

Summary

Indonesia's real Gross Domestic Product grew at 6.02% (year-on-year) in the first quarter of 2013—the slowest growth rate since September 2010 with net export growth improved from sluggish performance since mid-last year, coupled with slowdown of investment growth. Private consumption growth declined slightly, but strong enough to maintain as the key driver of the economy in first quarter of 2013. On the supply side, all sectors (except mining and quarrying sector) recorded steady performance. However, compared to similar growth rates in the previous quarter (%yoy), some sectors showed smaller progress. Meanwhile, at the same time, the Indonesian economy was full of strong inflationary pressures recorded throughout due to sustained high prices of foodstuffs as lack of ministries' coordination added to the seasonal factors.

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