Panin Asset Management
Subsidiary of PT Panin Sekuritas Tbk.

QUARTERLY REVIEW

December 2012

ECONOMIC REPORT

Indonesia Economic Review 2012: Not a bad year after all, but far from optimal

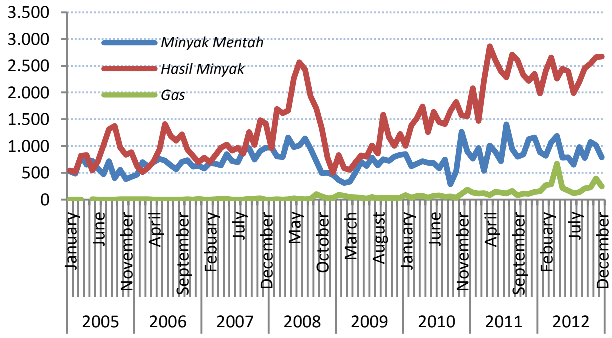
Year 2012 has been an interesting period for Indonesia. Once again, Indonesia's economy has shown its resiliency against the backdrop of weak global economy. If we close one eye for a moment, ignore the development of global economy, and solely concentrate on Indonesia's GDP growth over the past four quarters of 2012, one could easily come to the conclusion as if there was little turbulence in the global economy. At a glance, Indonesia's economic growth was indeed quite phenomenal considering the external environment. With most developed and some developing nations including the BRICs were struggling for growth, Indonesia managed to record consistent GDP growth over the past 12 quarters, ranging between 5.8% to 6.8%, owing to strong domestic economy as well as acceleration in investments into the country. Weak legal enforcements and poor infrastructure have not stopped foreigners from investing in Indonesia. The country's long term growth story with its highly attractive demography is too good for many large multinationals to ignore. This has been reflected in the growth of FDI, up 26% in 2012.

The view from the capital market on Indonesia's economic development however was not as rosy. A few observers, including foreign investors were somewhat worried on Indonesia's fiscal developments. Robust economic growth, record high consumer confidence, as well as relatively benign inflation were not sufficient to convince investors from increasing its equity allocation to Indonesia in 2012. Since the final quarter of 2011, Indonesia has started to experience negative current account, a situation which concerns some investors. The deficit is partly explained by lower exports, a function of weak commodity prices and rise in imports. The latter requires a bit more attention as we view there are two sources that lead to surge in imports. The first is due to increase in capital goods in relation to investments. As we highlighted in our previous *Quarterly Review (September 2012)*, Indonesia is currently experiencing a new cycle of strong investments growth. By nature, this cycle will lead to higher imports of capital goods as these investments i.e. building a new factory; require specific machines and tools that need to be imported from abroad. The same goes for the airline industry. As Indonesian aviation sector is rapidly expanding, we can expect increase in imports of aircrafts. We view this type of imports to be reasonably healthy as this should translate positively into the economy.

The second source that we find to be quite troubling is that the increase in imports has been caused by surged in refined oil. As we highlight in chart 1 below, Indonesia's oil-imports spiked in the second half of 2012. With majority of fuel in Indonesia are subsidized by the government, we think there has been an excessive usage of fuel in the country as consumers as well as certain factories take advantage of cheap subsidized fuel. Not to forget the smuggling that arises as a result of large arbitrage between subsidized and non-subsidized fuel prices. Unless the government reduces fuel subsidies, we don't believe Indonesia's current account will improve in the near term as imports will stay high for now.

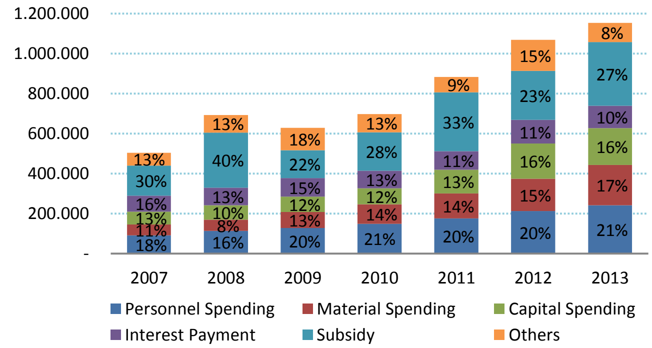
Another concerning development is the recent rise in minimum wage. We agree that higher wages should lead to higher consumptions; however, we argue that the recent hike was rather excessive and partly caused by populist move as we are closer to 2014 election. The new standard may result in Indonesia's labor market to lose competitiveness relative to some other countries in the region. While this is not necessarily problematic for factories that focus on domestic markets as they may be able to pass on prices, we think this is going to be a big challenge for labor intensive manufacturing companies, particularly export oriented sector as they may not have rooms to pass on higher costs.

Chart 1: Indonesia oil and gas import (in USD million)



Source: CEIC, Panin Asset Management

Chart 2: Subsidy eats up a big portion of govt budget (IDR mn)



Source: Ministry of Finance, Panin Asset Management

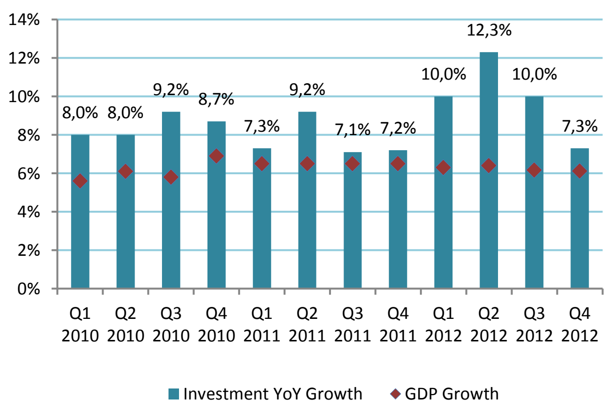
Outlook 2013

We have started 2013 with a somewhat more positive tone. In our view, global economic activities is gradually recovering, and tail risks particularly in relation to Europe and hard-landing in China have been reduced significantly. Recent economic data from key markets including China, US, and Europe supported our thesis and offers us more hope for a better economic outlook in 2013. One important measure that has changed our view is the ‘unlimited bond purchase program’ introduced by the European Central Bank during the second half of 2012. This has been a game changer in a way that it provides stability to the financial system, as well as enhances liquidity. We have witnessed relatively large inflows into European periphery capital markets (Italy, Greece, Ireland, Portugal, and Spain) during the last four months of 2012, a sign that investors have started to build-up confidence in these markets. Nevertheless, we think global uncertainties will continue to persist in 2013 as there is still a lot of work to be done particularly in developed markets. In the short-term, risks including the US fiscal cliff and recent political uncertainties in Spain and Italy could pull global economic from making a recovery. We don’t however believe that these risks will derail global economic activities like what we have seen in 2012 as the scale is somewhat smaller. On China, we take a more positive stance in 2013 and contemplating that the second largest economy will play an important role in supporting global economic recovery. In our view, the new Chinese government is rather ambitious in boosting economic activities in the country including further acceleration in infrastructure developments.

For Indonesia, recent data suggests that we may face slightly more headwinds in 2013. While the long-term economic story remains intact, recent data including slowdown in investments in the fourth quarter (+7.3% in Q4 vs. 10.0% in Q3) – *chart 3 below*, slight rise in inflation (1.03% in Jan’13 vs.0.76% in Jan’12), and continued current account deficit could have negative impact to the economy in 2013. Macroeconomic uncertainty has also put some pressures on Indonesian rupiah over the past couple of quarters – see *Quarterly Review (September 2012)*, which was down 6% in 2012 and came out as one of the weakest currencies in the region during the year.

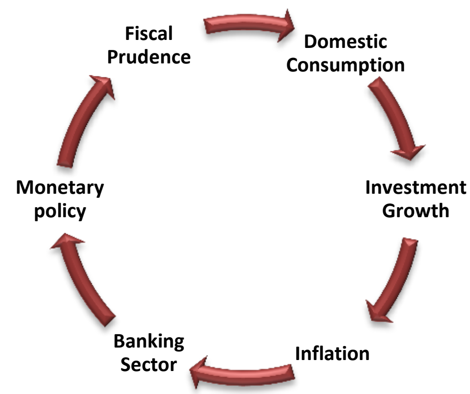
Having said all these, there are still good reasons to be optimistic. We still believe the main pillars of Indonesia's economy continue to be robust and this will provide support to weather short-term uncertainties. We highlight the main pillars of Indonesia's economic fundamentals in the chart 4 below. These include (1) domestic consumption, (2) growth in investments, (3) healthy banking sector, (4) manageable inflation, (5) supportive monetary policy, as well as (6) continuous improvements in public debt profile and progress in improving allocation of government spending. We are convinced that the first pillar, domestic consumption, which makes-up more than 50% of our GDP, will continue to be the backbone of our economy in 2013, as highlighted by strong consumer confidence in the country.

Chart 3: Investments vs. GDP growth



Source: CEIC, Panin Asset Management

Chart 4: Six main pillars of Indonesia's economy



Source: Panin Asset Management

Lastly, we would also like to highlight the importance of China and Japan, Indonesia's largest trading partners. As the external environment is getting more conducive partly supported by increasing activities in China and positive sentiment from the upcoming stimulus measures in Japan, we believe Indonesia may benefit from this development in the context of recovery in trade balance. After experiencing a decline of 6.6% in 2012, we believe there could be some upside on exports in 2013 as weaker currency should also increase the attractiveness of Indonesia's exports. Having said that, we are not denying that recovery in exports is dependent on commodity prices considering a large chunk of our exports remain exposed to the commodity related sectors.

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