Economics

Indonesia: investors staying put

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- **Sentiment is weak and investors are concerned about a currency at its weakest since 1997-98**
- **But foreigners have been net buyers of equities and bonds – some USD 22bn of them – since Jan14**
- **Most remain invested because of the long-term potential of the economy. The authorities need to step up its efforts in 2H15**

GDP grew by 4.7% (YoY) in 1Q15, its slowest since 2009. The rupiah is trading at its weakest level against the US dollar since 1997-98. Investors are concerned about the potential for capital outflow.

But investors are mostly staying put. Net foreign inflows into equities remain positive in 1H15 at around USD 0.3bn. Foreign purchases of IDgov bonds reached USD 6bn in 1H15, about the same pace as in 2014 (Chart 1). Since Jan-2014, foreigners have been net buyers of IDgov bonds every month except for Dec14 and Mar15. Despite fears to the contrary, more funds are coming in than going out.

The ghosts of 1997-98

The economy is in a much better shape than in past years. Public debt / GDP ratio is at 25%, down sharply from close to 100% in 2000 [1]. More importantly, foreign reserves coverage of short-term external debt is still above 200%, compared to an average of about 50% in the 3-year period prior to 1997 (Chart 2, next page). Non-performing loans (NPL) in the banking system are about 2.4% at present compared to 10% prior to the 1997-98 crisis [2].

Chart 1: monthly net purchase of equities and bonds

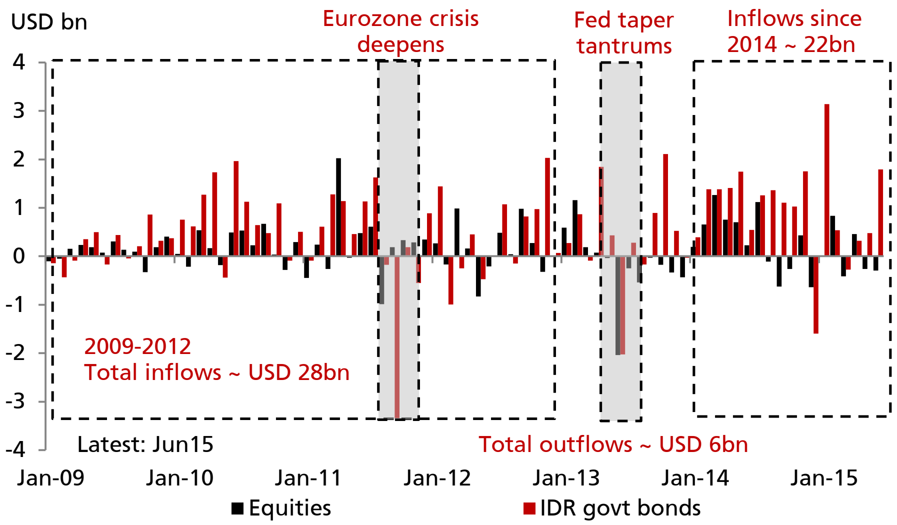

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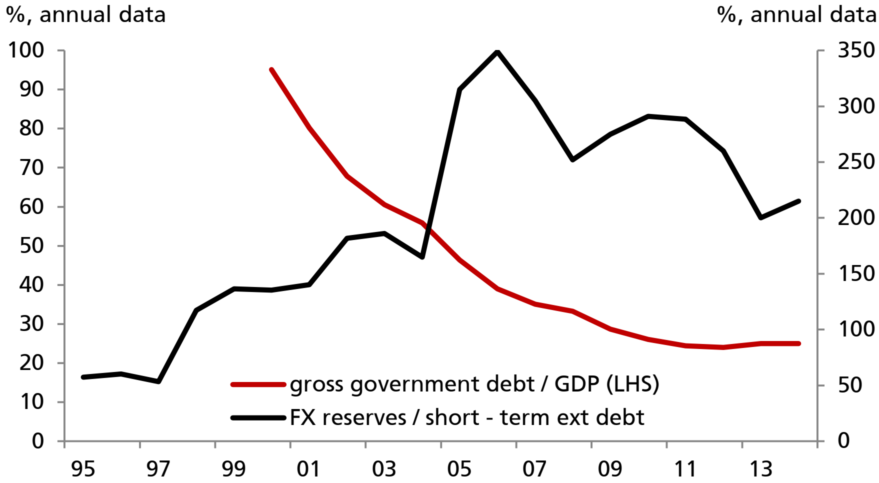
Chart 2: foreign reserves coverage and public debt - GDP ratio



The current account (C/A) deficit is more sustainable today than in 1997 as well. It is important to note that Indonesia needs foreign capital, and thus, the current account deficit is appropriate [3]. As long as this C/A deficit is financed by long-term, stable foreign flows, risks are manageable. More foreign direct investment (FDI) is preferred to short-term portfolio flows. The C/A deficit has averaged about 3% of GDP in the past 3 years, similar to the average seen in the 3-year period before 1997. Net foreign direct investment (FDI) is now running at about 2% of GDP, compared to 0.8% of GDP back then (Chart 3).

Indonesia has come a long way since 1997

It is true that the rupiah is at its weakest against the dollar since 1997-98. But much of this is due to the broad dollar strengthening more than anything else. The rupiah has been fairly stable on effective exchange rate basis since the mid-2013 selloff (Chart 4, next page). In fact, on a real effective exchange rate basis, it has appreciated 7% since the end of 2013.

No room for complacency

This is not to say that policymakers can afford to be complacent. Further narrowing of the C/A deficit is warranted (based on FDI trends, 2% of GDP seems

Chart 3: current account balance and net FDI

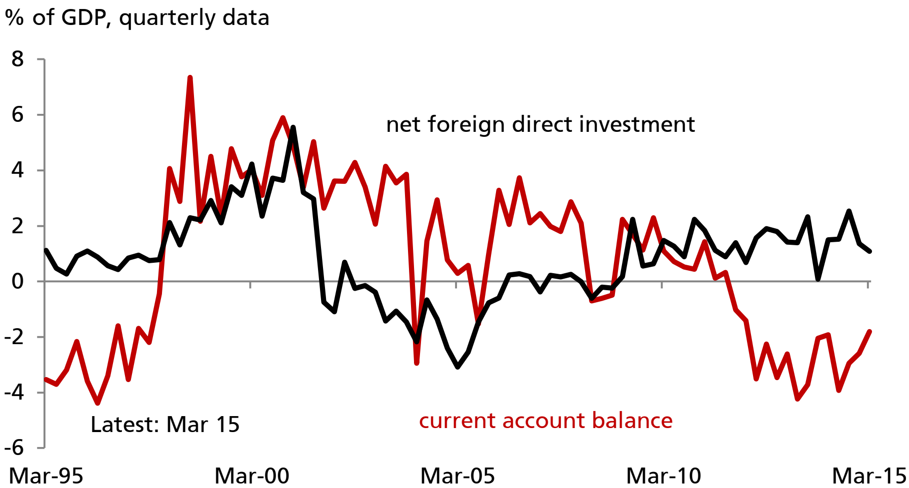
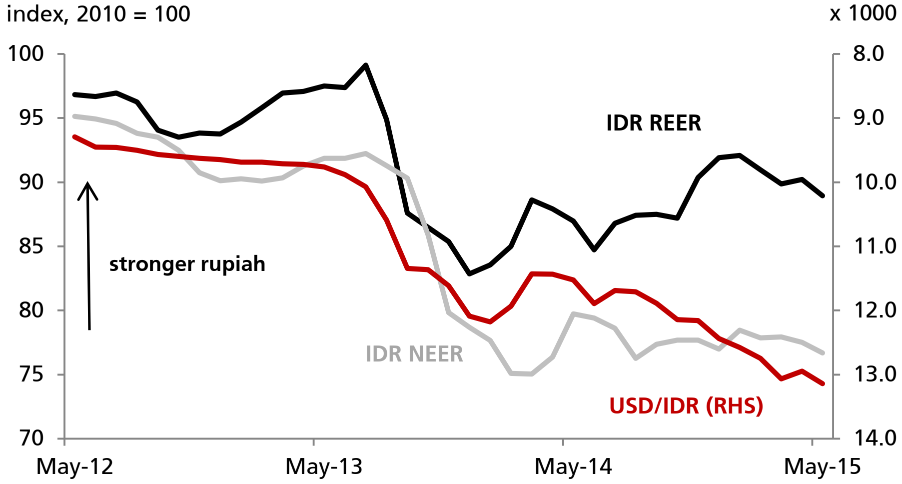


Chart 4: rupiah weak against USD but not on REER and NEER terms



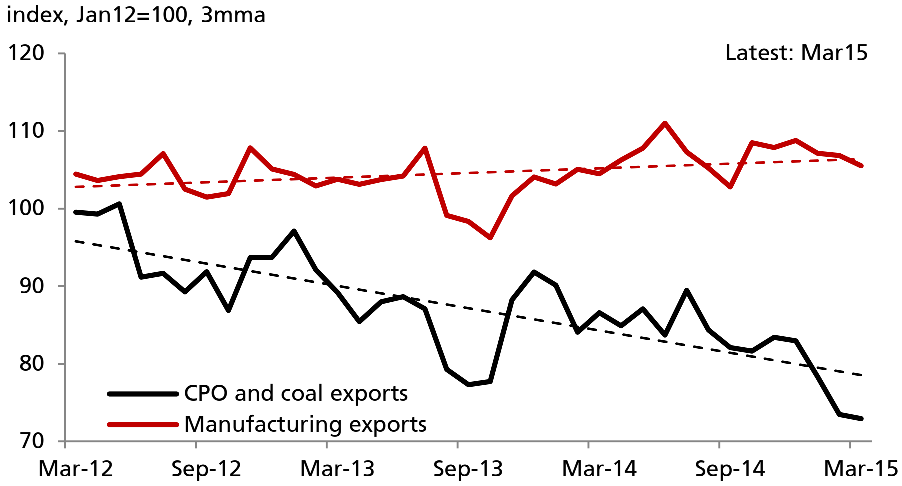
Despite weakness against the US dollar, the rupiah has been steady since 2013 on a real effective trade weighted basis

more sustainable). If this necessitates a weaker rupiah to boost exports, so be it. The problem is that a cheaper rupiah won't boost exports of commodities. And exports of manufactured goods have been almost flat in recent years, despite the rupiah moves (Chart 5).

A larger C/A deficit would be possible if FDI flows were greater. Not only does FDI provide stable financing but it can facilitate the technology transfer and know-how. Despite this year's introduction of a one-stop shop for investment applications, gross FDI has fallen in 1Q15. Meanwhile, the government is not expected to ease foreign investment restrictions in any sector, anytime soon. On current trends, 2015 FDI could fall below last year's USD 28.5bn, when most view USD 40bn per year as a reasonable target.

Disconcertingly, the government is perceived to be increasingly interventionist. Among other things, the government has issued new regulations to cap prices of food and basic goods during peak demand periods, in addition to the price caps placed on cement earlier this year. The authorities have also pushed to halve interest rates for microfinance loans through a state-owned bank, putting aside an estimated IDR 15-16tn worth of subsidies.

Chart 5: only a slight improvement in exports of manufactured goods



These measures are unlikely to lift demand by much as long as fiscal spending continues to disappoint. Through May, capital expenditures have only reached 6% of the full-year target. Even assuming disbursement can match the pace seen in 2H14, total capex spending may reach only 55% of this year's IDR 275tn target.

More FDI would allow a wider C/A deficit

A change in mindset

Most foreign investors remain invested because of the long-term potential of the economy. But this potential will be undermined if the authorities fail to step up efforts in 2H15, to prevent further slowing in growth. Investment is key – so long as it is productive, modestly higher debt is sustainable [4]. Indonesia today is far removed from 1997.

Notes:

[1] Gross government debt data is available from the IMF from 2000 onwards. According to data from the World Bank, central government debt/GDP averaged about 40% in the 5 years up to 1997. It has been practically stable at circa 25% for 5 years running now

[2] NPL ratio statistics are not released periodically until recently. Literature about the 1997-98 crisis typically estimate NPL ratio circa 10% in 1996. See for example, "The Asia Crisis: Causes, Policy Responses, and Outcomes", IMF, Oct99, https://www.imf.org/external/pubs/ft/wp/1999/wp99138.pdf

[3] See "Asia: arresting the Great Investment Slowdown" in "Quarterly: Economics-Markets-Strategy 3Q15", 11Jun15

[4] See "India and Indonesia: taking stock", 29Apr15

Sources:

Data are sourced from the World Bank, IMF, CEIC and DBS (forecasts and transformations).

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