

Indonesia Quarterly Economic Update

Battening down the hatches



10 December 2008

The World Bank

The last three months have been a critical and trying time for Indonesia. Like many other developing economies, Indonesia has had to cope with the immediate ripple effects of the turmoil and crisis of confidence that has disrupted the global financial system since mid-September, while at the same time preparing for an anticipated growth slowdown and continued tight liquidity in the coming quarters.

Indonesia entered the global economic turmoil of the last quarter of 2008 in a favorable position. Real GDP growth had accelerated to a ten-year high of 6.3 percent in 2007. And Indonesia was the only major economy in East Asia that did not experience a growth slowdown in the first half of 2008, despite unstable global markets and a slowing world economy. The assessment was that Indonesia would weather a moderate global slowdown relatively well, due to its size, robust domestic demand, the diversity of its exports and export destinations, as well as a record of prudent fiscal management.

The global turmoil since mid-September has, however, adversely affected Indonesian financial markets and economic outlook. With its relatively open capital account, a significant foreign presence in stock and bond markets, and the legacy of the 1998 crisis (which left Indonesian investors sensitive to exchange rate movements and prone to capital flight) Indonesia is subject to “externally mobile capital”. The greater financial exposure, combined with sharply falling commodity prices and large gross financing needs, has manifested itself in a falling stock market, dramatically higher domestic and international bond yields and credit default swaps as well as a depreciating exchange rate. In the context of a global liquidity crisis, spikes in risk aversion and volatility in financial markets, this exposure leaves Indonesia susceptible to sudden capital outflows.

In the face of these increased risks Indonesia’s economic management team has moved proactively. Precautionary measures have been taken to anticipate problems including providing the legal authority for the Government to intervene in financial institutions, to raise the deposit insurance limit, and reduce budget financing pressures as well as more immediate steps to provide needed liquidity in both dollar and rupiah markets.

The state of the Indonesian economy entering the final quarter of 2008

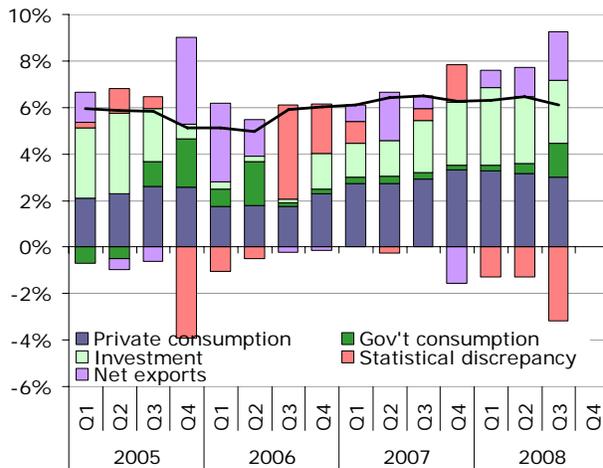
In the year and a half to mid-2008, Indonesia achieved its best economic performance since the crisis of the late 1990s, while the Q3 2008 outturn exceeded expectations. GDP increased by 6.1 percent in the year to the September quarter 2008, following the 6.4 percent growth in the first half of 2008 and 2007’s 6.3 percent increase. Unlike other countries Indonesia did not experience a growth slowdown over the first half of 2008, and its growth was broadly-based. Domestic demand, particularly private investment, was the main driver of growth, with net exports contributing into 2008. While still below pre-crisis levels, investment rose to almost 26 percent of GDP. The third quarter data continue to show broad-based growth.

Indonesia’s balance of payments continued to be in surplus for a third consecutive year over the first three quarters of 2008, and reserves built up significantly before falling back recently to the 2007 levels. Indonesia enjoyed a balance of payments surplus of 2.5 percent of GDP in 2007, and 1.8 percent of GDP over the first three quarters of 2008. The current account recorded a small surplus for the year, although there were small deficits in the second and third quarters as high oil prices affected trade values. Indonesia continued to accumulate foreign reserves through the first half of 2008, peaking at USD 60 billion mid-year before falling to USD 50 billion by late October as the central bank intervened to cushion the rupiah from the volatility on international financial

markets. Total external debt fell below 35 percent of GDP (at early December exchange rates) by October 2008, of which 16 percent of GDP is due within one year.

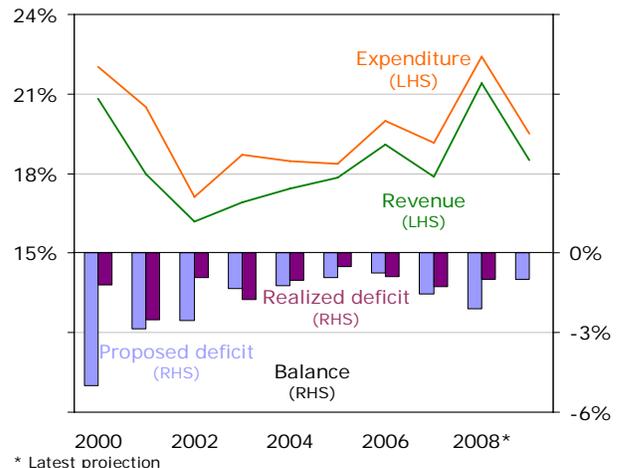
Indonesia has maintained overall budget deficits at levels that are low by international standards. The government realized a budget deficit of just below 1.3 percent of GDP in 2007, slightly smaller than projected. In fiscal 2008, the government's latest projections suggest a deficit falling to 1.0 percent of GDP, compared with the 2.1 percent deficit projected earlier in the year. The proposed budget for fiscal year 2009 projects a deficit of 1.0 percent of GDP as the government seeks to minimize financing. The current volatility in international commodity and foreign exchange markets plus significant uncertainty surrounding the global economic outlook lead to a wider-than-usual margin of error.

Indonesia approached the crisis with strong, broad-based growth
(Year-on-year growth and contributions)



Sources: BPS and World Bank

The government projects low budget deficits in 2008 and 2009
(Percent of GDP)



Sources: Ministry of Finance, BPS and World Bank

The improvement in Indonesia's public finances reflects overall fiscal discipline as well as specific policy moves to address energy subsidies. In May 2008 the government raised subsidized fuel prices by an average of 29 percent, relieving some of the budgetary burden of soaring oil prices. Part of the resulting savings funded a cash transfer program designed to offset higher fuel and food costs for 70 million of the country's poor and near-poor. In its proposed budget for 2009, the government took a further innovative step to contain the budgetary costs of energy subsidies. With the agreement of parliament, the government will, starting in 2009, reduce the effective base for regional transfers by the total amount of subsidies being provided. This measure will effectively reduce the subsidy cost by 26 percent for the central government, while aligning the incentives of regional governments, who will now share in the revenue gained from future reductions in fuel and other subsidies. This measure is particularly important because Indonesia's regulated fuel prices (kerosene, low octane gas and transport diesel) remain among the lowest in the region. In fact many countries tax fuel to capture environmental and other externalities. The sharp fall in oil prices through November brought international refined fuel prices below the level of Indonesia's regulated fuel prices, and in response on 1 December the government reduced the domestic gasoline price by 8 percent, to IDR 5,500 per liter. The government is now considering various mechanisms to link regulated domestic prices to movements in the market price of fuel, thus promoting market acceptance of changing fuel prices.

An impressive improvement in the government's tax collection systems has also strengthened Indonesia's finances. Total tax revenues in the first ten months of 2008 were almost 50 percent higher than the equivalent period in 2007 and this increase appears to be broadly based. Anecdotal evidence attributes this remarkable growth to a range of factors, including the tax office targeting tax payers in highly profitable commodity sectors and improving its internal personnel management.

Inflation, the main concern of economic policymakers mid-year, peaked in the third quarter of 2008, following BI's policy response and waning upstream price pressures. Indonesia's inflation rate in the year to November 2008 was 11.7 percent. With food items making up over 40 percent of Indonesia's CPI, higher food prices explained most of the rise through late 2007 to mid-2008. Inflation then became more broadly based as the government's average 28.7 percent increase in fuel prices in late May had the expected direct impact but also prompted generalized price resetting. From May 2008, BI moved to slow accelerating credit growth and rising inflation expectations by shifting monetary policy to a contractionary footing. BI increased its policy rate in six 25 basis points (bps) monthly installments, from 8.00 to 9.50 percent in October, and its public statements linked the rate increases to concerns over demand-driven inflationary pressures. While this year's inflation rate will exceed BI's target, the bank indicates that it remains focused on a longer-term target of 3.5 percent inflation by 2013. Inflation expectations have now returned to late-2007 levels, with commodity prices, upstream producer prices and growth in the money supply all suggesting inflationary pressures have slackened. Waning inflationary pressures, an apparent reduction in the downwards pressures in the rupiah and the rapidly weakening external growth environment (discussed below) led BI to lower its policy rate by 25 bps to 9.25 percent at its December meeting.

The accelerating growth over the last three years is reflected in Indonesia's poverty and employment numbers. Indonesia's poverty rate, measured at the national poverty line, fell from 16.6 percent in March 2007 to 15.4 percent in March 2008. The decrease continued the trend of gradually declining poverty rates. Both urban and rural poverty rates declined in 2008 and the decline was spatially uniform, with even the poorest provinces registering decreases in their poverty rates. Simulations suggest that given the robust growth in 2007 and 2008, poverty would have fallen even further, perhaps by as much as an additional two percentage points had it not been for the nearly 16 percent rise in food prices between April 2007 and April 2008. Indonesia's labor market had also appeared to be turning the corner and the phenomenon of "jobless growth" to be easing. The employment numbers from the latest (February 2008) national labor force survey indicated improvements in labor market outcomes, continuing an improving trend since 2005. The employment rate, the share of the labor force in non-farm employment, as well as the share of the labor force jobs in the formal sector have all been rising, while open unemployment has been falling.

However the global turmoil since mid-September has affected Indonesia's financial markets and economic outlook

Indonesia's financial markets have been adversely affected by the global turmoil since mid-September, though except for bond markets, not markedly more than in other countries. By the start of December 2008, the Indonesian stock exchange had fallen 56 percent since the start of the year, typical of other markets in the region. Mining and agricultural stocks have fallen sharply since the start of 2008 reflecting declining expectations for commodity prices. Financial sector stocks have, on average, fallen less than the overall market, reflecting the limited direct exposure of Indonesia's banks to developments especially in US financial markets, plus a strong capital base and low levels of non-performing loans (non-performing loans were 3.9 percent in September 2008).

The rupiah has come under pressure since early October. The rupiah had tracked broadly sideways against the US dollar over the 12 months to August. But in October 2008, it depreciated steadily, losing 29 percent of its value against the USD by the start of December. Bank Indonesia intervened in the spot market in September and October especially. The early intervention has been driven in part by concerns about letting the IDR cross various thresholds (e.g., IDR 10,000 per USD) that might trigger domestic capital flight. BI's net intervention appears to have been minimal in November, with the central bank's foreign reserves at USD 50.182 billion by late November, only USD 400 below the levels of end-October.

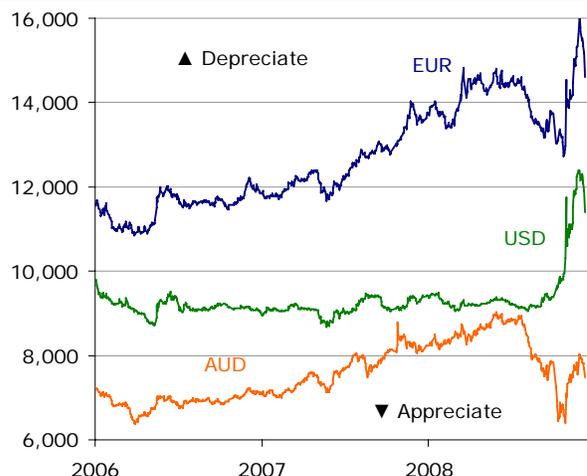
After out-performing other markets through 2006, the Indonesian stock market has fallen with global markets in 2008

(USD index, 1 January 2005=100)



Source: World Bank

The Rupiah has come under pressure since early October



Source: CEIC

Direct impacts of the US financial crisis on the domestic banking system, which holds nearly 80 percent of financial assets, have thus far been limited. The NPL ratio, at 3.9 percent in September 2008, is relatively low. However, Indonesian banks face challenges. Over the past year, loan growth, at over 36 percent, has been extremely rapid. With deposits growing at less than half this pace, the loan-deposit ratio increased rapidly and reduced liquidity coming into the crisis. The depreciation and demand destruction will affect corporate earnings and result in rising NPLs and the erosion of bank capital moving forward.

The exposure of the corporate non-financial sector to the global turmoil has been limited thus far except for a few specific cases and increasing reports of difficulties with trade finance. The balance sheet vulnerabilities of the Indonesian corporate sector have been reduced over the last decade. Indonesian firms largely finance their investment through retained earnings, and leverage ratios in the corporate sector have fallen. But when corporates have borrowed, they have often chosen to do so from foreign sources. In 2007 Indonesian firms obtained almost half of their external financing from foreign sources and this exposure to foreign sources of funding makes firms vulnerable to global financial market conditions as loans turn over. There are also cases of Indonesian corporations, especially commodity intensive ones, having taken on significant exposure to foreign debt markets after having pledged shares as collateral for expansions. However, overall short-term external debt exposure of both the private and public sector appears manageable—USD 22.8 billion due within a year from October 2008—given international reserves of USD 50 billion (as of November 28). There are also increasing reports by exporters and importers that Indonesian banks are not honoring overseas bank's Letters of Credit, and vice versa, due to dollar liquidity problems and perceptions of increased counterparty risk.

Government debt markets have been hit especially hard by the widening crisis, with yields on both IDR and USD bonds rising sharply. The domestic IDR bond market has been particularly susceptible to changes in sentiment. These tendencies were evident in March and April, when, in the context of rising oil prices and concerns over the financing demands of ballooning energy subsidies, yields jumped and turnover slumped. Following the government's increase in fuel price, BI's stronger anti-inflationary stance, and successful USD bond issuance, trading returned to normal levels through July and August, and bond prices rose. However, yields on Indonesian domestic bonds remained elevated and rose even more sharply and significantly than elsewhere with September and October 2008's global financial turmoil. End November saw prices recover somewhat, and sales by foreign bond-holders slowed, but the market remains fragile and bond yields more than one-third above their levels of a year ago.

Government finances have been especially vulnerable to spikes in global risk aversion and contagion from external markets because Indonesia's gross financing needs are large. The term structure of Indonesia's bonds led to sharply higher turnover in 2007 and 2008, and amortization is projected to remain at high levels through 2011 (assuming little change from September 2008 exchange and interest rates). Indonesia was successful in raising more than USD 12 billion from domestic and international markets in 2007 and 2008 respectively. But tighter global liquidity and higher risk premiums combine with high gross financing needs to raise interest rates on Indonesian debt compared to other economies in the region. The government's financing strategy for calendar year 2009 is predicated on borrowing the equivalent of USD 10.6 billion from markets. However, Indonesia proactively approached development partners and requested additional support for budget financing in the event that markets remain illiquid.

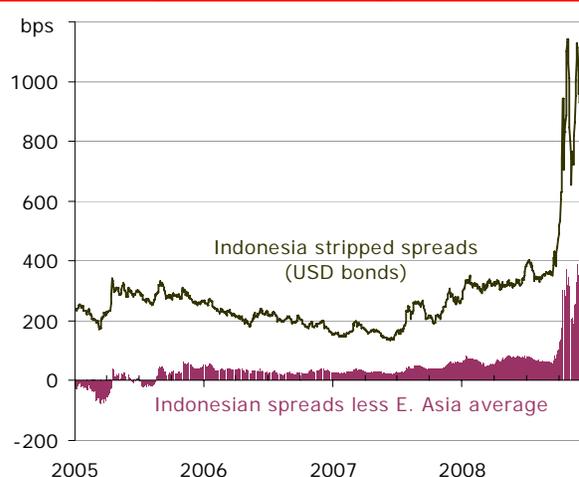
Yields on Indonesian government bonds rose more sharply than elsewhere during the October and early November peak of the current financial turmoil, and have since recovered somewhat

Domestic currency 5-year sovereign bonds



Source: CEIC

Spreads on USD sovereign bonds



Sources: JP Morgan and World Bank

The consensus is that the advanced economies are headed towards a prolonged recession and a more pronounced growth slowdown in Indonesia in 2009 is now expected as well. Slower growth in Indonesia's major trading partners is expected to feed through into falling exports. And as commodity prices fall sharply to 2006 levels (current projections), that will reduce the stimulus they have provided to Indonesia's growth as well. Finally the multiplier of these effects plus the tight liquidity and generalized uncertainty will reduce investment and consumer durables demand in Indonesia as elsewhere.

Assuming a prolonged global recession roughly comparable to the one in 1982 (the worst for a composite of Indonesian trading partners from 1970s to present), Indonesia's growth is projected to fall from 6 percent in 2008 to approximately 4.4 percent in 2009 before recovering towards 6 percent in 2010. Investment and exports are expected to be most affected by the current economic turmoil. Investment is expected to be flat in 2009, before recovering 2010 around 7 percent. Export volume growth is projected to slow from 2008's 14 percent pace around 1-2 percent in 2009, before recovering towards 8 percent in 2010. The one positive impact of global events is the marked slowing in inflation, which will provide some support to households' real incomes. After 2008's annual average inflation rate near 10 percent, inflation is expected to be approximately 7 percent in 2009 and 6 percent in 2010. Poorer households, which consume relatively more food, should see an even more marked slowdown in living costs. The uncertainty surrounding the global outlook, and the transmission from global events to the local economy, make these projections far more uncertain than usual. In addition third quarter results in Indonesia's major trading partners have been below expectations, and an array of indicators suggests that activity will be even weaker in the fourth quarter. In addition, commodity prices have fallen dramatically. Together these developments suggest significant downside risks.

While external capital has already left the country's financial markets, Indonesia continues to remain vulnerable to capital flight. Indonesia is a financially open economy with significant foreign holdings, especially in the stock and government debt markets. The legacy of the 1998 crisis left Indonesian investors sensitive to exchange rate movements and prone to capital flight. Indonesia is thus vulnerable, as are other emerging economies to heightened risk aversion, and sudden capital outflows. As funds leave due to liquidity demands and rising risk aversion, pressures on interest and exchange rates have risen. Indonesian corporations are believed to have reasonably well diversified in terms of finance and to not be significantly leveraged, but, domestic capital markets are volatile and subject to sudden changes in sentiment. In addition, the depreciation of the rupiah and demand destruction through the slowing domestic economy will affect corporations' profitability and result in rising non-performing loans and the erosion of banks' capital. In sum a prolonged recession with the associated erosion of Indonesia's current account surplus and further episodes of heightened risk aversion continue to pose challenges to macroeconomic stability. Developments since mid-November, particularly the stabilization of BI's foreign reserve holdings, the strengthening of the rupiah and falling interest rates coupled with BI's policy rate reduction suggest that, for now, a new equilibrium may have been reached.

The government is well-aware of this vulnerability and has taken a number of precautionary and proactive measures to reduce the likelihood of capital flight, to alleviate government financing constraints, and to maintain critical public expenditures in the face of a growth slowdown. Monetary policy has now shifted to accommodating growth by adding liquidity and, most recently, cutting interest rates. The Government also put in place regulations that would allow it to provide guarantees to the banking system, and raised the deposit guarantee ceiling to 2 billion rupiah (around 200,000 USD), while passing a Government regulation-in-lieu-of-law that would allow it to intervene in troubled financial institutions (as was done elsewhere). Despite Indonesia's conservative fiscal position, the government agreed with the Parliament to revise the 2009 budget to target a deficit of 1 percent of GDP in 2009. The government plans to do this by reducing routine line ministry spending by 5 percent to 15 percent, while maintaining infrastructure spending and scaling up social-sector spending, in particular, funding for the flagship community-based poverty alleviation program.

Notes

This note was written as part of the regular economic monitoring work being undertaken by the World Bank in Indonesia. For further information about this work, and about the World Bank's activities in Indonesia please visit the website of the World Bank's Indonesia country office: www.worldbank.org/indonesia. For specific questions or comments, or to be included in a distribution list for future Notes, please contact bulman@worldbank.org, ffitrani@worldbank.org, or madriani@worldbank.org