REVIEW OF ECONOMIC DEVELOPMENTS

Inflation and Balance of Payment Crises Shed Clouds on the Economy

IRA S. TITIHERUW AND HARYO ASWICAHYONO

IN LIGHT OF NEXT year election, most observers stated that the year 2013 would be the last opportunity for the second SBY's administration to do an overhaul reform, necessary to keep domestic economy in sustainable development mode. After big political commotion last year, the government proceeded carefully to raise domestic fuel prices in June 2013. The increase was urgent since the government budget (APBN) had already been at risk due to its huge fuel subsidy. However, even before the increase of fuel prices, consumer price index had been on the rise. Partly because of high (raw and processed) food prices that persisted since the start of 2013 and later, because of imported inflation after the Rupiah suffered severe depreciation pressures since August 2013. The pressure came from the worsening deficit in the country's Balance

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of Payment (BoP) due to financial market jittery over Federal Reserve's warning that they might start to end quantitative easing policy. Adding to that, export had still not picked up though some recoveries on Indonesia's biggest export markets are already underway.

The Government issued several policy reform packages, following the increase of fuel prices in order to contain its social and economic impacts such as distributing direct cash assistance (Bantuan Langsung Sosial Masyarakat/BLSM), raising interest rate (by Bank Indonesia) to curb inflation, introducing export and foreign direct investment incentive schemes and applying higher import taxes. While it would take some time for export drives to affect, direct impacts of higher interest rates and import taxes would surely be unfavorable for growth. However, the Government perceived these measures as necessary to speed up the improvement of BoP condition.

As a consequence of these measures, economic growth slowed down along with improving condition of BoP in the third quarter of 2013. Rupiah value was allowed to weaken to IDR 12,000/USD to push export performance in the last quarter of 2013. At the end, growth rate was relatively better than what was predicted by many analysts. Table 1 showed summary of economic indicators for 2013.

Table 1. Summary of Economic Indicators for Indonesia, 2013

	Q1	Q2	Q3	Q4
GDP growth (% yoy)	6.03	5.76	5.63	5.72
Inflation (% yoy)	5.90	5.90	8.40	8.38
Exchange rate (IDR/USD Spot:Mid)	9,719	9,929	11,613	12,189
Interest rate	5.75	6.00	7.25	7.50
Current Account Deficit/GDP (%)	2.7	4.4	3.9	2.0

Source: CEIC, BI, World Bank

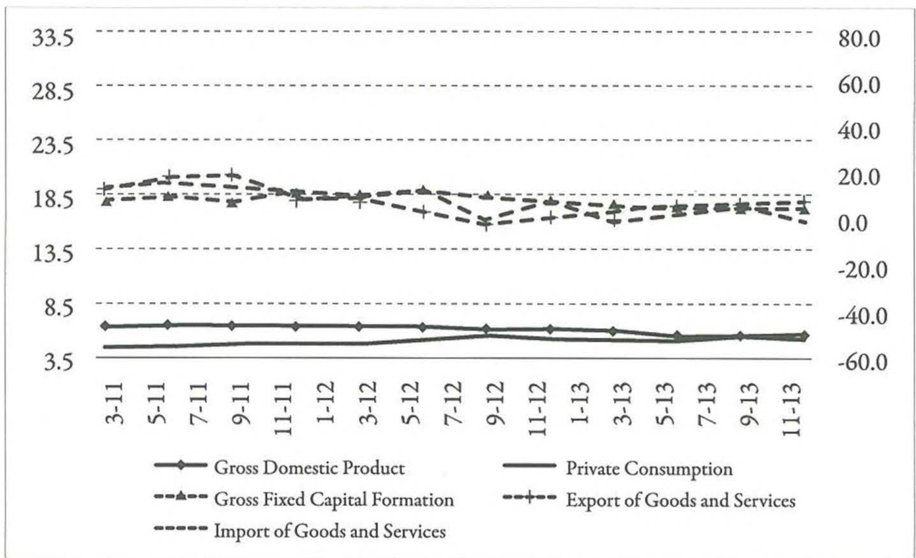
Economic growth in Q4 2013 reached 5.72% (year-over-year/yoy), a bit higher than consensus prediction of 5.6% (yoy). From production side, non-tradable sectors such as transportation and communication and finance, real estate and business services have still been major contributors with 10.32% (yoy) and 6.79% (yoy) growth rate respectively. The non-tradable sector with the biggest share in GDP was still trade, hotel and restaurants sector. However, growth rate for the sector in Q4 2013 was 4.78% (yoy)—far lower compare to its growth rate in Q3 2013 (6.14% yoy). This slower growth rate was translated to much lower non-tradable

sector total growth rate which had been dwindled since the start of 2013 from 7.4% (yoy) in Q1 to 6.5% (yoy) at the end of December 2013. Note that growth in non-tradable sectors is in fact derived growth from productive sectors such as manufacturing and agriculture sectors. Without increasing production capacity of the more productive sectors, growth in non-tradable sectors would deteriorate ultimately as already occurred in 2013.

Manufacturing industry grew 5.29% (yoy)—slightly higher compared to growth in Q3 2013 (5.01% yoy). The share of manufacturing industry in total GDP reached 23.7%--it has the biggest share in total Indonesia's GDP. Mining and quarrying sector expanded significantly since Q3 2013, indicating sizable production in the race before deadline of raw mineral export ban was in place on January 2014.

From the expenditure side, major contributor of GDP growth was household consumption. Its growth rate was recorded at 5.3% (yoy) in Q4 2013, followed by export (grew 7.4% yoy in the last quarter of 2013, higher than export growth of 5.2% (yoy) in Q3 2013. High export growth was expected as Rupiah value continuously depreciated since August 2013

Figure 1. Growth rate of GDP, Household Consumption, Investment, Export and Import, Indonesia 2010-2013



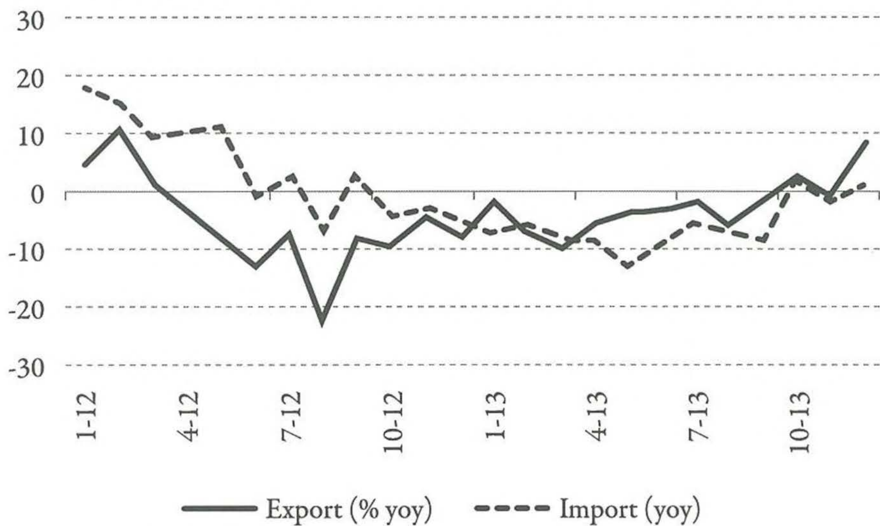
Source: CEIC

Observing Figure 1, quarterly GDP growth rate had been declining since mid-2011. In 2011, export growth started to fall sharply due to

weakening commodity prices in international market. However, GDP growth managed to sustain since investment continued to expand until Q3 2012. It started its downward trend at the end of 2012 as import had also on the declining mode. At the same time, export growth began to improve slowly as some recoveries had taken place in developed countries such as the US. But it was still far below its growth rate, let alone the driving force behind GDP growth. Up to end of 2013, export growth was still sluggish and just started to take off after the Government issued export and investment incentive schemes. As expected, upon Rupiah depreciation in the last quarter of 2013, export performance improved significantly while import growth had been halted.

Export-import data issued recently by BPS demonstrated that since the start of 2012, monthly import growth (%yoy) had always been higher than export growth due to high domestic demand until Rupiah depreciation and higher import taxes cut it short. During Q4 2013, import growth rates were respectively -8.9% yoy (October 2013), -10% yoy (November 2013) and -0.8% yoy at the end of 2013. Note that, during October-December 2013, the biggest import drop occurred on capital goods (it fell 16.8% yoy), while intermediate goods import shrank 4.7% (yoy). In contrast, import of consumption goods rose 9% yoy (particularly fruits and vegetables, cosmetics and plastic-made goods).

Figure 2. Average Monthly Growth Rates of Export and Import Indonesia, 2012-2013



Source: CEIC

Balance of Payment at the end of 2013 showed quite a substantial improvement. A surplus was booked in the amount of USD 4.412 billion, the first time after being in deficits for the previous three quarters of 2013. The surplus was due to declining deficits in current account balance (from USD 8.5 billion to USD 4 billion), coupled with an increase in surplus of capital and financial account balance that reached USD 9.2 billion. As Figure 2 showed, export increase and imports decline towards the end of 2013 were reflected immediately on surplus of trade balance in the amount of USD 4.894 billion. At the same time, foreign investors nervousness appeared to subside upon learning the Fed's move indicated that quantitative easing would be reduced slowly. Indonesia's capital and financial account balance was back to green with considerable foreign capital inflows in the form of Other Investment items (private sector foreign loan disbursement and withdrawals of domestic banks' overseas deposits into BI's monetary instruments). Nevertheless, the country's BoP would still have bleak outlook in the near future as the Government prepared to put mineral export ban in effect on January 2014. It should be expected that export will fall and trade balance would be in deficit territory once again.

In Table 2, Q4 portfolio investment was minimal compared to inflows

Table 2. Summary Balance of Payment Indonesia, 2013

	Q1 2013	Q2 2013	Q3 2013	Q4 2013
Current Account Balance	-5.905	-9.998	-8.529	-4.018
Trade Account	1.628	-0.517	0.145	4.894
Export	45.231	45.554	44.148	48.616
Import	-43.603	-46.071	-44.003	-43.722
Services Account	-2.511	-3.365	-2.675	-2.877
Others	-5.022	-6.116	-5.998	-6.034
Capital & Financial Account Balance	-0.394	8.300	5.587	9.238
Capital Account	0.001	0.007	0.005	0.008
Financial Transaction Account	-0.395	8.293	5.582	9.230
FDI	3.789	3.700	5.681	1.597
Portfolio Investment	2.760	3.389	1.942	1.756
Other Investment	-6.945	1.203	-2.041	5.877
TOTAL	-6.299	-1.698	-2.942	5.220

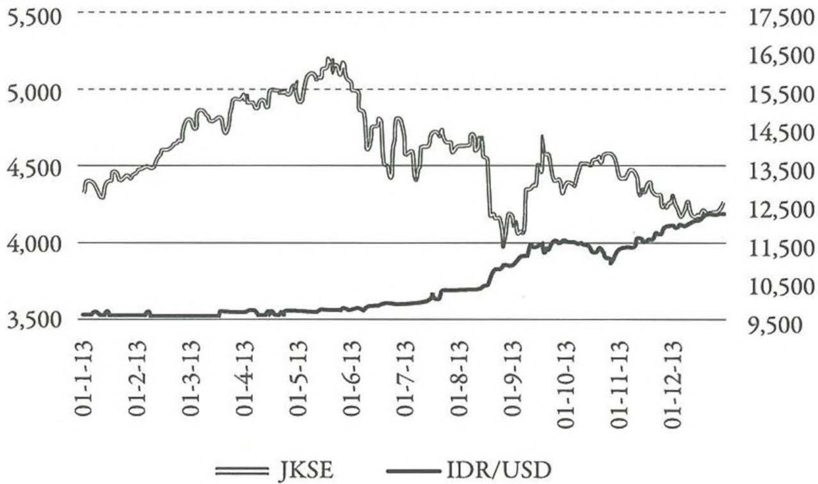
Source: Bank Indonesia 2013

in the first semester of 2013. Volatility in Indonesia's Stock Exchange was high with downward trend in the last quarter of 2013. (See Figure 3). During

the same period, negative outlook of BoP continued to add depreciation pressures to Rupiah in the foreign exchange market. The Rupiah value touched IDR 12.170/USD at the end of December 2013—its value has declined 20.8% (yoy) since the end of last year.

Besides BoP deficit, the Rupiah value had also been under pressure due to persistently high inflation during 2013. In the course of 2013, inflation rate reached 8.38% (yoy), far higher than 2012 inflation rate which was recorded at 4.30% yoy. The Government and Bank Indonesia struggled to keep the

Figure 3. Rupiah Exchange Rate and BEI Index Indonesia, 2013



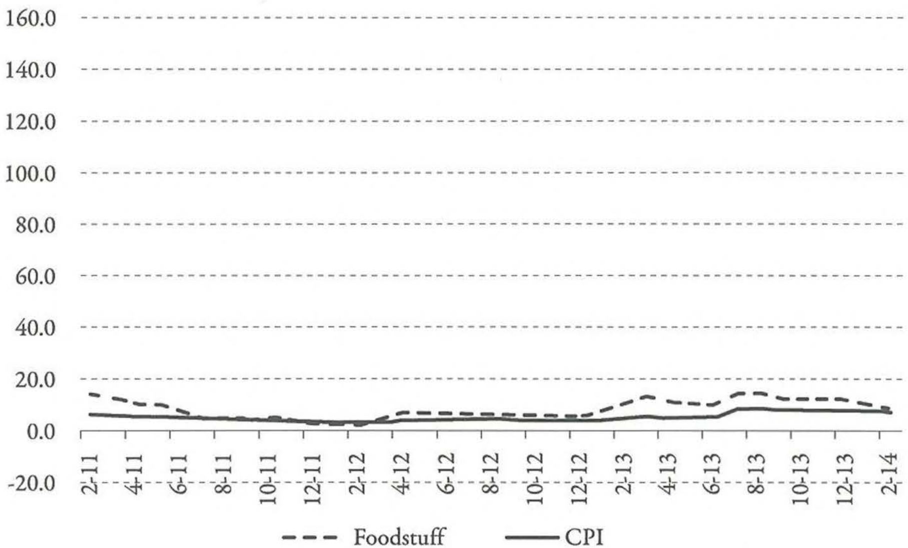
Source: CEIC

general price increase in check by joint efforts such as raising benchmark interest rate gradually to 175 bps and easing up import licensing of basic commodities.

In Figure 4, inflationary pressures in the economy had been intense since the start of 2013. Food price index soared since January 2014 when the Government regulated imports of fruits and vegetables to be confined in several ports. On April 2013, there was a short break due to rice harvest as always happened every year. However, in total, food price index in 2013 rose 11.83% (compared to last year 2012 which only increased by 5.68%). Looking back to 2008, Figure 4 showed that the Government's ability to manage inflation rate is greatly depended on its ability to manage volatility of food prices in domestic market.

Other factors also contributed to high inflation in 2013: quarterly increase of electricity tariff, one-time increase of domestic fuel prices in June and also increase of 12-kg LPG prices used by household in

Figure 4. Inflation and Change in Food Price Index, 2008-2013



Source: CEIC

urban areas. Increase of domestic fuel prices on June 2013 was the major contributor to administered price inflation (as much as 16.65% yoy). In 2014, it is expected that inflation rate will be down to 4.5% (yoy) ± 1%. There would be minor demand-side inflationary pressure coming from general election campaign.

Ballooning Deficits in Balance of Payment

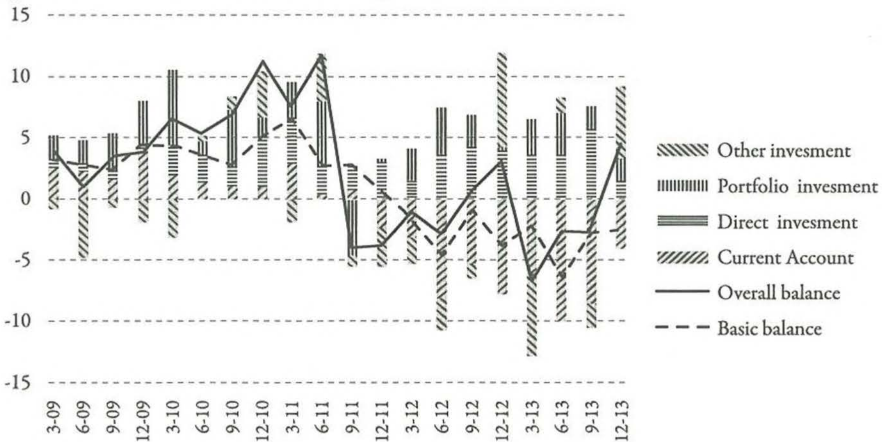
Despite having improved, balance of payments (BOP) deficit was still one of the main problems facing Indonesian economy in 2013. There had been a downtrend in balance of payments deficit since Q1 2009. A steep decline of the deficit had taken place since Q1 2011 before eventually became negative during Q4 2011. Since Q2 2012, current account deficit had been stabilized before getting better in Q4 2013, at $4 billion. The main reasons for the deterioration in current account were the weakening of trade account and the increasing number of income repatriation from foreign investments.

Non-oil & gas trade balance had deteriorated since Q3 2011, prior to becoming negative in Q2 2012 and tended to be negative up to Q3 2012. It was only in Q4 2012 that non-oil trade balance experienced a surplus,

at $7 billion. Meanwhile, the oil & gas trade balance had deteriorated since 2008 before getting stabilized in 2013.

Some factors contributed to the deterioration of balance of payments.

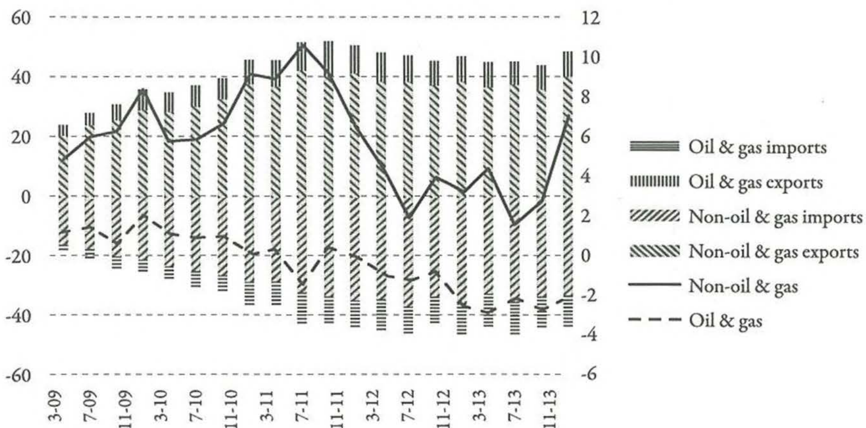
Figure 5. Current Account Position, 2009-2013



Source: Bank Indonesia

First, exchange rate appreciation and high inflation in Indonesia, in comparison to that of other competitor countries, had diminished the competitiveness of Indonesian exports in international market and undermined the competitiveness of domestic products to imported ones. Figure 7 shows Indonesia's Real Effective Exchange Rate (REER), that is, the exchange rate that has been corrected for inflation, had been strengthening since 2011.

Figure 6. Oil/Gas & Non-Oil/Gas Trade Balance, 2009-2013



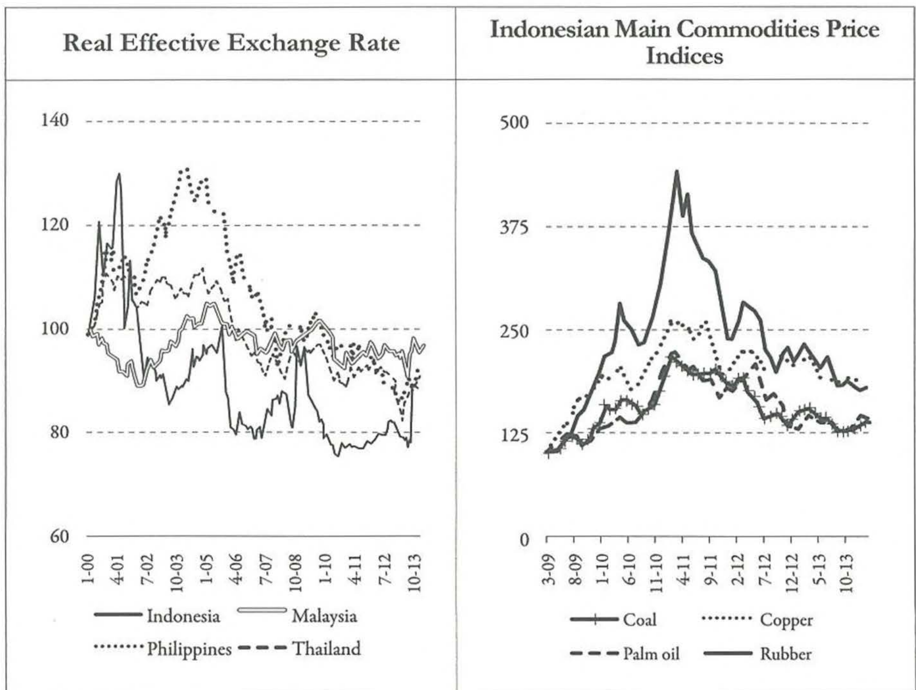
Source: Bank Indonesia

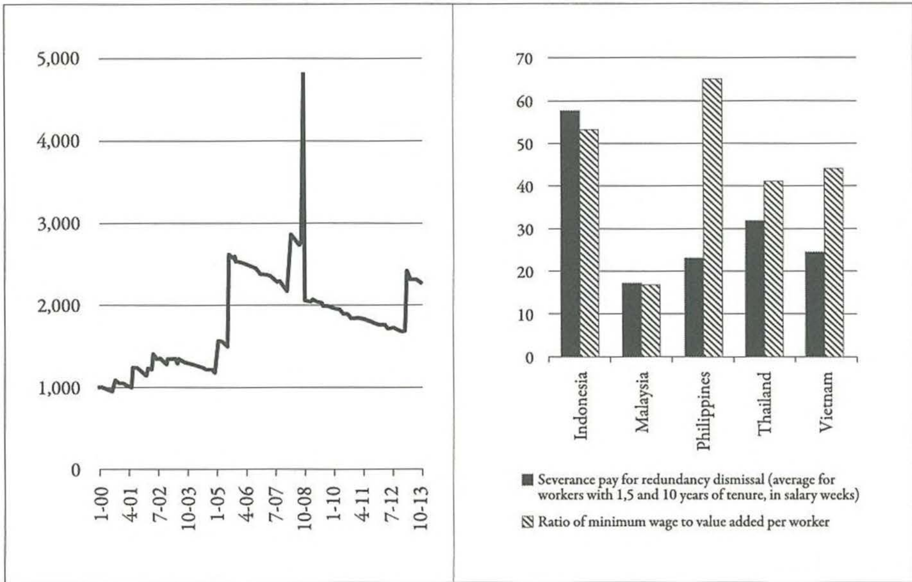
Second, economic slowdown in Indonesian main export markets, such as US, Europe, Japan, and China, had caused a slump in demands for Indonesian main export commodities. This declining level of demand would eventually push the price of Indonesian main export commodities down.

Third, although fuel price increased nominally on 22nd June 2013, on its real value, it was still cheaper than the 2005 price. The cheap price of subsidized fuels and the rapid economic growth (more than 6%) during 2008-2012 period, caused an upsurge in fuel consumption. On the other hand, the investment climate in the oil/gas sector was yet to be improved, leading to dwindling fuel supply. The gap between rising demand of fuel and its inadequate domestic supply was eventually bridged by increasing number of fuel imports.

Fourth, labor's wages had been rapidly increasing since 2000. Unfortunately, the wage hikes were not in line with proportionate productivity increases. As a result, the labor cost per unit of production soared. In addition, this had eroded the competitiveness of Indonesian exports and that of domestic products to imported ones.

Figure 7. Rupiah's Real Effective Exchange Rate 2000-2013, Indonesian Main Commodities Price Indices, 2009-2013, Real Domestic Price of Fuel, 2000-2013, Ratio of Minimum Wage to Labor Productivity and Severance Pay, 2000-2012





Source: CEIC

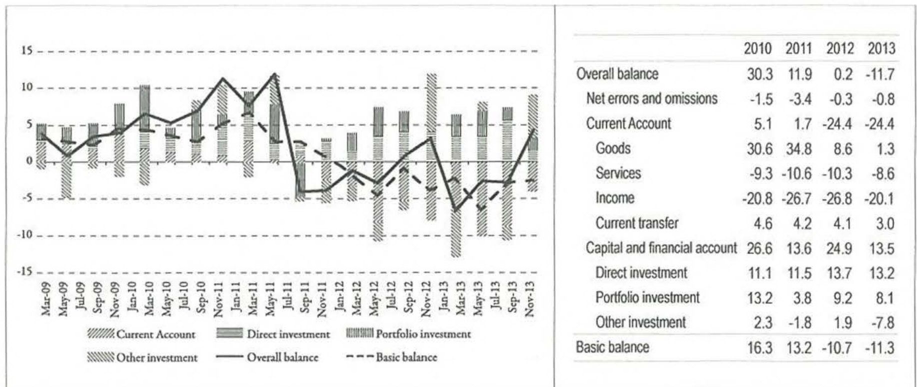
How was the deficit financed?

Current account deficit is not troublesome as long as there are sufficient incoming capital flows to finance it. Those incoming capital flows could take form as FDI and portfolio (either equity or debt) investment. If the incoming capital flows are not sufficient, the shortfall has to be covered by exhausting foreign reserves.

In 2011, Indonesia had a current account deficit of $24.4 billion, while it only received $13.5 billion from capital flows. Hence, the overall deficit was $10.9 billion. If we only account for capital flows which are relatively stable and long-run, that is, FDI, then the basic balance had suffered deficits since 2012.

Unless Indonesia can increase its attractiveness for FDI, then it needs to finance its current account deficit from the portfolio capital flows. Unlike FDI, portfolio investments are more likely to be unsteady.

Figure 8. Indonesia's Balance of Payments, 2010-2013



	2010	2011	2012	2013
Overall balance	30.3	11.9	0.2	-11.7
Net errors and omissions	-1.5	-3.4	-0.3	-0.8
Current Account	5.1	1.7	-24.4	-24.4
Goods	30.6	34.8	8.6	1.3
Services	-9.3	-10.6	-10.3	-8.6
Income	-20.8	-26.7	-26.8	-20.1
Current transfer	4.6	4.2	4.1	3.0
Capital and financial account	26.6	13.6	24.9	13.5
Direct investment	11.1	11.5	13.7	13.2
Portfolio investment	13.2	3.8	9.2	8.1
Other investment	2.3	-1.8	1.9	-7.8
Basic balance	16.3	13.2	-10.7	-11.3

Source: CEIC

The End of "Easy Money"

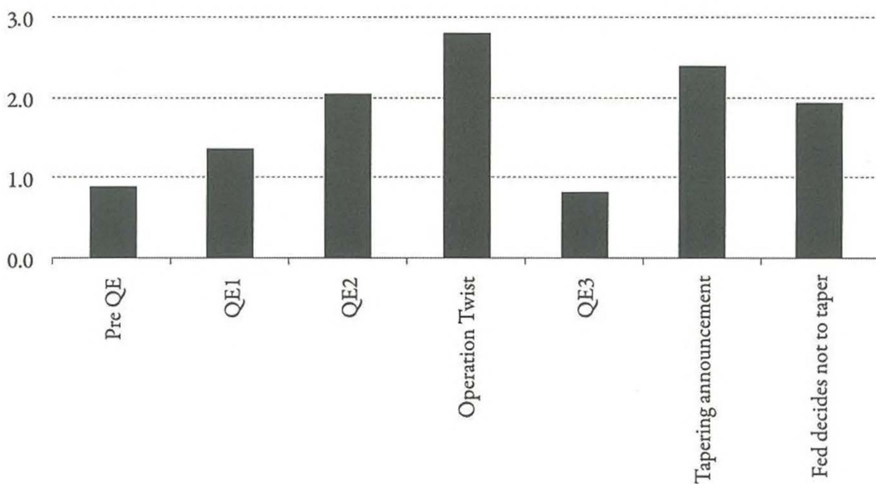
The incoming and outcoming capital flows in Indonesia were related to international upheaval. During 2009-2011, there had been rapid capital flows into Indonesia. In 2009, American central bank, The Fed, injected liquidity to American economy to stimulate its sluggish economy. This program is known as Quantitative Easing (QE). According to the plan, The Fed would acquire $600 billion worth of long-term bonds and US Treasury Notes from November 2008 up to March 2010, before eventually reaching $1.75 trillion (QE1).

On its second stage (QE2), The Fed also intended to purchase $600 billion assets from November 2010 to June 2011. Further, The Fed conducted Operation Twist, that is, buying long-term bonds and selling short-term ones to maintain long-term interest rate. Since basically, Operation Twist to some extent restrained the previous QE, its impact slightly reduced capital outflows from US (also means reducing the capital flows to emerging markets, including Indonesia).

Later on, the American central bank conducted the 3rd edition of Quantitative Easing. On 12th September 2012, American central bank announced that it would purchase long-term securities for $40 billion each month. At this stage, investors might start to question up to which time this QE would be carried on. Would it be stopped? In January 2013, two members of American central bank expressed their concerns over American monetary policies, that they thought were too loose.

Eventually, on 22nd May 2013, The Fed chairman, Ben Bernanke, gave a hint to American congress that QE would soon be reduced (tapering). In a clearer tone, the statement was repeated on 19th June 2013 in a clearer tone. Bernanke said that American central bank would reduce QE and stop QE at mid-2014. As a result of this announcement of possible tapering off, capital flows which previously were heading into emerging markets, turned around. This speculation finally ended on 17th September 2013 when The Fed announced that it would not conduct its tapering off.

Figure 9. Quantitative Easing and Net Capital Inflows (%GDP), 2008- Oct 2013



Source: CEIC

Figure 9 shows the incoming private short-term portfolio capital flows. From that figure, it is revealed that all sequences of QE, including the announcement and abandonment of tapering off, directly impacted private capital flows to Indonesia. The quarterly average private capital flows had gradually increased from QE1 up to Operation Twist. During QE3, there were a growing concern over American loose monetary policy, and wide-spreading expectation that QE would soon end.

The primary conclusion is that 'Easy Money' era, rapid incoming capital flows like the ones from early 2009 to mid 2011, has come to an end. Therefore, Indonesia has to spare more efforts to attract capital flows, especially FDI, which is less prone to sudden flee.

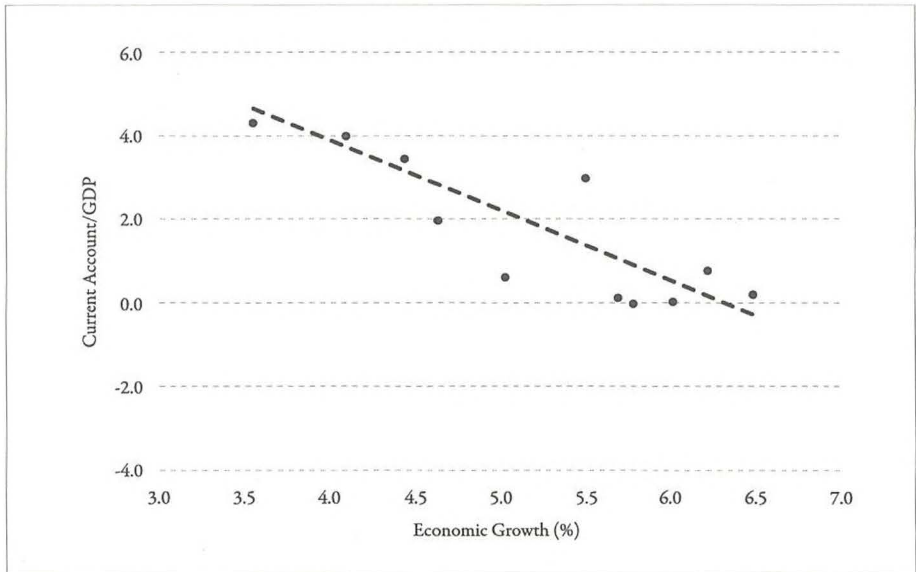
Structural or Temporary Problems?

Burning question that needs to be answered is whether BoP deficit was caused by structural problem that would need longer-term solution or is it caused by temporary problem which could easily be solved over a short period of time? Many indicated that the deficit is more of a structural problem

When we plot BoP deficits and economic growth rate, we should quickly see that our domestic economy overheats easily. Figure 9 showed that BoP inclined to become negative when domestic economy grew above 6.3%. This indicated there were structural problems in domestic economy. One of the problems is unresponsiveness of export to economic growth, while import is much more sensitive. In other words, there was a competitiveness problem in Indonesia.

Several indicators revealed un-competitiveness of Indonesian exports in international market. Figure 10 showed that export volume did not grow much even though export prices increased sharply since 1998 (see Figure 7). In fact, export volume tended to be stagnant over the years. Weak response of Indonesia's export supply to increase of export prices showed that there was an obstacle hindering exporters to react swiftly. Note that before 1998, Indonesia's export growth was induced by increase of export volumes—not merely prices.

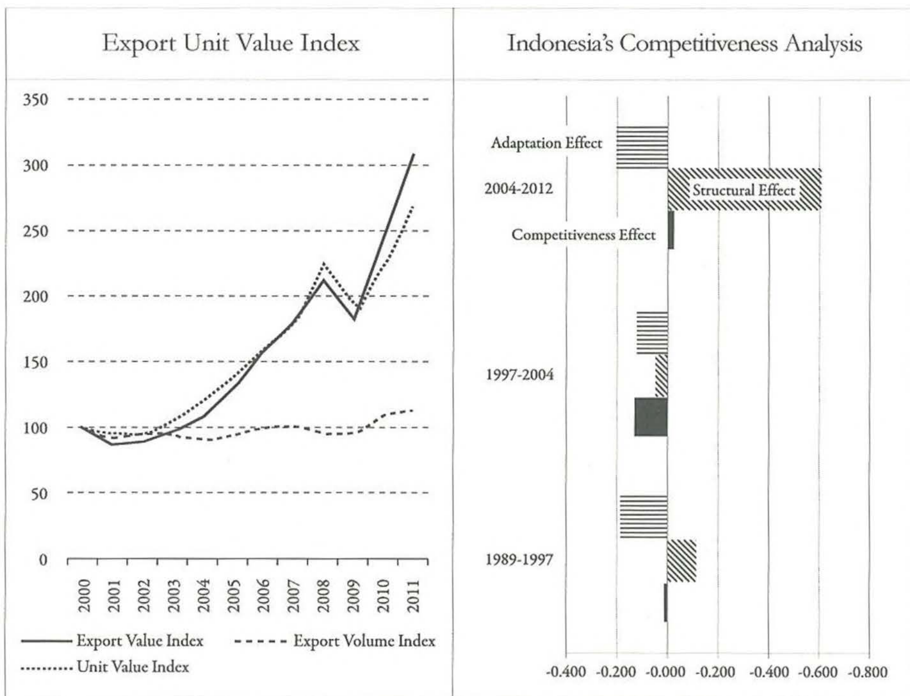
Figure 10. GDP Growth vs Current Account/GDP



Source: CEIC

Lack of competitiveness of Indonesia's export goods was also apparent when export growth sources could be specified into three: structural effect, adaptive effect and competitiveness effect. Structural effect refers to an increase in export that is solely due to an increase of world demand. Adaptive effect pointed to the country's ability to shift from declining export commodities/destination to other commodities/destination. Between 2004-2012, Indonesia's export growth has particularly been supported by increased demand, not by increase in competitiveness. Adaptive effect was negative as well, indicating that Indonesia's exports were not responsive to change in export demand pattern.

Figure 11. Export Performance Indonesia, 1990-2012



Source: CEIC

Government's Responses: Effective in Macroeconomics, Vague in Microeconomics

The Government acted swiftly to respond BoP crisis in 2013. On macroeconomic side, the central bank allowed exchange rate to surf the market ride. However, at the same time, Bank Indonesia also raised interest

rate. Rupiah depreciation stabilized BoP deficits through increasing export competitiveness (exporters receive more rupiah for one unit export) and reducing import competitiveness in domestic market since its prices become higher. Raising interest rate aimed at putting on brake on inflation rate and preventing capital outflows. However, this instrument would also decelerate economic growth. In turn, economic slowdown would reduce import demand, thus easing pressures on BoP.

On microeconomic side, the Government issued three reform packages in August, October and December in order to curb import through tax and non-tax instruments. The Government offered export incentives scheme and improved investment climate by revising negative investment list. The Government also applied added tax to luxury goods import. However, at the same time, the Government also introduced lots of domestic industry-protecting policies which did not support export incentive measures. The most controversial policy was raw mineral export ban. Besides the ban, the Government mandated mining companies to build compulsory smelters to process raw mineral before exporting. In the short time, the effect of export ban could worsen BoP deficit due to slump in export revenue and increase of capital goods import since mining companies is obligated to build smelters. USAID calculated two possible scenarios. The first scenario presumes smelter building continues smoothly in 2014. There would be additional deficit in current account balance in the amount of $6 billion in 2014. However, in 2015, the effect of export ban would be neutral to BoP deficit since import of capital goods would have been fell while declining export revenue will have been compensated by revenue from increase of processed mineral export (more value added to raw mineral will add to its export value). In the second scenario, smelter building does not go smoothly on the first year of export ban. When this occurs, there will be additional pressures on BoP deficit from $5 billion in 2014 to almost $8 billion in 2017.

Another policy that will affect Indonesia's BoP projections is Industry Law and Trade/Commerce Law. The spirit of both Laws leans towards prohibition, embargo restriction, and licensing regime. Referring to international trade principles, prohibition/embargo usually is related to health, safety, and security. However, with the implementation of Trade Law, any prohibition/ban could be executed anytime on behalf of national interests (cl. 35 stipulated that the Government applies prohibition of goods and services trade under special circumstances according to its own considerations.

Related to international agreement, cl. 83-84 showed inefficient governance management since Government is required to report to DPR (the parliament) within 90 days of signing on the agreement. However, the parliament can reject the agreement. When this happens, all the efforts, time and money used to negotiate the agreement is wasted. Cl. 85 stated the Government with parliament approval can reject or review the agreement that has been endorsed previously. Specific procedures on trade agreement will be regulated by Government Regulation/PP. This PP would be very important for Indonesia's credibility in world society.

Similar perspective is shared with Industry Law. The Law stipulated that the Government can take protecting action when two things occurred—either there is a threat to national industry due to government policy and business environment or there is a threat to national industry dominance due to global competition.

If these newly-approved Laws are implemented without good regulations, trade account balance could be adversely affected. The impacts will stem from three sources. *First*, majority of Indonesia's imports consist of capital and intermediate goods. Only 20% of the country imports are defined as consumption goods. Half of consumption goods imports are derived from oil and gas imports. The other 80% are intermediate and capital goods needed for production, including export activities. There has been an increase proportion of consumption goods imports since 2009. However, the increase occurred on imports derived products of oil and gas.

Second, recent paradigm in industrial, investment and trade world takes the form of global production network. In global production network, sub component could be imported from one country, use in production and in turn, would be exported to another country. It should be noted that, inside global production network, cross-country movement of components/parts happens frequently. There is no room for mercantilism and supply uncertainty.

Third, domestic industry protection often created inefficiencies without increased productivity, performance and time frame. It will only put more burdens to consumers, benefits rent-seekers and produce inefficient infant industry.

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