Business Times - 31 Aug 2005

Indonesian rupiah on a tightrope

Failure to take measures to prevent a further sharp depreciation of the currency could lead to a vicious cycle

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INDONESIA was the country that was hardest by the regional crisis eight years ago and has only recently shown positive signs of having almost recovered from it. But now it is up against a new but familiar challenge: a sliding currency. How did this happen and what are Indonesia's options in dealing with it?

After years of relative stagnation and a degree of socio-political unease, Indonesia's economic performance in 2004 was commendable. The smooth election of the reformist-minded President Susilo Bambang Yudhoyono in October 2004 has brought a measure of much-needed stability.

The economy has recently been growing at a respectable - but not remarkable - 5-6 percent, driven primarily by robust growth in domestic consumption and recovery of domestic capital formation, while inflation has moderated from its double-digit levels. Indonesia was among the best performing Asian equity markets in the last two years, and foreign direct investment has finally started returning to the country.

But until 2003 Indonesia remained a pariah of sorts to foreign direct investors, so much so that the acronym 'FDI' referred to 'foreigners ditching Indonesia', an allusion to negative FDI numbers since 1998.

Despite the improving economic outlook, Indonesia has remained vulnerable to external shocks. Much of this vulnerability has shown up in terms of a rather weak and volatile currency. Thus, while a number of other central banks in the region have intervened in the forex markets to prevent sharp currency appreciations, the Bank Indonesia (BI) has recently been intervening to moderate the depreciation of the rupiah.

Fiscal deficit

On Aug. 29 the rupiah closed at 10,700 to the dollar - its lowest in three and a half years - a loss in value of almost 16 per cent during the past year and around 20 per cent from its most recent peak in late November 2004. Most of the reversals in the rupiah have taken place in August 2005, with the rupiah losing around 10 per cent from the beginning of the month.

But while some observers are comparing the current slide in the rupiah to that experienced during the Asian crisis of 1997-98, such a comparison is premature. The collapse of the rupiah during the Asian crisis was nothing short of cataclysmic: It went from around 2400 per US dollar in July 1997 to around 16000 per US dollar less than a year later.

In real effective terms the rupiah lost some two-thirds of its value. In the innumerable post-mortems on the Asian crisis of 1997, the reasons for the drop in the rupiah ranged from poor governance, to an extremely vulnerable banking system, to endemic crony capitalism, to political unrest. Protests against the Suharto regime which culminated in his resignation on May 1998 were also no doubt responsible for the rupiah sliding to its nadir.

This time around, rupiah's weakness has been linked to the rising fiscal deficit. The mounting fiscal deficit is in turn largely the result of the government's hefty fuel subsidies. The subsidy is estimated to cost the government around 5 to 6 per cent of GDP this year (around US$15 billion).

The government announced on Aug. 24 that the 2005 deficit will rise from the previously forecast 0.8 per cent to 1 per cent of GDP because of higher oil prices. However, many analysts reasonably believe that the 1 per cent number being projected by the government may be optimistic, and that the final number may be closer to 1.5 per cent of GDP.

While this rise in the subsidy bill and fiscal deficit is of concern, it is hardly unsustainable at this stage. Many other developing countries that are growing at the same rate as Indonesia have been running far larger fiscal deficits without significant near-term repercussions on their currencies. Indeed, Indonesia's fiscal deficit in 2003 stood at around 2 per cent of GDP.

In any event, the government has said that the fiscal deficit will come down - or at least not get out of hand - as it plans to reduce the subsidy on oil. In fact, the stated aim is to gradually eliminate the subsidies by 2010.

Of course, one must question the ability of the government to put its words into action, given the possible socio-political repercussions of such a move. Nonetheless, as of now, the reformist Yudhoyono government should be given the benefit of the doubt.

Indonesia's current account balance, while in positive territory, has been falling recently. While some of this decline is inevitable as Indonesia imports more final and intermediate goods to generate domestic demand which will fuel output and employment growth, the decline in recent months has been because of increased oil imports (which in turn is being subsidised, thus worsening the fiscal deficit, as noted above).

Rising oil imports have also reduced the level of foreign reserves by US$4-5 billion to just over US$30 billion in August from the beginning of the year. This reserve decline is indicative of the forex intervention by the Indonesian government to help moderate the fall in the external value of the rupiah.

While financial markets may be wary of the country's recent drain of reserves, Indonesia's external debt indicators (such as the short term debt to reserves) do not offer immediate reason for concern.

The question therefore still remains as to why there has been such a sell-off of the rupiah. One might argue that the anticipated slowdown in the Indonesian economy because of the negative oil shock might have further spooked investors who off-loaded the rupiah in a hurry.

However, this appears rather dubious. In the budget proposal for 2006 that was announced on Aug. 17, the government forecast that the growth rate for 2005 would be 6 per cent.

While this forecast is probably too optimistic in view of the upward trend in the price of oil, Indonesia is not headed for stagnation.

Similarly, headline inflation currently stands at about 8 per cent on a year-on-year basis. While price stability is a concern, it has been under control thus far, though relatively higher inflation and limited domestic market competition implies that Indonesia faces a somewhat higher pass-through of a depreciating currency into domestic inflation than its Asian neighbours.

While timely data are not yet available, one probable factor behind the rupiah's weakness is the reversal in portfolio investments in search of higher yields. Indeed, the Jakarta composite index has also fallen by 15.5 per cent in August, and it is in large part likely due to a withdrawal of foreign funds.

The benchmark interest rate currently stands at 8.75 per cent, and while it has been steadily rising in tandem with the improvements in Indonesia's domestic economy, it has not kept up with the rate hikes internationally or relative to the country's domestic inflation. Thus, the yields on Indonesian assets are somewhat less unattractive when viewed in real terms, or vis-a-vis international assets.

While the BI has already said that it will raise its reference interest rate during their board meeting in September, it is unlikely that there will be an aggressive tightening policy, as this will stifle domestic growth which has just shown signs of rebound.

In addition, while the domestic banking system has undergone significant consolidation and strengthening, a large proportion of banks' capital takes the form of government recapitalisation bonds. As such, commercial banks are particularly vulnerable to interest rate hikes and concomitant capital losses.

Tightening policy

Failure to take measures to prevent further sharp rupiah depreciation could lead to a vicious cycle of falling reserves, rising current account and fiscal deficits and accelerating inflation.

The Indonesian authorities have to walk a tightrope - they need to tighten monetary policy to curb capital outflows and stem rupiah depreciation as well as rein in the fiscal deficit by curtailing subsidies, while simultaneously trying to ensure that these actions do not derail domestic output and employment growth or impair socio-political stability.

The authorities must also take care to ensure they maintain credibility. For instance, too sharp a rollback in budget-crippling fuel subsidies, or too marked an interest rate hike, might create grave domestic tensions and dislocations which in turn could lead to a reversal in policies. If this happens, the economic credentials of the government will take a severe beating.

Thus, the Indonesian authorities certainly have their hands full in the near term in determining the appropriate policy mix. The stated willingness of the Japanese to offer Indonesia lines of credit if the need arises may be helpful in alleviating some of the selling pressure on the rupiah. However, shorter term policies such as tightening foreign exchange regulations or requiring that Indonesian exporters surrender hard currency are unlikely to re-establish financial market confidence.

Overall, the rupiah sell-off has probably been overdone. This is not surprising as forex markets tend to overreact. It is commonly noted that the new monetary policy framework adopted by BI which centres on inflation targeting necessitates that there be a benign neglect of the external value of the rupiah.

This is incorrect. Insofar as exchange rate depreciation passes through domestic prices and threatens to derail the country's inflation target, an inflation targeting authority can and should take into account the currency value when determining its interest rate stance.

Over time, in addition to persisting with domestic real sector, labour, administrative, governance and monetary and banking reforms, the Indonesian authorities need to pay greater attention to addressing the constraints that have precluded Jakarta from fully exploiting its abundant natural oil and gas reserves.

Despite being an Opec member Indonesia has recently become a net oil importer. It's been unable to meet its OPEC quota since 2002 due to a lack of domestic investments in its oil and gas infrastructure. Investments in Indonesia's oil and gas fields by foreign investors, including Singapore, China and India, need to be actively encouraged if Indonesia is to regain its status as a significant oil exporter.

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