Poor Politics That Destabilized the Good Economy

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Introduction

Indonesia came out of the global financial crisis fairly unscathed. It experienced a limited banking deleveraging as a result of the crisis. However, it was soon discovered that structural issues, including burgeoning fiscal subsidies and inward-looking trade policies are more of a threat to the economy than the crisis itself. The case of Indonesia serves as a reminder that structural reforms, including fiscal and trade reforms, are needed for financial and monetary stability.

Early in the Crisis: The Limited Impact of Banking Deleveraging

Up until 2012, evidence showed that the impact of the bank deleveraging as a result of the crisis was limited in Indonesia. Funding exposures from European and American foreign bank branches are extremely small compared to those from local banks. With regards to loans in foreign currencies from foreign bank branches, up to 2012, deleveraging in the West had no impact in Indonesia. To begin with, the contribution from European creditors (bank and non-bank creditors) in domestic financing is relatively small, amounting to less than 30 percent of the total foreign liabilities to Indonesia. Exposures of trade financing are also considered relatively limited given its small share in the foreign liabilities figure.

In terms of onshore banking, the impact of post-crisis global deleveraging on Indonesia's banking activities has been miniscule. Nominal loans in foreign currencies extended by both foreign bank branches and local banks (in other words, foreign bank subsidiaries and local national banks) experienced a V-shaped decline in 2009, followed by a strong recovery up to 2011, which brought the post-crisis level above its pre-crisis level. Meanwhile, nominal loans in local currency by foreign bank branches mostly flattened out in 2009 while nominal loans in local currency by local banks remained strong.

In addition, local banks have been able to attenuate the impact of a decline in inter-bank borrowing as a result of the crisis. Total sources of funds, which include deposits, inter-bank borrowing—securities issued, and loans received by local banks—have remained strong and growing. One of the key reasons for this is that local banks were able to gradually shift towards deposit-based sources of funding from the inter-bank borrowing. The proportion of deposit to total sources of funding showed an increasing trend starting from 2007 to 2009.

Further deleveraging of European and U.S. banks will continue to have minimal effects on Indonesia's financing, as local banks replace the financial services of European and U.S. bank branches. Despite the strong lending recovery up to 2011, which brought the post-crisis level above its pre-crisis level, market shares (in terms of average total assets) of foreign bank branches of European and U.S. banks have continued to decline. Following the crisis, the role of local banks has increased, reducing Indonesia's exposure to foreign banks' activities.

On the financial account side, direct investments, portfolio investments and other investments in Indonesia remained stable until 2012, despite a substantial outflow in the third and fourth quarters of 2011. Short-term deleveraging was clearly demonstrated in portfolio investments in this period, as Indonesia experienced outflows of $4.7 billion and $261.3 million in the third and fourth quarters respectively. Nevertheless, this was not the case for foreign direct investment (FDI) in Indonesia. FDI flows remained positive at $1.71 billion in the third quarter and $2.1 billion in the fourth quarter.

Despite Indonesia's limited exposure to the crisis, some precautions were taken. Due to the very high level of leverage across multiple sectors in advanced economies, the deleveraging process in these advanced economies was expected to be a long one. To mitigate the unintended consequences of such shocks, Bank Indonesia (BI) implemented several measures. BI intensified macro-prudential and supervisory intensity on all banks, particularly on dollar liquidity issues. Liquidity backstop facilities were in place both for normal times (intraday liquidity facilities and short-term funding facilities) and to prevent systemic crises (emergency liquidity assistance in extremely stringent terms and conditions) for all banks operating in Indonesia. BI also has bilateral swap arrangements (as part of ASEAN+3 Chiang Mai Initiative). This enabled Indonesia to cushion liquidity issues for individual firms and systemic risk prevention. In addition, BI, together with the Ministry of Finance, implemented a Crisis Management Protocol (CMP) which acts to prevent and mitigate the risk of a crisis.

Other than increasing prudential regulatory measures and implementing financial stability infrastructure, it was not until 2013 that the central banks and other related government agencies made significant monetary and other structural policy changes. Rising structural issues forced these institutions to react to the rising threats against economic stability.

Later in the Crisis: How Domestic Politics Created its Own Economic Turbulences

Rising oil demand in Indonesia due to a growing middle class has made Indonesia a net importer of oil for some years now. However, further growth of the middle class and volatile global oil prices, exacerbated by black market trading on subsidized fuel prices, have increased the pressures of oil subsidies on the government budget. In the revised 2013 national budget, energy subsidies, which include fuel and electricity subsidies, are as much as 25.1 percent of the central government expenditure. Compare this to social expenditures of only 6.7 percent and capital expenditures, which are mostly spent on infrastructure, which are 15.7 percent of the budget.[1] In 2012 energy subsidies were 30.4 percent of central government expenditures. After the Asian Financial Crisis of 1997-1998, Indonesia adopted the terms of the *Maastricht* Treaty, a fiscal rule that caps the government deficit at 3 percent and the debt-to-GDP ratio at 60 percent. Currently, the large fuel subsidy expenditures are restricting Indonesia's capacity to spend in growth-enhancing categories, including social and capital spending. Ballooning oil subsidies are not only affecting Indonesia's fiscal space. Subsidizing fossil fuel with poor targeting increases inequality, degrades the environment, discourages innovations of renewable energy and is a drain on Indonesia's balance of payments.

Trade deficits in Indonesia are driven by the "structural deficit" on oil and gas trade. Indonesia's current account showed a significant reversal in 2012, starting from a small surplus in 2011 into a 2.7 percent deficit in 2012. Through mid-2012, most of the decline originated from a rapidly shrinking non-oil and gas trade surplus, followed in more recent months by a widening oil deficit. There is a domestic political-economy aspect of trade policies contributing to the trade deficit in 2012.[2]

In addition to weaker external demand (and in some cases, bad weather), the rapidly shrinking non-oil and gas trade surplus could be partly due to a recent ban on rattan[3] exports, export taxes on minerals and some inward-looking import policies. In late 2011, the government put a ban on the export of raw and semi-processed rattan materials. In May 2012, the government imposed an average of 20 percent export tax on 65 mining commodities. In addition to the export tax, export licensing on these minerals also became more restrictive, requiring mining exporters to be registered with the Ministry of Trade, after having secured an approval from the Ministry of Energy and Natural Resources.[4] Imports on finished goods have also become more restricted while a significant share of manufactured exports consist of imported value-added. What is more, in May 2012, the government passed a new regulation on finished goods. A general importer is now only allowed to import goods that fall under one heading, and an importing producer is now only allowed to import finished goods for market testing and as complementary goods. This may have contributed to a weak performance of exports. Measuring Indonesia's trade in value-added terms shows that while the bulk of overall exports consist of domestic value-added due to the high share of commodities, a significant share of manufactured exports consists of imported value-added.[5] About a third of imported intermediate goods are in fact re-exported, underlining the close link between import availability and the performance of manufactured exports.

In addition, Indonesia's value-added in service exports is particularly low.[6] This reflects little contribution of domestic subsidiary services for supporting exports. More robust developments of these services would have likely helped the overall export performance.

Two-thirds of Indonesia's gross exports rely on natural resource-based products. The aforementioned factors, combined with falling commodity prices, have weakened export performance, which declined by 6 percent in dollar terms in 2012. Compared to 2011, exports to China in 2012 alone declined by 5.6 percent, which is significant considering that export growths to China are usually positive and strong. China has also recently put a restriction on low-quality coal, which makes up about one third of Indonesia's coal export to China. Considering China's new growth norm[7] and trade restriction on low-quality coal, Indonesia's weak export performance could be structural. It may necessitate structural changes since it cannot rely on exporting raw commodities to big emerging markets, like China, anymore.

Some trade policies have also contributed to skyrocketing prices on basic food commodities. In the spirit of "self-sufficiency", since 2010 the government has gradually re-introduced import quotas on a range of agricultural products. For example, the Ministry of Agriculture issued a strategic five-year blueprint for 2010-2014, for 39 government-identified production targets, namely rice, sugar, soybeans, beef and corn. The target is to achieve self-sufficiency by 2014. In March 2012, the Ministry of Trade restricted the handling of all horticultural imports to Indonesia from seven ports of entry to four, which forced virtually all of Java's horticultural trade through Surabaya. Only after pressures from some trading partners, were the U.S., Canada, Australia, and New Zealand (those countries with Mutual Recognition Agreement) were exempt from the restriction. In 2012, the Ministry of Trade also regulated licenses to importers of horticultural products following an earlier recommendation by the Ministry of Agriculture. This was not the only measure that complicated the import licensing process. API (*Angka Pengenal Importer* or Importer Identification Number) regulations were later introduced by the Ministry of Trade. It is speculated that this measure is one of the main causes for the recent congestion at Jakarta's Tanjung Priok Port, Indonesia's main port, which handles about 70 percent of containers circulating in and out of the country.

Since June 2013, Tanjung Priok Port has had congestion problems with regards to processing containers of imported goods and controlling the flow of traffic in and out of the port itself. One of the main reasons for the congestion in containers is the explosion in the number of containers identified as "red lane," which jumped to 25 percent this year from about 8 percent last year. One possible reason for this sudden increase has to do with API. The regulation has forced companies to set up new subsidiaries that deal with their import needs. Since these subsidiaries are classified as new companies, customs automatically move their container to the red lane. Only after some time, when they have built a reliable track record, can they be classified differently. In the meantime, four main food commodities reported having very limited supplies during the June-August period. These four food commodities are shallots, big chilies, 'rawit' (or small) chilies, and beef. If the trend extends through the end of the year, sugar, 'rawit' chilies and beef will have a negative supply. This is yet another example of how restrictive trade policies have impacted food security and inflation of the domestic food market.

The new licensing system and port-entry restrictions had a negative impact on the import volumes and domestic prices of horticultural imports. Prices soared initially, between January and March 2013. For example, the prices of shallots climbed between $1.20 to $7 a kilogram in March alone. The price of garlic has tripled from around Rp.20,000.00 per kilogram in January to Rp.60,000.00 in March. Garlic price inflation is also a clear example of distortionary trade policies. While almost 90 percent of Indonesia's garlic consumption relies on imported garlic, the government sets a restricted quota that has caused a supply shortage and inflation. The government even admitted its mistake on the garlic quota.[8] The share in the food basket of four food items—red and green chilies, garlic and onions—is only 5 percent, however they contributed to almost 50 percent of the recent increase in food inflation.[9]

In the case of beef, the government's quota for live cattle and frozen beef between 2011 and 2013 caused a severe shortage in the domestic market, triggering a very sharp increase in beef prices. In 2011, a new restriction required importers of beef to have a special license and required them to import from designated "disease-free" countries. In 2012, the government decided to cut the beef import volume available to importers by 57 percent. This likely triggered a shortage of supply at the initial price, bidding up prices to clear the market.

Indonesia's restrictive trade policies have not gone unnoticed in the international community. In January 2013, the U.S. lodged a complaint with the World Trade Organization as it reported Indonesia's trade policies as being "restrictive" with its "complex web of import-licensing requirements" unfairly limiting U.S. exports.

The increase in food prices brought the poverty basket inflation rate up from its near three year low of 5.3 percent in November to 6.1 percent in February. Whether there is a justification for trade policies to promote self-sufficiency of agricultural products is subjective, but one study shows that there is little evidence these actions improve the terms of trade for farmers or increase rural real wages.[10]

Based on the continuing pressures on the "bleeding" fiscal budget from fuel subsidies, the threat of inflation, and the widening current account deficit, Standard and Poor's downgraded the outlook on Indonesia's credit rating. S&P not only cites Indonesia's waning reform momentum as the reason for this outlook. It explains that the subsidies are the main reason why S&P had not upgraded Indonesia's credit rating to investment grade yet. The consistent decline of the balance of payments has put pressure on the rupiah and has forced BI to intervene. As a result, International reserves have declined from the record high $120 billion in 2011 to less than $100 billion by July 2013, exacerbated by portfolio outflows due to the news of the Fed's exit strategy, which includes increasing the interest rate and winding down QE3.

Accelerating portfolio outflows have also put pressure on the currency. The onshore rupiah rate has depreciated to as low as Rp.9,960.00 per dollar in late June for the first time since September 2009, while offshore non-deliverable forward rates neared Rp.10,000.00 in early June.[11]

Moreover, the recent reduction on capital goods imports suggests that the recent slowdown in investment growth may extend due to the expected co-movement between imports and investment. The weaker commodity market may also continue to impact capital investment spending in capital-intensive resource sectors. At the same time, inflation will erode real purchasing power which could slow down domestic demand, one of the main drivers of Indonesia's GDP growth.

Investment is also likely to face some negative outlooks from ongoing and possibly further difficult politics as the 2014 election approaches.

The fiscal distortions and restrictive trade policies have clearly complicated macroeconomic stability in the country. Although public discussion to raise the fuel prices started in 2010, difficult coalitional politics and a lack of decisive leadership are delaying the decision to raise fuel prices, most likely until it becomes too late to save the rupiah. Moreover, a series of trade policies that adopt the spirit of 'promoting domestic industry' and 'protecting the balance of payments', as reflected in the new draft trade and industry laws, have adversely affected the trade balance and caused inflation.

As a reactive rather than systemic response to threats on macroeconomic stability (including downgraded growth, which is projected to be less than 6 percent in July 2013 by the World Bank[12]) and political stability, especially ahead of the *Idul Fitri*, also called the Feast of Breaking the Fast in Indonesia, different government agencies and the central bank have taken strong actions to reverse some of the policies they have adopted.

The government just made a revision to the 2013 national budget. The key features of the revised budget, which was approved by the parliament on June 17, 2013, include a revision of projected spending on fuel subsidies and a package of compensation measures designed to reduce the impact of higher fuel prices on the poor (including direct cash transfers, rice for the poor and scholarships for children). The rise in subsidized fuel prices was made effective on June 22 with the subsidized petrol prices rising by 44 percent to Rp.6,500.00 per liter and the subsidized diesel price increasing by 22 percent to Rp.5,500.00 per liter. The 2013 deficit has been revised upwards by 0.7 percentage points to 2.4 percent of GDP, due to lower projected nominal revenues, in line with weaker anticipated GDP growth, and higher total expenditure (including fuel subsidies, despite the increase in subsidized prices, due to higher projected global oil prices).

Higher temporary inflation is expected in the near-term due to the fuel subsidy reform package. It is predicted that the higher fuel prices will initially have a large impact on inflation, raising the annual average inflation in 2013 by around 1.8 percentage points to 7.2 percent, peaking at around 9 percent year-on-year, towards the end of 2013.[13]

However, despite the intention to narrow the oil trade deficit, it is estimated that the increase in subsidized fuel prices will only reduce the 2013 current account deficit by 0.2 percent of GDP relative to a no-reform scenario.[14]

At the same time, the BI reacted swiftly to the threat of the dollar liquidity condition. It issued sizable external sovereign and state-owned enterprise dollar bonds. Tight U.S. liquidity conditions were partly eased by net foreign purchases of domestic equities and bonds.

Moreover, rising inflation and the recent Fed announcement to unwind QE3 by the end of next year and increase the U.S. interest rate have prompted BI to increase interest rates. BI raised the overnight deposit facility rate (FASBI) (from 4 percent to 4.75 percent) and the policy rate (from 5.75 percent to 6.5 percent) by 75 basis point in less than one month since early June 2013. Although this increase is not as significant as the 400 basis point increase in 2005-2006 and the 150 basis point increase in 2008 when the government cut fuel subsidies, it is the first significant interest rate increase in five years. The increases in FASBI and the policy rate have prompted banks to also increase consumer and investment borrowing costs.

Meanwhile, complaints by the trading partners and media criticism of rising prices in domestic markets have prompted the Indonesian authorities to rescind several of their licensing requirements and to raise quotas for the affected products. On April 24, the Ministry of Trade issued a new regulation easing import restrictions and simplifying procedures for 39 of 57 horticultural items on the original list. In early June, the government appointed the National Food Logistics Agency (Bulog) to import additional beef outside of the established quotas, to help stabilize prices ahead of *Idul Fitri*. On July 20, the Ministry of Trade announced that it would remove import quotas for beef and live cattle to further stabilize domestic prices on beef.[15]

Whether Indonesia's economy has remained insulated from the crisis because of good economic management or pure luck is uncertain. What is certain, however, is that Indonesia's resilient economy is now exposed to the destabilizing effects of poor domestic politics and a lack of leadership.

Conclusion

Although the effects of the financial crisis were wide reaching, Indonesia has come out unscathed, as it was protected from the deleveraging of European and American banks. However Indonesia's macroeconomic landscape is quite different in 2013 than it was during the turbulent crisis period. Indonesia's economy is now characterized by rising inflation, the lack of fiscal space due to fuel subsidies, increasing stress on the balance of payments, declining international reserves, the depreciating rupiah, and a lowered forecasted growth. The picture above illustrates that structural (not cyclical) fiscal and trade issues are complicating policymaking in Indonesia and have led to ineffective and costly monetary policies. Some even accused the central bank for trying to do too many things at once as they worked to manage this range of issues. The most recent portfolio outflow that resulted from the Fed's exit strategy announcement reminds us of the integrated global banking and financial system and the various monetary transmission channels that operate across borders. Monetary coordination needs to be strengthened at the G-20 as no open economy is isolated from the monetary policy of another country. For example, the G-20 can provide a solution to better manage the spillover effects of QE measures implemented by an economy. Without better monetary coordination, tensions among member countries might escalate to name calling and finger pointing. Moreover, the above story also indicates how important structural reforms are to macroeconomic stability. The G-20 must not only prioritize financial regulatory reforms and monetary coordination, but it must also address structural reforms. In the case of Indonesia, for example, China's new lower growth norm and its trade restrictions on low-quality coal, may necessitate Indonesia to make structural changes so as not to rely too much on importing raw commodities from big emerging markets, like China, anymore. Traditionally, a poor economy often results in political instability. Across the modern world this lesson seems to ring true as America, Europe, and Arab nations face different political struggles. Indonesia, however, cautions that the reverse is also true; poor politics can result in economic instability.

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Endnotes

[1] See Nehru (2013) pp. 151
[2] Indonesia has never had an annual trade deficit at least since 1998.
[3] Rattan plant stems are used for binding and making cane furniture.
[4] See Anas (2012).
[5] See World Bank (2013) pp. 27
[6] See World Bank (2013) pp. 28
[7] See Huang (2013).
[8] See Lubis (2013).
[9] See World Bank, 2013, pp. 12-13
[10] See Nehru (2013) pp. 157
[11] See World Bank (2013) pp.8
[12] See World Bank (2013) pp. viii
[13] See World Bank (2013) pp. viii
[14] See World Bank (2013) pp. vii
[15] See Yulisman (2013).