Fragile Balance of Payment in Indonesia in the Midst of Recent Global Economic Uncertainties

Siregar, Reza and Wihardja, Monica

ASEAN+3 Macroeconomic Research Office (AMRO), CSIS Jakarta

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Reza Y. Siregar, ASEAN+3 Macroeconomic Research Office (AMRO), Singapore*

and

Monica Wihardja, CSIS, Jakarta, Indonesia*

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Abstract:

Amid global financial turbulent, the economy of Indonesia posted an annual average growth of above 6 per cent between 2008 and 2012, except in 2009. This was arguably among the most stable growth performance among the regional economies of East and Southeast Asia. The strength of domestic demand has indeed been a primary driver of the remarkably stable growth performance. However, the uncertainties with the advanced economies, particular in the US and the European Union, had negatively affected the local economy and exposed a number of apparent weaknesses with the Indonesian economy. A couple of these vulnerabilities are worth highlighted as they are arguably structural in nature. First is the country banking sector's exposure to global cross-border bank lending activities. Second factor has to do with the persistent current account deficit and its link to long-standing fiscal policy of fuel subsidy and global commodity market.

Key Words: Current Account, Capital Account, Global Financial Crisis, Energy Subsidy and Commodities

JEL Classifications: E50, E60, and F41.

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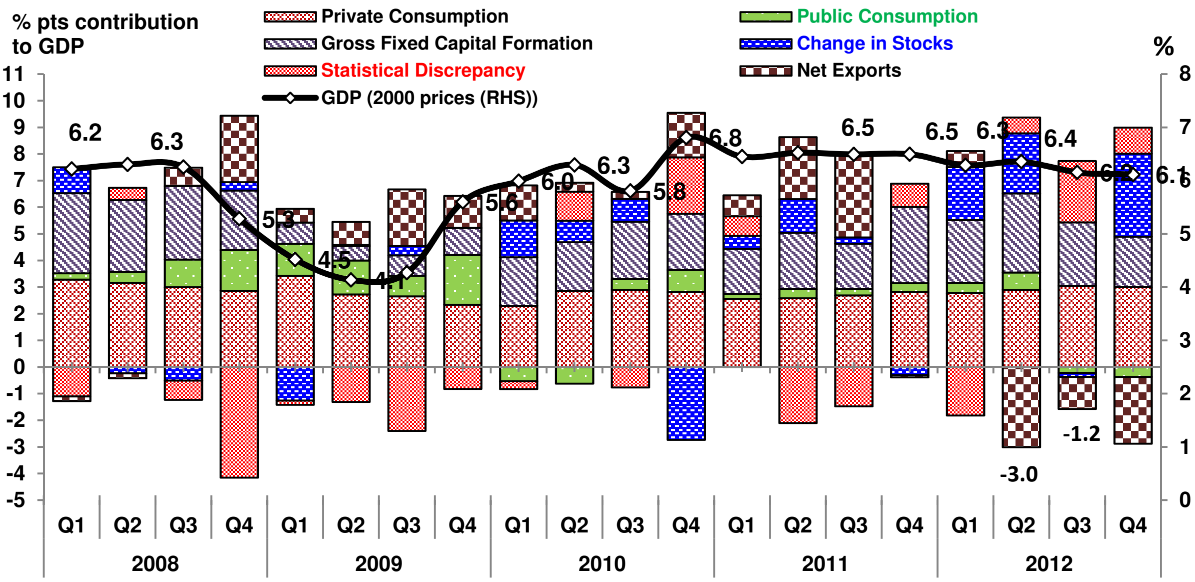
* Reza Siregar (Corresponding author) can be reached at (rezasiregar@yahoo.com). Monica Wihardja's email is (mariamonicawihardja@gmail.com). The views expressed in this paper are of the authors' only and do not necessarily represent those of the managements of AMRO and CSIS. The usual caveats apply.

1. Brief Introduction

Amid global financial turbulent, the economy of Indonesia posted an annual average growth of above 6 per cent between 2008 and 2012, except in 2009. This was arguably among the most stable growth performance among the regional economies of East and Southeast Asia. The strength of domestic demand has indeed been a primary driver of the remarkably stable growth performance. In contrast to the major Southeast Asian (ASEAN) economies, exports of Indonesia amounted to only less than 25 per cent of its GDP, compared to Malaysia more than 80 per cent and Thailand more than 60 per cent in recent years. Private consumption contributed between 44 to 49 per cent of the quarterly year-on-year GDP growth in 2012 (Figure 1). Indonesia has also seen investment to pick up in recent years, and the country's resilient growth in 2008-2012 can also be attributed to high commodity prices and capital inflow surges.

Figure 1: Domestic Demand Driven Economy



Source: National Bureau of Statistics

Despite the large domestic demand base, the uncertainties with the advanced economies, particular in the US and the European Union, had negatively affected and exposed a number of apparent weaknesses with the Indonesian economy. In particular, a couple of these vulnerabilities are worth highlighted as they are arguably structural in nature.

First is the country banking sector's exposure to cross-border bank lending activities. Like the rest of the ASEAN economies, banking sector assumes a vital role in the overall financing activity in the local economy. Among the major ASEAN economies, Indonesia arguably adopts the most-open banking sector regulation. Majority foreign ownership rule, as high as 100 per cent, has long been adopted following the outbreak of 1997 East Asian crisis. Furthermore, foreign banks are allowed to enter the local industry both as a branch or a subsidiary. The high interconnectedness of the local banking sector to the global banks exposed the local economy to increasingly volatile cross-border bank lending flows as evident particularly during the deleveraging of the European banks in 2011.

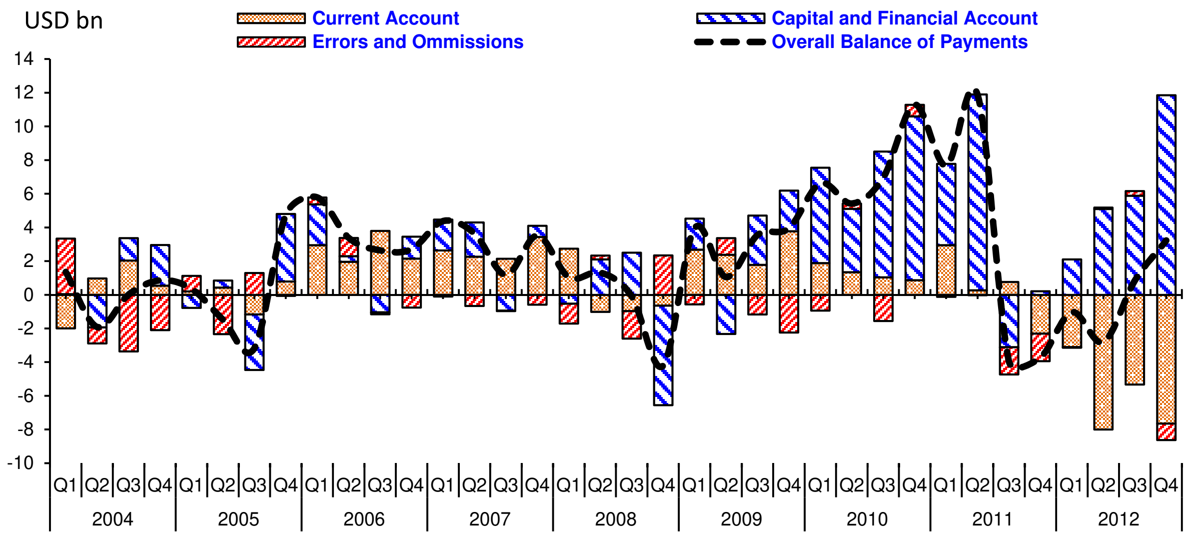
Second is with the current account weaknesses. The persistent current account deficits over a number of quarters in recent years have brought about concerns over macroeconomic stability of the country, causing marked depreciation pressures on the local currency. Most concerning, the primary root cause of the current account deficit has been attributed to long-standing and costly energy-subsidy of the fiscal policy and heavy reliance on commodity exports. On the back of weak external demand, especially from the major traditional trading partners of the advanced economies, and the volatile commodity price, especially oil price, subsidy measures have not only amplified fiscal burden, but also contributed to the robust import and weakening trade balance positions in recent quarters.

With the above issues at the centre of discussions, the roadmap of the paper will be as follows. Next section will briefly introduce selected key challenges facing the management of balance of payment of the country during the turbulent period of 2008 and 2012. Section 3 reviews issues surrounding persistent current account deficit reported in recent years. In particularly, the focus will be on highlighting the root causes of the deficit and the possible links to the overall management of fiscal in the country. Section 4 tables a number of issues facing the globally and regionally integrated banking sector in Indonesia during the recent years. A brief concluding remark section, focusing on the economic outlook of the country and major policy issues, ends the paper.

2. Navigating through Turbulent: Brief Overviews of Balance Payment Performance

As in many parts of East and Southeast Asia, balance of payment position of Indonesia improved significantly following the Lehman Brothers collapse in late 2008 (Figure 2). Moreover, the balance of payment performance until end of 2012 had been the story of two opposite forces of strong capital and financial account coupled with weak current account position. Strong economic growth, stable macroeconomic environment and high yields in the country attracted abundant global liquidity on the back of quantitative easing measures by major advanced economies. Capital and financial account surplus was in persistent surplus from the third quarter of 2009 to second quarter 2011. These quarterly surpluses coincided with the significant amount of liquidity injection to the global economies via quantitative measures by the US Fed, Bank of England and Bank of Japan (Table 1 and also see Table A.1 in the appendix). The return of high uncertainties in Eurozone area in the beginning of 2012 triggered another round of capital and financial account surplus until end of 2012. In a sharp contrast, we have seen relatively weak current account position with mild surpluses in 2010 turned into deficits since third quarter of 2011. At the end of first quarter of 2013, Indonesia experienced the first capital and financial account deficit since second quarter of 2009, and the largest balance of payment deficit in the past decade (Table 2).

Figure 2: Balance of Payment



Source: CEIC database

Table 1: Consolidated QE Amounts for Selected Periods (USD billion)

USD bn	Pre-QE: Sep '08 to Feb '09	Mar '09 to Oct '09[(a)]	Nov '09 to Oct '10[(b)]	Nov '10 to Jun '11[(c)]	Jul '11 to Aug '12[(d)]	Sep '12 to Apr '13[(e)]
U.S. Fed (changes in securities held)	102.1	1,108.5	354.1	604.1	-72.4	474.1
BOE (changes in Gilts)	0.0	274.4	25.1	-0.5	235.1	42.7
BOJ (changes in JGBs & Others)	0.0	0.0	255.7	203.2	284.2	162.1
Total	**102.1**	**1,382.9**	**634.8**	**806.7**	**446.9**	**678.9**

Notes:
(a) Period refers to U.S. Fed QE1 and start of BOE Asset Purchase Facility
(b) October 2010 is the start of BOJ's Asset Purchase Program
(c) Period refers to U.S. Fed QE2
(d) Re-launch of the BOE Asset Purchase Facility
(e) Period refers to U.S. Fed QE3. QE3 is still continuing, however, period is up to April 2013 only due to data availability

Sources: U.S. Fed, BOE and BOJ

Table 2: Worsening Balance of Payment Position

(Billion USD)	2013	2012				2011			
	1Q	4Q	3Q	2Q	1Q	4Q	3Q	2Q	1Q
CA	-5.27	-7.65	-5.33	-7.99	-3.11	-2.30	0.77	0.27	2.95
Goods	1.64	0.80	3.19	0.82	3.81	6.60	9.70	9.22	9.26
Services	-2.31	-3.32	-2.48	-2.91	-2.07	-3.11	-2.56	-3.13	-1.82
Income	-5.69	-6.34	-6.91	-6.80	-5.90	-6.96	-7.42	-6.78	-5.52
Transfer	1.10	1.21	0.86	0.90	1.06	1.18	1.05	0.96	1.03
Capital	0.00	0.02	0.01	0.00	0.01	0.02	0.01	0.00	0.00
Financial	-1.37	11.83	5.88	5.10	2.10	0.19	-3.11	11.62	4.83
FDI	3.39	4.45	4.54	3.76	1.56	3.12	2.12	2.51	3.78
Portfolio	2.91	0.18	2.52	3.87	2.63	0.24	-4.57	5.21	2.92
Other	-7.67	7.20	-1.18	-2.54	-2.09	-3.17	-0.66	3.90	-1.87
BoP	**-6.61**	**3.23**	**0.83**	**-2.81**	**-1.03**	**-3.73**	**-3.96**	**11.88**	**7.67**

Source: CEIC database

2.1 Capital and Financial Account

The dynamics of foreign direct investment and other investment dominated the performance of capital and financial account of Indonesia in recent years. Foreign direct investment has become a key driver of the economic growth and balance of payment position of Indonesia. Primary and secondary sectors recorded annual surges of investment since 2009 (Table 3). On the primary sector, food and mining industries received the most increases in foreign direct investment in 2011 and 2012. As for the secondary sector, a wider range of sectors has been the targets of foreign investors from food industry to chemical and machinery. Foreign direct investment (FDI) contributed more than 70 per cent of the total investment in recent years. In 2010, the quarterly average of net direct investment to the country was more than tripled the number in 2009, and the rising trend continued in 2011 and 2012. Accordingly, gross fixed capital formation (proxy of investment), reaching well above 30 per cent of GDP since 2009, has finally reached the level pre-1997 East Asian economic crisis and among the highest in Southeast Asia recent years.

Table 3: Steady Surge of Investment across Sectors

in US$ Million (I)	2010		2011			2012				Q1 2013			
	Value	Rank	Value	Growth (yoy)	Rank	Value	Growth (yoy)	share	Rank	Value	Growth (yoy)	share	Rank
Primary Sector	**3,042**		**4,870**	**60.1%**		**5,933**	**21.8%**	**24.2**		**1,695**	**4.7%**	**24.0**	
Food crops & plantation	751	**8**	1,236	64.6%	**6**	1,602	29.6%	6.5	7	314	-39.1%	4.5	7
Livestock	5		2	-55.3%		20	843.9%	0.1		2	-87.6%	0.0	
Forestry	39		14	-64.0%		27	89.7%	0.1		1	737.9%	0.0	
Fishery	18		10	-44.4%		29	189.9%	0.1		1	-78.3%	0.0	
Mining	2,229	**2**	3,608	61.8%	**2**	4,255	17.9%	17.3	1	1,376	27.1%	19.5	1
Secondary Sector	**3,357**		**6,780**	**101.9%**		**11,770**	**73.6%**	**47.9**		**4,552**	**96.8%**	**64.6**	
Food Industry	1,026	**5**	1,098	7.0%	**7**	1,783	62.4%	7.3	6	405	5.4%	5.8	6
Textile Industry	155		498	221.9%	**10**	473	-5.1%	1.9		234	44.7%	3.3	8
Leather Goods & Footwear Industry	144		250	73.3%		159	-36.4%	0.6		25	-63.3%	0.4	
Wood Industry	43		51	18.3%		76	49.6%	0.3		1	-91.1%	0.0	
Paper and Printing Industry	46		258	456.5%		1,307	406.0%	5.3	9	579	509.0%	8.2	5
Chemical and Pharmaceutical Industry	798	**6**	1,466	83.6%	**5**	2,770	88.9%	11.3	3	1,228	228.5%	17.4	2
Rubber and Plastic Industry	105		371	253.5%		660	77.9%	2.7		122	-44.0%	1.7	
Non Metallic Mineral Industry	28		137	383.1%		146	6.2%	0.6		30	-28.2%	0.4	
Metal, Machinery & Electronics Industry	590	**10**	1,773	200.8%	**4**	2,453	38.3%	10.0	4	1,042	108.3%	14.8	3
Medical Preci & Optical Instru, Watches & Clock Industry	1		42	2892.9%		3	-91.9%	0.0		0		0.0	
Motor Vehicles & Other Transport Equip. Industry	394		770	95.6%	**9**	1,840	138.9%	7.5	5	866	93.0%	12.3	4
Other Industry	26		65	146.2%		100	55.3%	0.4		18	105.6%	0.3	
Tertiary Sector	**9,815**		**7,825**	**-20.3%**		**6,862**	**-12.3%**	**27.9**		**801**	**-55.4%**	**11.4**	
Electricity, Gas & Water Supply	1,428	**3**	1,865	30.5%	**3**	1,515	-18.8%	6.2	8	218	30.4%	3.1	10
Construction	620	**9**	283	-54.4%		240	-15.2%	1.0		31	72.7%	0.4	
Trade and Repair	785	**7**	821	4.6%	**8**	484	-41.1%	2.0		216	36.9%	3.1	9
Hotel and Restaurant	312		240	-23.0%		768	219.5%	3.1	10	31	-84.6%	0.4	
Transport, Storage & Communication	5,046	**1**	3,866	-23.4%	**1**	2,808	-27.4%	11.4	2	52	-93.2%	0.7	
Real Estate, Ind. Estate & Business Activities	1,050	**4**	266	-74.7%		402	51.2%	1.6		117	61.8%	1.7	
Other Services	574		485	-15.5%		646	33.2%	2.6		137	-66.9%	1.9	
TOTAL	**16,215**		**19,475**	20.1%		**24,565**	26.1%	100.0		**7,048**	**23.1%**	100.0	

Source: CEIC database and Board of Investment of Indonesia database

In contrast, portfolio and other investment have been the sources of volatility and weakness of the financial account position. While volatility has long been the feature associated with portfolio capital, the recent intermittent of sharp surges and pull-outs of other investment has increasingly become source of policy concern in the country. Other investment consists predominantly of international bank lending. The substantial sharp pull-out of other investment was the primary source of financial and capital account deficit in the first quarter of 2013. Understanding further some of the root-causes of the fluctuations, in particular outflows, of international bank lending will be the primary objective of Section 4 of this paper. It is sufficient to note that Indonesia, amid the massive capital inflows in recent years, has seen a significant rise in the gross external debt from about USD141 billion at the end of 2007 to more than USD251 billion by end of 2012 (Table 4). A marked increase in the level of short-term external debts has largely been attributed to banks and non-bank financial institutions (corporates), issuing bonds to raise funding amid the low cost of funding.

Table 4: Gross External Debt

	2007		2012	
End-Period (USD billion)	**Q4**	**% share**	**Q4**	**% share**
Gross external debt (by sectors)	**141.2**	**100.0**	**251.2**	**100.0**
▪ *General government and Monetary Authorities*	80.6	57.1	126.1	50.2
▪ *Banks*	9.9	7.0	22.9	9.1
▪ *Non-bank Institutions*	50.6	35.9	102.1	40.7
Gross external debt (by maturity)	**141.2**	**100.0**	***251.2***	***100.0***
▪ *Long term debt*	**122.5**	**86.8**	**206.4**	**82.2**
Of which				
- *General government and Monetary Authorities*	77.6	55.0	118.7	47.3
- *Banks*	2.6	1.8	6.2	2.5
- *Non-bank Institutions*	42.3	30.0	81.5	32.5
▪ *Short term debt*	**18.7**	**13.2**	**44.8**	**17.8**
Of which				
- *General government and Monetary Authorities*	3.0	2.1	7.4	3.0
- *Banks*	7.4	5.2	16.7	6.7
- *Non-bank Institutions*	8.3	5.9	20.6	8.2
Short term debt/international reserves ratio (%)	**32.7**	-	**39.7**	-
Short term debt/GDP ratio (%)	**3.6**	-	**5.1**	-
Short term debt/long term debt ratio (%)	**14.2**	-	**21.7**	-

2.2 Sustained Current Account Deficits

As reported in Table 2, deficits accumulated in both service and income accounts contributed to the current account performance of Indonesia. Given the dependency of the economy to external service sectors, such as financial services for instance, the deficit in the service account is expected and has in fact been largely stable over the last few years. Similarly, the large participation of foreign firms and foreign direct investment in the local economy has for years led to negative income of the current account balance. Looking at the trend of the income balance, the deficit has largely been steadily fluctuating within the range of USD5.5 billion to USD7 billion during the past 2-3 years.

Observing closer the breakdowns of the current account balance, the deterioration in recent quarters can arguably be attributed to the worsening performance of goods trade account. From 2009 to 2011, the goods account recorded steady surpluses of around USD30.9 billion in 2009, USD 30.6 billion in 2010 and USD 34.8 billion in 2011. These healthy surpluses have kept the overall current account payment in positive on quarterly basis until end of 2011. However, in 2012 the net surplus dropped to only USD8.6 billion, with a mere 0.8 billion trade surplus reported in the final quarter of 2012. Next section will look into a number of primary root-causes of the deterioration of the goods trade in recent years.

3. Structural Trade Balance Deficit

3.1 Investment and Commodity Price Factors

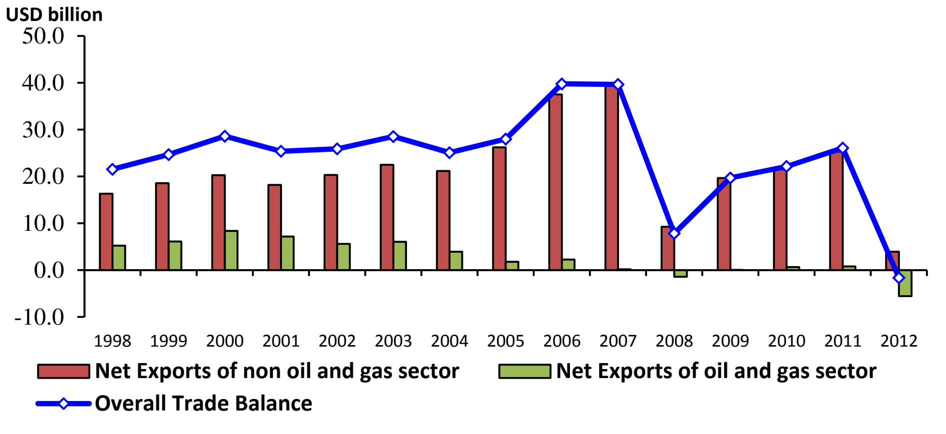
Strong growth, sound fiscal position and healthy financial market had led to a sequence of credit and investment rating upgrades by major rating agencies in 2011 and 2012.[1] Together with robust domestic consumption, investment surge, especially foreign direct investment, has in turn boosted strong import demand in the country since late 2011.

[1] Moody's upgraded Indonesia's rating to Baa3 in January 2012, with a stable outlook, from a Ba1 upgrade in January 2011. Fitch Ratings also upgraded Indonesia's rating in February 2011 to BBB- with a stable outlook, from BB+ and a positive outlook. In April 2012, Standard & Poor's affirmed its rating of BB+ and a positive outlook for the Indonesian economy. In October 2012, Rating and Investment Information Inc., (R & I) upgraded Indonesian's sovereign credit rating to BBB- with a stable outlook on the ground that Indonesia had achieved high growth amid the global economic downturn; fiscal management was conservative; Government's debt burden is relatively low and the financial system had become more stable. Most recently, in November 2012, Japan Credit Rating Agency Ltd., (JCR) affirmed for the second time Indonesia's sovereign rating of BBB- with a stable outlook, having already upgraded the rating from BB+ in July 2010.

Non-oil and gas imports continued to expand robustly on annual basis with average monthly year-on-year growth rates of 27 per cent in 2011 and 17 per cent during the first six months of 2012 (Figure 3). Concurrently, weak global demands for the country's export products have already been felt since late 2011. As such, a combination of weak exports and relatively robust import demand raised concerns over the possibility of the country facing a more sustained and structural trade deficit.

In addition to strong investment, another root-cause of the worsening trade balance lies on the dependency on commodity exports, particularly oil and gas products. Imports of oil and gas made up around 22 per cent of total imports in 2011 and 2012. Similarly exports of oil and gas contributed to around 20 per cent of total exports for the same years. As also reported elsewhere in the region, commodity exports of Indonesia have performed worse than non-commodity exports in 2012 (Figures 4 and 5). Furthermore, oil and gas exports and imports have been volatile, reflecting the swings in the commodity prices in the world market.

Figure 3: Trade Balances



Source: National Bureau of Statistics

Figure 4: Non-Oil and Gas Exports and Imports
(% yoy change)

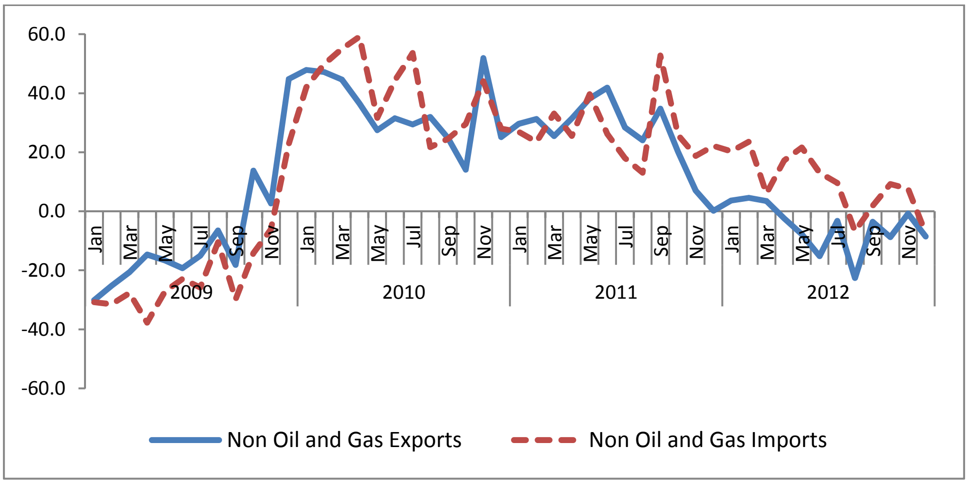
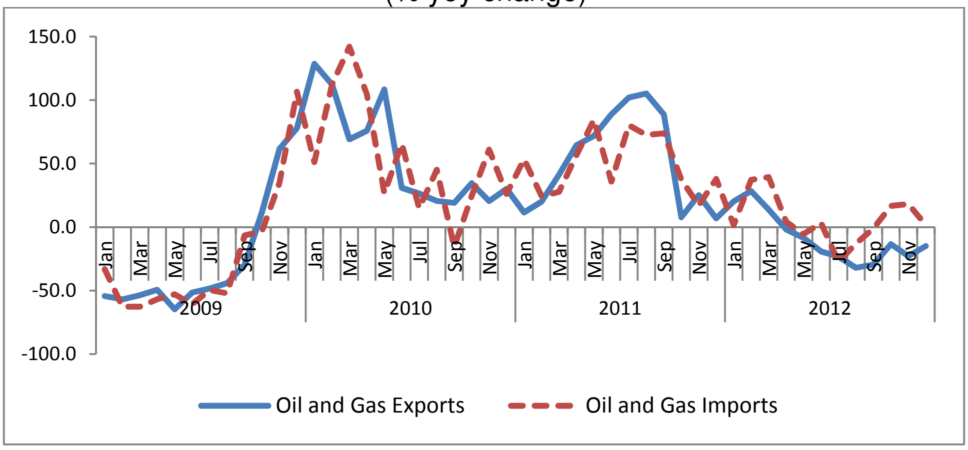


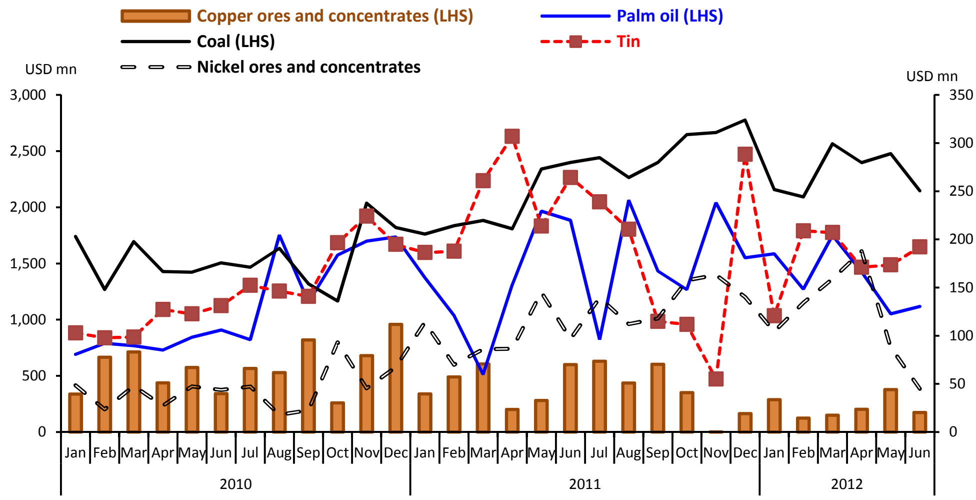
Figure 5: Oil and Gas Exports and Imports
(% yoy change)



Source: CEIC database

Soft global commodity markets continue to undermine export performance of commodity exporters in the region, including Indonesia. Cooling demand amid economic growth slowdowns in major global commodity markets, particularly China, has, to a large extent, depressed prices of major commodities. In turn, the fall in commodity prices and the slowdown in the global demand for commodities were the main reasons for the fall in Indonesia's exports since second half of 2012, of which coal, copper and palm oil comprise a large portion (Figure 6). China has also recently put a restriction on low-quality coal, which makes up about one third of Indonesia's coal export to that country. Although this restriction has not yet been implemented, China's policy towards more environmentally friendly energy use may pose a threat to Indonesia's coal export to China. Structural changes in the supply of energy fuels, in particular, the recent development of shale gas, may have had a persistent negative impact on Indonesia's exports of natural gas and/or coal.

Figure 6: Key Commodity Exports



Source: National Bureau of statistics.

3.2 Subsidy Policy Distortion to Trade Performance

In addition to strong investment surge and the external factor discussed above, one of the key and long-standing contributors to robust imports of oil and gas has arguably been the subsidy policy of the national budget. Energy subsidy policy has been a key feature of central government fiscal policy of the country. In 2012, actual energy subsidy expenditure consumed over 30 per cent of total central government expenditure and was more than 40 per cent higher than forecasted due to extra 76.1 billion rupiah of energy subsidy, predominantly fuel subsidy (Table 5). Given the fiscal rule that Indonesia has adopted since the Asian Financial Crisis 1997-1998, the so-called Maastricht Treaty, which regulates less than three per cent of budget deficit and less than 60 per cent of public debt-to-GDP ratio, the large spending on subsidy means that Indonesia has to spend less for other productive spending, including social and capital spending.

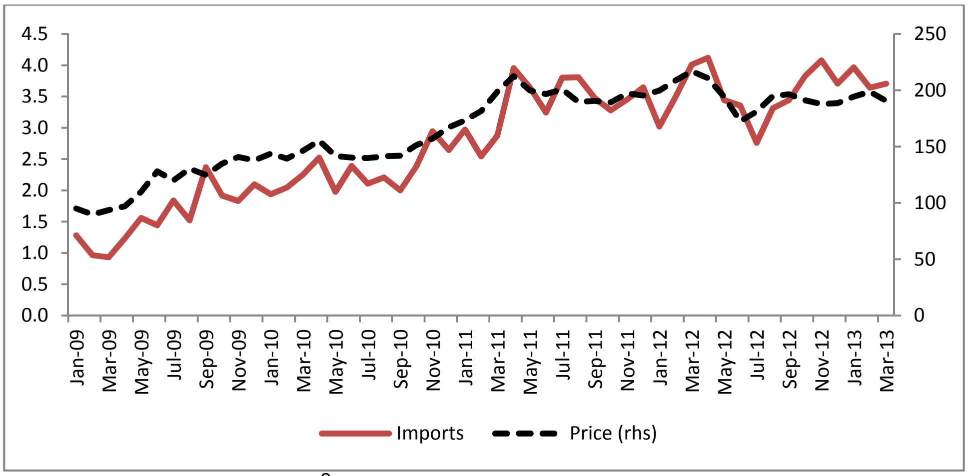
Table 5: Subsidy Breakdowns in 2012

	Revised Forecast (in billions of rupiah)	**% of Forecast Expenditure***	**Actual** (in billions of rupiah)	**% of Actual Expenditure***
Total Subsidies	245.1	22.9	346.4	34.3
Energy	230.4	21.5	306.5	30.4
Fuel	137.4	12.8	211.9	21.0
Electricity	93.1	8.7	94.6	9.4
Non-Energy	40.3	3.8	39.9	4.0

Source: Ministry of Finance. Note: */ as % of Central Government total expenditure

It has been well documented that sustained general administered price and subsidy could lead to a number unwanted distortionary consequences. One of them has to do with the impacts of global price movement on the local demand of the relevant good or product. Subsidy and administered price measures have to a large extent shielded domestic demand from the volatility of price. This feature is evident in Indonesia, as shown in Figure 7. The rise in the energy price in the world market has either limited or no impact at all on the domestic price of energy. Consequently, no demand adjustment to the price change took place. Despite the rise in the global energy price, imports of the oil and gas products in Indonesia climbed along. This often resulted in further deterioration of trade balance and also rising cost of subsidy in the country.

Figure 7: Commodity Fuel (Energy) Monthly Price Index & Gas & Oil Imports



Source: Index Mundi and CEIC.[2]

4. Globalized Banking Sector

4.1 Brief Historical Perspectives

To comprehend the openness of the banking sector in Indonesia, one needs to review its situation following the aftermath of the 1997 East Asian financial crisis. On November 1, 1997, the day after the first IMF agreement with Indonesia was signed, the government announced the liquidation of 16 banks. The banking restructuring program was one of two cornerstones of the IMF-led recovery programs. In addition to the liquidation program, a number of commercial banks (private and public) received recapitalised bonds, totalling about 435 billion US dollar (Siregar (2005)). These banks include 4 state banks and 7 major private banks. Following the restructuring of their balance sheets, most of these recapitalized private banks were eventually taken over by foreign investors. In addition to the vast potential market, with a high share of population having still limited access to banking service, friendly foreign ownership policy allowing majority ownership to a single foreign investor has become the major pull-factor behind the massive take-overs in the banking sector. Presently, Indonesian banking system is arguably the most open banking sector among the Southeast Asian (ASEAN) economies. Major private commercial banks are

[2] Index Mundi web-site: (http://www.indexmundi.com/commoditie/?commodity=energy-price-index&months=60)

predominantly controlled by global and regional investors, as shown in Table 6. Based on survey conducted by Siregar and Lim (2010), a number of these rescued commercial banks has established themselves among the largest and most influential banks in Indonesia in recent years.

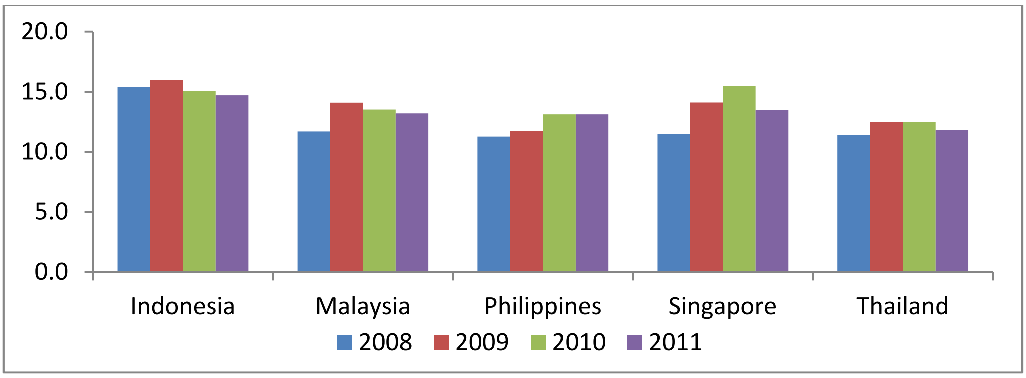
Table 6: Foreign Ownership in Domestic Banks

Bank	Foreign Owner	Foreign Share	Total Assets*	
		(%)	Rp Trillion	%
CIMB Niaga	CIMB Group Sdn Bhd, Malaysia	77.0	100.7	4.29
Danamon	Temasek Holdings, Singapore	67.9	98.0	4.17
Panin	ANZ Bank, Australia	35.0	72.2	3.07
Permata	Standard Chartered Bank, UK	44.5	56.8	2.42
BII	Maybank, Malaysia	54.3	54.5	2.32
Buana	UOB, Singapore	91.0	22.4	0.95
Ekonomi Raharja	HSBC, Hong Kong	99.0	21.2	0.90
BTPN	Texas Pacific, USA	71.6	19.3	0.82
ANK	Commonwealth Bank of Australia	83.0	10.9	0.46
Bumiputera	Che Abdul Daim, Malaysia	58.3	6.5	0.28
Mustika Dharma	RHB Capital Berhad, Malaysia	80.0	5.3	0.23
Nusantara	Tokyo Mitsubishi, Japan	75.4	4.0	0.17
Halim International	ICBC, China	90.0	3.5	0.15
Swadesi	Bank of India	76.0	1.5	0.06
Indomonex	Bank of India	76.0	n.a.	n.a.
Total			476.8	20.31

*/Based on 2009 audited reports. 'n.a' = not available. Source: Indonesia Stock Exchange and Wie and Negara (2010).

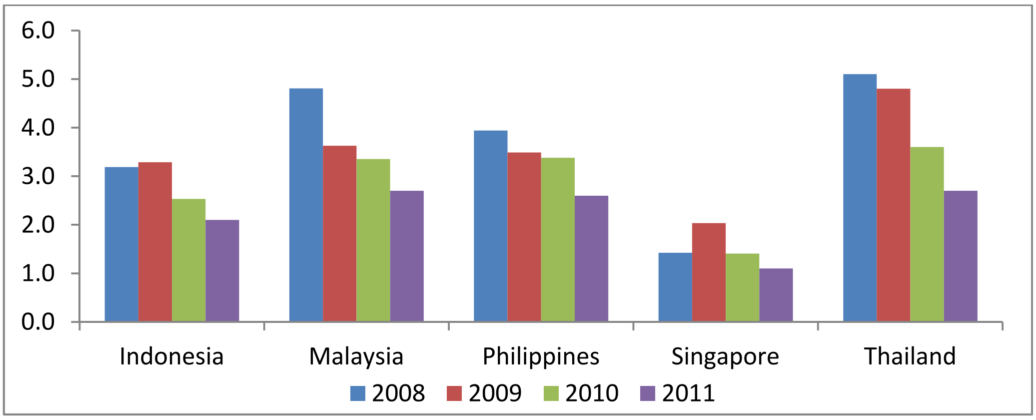
The alleged advantages of opening the local financial markets to the foreign banks are well-documented. Under the presence of foreign banks, emerging markets have benefitted from efficiency gains manifested in the form of greater variety in financial services and lower prices; transfer and spill-over of knowledge and technical know-how as well as greater availability of funding most especially to credit-constrained firms and households. Foreign bank lending has also been found to be more stable during the past economic and financial crises originated from the emerging markets. Balance sheets of the Indonesian banks, particularly capital adequacy position, non-performing loan level and profitability, continued to remain sound and among the best in the region, amid the global financial turbulent (Figures 8-10).

Figure 8: Regulatory Tier 1 Capital to Risk-Weighted Assets



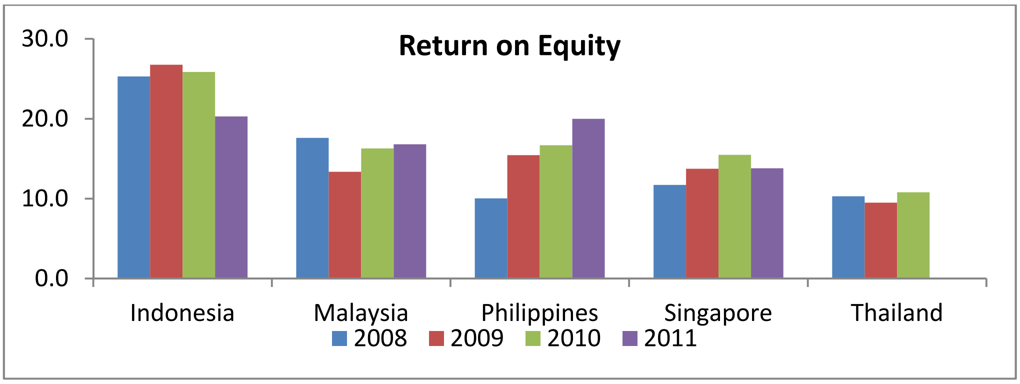
Source: IMF database

Figure 9: Ratio of Non-performing Loans to Total Gross Loans



Source: IMF database

Figure10: Return on Equity



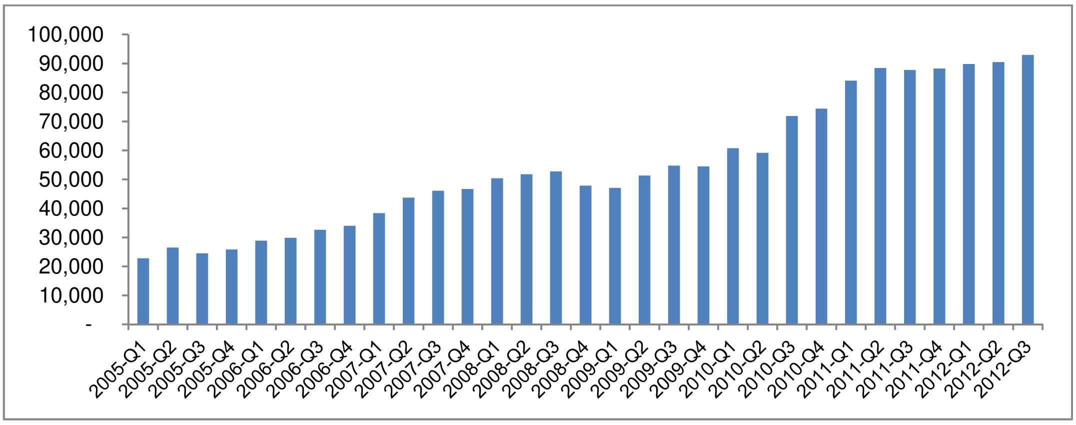
Source: IMF database

4.2 Headwinds and Recent Debates

The sudden interruption to this spectacular rise in international bank lending during the recent 2007/2008 global financial crisis serves as a stark reminder that international bank lending can rapidly transmit adverse shocks from developed markets to emerging markets. Total international bank claims to Indonesia reached over 92 billion US dollar by third quarter of 2012, more than 400 per cent of the level reported at the first quarter of 2005. Since the outbreak of the global financial crisis in 2007, total foreign bank claims contracted only in fourth quarter of 2008 and first quarter of 2009 by about 4.9 billion and 750 million US dollar, respectively (Figure 11).

Figure 11: Total International Bank Claims to Indonesia

(in millions of USD)

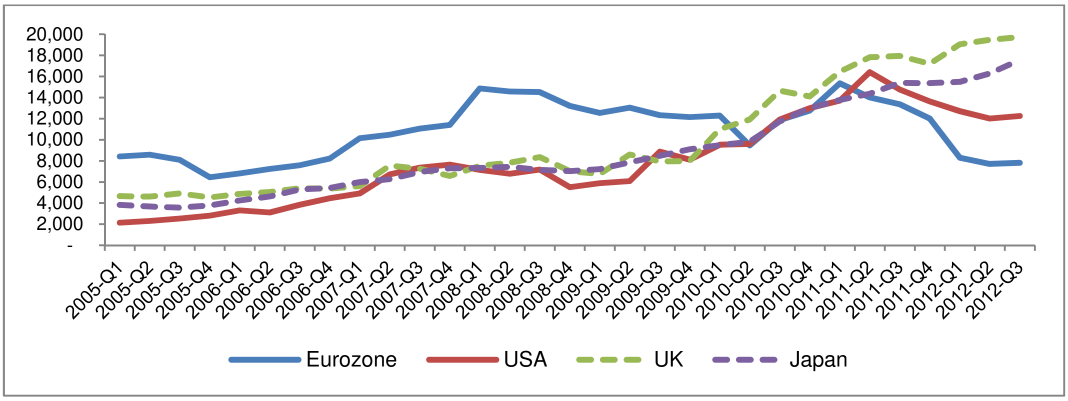


Source: BIS database

Assessing more deeply into the major international bank lenders, it is clear that the global financial turbulence has affected the Indonesian banking system through the lending of major global banks from the crisis-affected advanced economies. The claims of the US banks and the Eurozone banks were in declining trends from the first half of 2011 and showed mild rebounds in the third quarter of 2012 (Figure 12). Consolidation of the bank balance sheet, particularly among the Eurozone banks, has resulted on deleveraging from their exposures to Indonesia in two periods. The first occurred from quarter 1, 2008 to quarter 2, 2010, resulted in more than USD5 billion pull-outs. The second round of deleveraging, taking place more recently between first quarter of 2011 and second quarter of

2012, resulted in lending cut by more than USD7.5 billion. In contrast, the UK and the Japanese banks expanded their lending without marked interruptions.

Figure 12: Total International Bank Claims across Major Lenders



Source: BIS database

Beyond just the numbers, there are several fundamental challenges highlighted by the withdrawals of claims by the international banks to Indonesia. First one is the degree of exposure as highlighted by the share of the cross-border lending vis-à-vis local lending of these banks to Indonesia. Second is the allocation of these claims in Indonesia, particularly on the sovereign bond markets. These aforementioned issues will be elaborated in the following sub-sections.

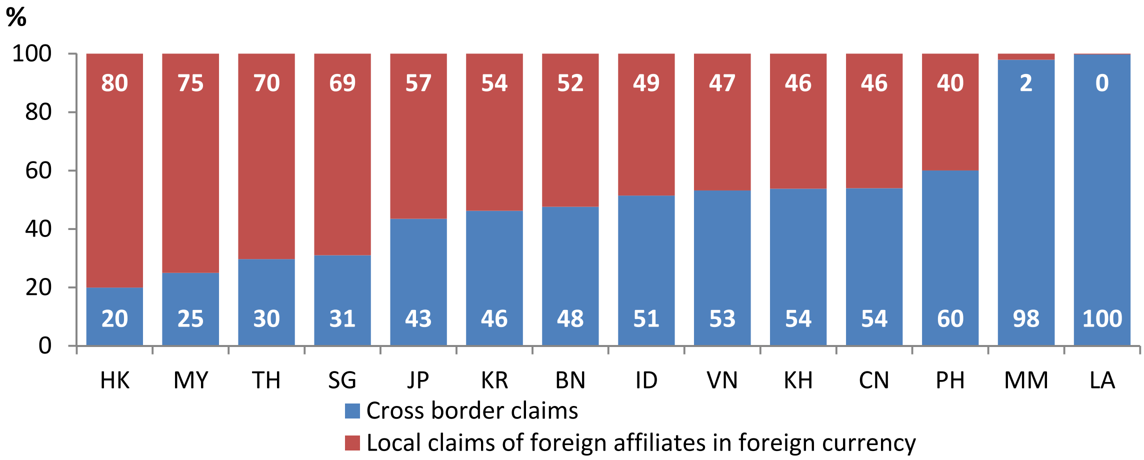
4.2.1 Cross-border Lending

What has been learnt from the recent experiences of sudden reversals of international bank lending? Recent studies such as Pontines and Siregar (2011), Kamil and Rai (2010) and de Haas and van Lelyveld (2010) demonstrate that cross-border operations of international banks are more prone to a "sudden stop" and sharp reversal during economic downturns in source economies. By definition, the total claims of international banks can be decomposed into: (a). lending by the local branch or subsidiary of the foreign bank or often refer to as local lending; and (b). cross-border lending –lending from the head-quarter or another branch or subsidiary of the bank located in another country. As shown in

Figure 13, around 50 per cent of the total international bank claims to Indonesia came in the form of cross-border lending. The high shares of cross-border claims of the Eurozone banks in major Asian economies, including Indonesia, have partly explained to the relatively marked declines in the total claims of the Eurozone banks in the region. Compared to major Latin American economies, claims of the Eurozone banks to Indonesia have predominantly been in the form of cross-borders (Table 7).

Figure 13: Shares of Cross-border Claims in Total Foreign Claims

(as of fourth quarter of 2011)



Note: HK: Hong Kong; MY: Malaysia; TH: Thailand; SG: Singapore; JP: Japan; KR: Korea; BN: Brunei; ID: Indonesia; VN: Vietnam; KH: Cambodia; CN: China; PH: Philippines; MM: Malaysia; and LA: Laos.

Table 7: Share of Cross-Border Lending of the Eurozone Bank Lending

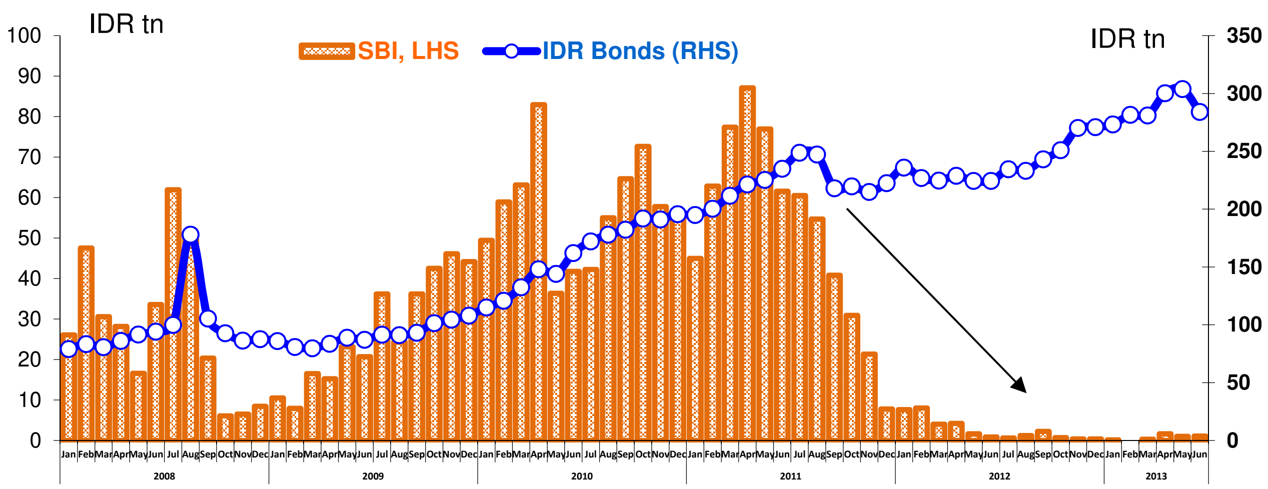
	Total Foreign Claims* (in US$ bn) (a)	**Cross-Border Claims* (in US$ bn)** (b)	**Ratio (a/b) in %**
ASEAN+3			
1. China	91	60.8	66.8
2. Indonesia	14	10.9	77.8
3. Korea	68	49.0	72.1
Latin America			
1. Argentina	24	6.4	26.7
2. Brazil	285	68.7	24.1
3. Mexico	179	31.2	17.4

*/Data as of the second quarter of 2011. Source: BIS database

4.2.2 Participation on Bond Market

The significance and potential impacts of foreign banks' activities are not only to be measured by the size of their claims, but also the allocations of these funding. More than 20 per cent of total claims of international banks to East and Southeast Asian economies were invested in sovereign bonds. Similarly, banks in Indonesia have played a major role in foreign investors' participation on the domestic bond markets, especially sovereign bonds, in Indonesia. Considered to be a relatively safer asset, especially following the collapse of the Lehman Brothers, with one of the highest yields in the region and the globe, local currency denominated sovereign bonds issued by the central banks (Bank Indonesia Certificate) and by the government of Indonesia (IDR Bond) had attracted foreign investors during the past few years (Figure 14). Following the collapse of Lehman Brothers, the foreign investors' holding of Bank Indonesia certificate plunged from 54.7 trillion rupiah (slightly over USD 6 billion) in July 2008 to a mere 6.5 trillion rupiah (or slightly over USD 720 million) in November 2008. The participation rebounded and peaked at 87.1 trillion rupiah in April 2011.

Figure 14:
Holdings of Sovereign Bond and Bank Indonesia Certificate by Foreign Investors



Source: Bank Danamon International, Bank Indonesia and Ministry of Finance, Indonesia.

Experiences of the emerging markets, including those in Asia, after the collapse of Lehman Brothers in September 2008 demonstrated that sudden withdrawals by the foreign investors from the bond markets could introduce greater bond yield volatility, and in turn complicate the conduct of open market operation. These have also been the experiences of Indonesia in recent years. To reduce short-term volatility, Bank Indonesia introduced a one-month holding period for its certificate purchased in both primary and secondary markets in June 2010 and prior to that the central bank has also launched a concerted effort to shift the maturity structure from one-month to longer term maturity. The policy has largely been effective in arresting foreign investor participation in its Central Bank Certificates (SBI). By January 2012, the foreign investor's holding of SBI was less than 9 per cent of its peak in April 2011.

The holding of government bonds by the foreign investors, including banks, however, continued to expand until early 2013. In recent months, particular since early second quarter of 2013, bond markets (corporate and sovereign) in Indonesia and the region in general have seen massive sell-outs, largely driven by the anticipation of tapering of quantitative easing measures in the US. While the rise in the foreign demand for government bonds sustained low cost of financing, as shown in the yield curve of the five-year government bond, the recent sell-outs by foreign investors have raised the yield curve (Table 8). The wide swings of the sovereign bond yields certainly would complicate and escalate the financing cost of budget deficits.

Table 8: 5-Year Local Government Bond Yield Curves of Major ASEAN Economies

(January 2007 – June 2013)

	Level as of mid-June 2013	**Maximum**	**Minimum**
Korea	3.1	5.8	2.5
Singapore	1.6	3.9	0.8
Thailand	3.3	7.2	2.6
Malaysia	3.8	5.8	2.7
Indonesia	7.4	10.4	4.4

Source: Nomura (2013) and Bloomberg

5. Brief Concluding Remarks on Outlook and Policy Challenges

Balancing the need to improve fiscal management and current account position in one hand, while maintaining steady economic growth will be more challenging in the near future for the policy makers in Indonesia. Concerns have emanated over Indonesia's weak external position, with the country positing a staggering USD 6.6 billion deficit in its balance of payment in the first quarter of 2013. The deficit was mainly attributed to the weak performance of the country's current account with a deficit of USD5.27 billion or 2.4 per cent of GDP. Continuing pressures on the "bleeding" fiscal budget from fuel subsidies, the threats of inflation, and the widening current account deficit has led to the eventual outlook revision by S&P from BB+ rating from positive to stable in May 2013. Declining Balance of Payment has put pressures on the Rupiah that necessitated Bank Indonesia to intervene. As a result, International reserve has declined from the record high US$125 billion in 2011 to less than US$100 billion by July 2013, exacerbated by portfolio outflows due to the news on the Fed increasing the interest rate and potential winding down of the quantitative easing measures or QE3.

To reduce subsidy pressure on the budget, the government made a revision to the 2013 national budget. The key features of the revised Budget approved by the parliament on June 17, 2013, were 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 transfer, rice for the poor and children's scholarship). The rise in subsidized fuel prices was made effective on June 22 with the subsidized petrol prices rising by 44 per cent to Rp. 6,500.00 per litter and the subsidized diesel price increasing by 22 per cent Rp. 5,500.00 per litter. The 2013 deficit has been revised upwards by 0.7 percentage points to 2.4 per cent of GDP, due to lower projected nominal revenues, in line with weaker anticipated GDP growth, and higher total expenditure (including on fuel subsidies, despite the increase in subsidized prices, due to higher projected global oil prices). The move to phase fuel subsidies is also wise considering that the Statistical Review of World Energy

2013 showed that Indonesia may run out of oil by 2024, holding constant the figures for production and proven reserves.[3]

On the back of rising fuel price and its wide spread impacts on headline inflation and the weak rupiah stemming by market concerns over current account deficits, Bank Indonesia increased its policy rate (the BI rate) by 25 basis point in June and another 50 basis point in July. These rate adjustments had to be taken amid soaring inflationary pressures coming from the fuel price increase. In addition, Bank Indonesia adjusted its growth target range between 5.8 to 6.2 per cent, lower than 6.3 per cent target of the government.

On the financial market front, especially banking sector, the challenges facing financial sector supervisors become more complex globally, including those in the emerging markets of East and Southeast Asia, such as Indonesia. The banking sectors are not only deeply interconnected regionally, but also globally. As elaborated, the local and regional banks have not only borrowed heavily from, but also extended loans to global banking system. The traditional global banks, such as the HSBC and the Standard Chartered bank, have increasingly become regional banks. At the same time, many of the ASEAN banks, such as the DBS, OCBC, UOB, MayBank and the CIMB, have become regional and global banks. Accordingly, the need to integrate financial market supervisory agencies is no longer a domestic issue (Lim and Siregar (2010)). Given the cross-border nature of these banks' operations, the regular supervision on domestic activities of these banks will not be sufficient to assess the overall risk exposures. There are a number of lessons from the recent global financial crisis that underscore the importance of establishing a closer coordination among banking supervisors across the borders.

[3] Siahaan, Tito Summa, "Indonesia Coal, Oil May Be Depleted in 10 Years: BP," *The Jakarta Globe*, June 14, 2013.

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Appendix

Table A1: Quantitative Easing and Other Key Extraordinary Measures by Major Central Banks

	US Fed	BOJ	BOE	ECB
2001-2006		Forerunner of central bank extraordinary measures. To combat deflation, weak growth and stabilize the financial system, the BOJ brought down interest rates to zero, introduced quantitative easing, credit easing and stock purchases. Further the BOJ also extended the maturity of funds supplying operations, while at the same time making commitments on the duration of zero interest rate and quantitative easing.		
2007				ECB provides liquidity to permit orderly functioning of the money market and announces supplementary three-month €40 billion longer-term refinancing operation (LTRO). (August)
2008	QE1, the Federal Reserve will purchase agency debt of Fannie Mae and Freddie Mac together with MBS guaranteed by these institutions. The Fed announces the creation of the Term Asset-Backed Securities Loan Facility (TALF) to provide liquidity to the ABS market. (Nov. 25)			The ECB decides to carry out weekly refinancing operations with a fixed-rate tender procedure with full allotment (FRFA). (Oct. 8)
2009	QE1 (continued), the FOMC announces it will purchase longer-term Treasury securities (US$300 billion) over the next six months. (March 18)		Asset Purchase Program 1, the MPC announces its first round of asset purchases, consisting mostly of conventional bonds with residual maturity between five to 25 years. (March 5)	Covered Bond Purchase Programme (CBPP) announced for €60 billion, one-year program. (May 7)
2010	QE2, the FOMC announces intention to purchase a further US$600 billion of longer-term Treasury securities by the end of the second quarter of 2011, a pace of about US$ 75 billion per month. (Nov. 3)	Comprehensive Monetary Easing (CME), announcement of purchases of Japanese government bonds (JGBs), commercial paper, corporate bonds, exchange traded funds (ETFs) and Japanese real estate investment trusts (J-REITs). (Oct. 5)		Securities Market Program (SMP) launched to ensure depth and liquidity in sovereign debt markets. (May 9)
2011	Operation Twist or Maturity Extension Program, the FOMC announces its intention to purchase US$400 billion of Treasury securities with remaining maturities of six years to 30 years and to sell an equal amount of Treasury securities with remaining maturities of three years or less. (Sept. 21)		Asset Purchase Program 2, the MPC announces another round of purchases amid sluggish growth (Oct. 6)	The ECB announced two three-year LTROs on Dec. 20, 2011 and Feb. 28, 2012, together with reduced reserve ratio and expanded collateral availability. (Dec. 8)
2012	QE3, The FOMC will purchase US$40 billion MBS a month (Sept.13) and longer-term Treasury securities at an initial pace of US$45 billion per month (Dec. 12)		Funding for Lending Scheme (FLS), designed to increase lending to households and businesses by providing banks cheaper costs of funds. (July 12)	Technical features of Outright Monetary Transactions (OMT) released, including strict and effective conditionality. (Sept. 6)
2013		Quantitative and Qualitative Monetary Easing (QQME), announcement of intensified asset purchases with the goal of increasing the monetary base by JPY 60 to JPY 70 trillion annually, increasing the average maturity of JGBs held from three to seven years and meeting the 2 percent inflation target in two years. (April 4)		

Source: Shirakawa (2009) and IMF 2013