Lessons learned from the Taper Tantrum 2013: the case of Indonesia

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Questions to be addressed

- How did Indonesia manage the Taper Tantrum?
- How was the policy making process?
- What are the lessons learned?
Indonesian Economic Growth was much more stable compared to G20s, BRICS countries, and ASEAN members...

Pre Taper Tantrum

G-20s, Q2 2013 GDP Growth (% yoy)

Comparison with BRICS and ASEAN members (GDP Growth, % yoy)

Source: WEO, Bloomberg
The song remains the same: commodities and investments boom
Investment: dominated by domestic market oriented sector... Portfolio investments remain important

**Indonesia: Investment realization, by sectors 2000-2014**

**FDI and Portfolio investment in Indonesia**

Source: CEIC
OUTLOOK FOR MODERATE EXPANSION BUT WITH CONTINUING FINANCIAL MARKET VOLATILITY

The government's stepped-up policy efforts are positive, but slow implementation along with the drag from external factors suggests that real GDP growth will remain moderate at 4.8% in 2015 and 5% in 2016 (Chart 13). For an improved growth performance over the medium term, President Jokowi needs to follow through with stronger political leadership to tackle structural challenges, stand up to inward-looking interest groups and drive the legislative process through parliament. Indonesia's strengths are its favorable demographics through 2025 and its potential to attract some of the labor-intensive manufacturing investment shifting from China, but it lags well behind in business climate, logistics and infrastructure (Charts 14, 15 & 16).

Exports are likely to remain weak due to depressed commodity prices and restrictions on metal ore shipments along with slower demand from China, although manufacturing shipments are rising. Commodities, including coal, palm oil, gas, oil, rubber and metal ores (copper, nickel and bauxite) account for around 40% of total exports, while China's share of total exports is around 10%. However, with imports restrained by tight monetary policy, weak oil prices and fuel subsidy reductions, the current account deficit should fall from a 23-year high of 3.2% of GDP in 2013 to 2.4% in 2016 (Chart 17). Our projections are based on the price of Brent crude averaging around $58 per barrel in 2015 and $63 per barrel in 2016. Oil accounts for a quarter of total imports and oil and gas around 16% of total exports. A $10 per barrel change in the oil price alters the trade balance on average by $1.7 billion (0.2% of GDP) a year.

Despite a declining current account deficit and policy emphasis on macrostabilization and reforms, periodic financial market volatility is likely to continue due to broader swings in investor attitudes towards EMs. Net private capital inflows are projected to slump from $60 billion in 2014 to around $28 billion in 2015 before edging up to $33 billion in 2016, limited by the uncertain environment, especially for portfolio flows, given continuing tensions surrounding 40

55

70

85

1980 2020 2060 2100

Chart 14

Dependency Ratio

dependents as percent of working-age population

Source: UN.

1

Age 15-64 years.

World

Kor.

30

50

70

90

Mal.

30

50

70

90

Chn.

30

50

70

90

Tha.

30

50

70

90

Indo.

30

50

70

90

Ind.

30

50

70

90

Phl.

Chart 15

Ease of Doing Business

s

core; 0=lowest quality, 100=highest quality


2.0

3.0

4.0

5.0

Overall

Transport Infrastructure

Chart 16

EM Asia: Logistics and Infrastructure Performance

s

core; 1=lowest quality, 5=highest quality

Indonesia made slow progress in export diversification; Dutch Disease could be one of the reasons.

Source: Bank Indonesia and authors’ calculation using UN-Comtrade data. Classification based on Lall (2000).
Fragile five countries

Budget balance (% of GDP)

GDP growth

Source: CEIC, FRED economic data
Indonesia experienced increasing pressures in the financial market in the mid of 2013...

- In the period of June – Sept 2013.
  - IDR depreciate 14%,
  - Jakarta Composite Index fell 15%.
  - Capital market outflow reached IDR 28,67 T in Stock Market and outflow in bond market reached IDR 7,52 T.
  - Indonesian Bond Yield Increased more than 200bps
Fundamental vs size of country’s financial market

- Brazil and India: high reserves
- Indonesia: strong GDP growth, low budget deficit, low debt/GDP
- But all countries have current account deficits
Indonesia: external and internal balance

- CA balance (% of GDP, RHS)
- Forex $ Bn (LHS)
- IDR/USD (thousand) RHS
- BI Rate, % RHS
- GDP Growth RHS

Expenditure switching and reducing policy

QE 1

QE 2

QE 3

Exit
Policy response: stability over growth

- Reduced fiscal deficit by cutting the fuel subsidy: raised the fuel price by 44%
- Tightening monetary policy: raised interest rate by 175 bps
- Allowing exchange rate to depreciate
- Prepared bilateral swap agreement
- Curb inflation by opening import

These expenditure reducing and expenditure switching policy were combined with

- Cash Transfer for the poor
- Deferring income tax for labour intensive industry, if they do not lay-off their workers

These policy measures were politically difficult, but we managed to do it.
Interest Rates policy

Source: BACEN SELIC, BI, SARB, CBRT, RBI
These efforts were evidently quite successful in creating a stable economic condition amidst global uncertainties...

- Government and central bank (BI) policies were quite effective in turning the trade balance into surplus in the last 3 months of 2013 (Oct US$0.03 bil, Nov US$0.79 bil and Dec US$1.51 bil).
- In December 2013: inflation reached 0.54% (mtm) or 8.38% (yoy), inflation pressure has slowed down after the subsidized fuel price adjustment in mid 2013.
- IDR movement has shown convergence. Singapore’s financial market has discontinued the use of NDF for USD/IDR Price and decided to use Bank Indonesia’s JISDOR as reference.
- BI’s FX Swap Facilities have also helped to reduce the local forex market’s overreliance on the spot market.
Indonesia's BoP

Source: BI
GDP Growth
(Countries, annual, 2015 data is q1 data, percent, last data in the bracket)

Source: CEIC, World Bank
Quantitative approach

Theory
Standard accounting identity
CA = (S-I) + (T-G)
Mundell-Flemming
Ricardian Equivalent Hypothesis

Econometerics test using VECM

Policies: Stability over growth

Expenditure reducing policy:
Cut G (fuel subsidies, partially transfer it into cash transfer)
Raising interest rate

Expenditure switching policy
Allow ER to depreciate

Structural reform
Deregulation
Remove import quota on meat, etc

Second line of defence
Incentive for FDI to re invest
Data

- Expenditure Reducing
  - CA: current account
  - BDUS: budget surplus
  - BI: BI rate

- Expenditure Switching
  - CA: current account
  - ER: exchange rates

- Quarterly data
  - 2004Q1 – 2014Q1
# Granger Causality

Pairwise Granger Causality Tests
Date: 11/13/15   Time: 00:40
Sample: 2004Q1 2014Q1
Lags: 2

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Granger causality test (Toda-Yamamoto approach)

VAR Granger Causality/Block Exogeneity Wald Tests
Date: 11/25/15  Time: 01:04
Sample: 2004Q1 2014Q1
Included observations: 36

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Cumulative IRF (use generalized impulse)
Impulse Response Function
Variance Decomposition

![Variance Decomposition Graphs](image-url)
The economic improvement had been recognized by positive responses from media...

Capital flows in Indonesia

Fragile no more

How the world’s fourth-most-populous country is weathering the emerging-market turmoil

Feb 22nd 2014 | JAKARTA | From the print edition

LAST year Indonesia was struck by the financial storm that pummelled emerging markets, earning itself a place among the so-called “fragile five” of the developing world. When in May the Federal Reserve began discussing plans to scale back its asset purchases, the prospect of higher yields in rich countries made investors reluctant to pour more money into emerging economies. Indonesia’s currency sank in value, along with those of other countries that had been prime destinations for rich-world cash.

This year other emerging markets suffered a similar slump, caused by the Fed’s decision to go ahead with the mooted “taper”. Central banks in Turkey, India and South Africa have all hiked interest rates to defend their battered currencies. Yet Indonesia’s rupiah has rallied by 3.3% against the dollar—the most among major emerging-market currencies. Jakarta’s main stockmarket is trading close to four-month highs. And foreign funds have bought $1 billion more local bonds and shares this year than they have sold.

rebalancing. Despite slower consumption growth, annual GDP growth accelerated to 5.7% in the fourth quarter, boosted by exports. Indonesia no longer looks so fragile.

Indonesia fleeing ‘Fragile Five’ as CAD narrows


Indonesia is forcing itself out of the infamous grouping of the “Fragile Five” economies most vulnerable to outflows, after its current-account deficit (CAD), the major worry among foreign investors last year, surprisingly improved to a sustainable level faster than expected.

Bank Indonesia (BI) announced on Thursday that the CAD — the shortfall in the broadest measurement of international trade, an indicator of an economy’s health — narrowed to US$4 billion, equivalent to 1.96 percent of the gross domestic product (GDP), in the fourth quarter.

The improvement in the CAD was better than estimates of many economists, including those from US-based Goldman Sachs, which earlier estimated that the deficit might narrow to only 3.3 percent of the GDP in the fourth quarter.

The fourth quarter figure took full-year 2013 CAD at $28.4 billion throughout 2013, according to BI.

The central bank attributed the better-than-expected CAD data to the latest string of trade surpluses, which Indonesia already posted for three consecutive months. In December, the surplus grew to a two-year high level of $1.5 billion.
IMF Staff Visit (March 2014)

“Indonesia has navigated the transition to a tapering environment well”

World Bank IEQ- 1st Quarter 2014

“. . GDP Growth to slow moderately to 5.3% in 2014, and the current account deficit to narrow to 2.9% of GDP . . .”
IMF Staff Visit (March 2014)

“Indonesia has navigated the transition to a tapering environment well”

World Bank IEQ- 1st Quarter 2014

“.. GDP Growth to slow moderately to 5.3% in 2014, and the current account deficit to narrow to 2.9% of GDP ...”
The political economy of decision making process
Political landscape

- Presidential system with multi political parties
- No single majority
- Rainbow coalition in the Cabinet
- Presidential election every 5 years (incumbent can be re-elected, 2 times max.)
- Technocrats tend to play an important policy role only when economic crisis strikes (esp. when the economic situation is really bad)
- In bad economic times, politicians provide technocrats with the room and support to fix the bad economic situation.
- In good economic times, politicians are reluctant to sacrifice their political capital by adopting unpopular policies in the short term, even though these are vital in the long term.
Taxonomy

**Actors**
- Technocrats/ Professionals
- Politicians
- Bureaucracy
- Media
- Civil Society

**Policy stance**
- Pro reform but number of actors are limited
- Will push reform as long do not jeopardize the interest of political parties (populist policies)
- Status quo
- Strong political interests
- More ideological
What are the lessons learned?

- Capital inflow $\rightarrow$ real ER appreciation $\rightarrow$ CA deficit $\rightarrow$ increase vulnerability; however, sterilization is expensive, could not implement capital control.

- High current account deficit makes economy become vulnerable, especially if it is financed by portfolio or FDI on domestic market.

- In the case of Indonesia: Bank Indonesia should have raised the interest rate earlier and let the exchange rate to depreciate; government should have raised the fuel prices earlier.
Dependency on external financing may increase the vulnerabilities → financial deepening and mobilize domestic savings are very important.

To overcome Taper Tantrum, consistency on stability over growth strategy is important. This explain why Indonesia and India were not so bad after all.

Bad times make good policy.

The importance of communication through G-20 or IMF meetings.
Thank you