Indonesia: positive policy moves amid macro headwinds

- The recent selloff in Indonesian bonds, currency, credit and stocks reflected both an unfavourable global backdrop for EM assets amid US QE tapering concerns and weaker domestic macro fundamentals and policy uncertainty
- On 21 June, the government announced an increase in the price of subsidized gasoline by 44% a liter, while diesel price was hiked 22% a liter, sparking protests
- The latest policy moves on fuel subsidies and interest rates are positive developments. However, the impact of fuel price hikes on the current account and fiscal balance will likely be modest, while the resulting (transitory) inflation spike and monetary tightening could potentially slow growth
- Given the challenging inflation-growth dynamic, external (and currency) vulnerability, additional sovereign debt issuance, monetary tightening and potentially increased political noise heading into the elections next year, we remain underweight duration in local rates. We are still cautious on sovereigns and favour corporate credit with sound fundamentals, with valuations now more attractive after the recent correction

Market jitters and BI policy actions

The Indonesian markets had a difficult month in May and the selling pressure intensified into June, in tandem with a broad sell-off in the emerging markets (EM) amid concern about the Fed tapering QE asset purchases earlier than expected and the impact on global liquidity. There has been a volatility spike in EM assets, with a sell-off in rates, spreads widening in the credit complex, and risk reduction in the FX and equity markets.

In Indonesia, an unfavourable balance of payments dynamic, intensified inflation concerns and the repeated delay in fuel price adjustment added to the selling pressure. In the local rate markets, the 10-year government bond yield rose sharply to 6.9% on 21 June from 5.5% at end-April. Indonesian sovereign underperformed other Asian sovereigns year-to-date, with the five-year CDS spread widening 140bp between 20 June and 8 May. The rupiah (IDR) weakened to surpass the psychological level of 10,000 against the USD. Meanwhile, the Jakarta Composite Index (JCI) was down over 12% as of 21 June from a record high set on 20 May.

As a pre-emptive response to rising inflation expectations and in a bid to maintain macroeconomic and financial system stability amid increasing uncertainty in global financial markets, Bank of Indonesia (BI) raised the policy reference rate by 25bp to 6.00% on 13 June, the first hike since February 2011. The policy rate hike came after BI raised the deposit facility rate (FasBI) rate by 25bp to 4.25% on 11 June, the first hike since August 2012, to stem IDR depreciation. The hikes were not unexpected but the timing (before the announcement of the change in fuel subsidy policy) was a surprise to the market. BI pledged to stabilise the IDR exchange rate and maintain adequate liquidity in the FX market, and bought government bonds in the secondary market. Local bond yields and CDS retreated following the BI policy actions while the IDR showed some stability.

Fuel price hikes amid protests

Indonesia’s fiscal position has been prudent, with its budget deficit and public debt relative to GDP being lower than many developed countries and other emerging economies. However, spending on energy subsidy has been a significant fiscal burden, contributing to a widening budget deficit in recent years. In 2012, energy subsidies amounted to IDR307tn (3.7% of GDP and 20.7% of government spending). Fuel subsidy accounted for nearly 70% of energy subsidies. The government has spent more on energy subsidies than on crucial development areas such as education, healthcare and infrastructure. The current fuel subsidy policy also benefits middle-to-upper income groups more than the poor (~70% of subsidised fuel is enjoyed by the rich).

The government has been under heavy pressure to end/cut fuel subsidies, but such a move is politically sensitive, especially in a pre-election year. Protests derailed a plan to raise fuel prices in 2012. President Susilo Bambang Yudhoyono has since then repeatedly delayed the decision, despite the government’s discretionary powers to increase subsidised fuel prices without parliament approval this year. The President has put a compensation programme in place to shield the poor from the impact of fuel price/inflation hikes a precondition to subsidy reduction, to reduce the potential public backlash. Amid street protests and opposition parties’ objections, the parliament on 17 June voted to approve a revised 2013 state budget which includes a temporary direct cash transfer programme for lower-income households and entails a 22% rise in diesel prices and 44% increase in 88 RON gasoline prices. The government went on to implement the price hikes, its first since 2008, on June 21 amid further protests.
The revised 2013 state budget accommodates a swollen fuel subsidy of IDR200trn, up from IDR194trn in the original budget (vs. actual spending of IDR212trn in 2012). The deficit target was raised to 2.4% of GDP, higher than the 1.7% set in the original budget (and the actual 1.8% in 2012). The upward revision was due to both higher spending targets (driven mostly by energy and social subsidies) and lower revenue projection (reflecting lower GDP growth assumption and weakness in the commodity prices). The revised budget assumes GDP growth of 6.3% for 2013, well below the previous assumption of 6.8%.

Growth has slowed since H2 2012 but stayed resilient (6.0% yoy in Q1 vs. 6.2% in 2012), despite weak export commodity prices, with consumer spending powering the growth engine recently. However, investment has weakened, in response to worsening terms of trade and commodity price weakness, particularly coal and palm oil. Fuel price hikes (and the resulting higher inflation) and monetary tightening will likely weigh on domestic demand, although the government’s compensation package for the poor and an expected increase in pre-election government spending may provide some offset. Global and domestic market volatility and possible political noise ahead of the 2014 elections may also negatively affect confidence, particularly business sentiment (and, in turn, capex). An expected modest export recovery is unlikely to fully offset a moderation in domestic demand.

The Ministry of Finance estimated that the fuel price hike could save the government some IDR40trn (less than 0.5% of GDP). However, taking into account the fuel subsidy savings that are being recycled into other areas of expenditure such as the compensation programme for the poor, the actual impact on fiscal tightening is likely to be smaller.

Transitory inflation spike

Headline inflation has risen in recent months, largely due to food price spikes, mainly caused by earlier floods and the temporary import quota restrictions on select food items, and higher electricity tariffs. Core inflation has been in mild deceleration since November 2012 and stayed relatively stable. However, the upcoming fasting month Ramadhan and Idul Fitri celebration (early-July to early-August) will exert upward pressures on food prices. Administered prices are rising, triggered by electricity tariff hikes and disruption of the supply of LPG. There is also upside to inflation from IDR weakness, although the lower global commodity prices have so far contained the impact on imported inflation. Domestic credit growth has been strong, underpinned by low real interest rates and loose monetary policy.

Past experience (in 2005 and 2008) suggests that fuel price hike could trigger a general price increase as the costs for public services such as transportation and the price of basic necessities, especially food, would also rise. An increase in fuel prices will lead to a temporary spike in inflation in 12-month’s time, although it should subside (“normalise”) on base effect thereafter. BI raised its inflation forecast range for 2013 to 7.2%-7.8% (from 3.5-5.5% previously) and warned that inflation could reach 8% without successful government intervention to mitigate the impact (e.g. to improve distribution of basic necessities and control transportation costs) and calm inflation fears. We expect further monetary tightening via interest rate hikes and macro-prudential policies aimed at certain sectors that have seen rapid credit growth.

External vulnerability

Massive fuel subsidies have also contributed to the widening trade deficit due to “excessive” fuel demand. While structurally and naturally, domestic fuel consumption increases as the economy grows, the “artificial” consumption i.e. demand for smuggling purposes has emerged given the large disparity of prices between the domestic and international markets. The strong fuel demand against falling exports due to the decreasing domestic crude production has led to a surge in Indonesia’s net oil import bill, resulting in a widening oil & gas trade deficit and overall deterioration in the total trade balance. Current account balance posted a deficit of 2.7% of GDP in 2012, after a surplus of 0.2% of GDP in 2011 and its is the first deficit since 1998. The fuel price hikes should help reduce the current account deficit via the direct impact on oil import demand and the indirect impact of fiscal tightening on domestic demand, but the impact is unlikely to be substantial. The deterioration in current account balance is both cyclical and structural - reflecting weaker global/Chinese demand and commodity prices, worsening of Indonesia’s terms of trade, increased investment needed to boost potential growth, and a larger income account deficit. Profit repatriation from FDI in Indonesia; dividend and bond coupon payments to foreign investors; and the servicing of rising amounts of USD loans keep Indonesia’s income account in substantial deficit.

FDI in Indonesia remains robust, but net FDI inflows have been insufficient to finance the current account shortfall, resulting in a deficit of basic balance since Q1 2012 and increasing external financing from volatile portfolio capital inflows. High foreign participation in Indonesia’s local asset markets adds to the external vulnerability (foreign ownership of local government bonds is currently at around 33%, nearly doubling the end-2008 level and up from below 8% at end-2005). Indonesia’s overall external debt profile remains sound, with the debt-to-GDP ratio rising recently from a low level (below 30% currently). However, the FX reserve cover (% of short-term debt and repayment) has trended lower over the past few years. Moreover, IDR weakness, if persisted, and any re-pricing of US Treasuries or EM yield spreads higher would raise the cost of debt servicing.

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Investment implication

Despite its impact on inflation (transitory) and potentially growth, the passing of the long-awaited fuel price hikes together with tightening monetary policy is positive from a policy credibility perspective and represents a step in the right direction from a reform perspective. It is encouraging to see this materialising
before the elections in 2014, a showing of the government’s commitment to undertaking tough reforms. It is supportive of current sovereign ratings, in our view, as subsidy rationalisation is one of the key ongoing reforms the agencies are looking for given its impact on easing fiscal and current account stress.

However, there are other key inputs for Indonesia’s credit ratings and outlook, such as potential growth, inflation management and external vulnerability. While we believe the move to reduce fuel subsidies is a right step to improving Indonesia’s long-term macro fundamentals, the short-term pain in the form of higher inflation and interest rates and potentially slower growth may curb investor appetite for IDR assets in the near term. The fuel price hike, which we believe would have been taken very positively by the market had the reform been passed a year ago, came only after the current account balance worsened markedly for more than a year and the IDR came under increasing pressure with the BI deploying FX reserves to arrest the fall.

Current global financial conditions are volatile with EM having been hit hard by global fund reallocation and bond outflows amid concern about Fed QE tapering and rising Treasury yields. The fuel price hikes are unlikely to reduce the fiscal and current account pressures substantially (more need to be done). Political noise could increase in coming quarters as we head into the elections next year, limiting the scope for reforms and raising risks of populist and/or nationalist policy bias.

Given the challenging inflation-growth mix, increased volatility in EM high-yielders, IDR weakness, additional sovereign debt issuance this year required by the revised budget and expected further monetary policy tightening, we remain underweight in duration in local rates, as we head into the elections in 2014.

Domestic macro headwinds, a challenging balance of payments dynamic, and a potential rise in political risk premium will likely continue to weigh on the near-term IDR outlook, even if domestic interest rates are raised further to increase rate differentials in Indonesia’s favour. FX flexibility via an orderly depreciation of the IDR on a real effective exchange rate (REER) basis may be needed to facilitate the adjustment of external imbalances in line with fundamentals.

We remain cautious on the Indonesian sovereigns and favour corporate credit with strong fundamentals, with valuations now more attractive after the recent correction. The long-term growth prospect of Indonesia still looks positive, given the country’s relative political stability, demographic dividend and endowment of natural resources, and as it pushes forward structural reforms, with a wide range of investment opportunities including a reviving manufacturing sector, accelerated urbanization and a growing middle-income class. However, current stock valuations look unattractive against the backdrop of weak macro fundamentals.

Renee Chen
Macro & Investment Strategist
HSBC Global Asset Management
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