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The U.S. Economic Recovery and Its Impact on the Global and Indonesian Economies

USINDO-PPPI Open Forum with:

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On October 22, 2014, USINDO in cooperation with Paramadina Public Policy Institute, hosted an Open Forum with Wijayanto Samirin, Managing Director PPPI; Ndiamé Diop, Lead Economist World Bank; and Fauzi Ichsan, Senior Economist and Head of Government Relations Standard-Chartered Bank, discussing the U.S. Economic Recovery and Its Impact on the Global and Indonesian Economies. This brief is USINDO's summary of the talk.

The photos of this event can be accessed here

Introduction by Dr. Arifin Siregar

Despite the rise of China as an economic powerhouse, the U.S. is still one of the leading economies in the world. Up until now, as a buyer and an importer of goods and services from all over the world, the U.S. has been very powerful. Many countries, including China, Japan and some developing countries are dependent on the export of goods and services from the U.S.

As a provider of capital, the U.S. has always played an important role, especially in the fields of mining, including oil and gas, copper, gold and other mining activities. But lately, what is very striking is the role of the U.S. dollar. Today, the U.S dollar remains the most important trade and reserve currency. Powerhouses like China and Japan hold most of their reserves in the form of the U.S. dollar. Thus, they are also highly dependent how the Federal Reserve (the Fed) regulates monetary policy in the U.S.

In 2008, the Fed launched Quantitative Easing (QE) as part of its monetary policy to revive the national economy. QE enables the Fed to buy a large amount of securities, both from the public and private sectors, to add liquidity to the market. The purpose of this expansionary monetary policy is to lower interest rates and spur economic growth. However, much of this money flows overseas, including to Indonesia.

There are several reasons short-term capital flows play an important role in Indonesia. One example is in buying stocks and bonds in the stock market and the private capital area of Indonesia. The ratio between Indonesia's reserves (USD 111 billion) to foreign debt (USD 290 billion) is about 40% which is a very low ratio compared to other countries. If the Fed sees QE lessen the purchase of securities, interest rates can rise in the U.S., causing the money which has flowed abroad possibly to return to the U.S.

It is essential to remember that the U.S. is not only a provider of short-term capital, but also long-term capital or foreign direct investment. Thus, if the U.S. economy improves, more American capitalists are also likely to invest their money in other countries, including Indonesia. Nevertheless, a lot of people expect the improvement of the U.S. economy will not take place too soon and too much. For all of these reasons, the impact of the U.S. economic recovery becomes very important to Indonesia and to the rest of the world.

Mr. Wijanto Samirin
The Four Main Engines of the World's Economy

According to Mr. Samirin, the world's economy consists of four main engines, the European Union, Japan, China, and the U.S. These four engines represents 70% of the global economy; thus what happens to each of them impact the rest of the world. Mr. Samirin examined the current economic situation in every engine before finally relating it to Indonesia.

<u>The European Union (EU)</u>

Today, the EU economy continues to decline due to a serious fiscal problems and budget deficits. Although some improvements are currently taking place, the EU's structural problems hinder it from reacting to economic global change. For example, countries in a small economy like Greece do not have the option to depreciate their currency in order to gain competitiveness. Therefore, the EU is fighting the economic decline solely through fiscal policy. In reality, it actually needs a combination of fiscal and monetary policy.

<u>Japan</u>

Last year, people were very optimistic about the Japanese economy, especially after the government initiated Abenonomics. Abenomics seeks to remedy stagnation by increasing the nation's money supply, boosting government spending and enacting reforms to make the economy more competitive. Although the plan seemed to work well until the first quarter of 2014, Japan experienced a significant decrease in GDP growth in the second quarter of 2014. This showed that apparently Japan has not yet recovered since its crisis in 1991, making it impossible to rely on itself to ensure that the world's economy keeps moving.

<u>China</u>

China also continued to slow down this year which is obviously in contrast with three years ago when everybody expected it to become the engine of growth.

<u>The U.S.</u>

However, the U.S. will play a very important role. Unlike Japan, which was perceived to experience economic recovery only through the government's budget stimulus, the U.S. has evidenced a real recovery by showing a consistency in GDP growth.

Evidence of the U.S. Economic Recovery

Mr. Samirin outlined six key indicators of whether an economy experiences a crisis or a recovery. First, manufacturing shows an increase in capacity utilization. This proves the real sector is actually moving forward. Second, corporate profits in the U.S. experienced a very large increase, much higher than the rate of profit during the crisis. Though since the crisis, inequality is getting worse, productivity and economic growth are improving. Third, since 2010, the number of bankruptcies has been consistently decreasing. Fourth, the unemployment rate continues to decrease from 10% in 2010 to around 5.7% by September this year. Fifth, is the housing market, which has a mixed picture of booms and busts. Sixth, the U.S. inflation rate is at a normal 2% while the Fed funds rate is almost zero (0.09%) since the crisis.

Challenge and Opportunity for Indonesia

1. Tapering Off

A tapering off in the U.S. economy means a reduction of purchase of securities issued by the federal government, the local government or the private sector. Thus, if the taper happens too suddenly, the impact to many economies, including Indonesia, will be tremendous. Fortunately, American companies are experiencing profitability, giving them have a higher appetite to invest abroad.

Responding to the taper, the Indonesian central bank (BI) will certainly increase its own Fed rate in order to manage inflation and exchange rate. However, BI should also consider the impact of increasing the Fed rate to the unemployment rate, similar to the practice in the U.S.

Furthermore, BI should implement a policy which can avoid huge budget deficits. Domestically, the Indonesian banking sector experiences liquidity, causing the government to issue debt notes. At the same time, there is a competition between the government and the private sector, causing an increase in interest rates. Moreover, due to the potential of tapering and an increase of the Federal Funds Rate, the government cannot expect to borrow a significant amount of money from abroad, affecting the cost of funds for the Indonesian government. Reducing the fuel subsidy was also necessary to help the government to raise its funds next year.

2. Making the Most of Foreign Companies' Increasing Appetite to Invest Abroad (through their Foreign Direct Investment)

In the near future, there is a great opportunity for Indonesia to attract more FDI because various multinational companies are interested in Indonesia. Compared to before the global economic crisis in which average FDI to Indonesia was only USD 6 billion per year, after the global crisis it more than tripled to an average of USD 19 billion. Then by 2013, FDI to Indonesia reached USD 23 billion, more than double than the FDI to Malaysia and the Philippines. Responding to this, Indonesia should provide a competitive environment through easing strict regulations and ensuring policy certainty.

In 2013, most countries' policy on attracting foreign investment leans towards giving flexibility. In contrast, Indonesia leans towards giving more restrictions on foreign investment, but still receives considerable foreign investment in 2013.

Moreover, for the first time in history, Japan sets Indonesia as its top investment destination, while other foreign investors are more reluctant to invest in the country. One study shows that Japan is likely to invest more in areas where market influence is dominant and government influence is minimum, while other countries like the U.S. may focus more on the opposite.

3. Increasing Demand of Goods and Services from Abroad

Although Indonesia has a trade deficit overall, with the U.S. it experienced a trade surplus of USD 6.7 billion last year. Hence, there is a great opportunity for Indonesia to expand the surplus by increasing its sales of goods and services to the U.S. This is actually in line with the U.S. economic recovery because more Americans now need to consume daily products, like coffee, tea and rubber.

Mr. Ndiamé Diop

Mr. Diop stated that there are three main channels which can help us understand the impact of the U.S. economic recovery for Indonesia: trade, capital markets, and the U.S. dollar.

1. Trade Channel

In order to fully understand the impact of the U.S. economic recovery to Indonesia and to the rest of the world, one has to take into account the drivers of the economic growth in the U.S. first. Over the last few years, the U.S. economic growth has been driven by mainly two factors; business investment and fiscal sector activities. Business investment reflects growth in corporate profits, and can be translated into a very rapid increase in investment. On the other hand, the fiscal sector is related to the recent implementation of the U.S. fiscal sequester which causes harmful budget cuts. Although this fiscal sequester has been a drag on growth, the U.S. has actually been ready to recover since 2012 as in the following year it had taken about 1.8% of the country's GDP.

What does this mean for the impact for the rest of the world? It essentially means the U.S. import demand has been recovering very fast and since growth is driven by investment, the countries that benefited the most are those which export technological goods. In ASEAN, countries like Malaysia, Singapore, Taiwan and South Korea receive a significant export stimulus from the U.S. import demand than a country like Indonesia which exports consumer goods and other non-high technology goods to the U.S.

The U.S. economic recovery is great news for Indonesia because it results in a higher demand for the export of Indonesian products. However, competitiveness is very key in order to be able to capture a greater share of the U.S. import demand, especially since many exporters perceive the U.S. as the most competitive market in the world. According to Mr. Diop, Indonesia, which is currently focusing mostly in the low value-added areas, will have to compete with such countries as Bangladesh, Vietnam and Myanmar. Hence, Indonesian firms need to gradually move towards producing higher value-added products such as technological goods to gain more competitiveness in the U.S. market.

Mr. Diop explained that currently in Indonesia domestic demand actually gives a more significant contribution to growth than external demand. Indonesian exports accounted for only 20% of the country's GDP, while the other 80% represents domestic demand, domestic consumption, private investment, etc.

2. Capital Market Channel

As the U.S. Federal Reserve is expected to start hiking interest rates, many investors anticipate the impact it will have on their portfolios. In a world of high capital mobility, global liquidity has also become very important. Today, Europe, China and Japan are experiencing a capital current account surplus. Europe has about USD 400 billion of surplus while China's current account surplus accounted for about 3% of its GDP.

If the liquidated amount of surplus is added altogether, there is about 6% of GDP that should be invested abroad. Since the U.S.' budget deficit has fallen to only 3% of GDP, it presented high yield for longer term bonds and became in a position to attract significant firms, despite its anticipated hike in increase rates. Mr. Diop concluded that this presents an opportunity for Indonesia, particularly when it comes to financing investment in infrastructure.

3. Dollar Channel

In line with the economic recovery in the U.S., the U.S. dollar is relatively strong. This means that the balance sheet of government and firms will be affected. The favorable aspect of Indonesia when it comes to the public sector is that over the last few years, the fiscal deficit has been mostly financed by Rupiah dominated bonds. This isolates the government from a sudden increase in the cost servicing the debt due to exchange rates.

However, it is not the same with the private sector. Private debt has been increasing significantly to about USD 156 billion today. Recently, it has stabilized and not all of it attracted company loans and trade credit. Some of the private debt will generate higher servicing costs if the dollar becomes stronger. Probably it is one of the areas to watch going forward to see which sectors are more affected and which sectors are relatively covered.

Mr. Fauzi Ichsan
Better Prospects for the Future of Global Economy

In a broad perspective, the global economy is improving. Both the U.S. and Eurozone economy are certainly accelerating as evidenced by the U.S.' 20% contribution to global GDP and the rise of the Eurozone from recession last year. However, just because the global economy is recovering does not necessarily imply good results for Indonesia. Now that the U.S. economy is gradually recovering towards a normal growth rate, there is less need for the U.S. central bank to maintain a very low interest rate policy, increase its balance sheet, print money and buy U.S. treasuries, bonds, and mortgage debt. In addition, the U.S. central bank is expected to end its Quantitative Easing (QE) Program and start hiking the Fed fund rate from 0% to .5%.

The End of the Commodity Boom and Its Impact on Indonesia's Current Account

The end of the commodity boom was the result of not only the slowdown in the Chinese economy, but more importantly the shale gas revolution in the U.S. The shale gas revolution in the U.S. is a clear indication of the country's success in developing hydraulic fracturing (fracking) and horizontal drilling to produce more oil. Unlike in 2011 when oil prices reached

USD 120 per barrel, currently oil prices have continually been declining by over 50%. Given this, the International Energy Agency predicted that the U.S. would surpass Russia and Saudi Arabia as the world's top oil producer by 2015, and be close to energy self-sufficiency in the next two decades. Furthermore, over the last five years, U.S. energy imports have also been declining and even better, the U.S. has accelerated its energy exports. As a result, the commodity boom that we witnessed in 2011 is unlikely to return.

In Indonesia, 60% of Indonesia's export is commodities in which includes energy commodities such as palm oil and crude oil. Thus, the collapse of commodities prices, especially the decline in oil prices, has hit Indonesia hard. Furthermore, it has shifted Indonesia's current account from a surplus of about USD 2 billion in 2011 to a deficit of USD 23 billion last year. In addition, Indonesia's large current account deficit was exacerbated by a policy to ban mineral exports in the beginning of this year. This policy has caused a decline in exports of at least USD 6 billion and a decline in government tax revenue of at least USD 1 billion.

According to Mr. Ichsan, it is actually fine for Indonesia to have a current account deficit as long as the U.S. continues to pump money, maintain low interest rates and retain its QE program. However, it seems that the U.S. will likely increase its interest rate. Thus, since Indonesia has been very dependent on capital inflows from the U.S. low interest rate, the Central Bank of Indonesia, alongside with the government, has to shrink its deficit before the U.S. central bank starts hiking the interest rate in possibly the second quarter of 2015.

Steps to be taken to Reduce Indonesia's Current Account Deficit

Mr. Ichsan outlined a couple of steps the Indonesian government should take in order to reduce the country's current account deficit. First, it is necessary to increase exports and decrease imports as rapidly as possible. The Indonesian government has to try to cut imports by hiking fuel prices. Fuel prices were actually supposed to be increased by 20% last September during President SBY's term, followed by another 20% increase in President Jokowi's term. However, due to a delay, President Jokowi has to ensure that the government will hike the fuel price sharply. If this is done, the fiscal deficit is expected to remain below 3% of GDP and the government can have the possibility to realize its ambitious infrastructure program.

Secondly, BI might have to hike interest rates to maintain the relative attractiveness of the Rupiah. If exports can't be increased, imports have to be decreased. Meanwhile, the Indonesian Rupiah has to remain strong so that it will not be too difficult to attract capital inflows into the country. For example, over the last twelve months, Brazil and India, the two other countries who are running current account deficits, have hiked their interest rates to 11% and 8 % as they hoped to decelerate import growth.

Investors' Expectations towards Indonesia

In Mr. Ichsan's perspective, foreign investors show concerns over several issues in Indonesia. First, they expect a smooth transition of power from President Yudhoyono to President Jokowi. Second, they look forward to a cabinet that is comprised of not only professionals, but also politicians from President Jokowi's challenger, Lieutenant General Subianto's camp, to ensure that President Jokowi's coalition controls more than 50% of the parliamentary seats. Third, the market wants to see the government hike fuel price sharply (done). By doing so, market believes the government will generate sufficient budget to build infrastructure projects that can create a strong foundation in the manufacturing and agricultural sector. Lastly, the market expects an increase in the BI rate by 25 to 50 basis points and a further hike in the interest rate in the second quarter of 2015.

Questions and Answers

Q: Aside from increasing the interest rate and cutting the fuel subsidy, how can Indonesia fundamentally grow its economy?

Fauzi Ichsan: At the end of the day, whatever economic strategy the government chooses to adapt, infrastructure projects are badly needed. Given the government's commitment to change the state budget, the only way to finance these projects is by cutting fuel subsidy. Indonesia is currently producing 8,000 to 10,000 barrels a day but consuming 1,5 million barrels a day. This means that on a net basis, the country imports 700,000 barrels a day

The price difference is subsidized by the government and funded by borrowing. This is completely a misallocation of resources. As a consequence, the government needs more money but it is impossible to increase its borrowing debt since there is a significant fiscal gap and a fiscal deficit of 3% GDP. Thus, the only way to cover it is by hiking fuel prices.

It is necessary for countries that are running a current account deficit, namely Brazil, India, Turkey and Indonesia, to increase their interest rate. The bigger the current account deficit, the higher the interest rate needs to be. Once the Indonesian government has more money, the government can build infrastructure projects, build geothermal power plants and modernize harbors, airports and rail system across Sumatra and Java.

Ndiamé Diop:

Like many other countries that are affected by the long period of commodity boom, Indonesia is currently in a transition period. The end of the commodity boom coincided exactly with what happened in 2011 when Kenya decided to reduce the energy and resource intensity to rebalance its growth towards consumption and services in order to stir up resource incented investment. Then, we saw prices went up. If we look at the global commodity market from 2009 to 2012, 80% of the increment was in demand for coal mining which resulted in policy shift towards less coal, less pollution and less energy and mining production.

Indonesia, as well many other countries, is now facing two challenges. The first one is to adjust to the trade shock since the commodity price gets much higher compared to other sectors. In the last 10 years, much investment went to the resources sector due to its relative price and confidence that you could make much more money investing in resources rather than if you invested in manufacturing sector. Now, these terms of trade are changing and completely reversing. Thus, the challenge is to manage the transition on current account deficit since export will decline significantly.

The second challenge is to change the growth strategy by being competitive and becoming a strong powerhouse which Indonesia had done in the past. Indonesia also needs to switch its growth strategy by investing in infrastructure and skills development so that it can gain competitiveness in the global economy, including the U.S. market.

Other short-term matters like the fuel subsidy will save tremendous amounts of money for Indonesia to invest in infrastructure. Hence, shifting the money from the fuel subsidy to other areas will give not only a bigger impact on economic growth, but also a better welfare, health and social assistance for its citizens.

Wijayanto Samirin: I think we need to move from traditional economic activities towards higher value-added economic activities. For instance, Samsung as a high tech company had sales of USD 220 billion last year. This clearly shows us that the future economy is going to be the high tech economy. Therefore, we have no options but to move towards that direction.

We should start by improving the quality of our state budget. Much of our money is now being misallocated. For instance, since 2012 Indonesia borrows money not only to pay its debt, but also to pay the interest of its debt. That is why moving from consumptive activity, like subsidizing fuel, to productive activity is necessary.

Besides that, it is important to improve the business environment in Indonesia. This way, we can encourage the private sector to have more investments because the government is not an expert in creating high-tech industries.

Currently, it is not an easy task to stimulate the business environment since there are a lot of policies designed without a proper public policy process. The government most of the time only tries to address the direct effect without taking into account that any public policy also has indirect impact.

Q: From the presentations, I understand that we are heading towards a global economic recovery. However, does that mean that the big economies like U.S. and China are going to be more egoistic in their approach? Can U.S. and China still cooperate to reduce the deficits? How can Indonesia transform its economy?

Ndiamé Diop: There is a great probability to see higher economic growth in Indonesia but the situation is relatively challenging because what we have seen over the last two years is an economic slowdown. I think the main challenges for Indonesia to grow fast depends a lot on the government's priorities and their implementation. In the last few years, there were actually many great initiatives created to boost growth in Indonesia, but they became ineffective in the implementation stage.

Indonesia needs to increase its economic growth, for example by sending good signals to investors and establishing a team to work on the government's reform program. At the same time, it is important too to realize that it takes time to rebalance the economy. If you spend significant amounts of money on infrastructure projects like the MRT, there will be a spending effect in the first year. The money will first be disbursed to contractors and turn into job creation. However, productivity effect and long-term growth can only happen after the MRT is built and operated within three or four years.

In the next five years, about 50 million people will enter the labor force and Indonesia needs to have such economic growth that can generate enough jobs to absorb this demand or otherwise there will be an employment issue. Indeed, implementing the right policies, generating growth and creating jobs are not an easy task.

Wijayanto Samirin: In my opinion, interest rates are not the main barrier to our economic growth, instead it is the conflict among policy makers which hindered them from developing good policies. I am very optimistic of the new government's ability to create good policies to recover Indonesia's economy. It was a positive start that President Jokowi appointed clean ministers in the cabinet. In the past, I experienced advising the government during the transition period and felt that often some ministers gave the impression of working for their personal interests more than the country's interests.

Although there was a delay in the ministerial appointments, we still have to appreciate President Jokowi's effort in involving the Corruption Eradication Commission to help select the right people. The new government doesn't seem to care to gain popularity, instead it cares to do the job well and take unpopular actions, for instance by cutting the fuel subsidy. Lastly, I think the global economy will be very dynamic, so we should respond to this with a flexible and innovative attitude.

Q: Why can't strong opposition in the parliament help economic growth?

Fauzi Ichsan: Many of the investors I talked with were worried about the ongoing situations in Indonesia which resulted in their hesitation in buying Indonesian government bonds, both in Rupiah and U.S. dollar. Many of the newly appointed leaders in the parliament are from the opposition party since the Red and White Coalition had successfully dominated the parliament.

The market has the perception that the opposition party will just oppose for the sake of opposing. Whether this is right or wrong, as a consequence, the Rupiah and equity market might tank. If the Rupiah continues to decline beyond 12,000 per U.S. dollar and the equity market continues to tank, corporate earnings and household spending will be hit. Of course opposition is necessary, but as far as investors are concerned, they just want to make sure that the government will have a majority in the parliament. Thus, the only thing that can recover this situation is a reconciliation between President Jokowi and Prabowo, the opposition leader.

Wijayanto Samirin: What's happening in the government right now is a bipartisanship situation, not between two political parties, but between two coalitions of party. Indonesian politic is very dynamic and unpredictable, but I believe Indonesians are great consensus makers. No matter how tough the conflict is, Indonesians can come together to create a resolution. In the past, there was no real competitions in the parliament since President Yudhoyono's party had always been the majority. However now, I think it is actually a good opportunity for us to learn about real democracy.

Q: Since Indonesia is a resource-based economy and does not produce high tech goods, how can it attract more investors from the U.S.? Moreover, with the impending hike of the U.S. interest rate, there is a likelihood of massive capital outflow in the second quarter of 2015. How should Indonesia respond to this?

Ndiamé Diop: Capital outflows, as a result of the U.S. interest rate increase, can be tempered if Indonesia manages to further boost its incoming FDI. We know that the money invested in real sectors in Indonesia, or FDI, has been very strong. Investors show great interest investing in Indonesia as they see a lot of potential. For Indonesia, FDI can bring a very good externality, in terms of technological development, management, and job creation.

Therefore, I don't think we should be afraid of what will happen when the U.S. starts increasing its interest rate. In fact, many countries that are facing a decline in trade like Indonesia are not really concerned about the potential increase of the U.S. interest rate because they have long-term FDI capital coming in to compensate it. The external balance today is still relatively vulnerable and if the FDI is increased, it should at least covers the current account deficit. The only constraint today is Indonesia's legal uncertainties which can lessen the investor's confidence on their return on investment.

Wijayanto Samirin: In theory, there are three types of FDI: natural resources seeker, market seeker and efficiency seeker. Unfortunately, it is indeed true that a lot of FDI flows to Indonesia in the natural resources sector which actually doesn't really create jobs for Indonesians. In contrast, investing in the manufacturing sector creates jobs but it also brings trade deficits at the same time since many of the companies import raw materials and half-finished products from abroad. Thus, we need to make tough choices and give more incentives for those who come to Indonesia for efficiency reasons. Sadly, our current environment does not support high tech companies to invest in Indonesia.

Now let's talk about the problem in human capital. I heard this story from Mr. Diop who asked a question to one of the senior officers in Toyota Japan. Mr. Diop asked the officer why he did not redevelop a new car under the Toyota brand in Indonesia and his answer was because he could not find enough capable design engineers in Indonesia.

Q: What if President Jokowi decided not to increase fuel price by this November or December? Would the Rupiah depreciate rapidly against the U.S. dollar? Also, is it true that the Chinese central bank is going to increase its interest rate by next year? How will that impact Indonesia's economy?

Fauzi Ichsan: The market does expect the fuel price to increase in November. If the global oil price continues to fall below USD 70 per barrel, then there is very little need to hike the fuel price. However, we are only saved by the bell if the price remains the same for two to three years. If not, market would question the government's commitment since the government had initially expressed its motivation to raise the fuel price.

Wijayanto Samirin: I don't think the government has other options but to raise the fuel price because the current budget we have might not be powerful enough to create prosperity. It is indeed the priority of President Jokowi and Vice President Jusuf Kalla to cut fuel subsidy. By the end of November, the volume of subsidized fuel will run out. Hence, the earlier the government raises fuel price, the lower the price increase needed. However, even if the global fuel price drops, Indonesia still should not take a risk by putting its economy at the hand of the dynamic oil price. It is important to educate the public gradually that the fuel price can go up and down. Fortunately, I heard that the government would like to move from a fixed fuel price to a fixed fuel subsidy, so the price can go up and down. As for the second question, I doubt the Chinese central bank will increase Chinese interest rates.