Indonesia's Brush with Currency Turmoil

Summary:

- *Comments about the nation's rapidly dwindling reserves sparked off IDR's fall to a four-year low at the end of Aug.*
- *The reserves, though by no means insufficient, had fallen by a worrying $6bn in five months.*
- *The reasons for the decline include central bank intervention to stem the fall and Pertamina's USD-buying for oil imports amid soaring global oil prices.*
- *Remedial govt action such as raising interest rates has so far managed to reverse IDR's fall.*
- *Longer-term, the cutting back of fuel subsidies and raising domestic fuel prices will likely relieve the pressure on IDR.*

The rupiah fell to its lowest level in four years on Aug 30 with USD/IDR touching 11,800. This triggered anxiety and questions over whether we are seeing a repeat of the Asian crisis. Although sanity seems to have returned to the market with USD/IDR now at about the 10,200 level, some questions remain. We examine the reasons for the sharp fall in the IDR to assess if it was a result of an over-reaction on the part of jittery investors or a justified response to shifting fundamentals in the country.

The Trigger

The IDR's rapid fall began on Aug 12 when Finance Minister Jusuf Anwar stated that the country's foreign reserves were being used to fund oil purchases and had fallen to an "alarming level". That comment, which overstated the economic impact of the domestic fuel subsidy, was a political move calculated at gaining public acceptance for another round of fuel price hikes after the 29% increase in March this year. Unfortunately, it also focused attention on the speed at which the nation's reserves were being depleted.

Indonesia's foreign reserves have fallen by more than $6bn in five months since its peak in mid-April when the government issued US$1bn of bonds. The IDR has fallen as much as 17% against the USD since the start of the year. The exchange rate had continued to weaken, despite sizeable FX interventions and higher interest rates. Although Indonesia's exchange rate is ostensibly a free float and typically classified as one of the most flexible in the region, the IDR's rapid fall prompted Bank Indonesia to manage it closely, making it look more like a managed float.

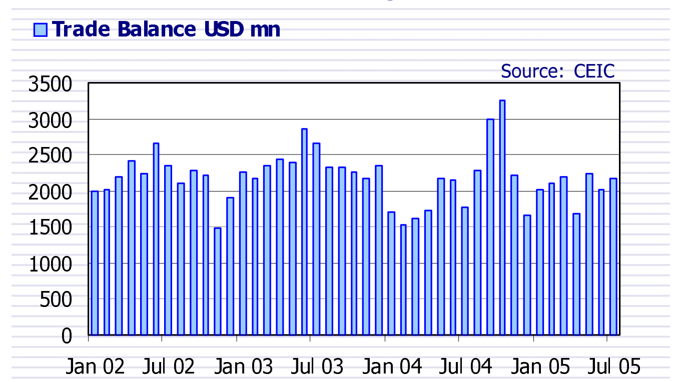
The $6 Billion Question

The central bank's intervention in the market can be seen by the rapid fall in the reserves. To be sure, Indonesia's foreign reserve of $30 bn is adequate. It covers about 6 months of imports and short-term government debt twice. But the stock of reserves is limited and intervention of such a large magnitude to support the currency is unsustainable unless the pressure on the exchange rate is temporary.

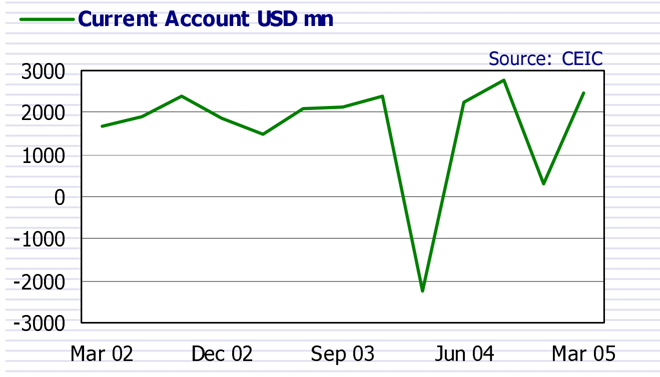
Net debt repayments by the government and central bank amounted to about US$125m a month; hence debt repayments alone cannot explain the decline in the FX reserves. A closer look at the trade data suggests that the current account was not likely to have contributed to the depletion in the reserves. The balance of payments is healthy with the current account in surplus and export growth gaining strength (17% y/y in July). Instead, the capital account may have been the culprit. Steady capital outflow since the beginning of the year in

Reserves Fall as IDR Takes a Tumble

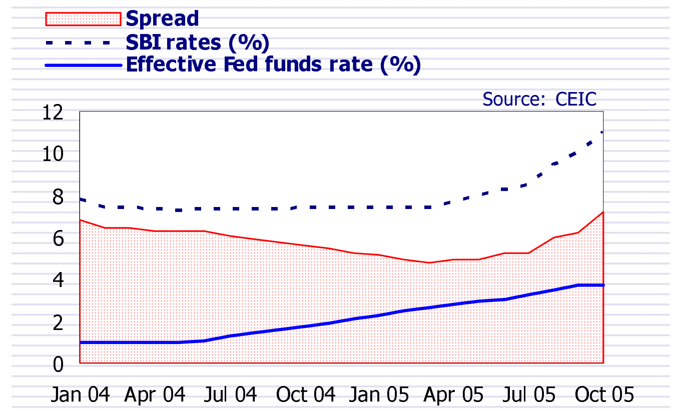
External Position Looks Healthy



External Position Looks Healthy



Narrowing Spread



excess of US$1bn likely contributed to the drop in reserves.

State-owned oil company Pertamina's buying of USD for the purchase of fuel when oil was near US$70 bbl also put pressure on the IDR. In order to prevent Pertamina's purchases from roiling the rupiah further, the government arranged in July to supply the company's dollar needs from its own account with the central bank. As oil price stayed at record-high levels and oil consumption showed no signs of a retreat since domestic fuel prices are kept artificially low (about 40% below market price), Pertamina's USD needs created further pressure on the IDR. There was also talk in the market that the government arrangement with Pertamina was not actually working out (the government later refuted those claims) and reports that it needed $1.5-$1.8bn a month for its oil import needs. This would partly explain the rapid drop in reserves.

Despite central bank intervention, the IDR continued to weaken. Coupled with jitters over the country's declining forex reserves, this triggered a mini crisis of confidence, which in turn weakened the IDR further, resulting in a vicious circle.

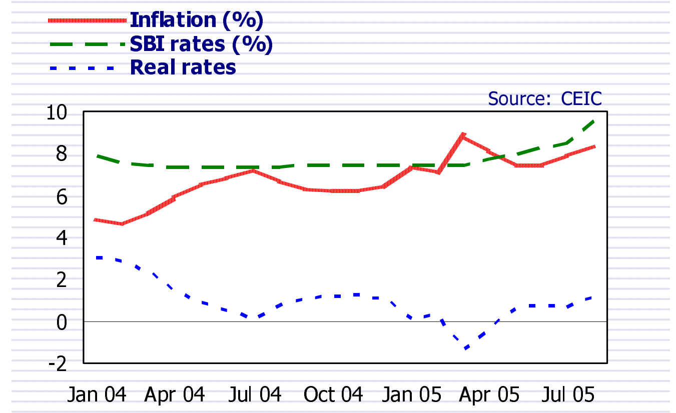
Government Action

Only after BI raised rates a second time in a week did the IDR's precipitous slide halt. The government action so far seems to have stopped IDR's fall and the drop in reserves has also slowed. Latest BI data showed that reserves actually rose by $171m in the third week of Sept to $30.41 bn from a drop of $911m in the second week of Sept.

Indonesian Government's Remedial Actions Included:

(1) Raising interest rates aggressively. BI raised benchmark SBI rate by 75 bps to 9.5% on Aug 30 and again by 50 bps to 10% on Sept 6. With the US Fed's tightening, the spread between Fed Funds rate and Indon interest rates has narrowed. Investors holding on to IDR needed to see increased rates of return in order to hold on to IDR. The interest rate differential before Fed started its latest round of tightening in mid-Aug was about 7%. In addition, with inflation creeping up, real rates need to keep up. To this end, BI once again raised 1-mth SBI rates by 100 bps to 11% on Oct 4.

Real Rates on a Downtrend



(2) Hiking demand deposit interest rate from 3% to 5.5%.

(3) The government is also planning another US$1 bn bond issue this year, despite saying earlier in the year that it was not raising any more debt this year after the April issue.

(4) It has also boosted liquidity support from international agencies, such as doubling its bilateral swap deals with Japan to $6bn, in addition to the Chiang Mai Initiative, which gives Indonesia room to tap up to USD$5 bn of short-term liquidity in currency swaps. On Sept 3, BI, National Bank of Cambodia, Monetary Authority of Singapore and Bank of Thailand also jointly signed an agreement to increase the amount of the ASEAN Swap Arrangement from US$1bn to US$2bn.

(5) The govt has made a decision to hike fuel prices by an average of 126% on Oct 1 for a second time this year. It has tried to prepare the ground for domestic fuel price hikes by disbursing payouts to 15.5m lower income families (translating to 62m people or about a quarter of the population) with each family getting IDR 300,000 per mth for 3 months. The government has allocated IDR 4.8 trillion in aid for the poor from Oct-Dec. The aid package is expected to rise to IDR 25tr in 2006.

Bank Indonesia's Measures to Restore Calm to IDR

30 August 2005

1. Raise BI rate by 75 bps to 9.5%, effective Aug 30
2. Raise 7-day FASBI rate by 100 bps to 8.5%, effective Aug 31
3. Maximum absorption of liquidity through fine-tuning operations, using variable rate tenders
4. Raise maximum deposit guarantee rates for Sept 2005:
   a) 1-mth rupiah deposits: to BI Rate + 50 bps
   b) Foreign currency deposits: from 3% to 4.25%.
5. Raise the Rupiah Statutory Reserve Requirement, with effect from Sept 6, 2005:

LDR	% increase
> 90%	0
75-90%	1
60-75%	2
50-60%	3
40-50%	4
< 40%	5

6. For all additional funds held in Rupiah Statutory Reserves above 5%, raise the demand deposit interest rate from 3% to 5.5%.

06 September 2005

1. Raise BI rate by 50 basis points to 10.0%.
2. Institute the following exchange rate policies:
   i. Ban on rupiah margin trading against all foreign currencies, effective Sept 15, 2005.
   ii. Launching of foreign currency swap interventions as an instrument in Open Market Operations with 1-7 day tenor, effective Sept 15, 2005.
   iii. Provision of swap facilities to enable investors to take out currency risk hedging for terms of 3-6 months extendable, effective Oct 1, 2005.
   iv. Amendments to the Net Open Position (NOP) regulations, effective Oct 1, 2005, as follows:
      a) Revoke the provisions concerning the requirement to maintain NOP between foreign currencies.
      b) Require banks to maintain the NOP at all times throughout the day.
      c) Impose financial and administrative penalties for violation of the NOP provisions.

Source: BI

Maintaining Our Positive Medium-Term Outlook

We maintain our optimism in the country's medium-term outlook given that Indonesia is endowed with abundant natural resources, which can be exploited. What is needed is for the government to devise a strategy to reduce the costs involved in encashing these resources. To this end, the government's decision to cut fuel subsidies further is laudable.

Much as fuel price hike is a political minefield that has caused the fall of previous administrations, the SBY government's bold decision to go beyond an increase of 50% (as previously suggested) shows its resolve in capping fiscal spending on the much-criticised fuel subsidy programme. Fuel price subsidies cost the govt $7.4b (or 3% of GDP) in 2004 and the decision to raise fuel prices will cap 2005 total budget outlay for subsidies at $8.7bn.

We reiterate our view that the fuel price hike is necessary for Indonesia's economic development. It will force more efficient use of energy, especially by industries - a sorely-needed move in the face of rising global oil prices. It will also cut down on illegal arbitrage opportunities. Moreover, cutting down spending on fuel subsidies will enable the government to put the budget to more productive uses, such as on infrastructure spending.

There will no doubt be short-term pain by way of higher prices, which will hurt consumers, as well as uncertainty with regards to how Indonesians take to the measures and whether protests get out of hand. But longer-term, the IDR will come under renewed pressure if no hike had been forthcoming. Not only would it have shown a lack of resolve and indecisiveness on the part of President Susilo Bambang Yudhoyono (SBY), undermining the goodwill the government has built up so far in the eyes of investors, the need to supply cheap fuel would also have continued to weigh on IDR as Pertamina would have had to continue USD-buying for oil imports.

However, execution risks remain. The key now will be in the implementation of the aid package to ensure that the money is indeed disbursed to the poor in a timely manner and protests

are kept under control. Other risks to our positive view in the near-term include: 1) if the FDI commitments fail to translate into actual FDI flows; and 2) if oil price makes another attempt to scale new heights.