

“US Slowdown and the Implications for Indonesia”

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Introductory remarks by Mr. Gene Galbraith, President Commissioner PT Bank Central Asia (BCA):

Mr. Galbraith noted that the financial media reported that the risks of a protracted recession in US have not diminished in recent weeks despite the rally in the stock market and improvements on some credit marks. The U.S. economy is expected to receive a significant but temporary boost from tax rebates. The question will be, what happens after the stimulus fades? If financial markets continue to improve, if consumers remain resilient, and if the decline in house prices begins to moderate, the US Federal Reserve bank would be prepared to return to a tightening mode. But if the economy continues to decline after the distribution of tax rebates and house prices continue to decline, the Fed could resume cutting interest rates later this year. However, the information required by the Fed to take further action will probably not be available until the autumn.

Presentation by Dr. William Wallace:

The bubble in U.S. housing prices has triggered problems in the financial markets which have spread into the housing market more broadly. These problems have depressed demand in the US and have spread to other global markets. The Indonesian economy has remained strong but is threatened by some serious weaknesses.

US home mortgage delinquencies began in an

obscure corner of American finance which provided mortgages for people with poor credit. Although initially stable, bit by bit those mortgages started to default. The securitization of those mortgages further compounded the problem by obscuring the magnitude of the liabilities. This uncertainty spread to other credit markets and liquidity dried up.

The U.S. credit crunch eventually depressed Wall Street stock markets and some international equity markets. The markets of emerging economies initially withstood the negative effects of the U.S. credit markets, but eventually also declined..

An interesting question is the effect of U.S. credit problems on growth rates in the developing world. Current data indicate that overall growth rates in the emerging countries are steady or increasing, while the trend in the developed countries is actually flatter and turning down. In 2007 growth rates in East Asia were rising whereas U.S. rates slowed during that year.

In Indonesia: the economy remains solid, after enjoying strong growth in 2007. Debt levels have declined, balance of payments is in surplus and reserves are growing.. On the negative side inflation is high and increasing, energy subsidies burden the government’s budget and financing is a real concern.

- Growth rate in 2007 was 6.3%, highest since 1997 crisis.

- Indonesia's growth is supported by higher commodity prices (coal, palm oil and mining).
- Indonesia is becoming less dependent on the U.S.
- Reserves are growing very rapidly; as of mid-April were about USD 56 billion
- Exports are at record high
- Commercial banks' financial ratios are good

On the downside:

- Inflation rates are high.
- Energy subsidies remain a problem.
- Debt costs are increasing.
- Bond spreads have moved higher.

Conclusions:

- Higher food prices create inflation and social insecurity, exerting pressure on government spending
- High subsidies for domestic fuel prices burden the budget and have created uncertainty over how the government will respond
- High Government borrowing amidst uncertainty especially related to the level of subsidies complicates government financing.

2007 was a good year for Indonesia, and 2008 is promising: exports were up 28%; capital goods imports (indicator of investment) were up an amazing 69%; and motorcycle sales are up 35% in the first quarter of 2008. With a commodities-based economy, Indonesia is likely to avoid the ill effects that might occur with declines in the exports of manufactured items.

Question and Answer Session

Q: An Indonesian banker has made calculations on nominal GDP from 2004-2007. The nominal increase in each case is greater than inflation (taken from BPS) + real economic growth. Do you think that is possible?

A: It is certainly possible.

Q: Is it meaningful to calculate the reserves in Euros rather than in US\$?

A: These reserves are actually in yen, euros and dollars but they are turned into dollars. Some of the growth may actually come from euros. The problem is that the Rupiah is too closely tied to the dollar so the Rupiah does not float freely enough to find its own equilibrium.

Q: How do you assess the decoupling between US and Indonesian economies? Which of the US Presidential candidates -- Clinton, Obama, McCain -- do you think can quicken the recovery of the US economy?

A: Generally speaking, emerging Asian countries will have different relationships but for example if U.S. growth were to fall from 2% to 0%, an average country in East Asia will lose 1% off its growth rate. Overall, Asia will be a bit of a firebreak on this kind of global contagion. And within Asia, Indonesia will be a bit of a firebreak.. As for this second question, it is really hard to tell. None of these candidates is creating a sense of confidence about economic recovery.

Q: Bush said that he wants to depend on domestic energy resources. Can that policy quicken US economic recovery?

A: U.S. officials are trying to figure out what to do on energy policy. But any energy policy can take decades to implement, not months. I do not think ending the war will solve the problem, although I am not fond of the war.

Q: In the short-term, more people are falling below the poverty line, and they won't be able to buy food. Is the government doing anything about this?

A: The first step was to cut all import taxes and the VAT. The government's next step was to increase the raskin (beras miskin---rice for the poor) from 10 to 15 kg and to provide cooking

oil. The major program is a cash transfer to be put in place by June. The government is providing Rp.100,000 per poor household, per month to 90 million households. If the system runs well, the bottom 30% of the population will receive assistance.

Q: Will the year 2008 be tougher than 2007?

A: Almost certainly. Growth would be down to 5.5 – 6%. Inflation would be up to about 11% or so.

Q: Will the US economic slowdown increase investment by the US in Indonesia?

A: US investors will be less aggressive and will likely reduce international investment, including in Indonesia. The interesting thing right now is the divergence between the growth story and the commodity price story. Indonesia is winner because of the high commodity prices. Indonesia would attract greater foreign investment levels if its fiscal policies were on a stronger footing and subsidies were reduced.