Balance of payments:

More deficits, less fuss

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23 August 2023

Executive Summary

- Indonesia recorded a USD 6.89 Bn balance of payments deficit in Q2 2023, driven by deficits in both the financial account (USD 4.97 Bn) and the current account (USD 1.9 Bn).
- The deficit in the financial account is attributed to payments on maturing bonds, while the weakening demand for Indonesian assets is more of a product of worsening global sentiment rather than Indonesia's deteriorating fundamentals.
- The decline in exports relative to imports explains the reversal in the CA balance. The CA deficit trend may continue for some time, given the supply shock concerns that mainly impact Indonesian imports rather than exports.

- We have been speculating for a while that Indonesia has not cemented its status as a net capital exporting country despite improvements in recent periods. The Q2 2023 balance of payment data validates this argument. Indonesia recorded a USD 6.89 Bn (1.91% of GDP) BoP deficit in the previous quarter, marking the deepest BoP deficit since the -USD 8.54 Bn recorded in early 2020.

- The decline in the BoP number was driven by the reversal in both the current and financial accounts ***(see Chart 1)***. Given the nominal value, the USD 4.97 Bn in financial account deficit recorded in Q2 2023 seems particularly striking. The sharp decline in the financial account is due to several factors. The first factor is well recorded in the external debt data and Bank Indonesia's financing survey: the growing conservativeness of Indonesia's public and private sectors. **Ample liquidity within the domestic private sector allows the private sector to reduce its exposure to risky external debt, opting instead for safer financing options such as retained earnings or credit facilities from domestic banks** – explaining the USD 1.99 Bn reduction in the 'other investments liabilities' account of the private sector. Record-high liquidity in the public sector also allowed the government to follow a similar strategy, which saw the USD 358 Mn reduction of public sector liabilities in the same account.

- The public sector's deleveraging strategy is not the government's only action that explains the USD 5.60 Bn deficit in the 'other investments' account. The anticipation of the strengthened export earnings (DHE) policy may spur an increase in purchases of foreign assets by private businesses, as indicated by the USD 891 Mn increase in deficits on the asset side of the 'other investments' account. This situation might be a one-off, as greater clarity over the mechanism and instruments used to implement the DHE policy may reduce the incentive to circumvent the regulation.

- The surplus-to-deficit reversal in the financial account was also noticeable for the portfolio investments account. However, **pointing to the USD 2.59 Bn deficit in portfolio investments account as a sign of weakening demand for Indonesian assets and a subsequent deterioration in Indonesia's macroeconomic fundamentals may lead us to a red herring.** A factor that significantly contributed to the deficit in the portfolio investment account was a USD 2.26 Bn deficit recorded in the private sector's bond market liabilities, owing to several corporate bonds that matured in Q2 2023. Indonesia's less-vibrant corporate bond market limits investors to re-enter the market, especially given businesses' declining appetite for external debt.

- Another significant contributing factor is the sharp decline in the public sector's bond market liabilities. Foreign inflows to Indonesia's sovereign bond market may appear to be stagnated in Q2 2023, especially compared to the heyday of the previous quarter ***(see Panel 2).*** However, we should recall the dominance of the Fed pivot expectation in Q1 2023, which drove the demand for risky assets such as the Indonesian government's IOUs. Now, the 'Fed pivot' expectation is swapping places with the 'soft landing' optimism, leading to an increase in the USD's value while China's anaemic growth potential worsens the sentiment on the Asian market.

> ***"Foreign investors' weakening demand for Indonesian assets reflects the worsening global condition rather than Indonesia's deteriorating fundamentals"***

- Despite this double salvo of growing optimism in the US and weakening sentiments in Asian markets, the Indonesian financial market appears to be faring better than its Asian counterpart. This development, we should note, highlights the hitherto robust condition of Indonesia's macroeconomic fundamentals. Hence, while the slowing demand for Indonesian assets cannot be mistaken, such a drop in demand for Indonesian assets appears to be more consistent with the increasingly unfavourable external condition rather than growing cancer in Indonesia's fundamentals. Given this assumption, **we saw no reason for BI to announce a major change in its prevailing monetary stance on the back of the widening BoP deficits**, although less-committal interventions such as open market operations might be necessary to stabilise the IDR's value in the upcoming periods.

- Meanwhile, Indonesia continues to record a surplus in its direct investments account, amounting to USD 3.31 Bn in Q2 2023 compared to USD 3.86 Bn in the previous quarter. The direct investments account's flattish trend stands in contrast to

Indonesia's skyrocketing headline FDI data, signifying many methods in declaring and counting the FDI number. The surplus trend in Indonesia's direct investment account seems to be structural in nature, although rumours of a moratorium for RKEF nickel smelters could potentially impact the direct investments account in the future.

- We move to address the other side of the balance of payments data: the current account, which recorded a USD 1.93 Bn deficit in Q2 2023. The reversal in the CA account balance after seven quarters of the surplus is due to many factors, including the widening deficit in the primary income account ***(see Panel 1)***. The USD 9.15 Bn deficit in the primary income account was propelled by an increase in dividend payments, primarily stemming from dividend payments on direct investments – an increasingly structural trend given the increasing population of foreign-backed businesses in Indonesia.

- The expanding deficit in the primary account, however, is mainly propelled by the surge in dividend payments related to portfolio investments (-USD 1.29 Bn in Q2 2023, -USD 911 Mn previously), a consequence of the sharp increase in corporate revenues in the preceding year. This deficit trend may persist in the upcoming quarter, given the ongoing dividend cycle that extends into Q3 2023. Fortunately, this trend might not be as structural as it is with direct investments, considering the mercurial revenue patterns in some commodity-producing corporate sectors.

- The services account, as always, did not provide much fighting chance to keep the CA balance on a surplus either. The service account recorded a deficit of USD 4.65 Bn in Q3 2023, continuing the trend from previous quarters. However, a further scrutinisation of the service account reveals a shift towards a more consumptive pattern. Indeed, external payments for more productive accounts, such as IT and other business services, appear to have decreased in Q2 2023.

- The reduction in expenditures on IT and other services was offset by a notable increase in the travel account, which despite the continued recovery in the domestic tourism industry, is overshadowed by an influx of Indonesians travelling abroad. The increase in tourism imports strengthened the argument for a weaker IDR, although the increase may be seasonal given the hajj season that falls in Q2 2023.

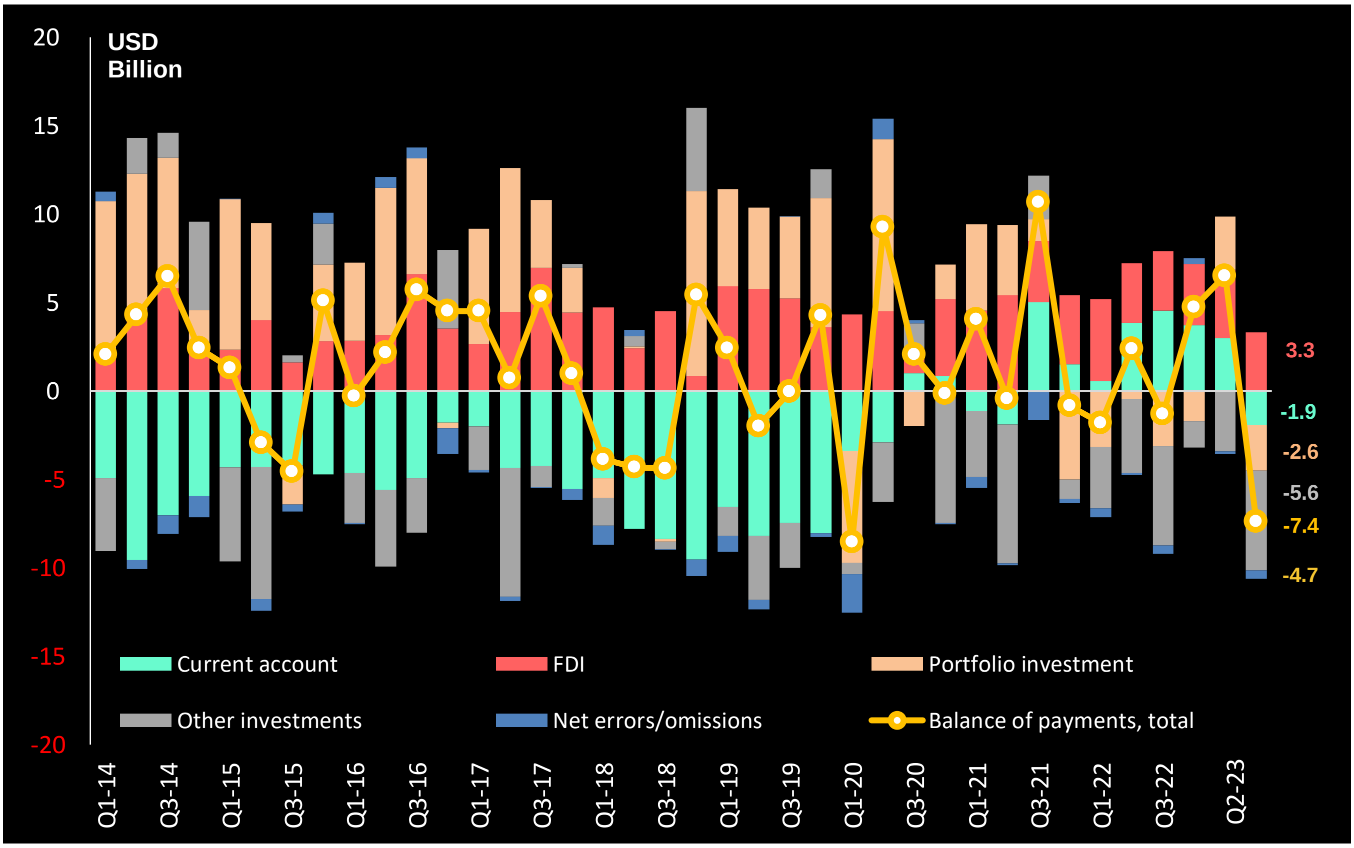
"The expected widening CA deficit highlights Indonesia's growth potential in 2023"

- The determining factor behind the USD 1.93 Bn in the CA balance, however, is the USD 4.4 Bn decline in the goods account. What caused the sharp decrease in the CA account is hardly surprising: commodity prices are weakening throughout 2023, while the still-robust domestic aggregate demand level only leads to a negligible decline in imports ***(see Panel 1)***. Indonesia's goods account may continue to put the CA on a deficit in the upcoming quarters, considering the global supply shock concern that mainly benefits commodities that Indonesians import (fuel, grain) while the unfavourable situation in China may suppress the demand for Indonesia's mainstay export commodities.

- However, much like the FA, the deficit in the CA account should not invite much fuss. **The current account deficit illustrates Indonesia's continued appetite for expansion, despite the darkening global situation.** This theory is further strengthened by the recent dynamic in the domestic banking sector, where demand for loans (7.8% YoY in June 2023) continues to exceed the growth in deposits (4.7% YoY in June 2023).

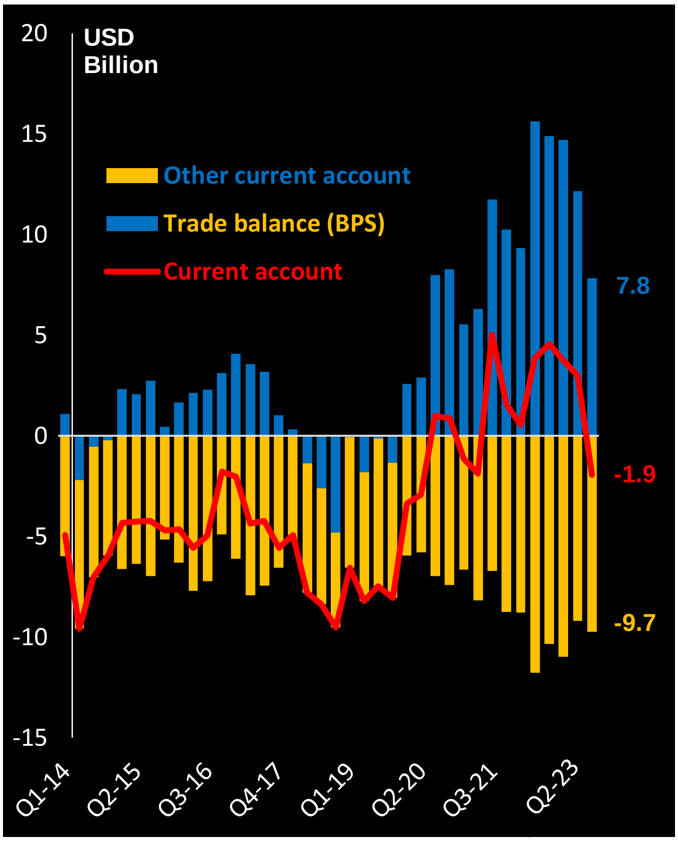
- The assumption for a continued CA deficit in the upcoming periods amid the expectation of still-high imports relative to the normalising export explains the improvement in our assessment regarding the growth potential of the Indonesian economy in 2023. Continued growth in imports of capital goods strengthened this argument, which is also aligned with our observation of continued CAPEX growth in the domestic corporate sector. However, we also observed a recent surge in imports of consumer goods over the past three months, meaning that the widening CA deficit may not exclusively serve productive ends. However, regardless of the consumptive or productive approach taken, the anticipated widening in the CA deficit highlights the driving force of growth within the Indonesian economy, which adds to our expectation of 5.1-5.2% GDP growth in 2023.

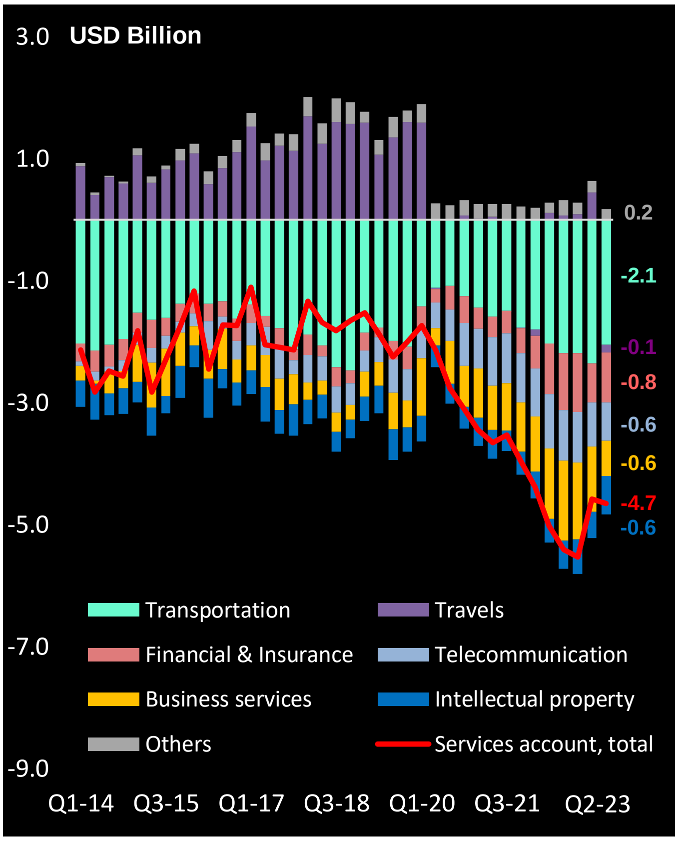
***Chart 1.* The reversal in current and financial accounts explains the sharp decline in the BoP number, which falls into its deepest deficits since Q1 2020**



Source: Bank Indonesia

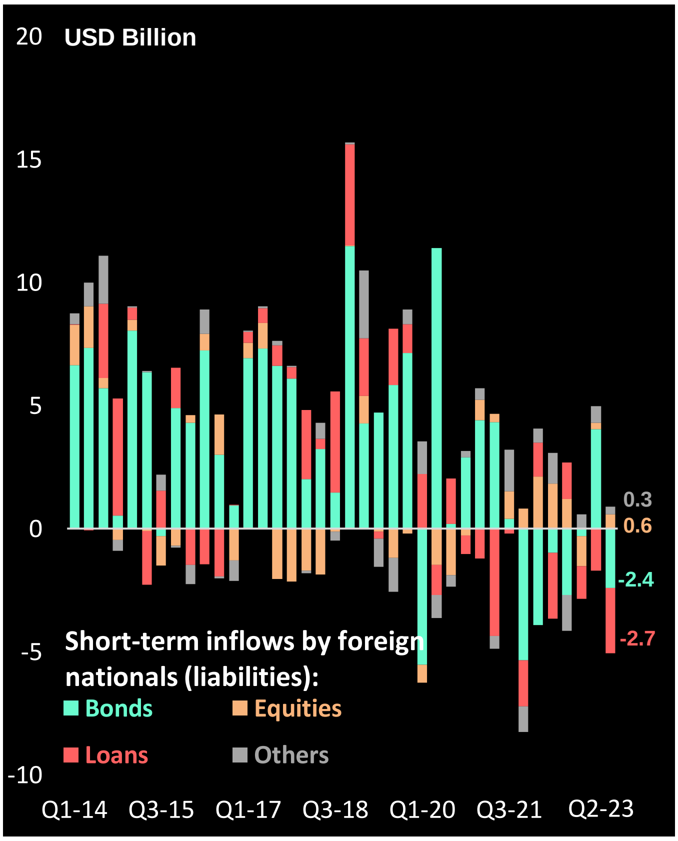
Panel 1. Declining trade surplus due to still-high imports relative to the normalising export may continue to pose a challenge for the current account

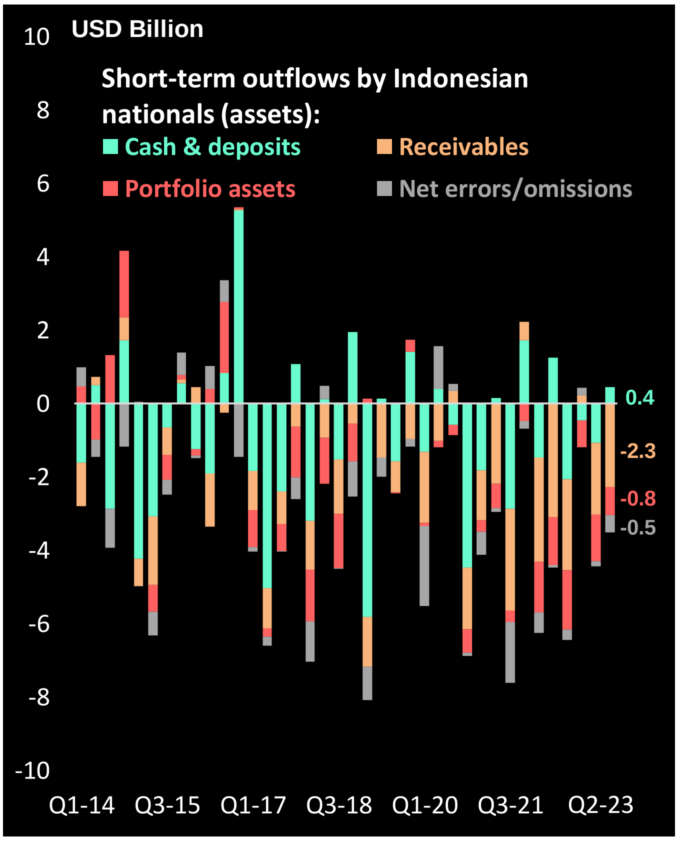




Source: Bank Indonesia, BPS

Panel 2. In contrast to the pivot expectation in Q1 2023, the soft landing optimism weakens foreign investors' appetite for Indonesian assets





Source: Bank Indonesia

Selected Macroeconomic Indicators

Table 1. Balance of payments (current USD Million)

	Q2-22	Q3-22	Q4-22	Q1-23	Q2-23	2020	2021	2022
CURRENT ACCOUNT	***3,849***	***4,547***	***3,723***	***2,982***	***-1,933***	***-4,433***	***3,511***	***12,670***
(as % of GDP)	***1.34***	***1.13***	***0.96***	***0.90***	***-0.55***	***-0.42***	***0.30***	***0.96***
A. Goods	16,797	17,623	16,951	14,701	10,352	28,301	43,806	62,672
- Non-Oil/Gas	24,445	25,160	22,958	19,013	15,164	29,954	57,804	89,773
- Oil/Gas	-7,187	-6,481	-5,415	-3,976	-4,327	-5,386	-12,965	-24,777
B. Services	-5,021	-5,408	-5,532	-4,581	-4,655	-9,755	-14,599	-20,337
C. Income	-9,450	-9,077	-9,628	-8,608	-9,146	-28,911	-31,961	-36,023
D. Current Transfers	1,523	1,410	1,931	1,469	1,515	5,932	6,264	6,358
CAPITAL TRANSACTIONS	**3.04**	**2.43**	**445.10**	**1.46**	**4.86**	**36.91**	**80.15**	**451.44**
FINANCIAL TRANSACTIONS	**-1,332**	**-5,379**	**240**	**3,684**	**-4,969**	**7,884**	**12,492**	**-8,325**
A. Direct Investment	3,386	3,346	3,451	3,861	3,309	14,142	17,286	14,816
B. Portfolio Investment	-449	-3,121	-1,717	3,030	-2,587	3,369	5,086	-8,469
C. Derivative Instruments	-86.05	8.55	-10.90	204.92	-83.16	17.73	332.71	48.36
D. Other Investment	-4,182	-5,613	-1,483	-3,412	-5,609	-9,645	-10,212	-14,721
NET ERRORS AND OMISSIONS	**-130.42**	**-473.78**	**322.08**	**-149.91**	**-474.50**	**-891.30**	**-2,622.30**	**-796.78**
BALANCE OF PAYMENT *(= change in BI international reserves)*	**2,389**	**-1,304**	**4,730**	**6,517**	**-7,372**	**2,597**	**13,461**	**3,999**

Source: Bank Indonesia

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Indonesia – Economic Indicators Projection

	2018	2019	2020	2021	2022	2023E
Gross Domestic Product (% YoY)	5.2	5.0	-2.1	3.7	5.3	5.2
GDP per Capita (US$)	3927	4175	3912	4350	4784	5285
Consumer Price Index Inflation (% YoY)	3.1	2.7	1.7	1.9	5.5	2.7
BI 7 day Repo Rate (%)	6.00	5.00	3.75	3.50	5.50	5.75
USD/IDR Exchange Rate (end of year)**	14,390	13,866	14,050	14,262	15,568	15,173
Trade Balance (US$ billion)	-8.5	-3.2	21.7	35.3	54.5	35.3
Current Account Balance (% GDP)	-3.0	-2.7	-0.4	0.3	1.0	-0.7

** Estimation of Rupiah's fundamental exchange rate

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