

Shared Learnings: Indonesia's and Australia's Current Account Balances

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Indonesia is currently experiencing its most sustained stretch of current account deficits (CADs) since the Asian Financial Crisis. This fact has generated much discussion within policy circles.

Yet CADs are not inherently harmful – Australia has sustained CADs for much of the past 150 years with little harm to the economy. As in Australia, Indonesia's CAD is structural in nature. This reflects the fundamental features of the Indonesian economy, such as a relative abundance of investment opportunities. As such, short-term, 'tactical' policies designed to counter the CAD may inadvertently generate long-term distortions. Where they increase the risk of investing in Indonesia, they may even reduce the stability of the external position.

This paper highlights how, through a long process of reforms, Australia has improved the stability of its external position while also running a persistent CAD. Indonesia can also continue to promote stability and economic growth more broadly through further structural reforms that would liberate it from short-term management of its CAD.

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Introduction

Indonesia is experiencing its most sustained stretch of current account deficits (CADs) since the Asian Financial Crisis, with twelve consecutive quarters of deficits. Even so, this series of deficits is relatively brief compared to its stretch of CADs before the crisis. Since then Indonesia has undertaken significant reforms aimed to mitigate some of the vulnerabilities that affected it so severely in the Asian Financial Crisis. Those reforms likely contributed to its comparatively robust performance during the Global Financial Crisis.

Australia, by comparison, has run a CAD for the majority of the statistical record, weathering both the Asian and Global Financial Crises without significant capital flight or serious impediments to real economic performance. The perception of Australia's CAD has changed over this time. Australia's current account position in recent decades was not a significant concern, due to the move away from a fixed exchange rate and a trade deficit that was unmatched by capital inflows. Empirical experience suggested that under a fixed exchange rate regime with limited capital mobility, large and persistent CADs were unsustainable, and left the economy vulnerable to changes in market perceptions of risk.

During the 1980s, various arms of macroeconomic policy in Australia were partly targeted toward managing the CAD, under the assumption that foreign borrowings were unsustainable. These policies ultimately proved to be an inefficient means of managing the economy. After the floating of the dollar, academics such as Makin (1988), Pitchford (1989) and Corden (1991) challenged the view that Australia's persistent CAD was 'unsustainable'. Instead, they argued that the CAD was a result of optimal consumption and investment decisions made by 'consenting adults'.

In considering Indonesia's current account position, Indonesia's policymakers today face many of the same concerns that Australian policymakers faced in the 1980s. The continued normalisation of global monetary policy is likely to see markets re-evaluate Indonesia's external position. At worst, a possible consequence of this normalisation would be a sharp reversal of capital flows. The Indonesian government recently demonstrated its commitment to managing currency stability during periods of volatility, at least in the short run.

This paper, posits that a CAD itself is not necessarily 'bad'; rather it is the fundamental factors that drive a CAD that determine whether or not it is a 'sustainable' position for a country. Moreover, considerations of the stability of the external position are more relevant to Indonesian policymakers than notions of sustainability. The paper begins by outlining some key concepts characterising the CAD, followed by a description of the makeup of Indonesia's recent stretch of CADs. It then examines the drivers of the stability of the external position – especially its financing – and the relevance to Indonesia.

Maintaining stability is a function of managing perceptions of the riskiness of investing in a country. Frictions between theoretically stable long-run CADs and the realities of perceptions about Indonesia's CAD mean that there is a short-term role for mitigating risks to stability. It is widely acknowledged however that such measures have a limited effective lifetime and come at a direct cost to economic growth.

Indonesia's and Australia's current account positions are viewed differently by markets today (and indeed there is ample research on the vulnerability of emerging market economies running CADs to volatility). It is not the purpose of this paper to outline a series of 'tactical', short-run responses to threats to the stability of Indonesia's CAD, and indeed, Indonesia has been proactive in managing the risks to the stability of its external position brought about by recent global monetary policy changes. In this paper, lessons are drawn from Australia's experience in running prolonged CADs, while

maintaining high investment flows – an experience that highlights the importance of a commitment to long-term reforms, as a way of promoting the stability of the external position over a long horizon. In this vein a series of policy recommendations for Indonesia are outlined towards the end of the paper.

Definitions and perspectives on the drivers of CADs in Indonesia

Fundamental current account concepts

The current account balance is defined as the sum of the trade, net income and unilateral transfers balances:

$$CA = (X-M)+NFI+UT$$

where CA is the current account, X is exports, M is imports, NFI is net foreign income (essentially the net 'returns' paid to foreigners' investments in the home country) and UT is unilateral transfers (such as aid to foreign Governments and remittances by immigrants to their former home countries). The current account balance can also be described as the difference between the acquisition of foreign assets by domestic parties and the acquisition of domestic assets by foreigners. Note that in order to run a CAD, it is necessary to run a capital account surplus of the same magnitude (in the absence of currency intervention):

$$KA = FDI+PI+OI+R$$

where KA is the capital account, FDI is net foreign direct investment, PI is net portfolio investment, OI is other net investment and R is the change in foreign exchange reserves.

Thinking about it from a different perspective, a CA that is in deficit reflects a situation where domestic investment exceeds domestic saving, and the shortfall is financed by foreign investment:

$$KA = I-S$$

where I and S are domestic investment and savings, respectively. While this relationship appears relatively simple at first glance, it encapsulates the complexity of the current account as a figure reflective of underlying macroeconomic trends (and determinants of both investment and savings behaviour), as opposed to a variable that can be controlled in a direct way. The relationship between domestic saving and investment opportunities also determines the extent to which foreign capital will flow into a country (FDI and portfolio investment), in the absence of policy intervention. The trade balance (X-M) and the net income balance (NFI+UT) are effectively the 'balancing items' when considered from this perspective.

Looked at this way, efforts to reduce a CAD as an explicit goal may constrain the development of productive projects – and harm the long run growth potential of an economy. For example, policies that distort consumption or production decisions mean that aggregate national savings are being diverted to less productive endeavours, compared to what might have otherwise occurred. Similarly, limiting restrictions to capital flows in a country will optimise investment into a country – both foreign and domestic.

Generally speaking, a CAD itself is merely reflective of the economy-wide set of investment and consumption possibilities and is not inherently problematic. When viewed in this light, the issue of the 'sustainability' of the CAD is moot – as long as it is the result of productive consumption and investment decisions then, in aggregate, the external position ought to be 'sustainable'. Indeed, it is

the case that, either through exchange rate adjustment or other means, the external accounts will balance and solvency would be preserved even if the adjustments are economically painful.

Obviously, there are situations where balancing of the external accounts in this way is not desirable and would have severe consequences for the macro-economy. These are the situations that Indonesia is seeking to avoid – and is managing through currency stabilisation. But market perceptions about sustainability inevitably influence the stability of the external position. This highlights the importance of the 'stability' of the external position – which is determined by perceptions of risk.⁴ Risks can be exogenous to the economy, such as oil price shocks, or changes in foreign monetary policy. For the most part, there is little that can be done to guard against a sudden reversal of capital flows stemming from exogenously determined factors. However, risks can also be endogenous to the economy, with policy decisions having a potentially significant bearing on the country-specific risks of investing in a country – in turn making the task of currency stabilisation inherently more difficult. Reducing these risks contributes to the stability of the external position.

The basic makeup of Indonesia's CAD

There are two main developments relevant to the recent widening of Indonesia's CAD – the export performance of its mining and manufacturing industries, and the offsetting effects of energy imports and other inputs into production. Though these developments have driven Indonesia's trade balance into deficit recently (Chart 1), the underlying drivers of Indonesia's CAD are structural in nature – and not the result of a temporary 'gap' that can be quickly and easily filled. As such, Indonesia's CAD is likely to persist beyond the range of short-term macroeconomic management tools and the CAD should therefore not be continually targeted by short-term measures.

The main driver of the initial widening of the CAD in 2012 was a significant deterioration in Indonesia's terms of trade. Highly dependent on commodity exports (around 60 per cent of total exports), Indonesia's CAD is particularly vulnerable to swings in international commodity prices. Prices for key exports such as coal, rubber and palm oil began falling in 2012 following weakening global demand, especially from China, and have continued to weigh on export earnings through 2014.

Until the second half of 2014, the deterioration of export prices was exacerbated by persistently elevated fuel prices, of which Indonesia is a net importer. With fuels accounting for almost 10 per cent of 'raw material' inputs into production, this has hampered the ability of the manufactured exports to capitalise on currency depreciation and offset reduced commodity export earnings. In short, rising input costs to manufacturing production have eroded the ability of the sector to generate trade returns. Exacerbating this effect is the fact that around half of Indonesia's consumption goods imports have been fuels – encouraged by generous fuel subsidies.⁵ In the first half of 2014, the deteriorating terms of trade was accompanied by a fall in export volumes of unprocessed ores as the minerals export ban came into effect. Late 2014 and early 2015 has seen the new administration in Indonesia introduce welcome reforms that completely overhaul fuel subsidy arrangements. Indonesians now pay the market price for gasoline as the subsidy has been removed. Gasoline accounts for about 65 per cent of the total fuel subsidies. For diesel, the Government has moved from a capped price (and associated risks to budget) to a fixed subsidy arrangement of Indonesian 1,000 Rupiah per litre.

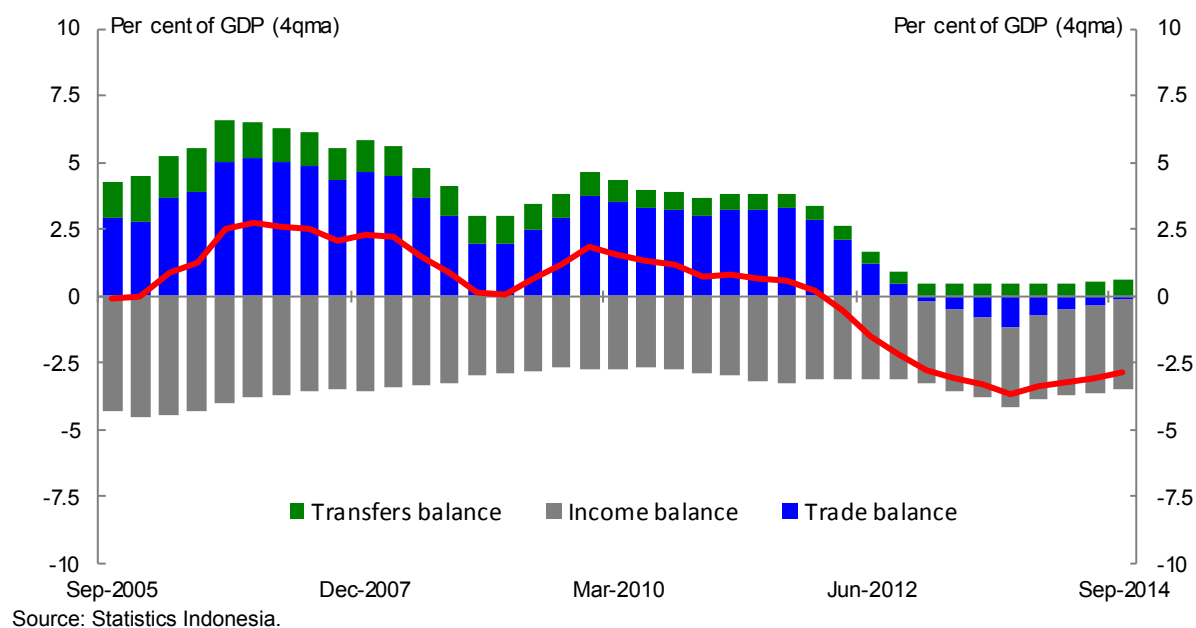
Finally, Indonesia has a persistent services trade deficit (which is driven primarily by transportation and business services deficits). It is important to note that these factors are endemic to the present

⁴ Note that this is the distinction between a 'sustainable' CAD, and a particular level of the CAD being sustained.

⁵ Admittedly, Indonesia's consumption goods imports are reasonably low, averaging around 13 per cent of total goods and services imports over the past five years.

structure of Indonesia's economy – the far-reaching effects of the commodity cycle on Indonesia's economy, and deficits in tertiary industry trade (to be expected in a rapidly developing economy) suggesting that Indonesia's CAD is inherently structural, at least for foreseeable future.

Chart 1: Breakdown of Indonesia's current account balance



Data for the net income deficit (the NID) in Indonesia reflect the net income flows out of Indonesia that are the returns paid on domestic investment, offset by returns made on Indonesians' investments overseas. This confirms that the shift into CAD that Indonesia is currently experiencing is related to the trade balance – with the returns paid on investments in Indonesia largely unchanged over the duration of Indonesia's recent CAD. For the first time after 50 years, Indonesia's (goods) trade balance has been back to deficit since 2012. Even so, as much as the commodity-driven shortfall in the trade balance is an obvious cause of the current CAD, it should not be forgotten that investment opportunities in Indonesia are now necessarily exceeding the capacity of domestic savings to finance them (Chart 2), and represent the aggregate consumption and investment decisions of individuals. This is an experience familiar to Australia, which has seen investment as a share of GDP exceed saving for a considerable period of time.

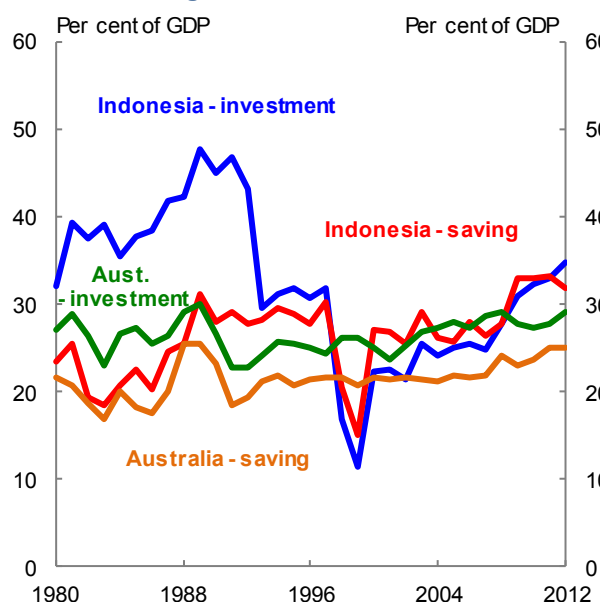
The makeup of Indonesia's capital account

The capital account data available for investment in Indonesia indicate that, generally, Indonesia attracts more foreign direct investment relative to portfolio investment than its ASEAN peers, as a result of the run-up in FDI flows into Indonesia in recent years (Chart 3).

That said, while Indonesia is the third-largest destination for FDI in the ASEAN region, when the relative size of its economy is taken into account, its FDI flows are comparatively low (Chart 5). Over the past five years, Indonesia's communications industry, mining industry, pharmaceuticals and machinery manufacturing industries, and electricity, gas and water provision have attracted an average of almost 60 per cent of total foreign investment (both FDI and portfolio investment, Chart 6). The next five largest industries attracted an average of an additional 26 per cent of total foreign investment over the past five years. Turning to portfolio flows, around 57 per cent of portfolio flows into Indonesia are in the form of equity investments, while the remaining 43 per cent are invested into Indonesian debt securities. Of Indonesia's debt securities, most foreign portfolio investment flows into government bonds (around 89 per cent of all debt securities investment), with almost all of the

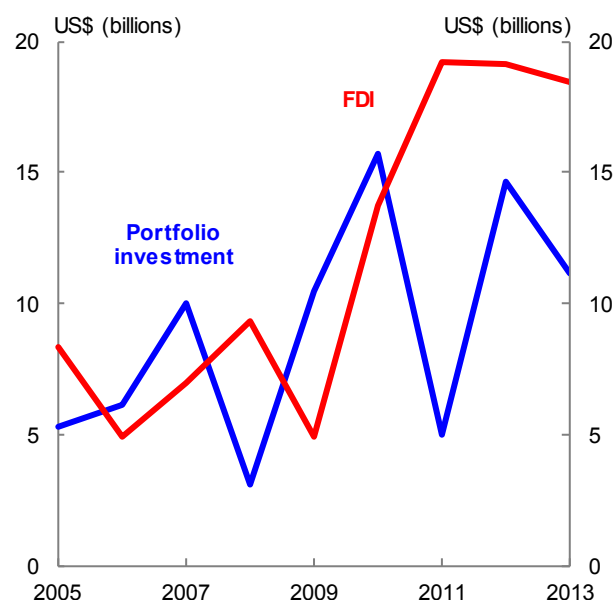
remainder of debt security investment seemingly invested into corporate bonds. Indonesia's equity securities are similarly distributed, with around 70 per cent of portfolio equity investment destined for corporate equities, while banks attract the remainder.

Chart 2: Gross investment and gross savings as a share of GDP



Source: IMF April 2014 *World Economic Outlook* database.

Chart 3: Indonesian net FDI and portfolio investment



Source: Statistics Indonesia.

It is difficult to determine the true extent to which portfolio investment flows into Indonesian debt securities are reflective of wider financing patterns in Indonesia. Nonetheless, the primary destination for credit in the wider Indonesian economy has been retail businesses, manufacturing, dwelling investment, personal credit and the forestry industry – which have collectively accounted for almost 60 per cent of financing over the past five years (Chart 7). That said, Indonesia's financial markets are relatively shallow, which exacerbates its vulnerability to exchange rate fluctuations. Additionally, given the constrained financial system, many businesses in Indonesia will seek foreign financing directly, rather than intermediated finance through the banking system – which is often unhedged, creating further risks from currency volatility.

Assessing the sustainability and stability of Indonesia's current account position

Chart 1 clearly shows that the fall in Indonesia's trade balance has been a primary contributing factor to the widening of Indonesia's CAD since early 2012, with the exogenous downturn in the global commodities cycle having a large part to play in this development. Indonesia's policymakers have long been aware that fuel subsidies have contributed to this pressure on the trade balance. By diverting national savings toward the subsidisation of energy consumption, they have distorted consumption and investment decisions and weighed on growth. Accordingly, the 2015 structural reforms removing the government subsidy on gasoline and changing to a fixed diesel subsidy will contribute positively to perceptions about Indonesia's growth potential and the sustainability of the CAD.

Even so, as Chart 2 shows, there also appears to be an emerging trend of investment opportunities in Indonesia exceeding the capacity of domestic savings' to satisfy these opportunities. Indeed,

Indonesia's savings and investment rates currently exceed those in Australia and most of ASEAN (Chart 2, Chart 4), and if Indonesia's CAD is considered to be structural in nature, then so too is this relationship between savings and investment.

As noted in the previous section, close to 60 per cent of foreign investment in Indonesia appears to be directed toward sectors of the economy that are either directly related to utilising Indonesia's most prominent comparative advantages and factor endowments (mining and machinery manufacturing are the second- and fourth-largest foreign investment destinations by industry), or cater to Indonesia's exceptionally large and growing consumer market (communications, pharmaceuticals and utilities). Financing statistics for the Indonesian economy in general show a similar pattern, with credit being most prominently extended to similar sectors of the Indonesian economy.

While it is certainly the case that higher FDI typically results in a higher CAD, FDI offers many collateral benefits, such as the transfer of skills through 'learning-by-doing'. The behaviour of portfolio flows – as a barometer of perceptions about Indonesia's CAD – has much more direct implications for Indonesia's economic stability.

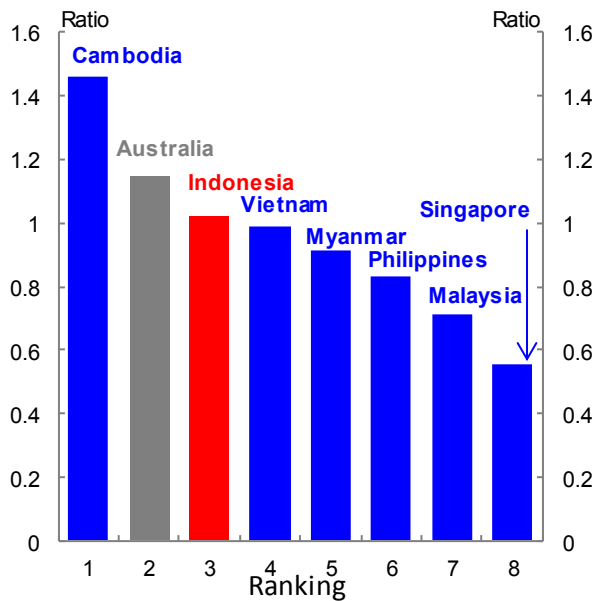
As alluded to earlier, the perceptions of both exogenous and country-specific risks will influence the volatility of portfolio flows. When viewed from a savings/investment perspective, it is clear that the only way to eliminate the possibility of the vulnerabilities of capital flight arising from a CAD in the short term would be to deliberately prevent productive investments from being undertaken in the economy, by only funding investment to the level of domestic savings' capacity. This would result in reduced productive capacity and growth potential for the Indonesian economy. And indeed, it is clear that there are plenty of productive investment choices available to foreign investors in Indonesia. To be clear, this savings-investment imbalance in Indonesia is not the result of a deficiency of domestic savings.⁶

Mitigating country-specific risks need not be so damaging to economic performance. In a situation where markets will increasingly be re-evaluating the riskiness of investments as global monetary policy normalises, then there is a role for policy to provide transparency and clarity with regard to the macro-economy – to avoid contributing to further instability.

Let's take as a specific example Indonesia's banking system. Although it is significantly improved since the Asian Financial Crisis, it does not appear to have the capacity to intermediate all of the investment requirements of domestic businesses. As a result, businesses have resorted to seeking unhedged finance directly on the open market, creating currency risks. Microeconomic reform of the banking sector could thus have far-reaching benefits to Indonesia's economy. In this respect, the way Australia managed perceptions about its CAD during the 1980s – a period of market concern about Australia's CAD – is instructive as a basis for designing a longer-term strategy to improve the 'stability' of perceptions about Indonesia's external position.

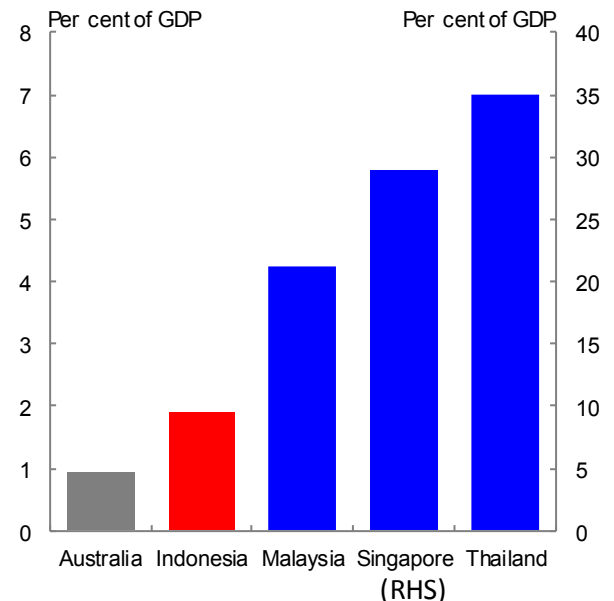
⁶ While efforts such as recent mooted tax incentives for retained investment earnings may artificially raise the savings rate in Indonesia, it could come at the cost of stability – with these tax-incentivised savings being directed into relatively volatile portfolio investments, possibly adding to the present instability of capital flows.

Chart 4: Gross investment/gross savings ratio — ASEAN region (2008-13 average)



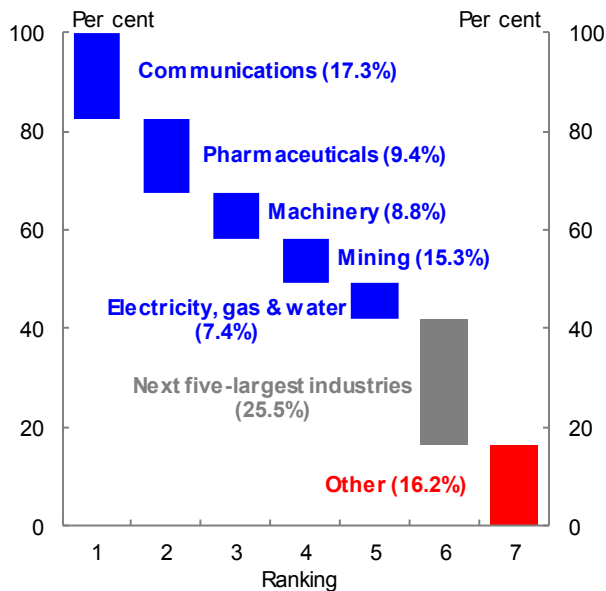
Source: IMF April 2014 World Economic Outlook database

Chart 5: ASEAN region FDI inflow-to-GDP shares (2013)



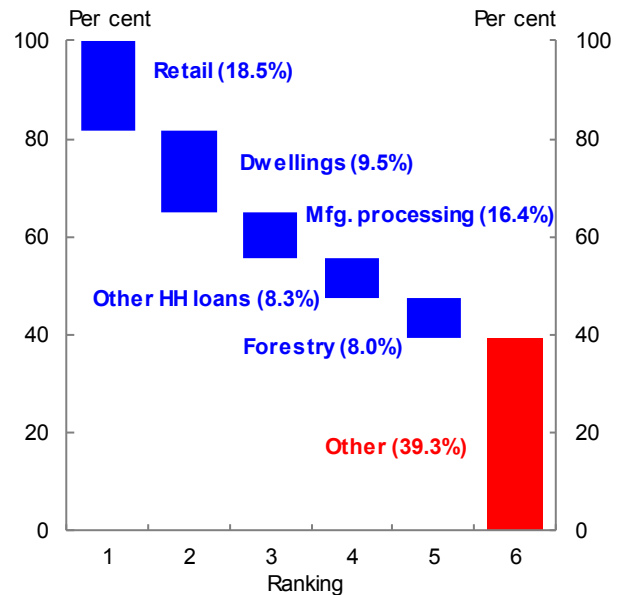
Source: National statistical agencies. Note: Thailand's data are for 2012.

Chart 6: Share of foreign investment by industry (5-year average)



Source: Statistics Indonesia.

Chart 7: Indonesia — share of financing by sector (3-year average)

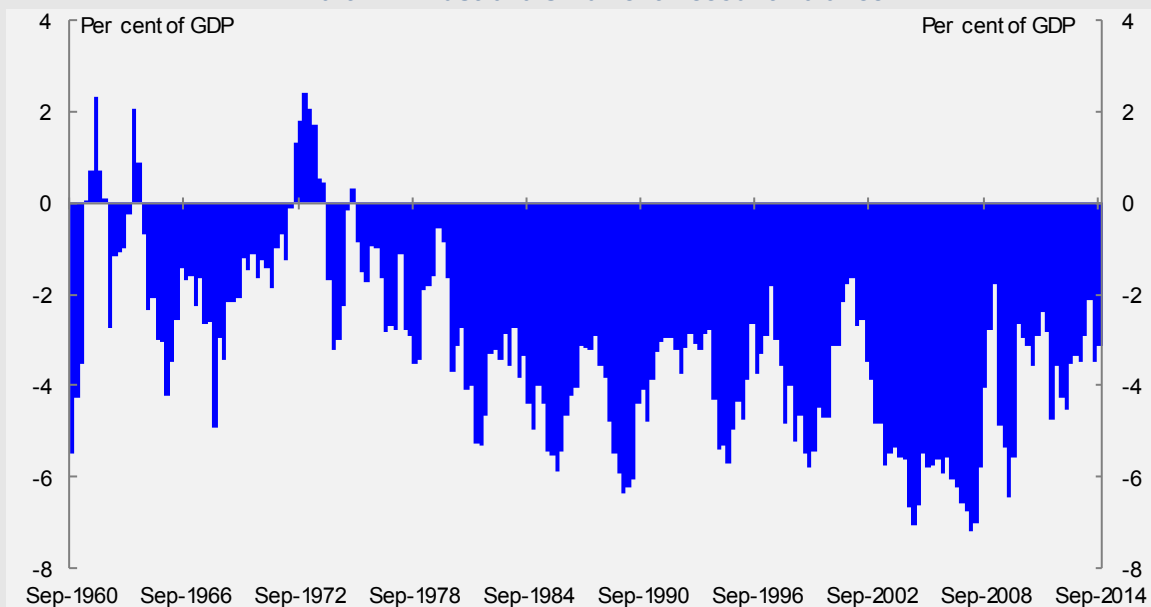


Source: Statistics Indonesia.

Box 1: Australia's experience with CADs

Australia's current account has been in deficit almost continually since official statistics began in the late-1950s (Chart A), though research by the Reserve Bank of Australia points to the current account being more often in deficit as far back as the mid-1850s (Belkar, Cockerell and Kent, 2007).

Chart A — Australia's Current Account Balance



Source: ABS cat. no. 5302.0 and 5206.0.

Despite Australia's prolonged CADs, periods of capital flight have been limited. The most notable occurred during the 1890s depression after significant inflows had contributed to a property bubble. When it burst, foreign capital retreated for much of the decade — except for inflows related to the West Australian gold rush — which contributed to a banking crisis that resulted in the closure of roughly half the nation's banks (Belkar et al. 2007). Capital inflows also slowed during the 1930s depression but less dramatically than in the previous episode. Fears that Australia would be unable to meet repayments on Treasury bills issued in London and due in mid-1931 dissipated following a raft of measures, many of which entailed greater austerity, coming out of a conference of federal and state ministers that became known as the Premiers' Plan (Giblin, 1951, Gruen and Clark, 2009).

There was less concern with the current account during the period of capital controls enacted during the Second World War, which lasted into the 1970s. As the controls were progressively removed, the CAD increasingly became problematic due to the fixed and subsequent crawling peg exchange rate regimes, given the finite level of foreign exchange reserves and periods of intense speculation that the currency would have to be devalued. After the floating of the Australian dollar in December 1983, the CAD increased, with the government focusing on fiscal consolidation and microeconomic reform to improve Australia's international competitiveness, though only in part because of their concerns about the balance of payments. Meanwhile, for a brief period in the 1980s, the balance of payments became one of several explicit targets of monetary policy.

Box 1: Australia’s experience with CADs continued

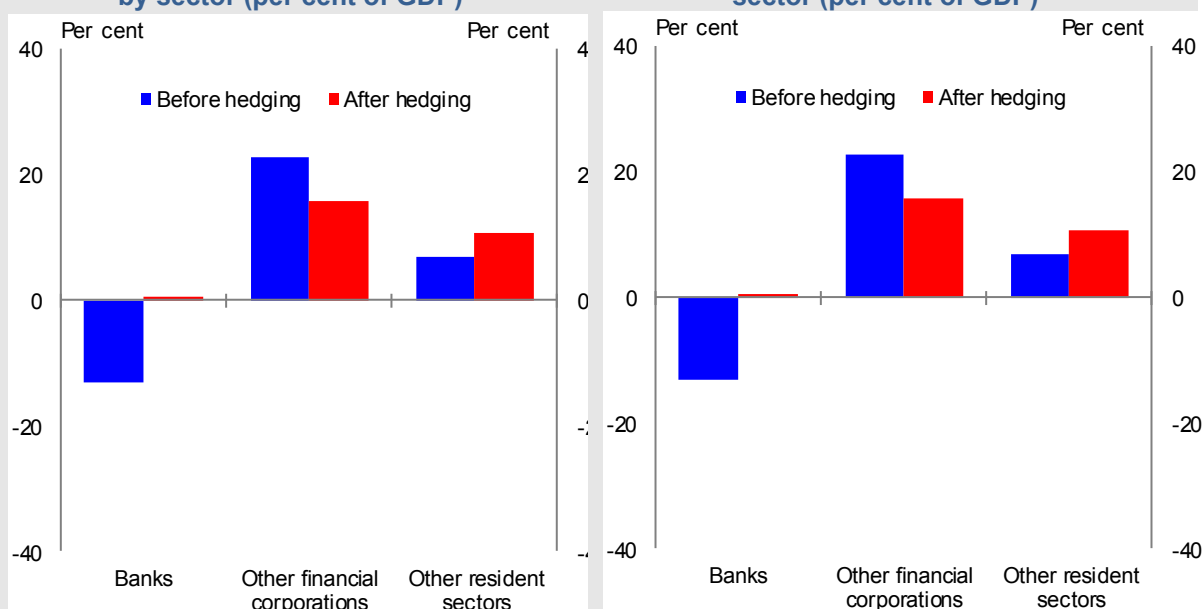
As the economic reforms of the 1980s began to reduce rigidities within the economy, concerns about the CAD gradually diminished. The steady reduction in tariffs and other trade barriers exposed domestic industries to greater international competition, labour market reforms and subsequent policies enhanced labour market flexibility, and financial deregulation (including by allowing foreign owned banks to compete for corporate and (eventually) deposit taking business) along with reforms to the financial regulatory framework provided an environment for the private sector to manage its own financing risks.

Monetary policy eventually moved to an inflation targeting regime and the benefits of a freely floating exchange rate in absorbing some of the impact of international shocks became apparent. Through time, fewer official foreign exchange reserves were required, though there were still episodes of heavy intervention in 2001 and 2008. In recent years, Australia has had relatively high levels of saving in comparison to other developed economies, with household savings increasing since from the mid-2000s. In addition, Australia’s CAD has been one of the drivers for running conservative fiscal policy – ensuring the public sector does not exacerbate the private sector position. As such, rather than being the product of insufficient domestic savings, Australia’s CAD is better characterised as being the result of ample investment opportunities attracting foreign capital (Gruen and Sayegh, 2005 and Debelle, 2011), which became particularly apparent during the commodities boom.

Concerns about Australia’s current account are still periodically raised by international organisations, such as the International Monetary Fund, and the credit rating agencies, though these concerns mainly focus on how Australia’s current account and the accumulated net foreign liabilities from past CADs are financed. The Australian banking system has traditionally intermediated a significant proportion of the CAD, though the recent mining investment boom saw an increase in direct investment by mining companies. While a significant proportion of Australian bank funding is sourced offshore, the foreign exchange risk is almost completely hedged (Charts B and C).

Chart B — Gross foreign currency exposure by sector (per cent of GDP)

Chart C — Net foreign currency exposure by sector (per cent of GDP)



Source: Bank for International Settlements and ABS cat. No. 5206.0.

Box 1: Australia's experience with CADs continued

Moreover, net of hedging, Australia's foreign currency exposures are on the asset side of the balance sheet, in part reflecting the benefits of international diversification and Australia's expanding pool of superannuation assets. Accordingly, Australian dollar depreciation improves the net position. Since the global financial crisis, Australian banks have increased their sources of domestic funding, mainly in the form of deposits, and have retired some of their foreign debt.

This shift has taken place even though Australian banks have had little difficulty in accessing foreign funding – with the exception of the height of the GFC. Over this time, the term to maturity of foreign debt has been lengthened, which has increased the stability of banks' foreign funding and reduced rollover risk. In addition, the share of foreign debt denominated in Australian dollars has been increasing, though diversity in funding sources by currency remains.

Current accounts — a macro phenomenon with strong microfoundations

With the prospect of further re-evaluations of risk as global monetary policy begins to slowly normalise, the sustainability of Indonesia's current account will be an ongoing concern, as exogenous shocks may still present themselves. The roots of Australia's success in managing market confidence in Australia's external position in similar situations lie in a long process of economic reforms, acting to mitigate the country-specific risk component of the stability of the CAD over the long term.

Part of the difficulty of dealing with the negative perceptions of the CAD lies in its apparent simplicity. Yet, as an aggregate figure reflecting a wide range of different drivers in the economy, the CAD is not necessarily 'good' or 'bad'. As such, policies targeted at the headline figure risk having unintended consequences. 'Tactical' responses to short-term CAD concerns may exacerbate wider macroeconomic imbalances that are collectively contributing to external vulnerabilities in the first place, or in the case of Bank Indonesia's stabilisation efforts, have the side effect of reducing economic growth.

Instead, longer term policies that are beneficial to the structure of the economy in general – can in turn either mitigate the potentially damaging effects of an unsustainable/unstable CAD, or contribute to reducing the CAD altogether. The key point is that the structure of the economy should be developed in such a way that natural comparative advantages are allowed to assert themselves, and that policy is transparent and foreseeable to investors through a shared understanding of the 'rules of the game'. A well-articulated and transparent framework for policy (and its formulation) is important in this regard.

Policy reforms undertaken by Australia and outlined in Box 1 have had direct implications for the sustainability and stability of the current account. The floating of the dollar reduced the need for intervention into the external account to relieve internal pressures on the domestic economy. Additionally, Australia's commitment to robust prudential regulation and comparatively low government borrowing has encouraged a favourable perception of its economy that might otherwise be incongruous with the running of persistent CADs.⁷

There have also been many instances where other reforms, not explicitly targeting the CAD, have nevertheless improved the external position. For example, liberalising the banking sector has contributed to the development of Australia's financial system which has helped Australia's financial markets to absorb and manage portfolio flows in a transparent and credible manner – contributing

⁷ Moreover, the majority of Government debt is denominated in Australian dollars, thereby avoiding duplication of banks' currency exposures.

to the stability of Australia's current account position. Improvements to the external position were unintentional and secondary benefits to a productive series of microeconomic reform.

Even further removed from concerns over the external sector was the implementation of the Higher Education Contribution Scheme (HECS)-HELP program, and its antecedents. Initially targeting productivity gains by improving the structure and functioning of the economy, these higher-education reforms have, subsequently and unintentionally, had positive effects on the trade balance and the CAD by boosting the capacity of Australia's tertiary education sector in the face of rising demand for education services exports.

Options for Indonesia

There are a number of similar opportunities for reform available to Indonesia, with direct and indirect effects on the sustainability of the external balance. This paper offers a set of policy options under three broad categories that would improve the stability of Indonesia's CAD: (i) fiscal reform; (ii) using investment to promote stability; and (iii) a transparent, productivity-led growth strategy.

Fiscal reform

In terms of direct measures to influence the CAD, Indonesia has already made progress to improve the sustainability of the CAD by significantly reducing fuel subsidies. Broadly speaking, reducing recurrent Government expenditures like the fuel subsidy will reduce the public sector call on the CAD. It is important to note that a fiscal deficit led by productive public investment is not inconsistent with a stable CAD, but expenditures that distort private consumption and investment decisions do not enhance the sustainability or stability of the CAD.

The recently announced fuel subsidy reforms will provide fiscal relief allowing for much needed infrastructure, health and education spending and is a very positive first-step in reforms. Further to this, a clear, credible medium term fiscal strategy would also assist by signalling a more coherent strategy for the future. Further reforms should also incorporate fiscal targets that distinguish between infrastructure spending, social spending and tax reform objectives. Tax reform as part of the fiscal strategy will be essential. Efforts to broaden Indonesia's tax base using efficient taxation mechanisms such as reforms that maximise revenue from existing consumption taxes would contribute to market confidence. Further, efforts by Indonesia to improve compliance of personal taxpayers have the potential to deliver significant revenue gains.

Increasing revenues would also have potentially beneficial effects on Indonesia's CAD. Efforts to broaden the tax base in Indonesia, particularly via personal income tax and consumption taxes, would firstly contribute towards market confidence in the Government's ability to more credibly guarantee any foreign debts incurred in financing the CAD. Secondly, broadening the tax base could potentially lean against consumption somewhat – having a commensurate effect on imports. The type of revenue broadening is important. Selecting the most efficient, least-costly-to-growth taxation strategies are crucial.

This could also reduce market anxieties about a 'twin deficits' scenario.⁸ While Indonesia's budget deficit rules are an important existing feature of the policy landscape that promote confidence in the Government's ability to manage shocks, limited revenue-generating capacities will eventually curtail the ability of the Government to undertake productive investment that would benefit growth. Australia has allayed such market anxieties through public commitments to fiscal prudence, such as

⁸ Where public expenditure is contributing directly to the CAD, placing the risk of capital flight and currency volatility on the public balance sheet and thereby risking the solvency of sovereign borrowing.

the *Charter of Budget Honesty* (similar to Indonesia's deficit limit, in its intent), coupled with various public mechanisms for evaluating fiscal sustainability and economic/budgetary pressures (such as the *Intergenerational Report* and the *Tax Expenditure Statement*).

Investment to promote stability

As noted earlier in this paper, one of the most important things that can be done to mitigate the risks of capital flight is to reduce the country-specific risks of investing in a country. Indonesia will remain an attractive destination for investment for the foreseeable future, and it would be detrimental to Indonesia's growth potential to leave investment opportunities unfulfilled for the sake of trying to reduce the risks of capital flight.

There are examples where a lack of principle-based policy changes and uncertainty surrounding policymakers' reactions contributes to uncertainty for both foreign and domestic investors in Indonesia. For example, new industry and trade laws enable Ministerial authorities to act independently to significantly intervene in markets. There would be benefits from the adoption of a coordinated and strengthened policymaking and regulation process. Aside from allowing all senior Government Ministers to consider new regulations and policies, Indonesia may also benefit from adopting strong, statutorily independent institutions such as Australia's Productivity Commission, which has a role to play in generating support for the settings of the macroeconomy and the importance of reform at the microeconomic level. This would be somewhat different to Bappenas' (the National Development Planning Agency) remit, with Australia's Productivity Commission having deliberate independence, and requirements for the dissemination of a policy narrative based on productivity, rather than broad-ranging policy delivery.

Economic reforms are generally not easy – a move toward greater efficiencies will typically involve depriving one or many interest groups of resources for the good of the wider economy. Thus, it takes political commitment and consensus building to achieve these goals. In Indonesia's case, there is a role for institutions to establish a coherent policy narrative between regional governments and the central Government.

More broadly, investors need to have faith that their legal contracts and property rights will be binding and upheld in the Courts of Indonesia. A veritable tome of economic literature and international experiences shows that property rights, investor protection and legal enforcement of these are an essential part of well-functioning markets, particularly when making long-term financial decisions.⁹ Reforms such as those included in Indonesia's new land acquisition law, if well implemented and enforced, are a step in the right direction. Another key factor for business and employees is conducive and supportive labour market policy that is supported by a strong legal framework.

Recent experiences with currency volatility driven by volatile portfolio investment flows reflect some of the uncertainties investors face when undertaking investments in Indonesia. Promoting an environment of increased policy certainty would, encourage investment into Indonesia and not necessarily at a greater risk of capital flight.

Removing impediments to longer-term investments in Indonesia (such as FDI) would also promote stability. Recent amendments to the Negative Investment List (the list of business areas closed to

⁹ Dam (2007) presents such a comprehensive tome, though the work of Gould and Gruben (1996) and Levine (1998,1999) focus on specific aspects of the relationship between property rights, law enforcement and economic growth, while and Mahoney (2001) examines the influence of different legal traditions on the development of financial markets.

foreign investment, or otherwise restricted) appeared to reduce FDI access to a number of markets, which arguably adds to uncertainty about future investment opportunities – influencing perceptions about the riskiness of investing in Indonesia, and biasing investment toward short-term, flightier portfolio investment. Allowing more FDI to occur in conjunction with a deepening of Indonesia's domestic financial markets, and increasing the capacity for the banking sector to intermediate such investment (and manage currency risks) would also mitigate risks associated with capital flight. This could be achieved by financial sector deregulation, consolidation and the encouragement of foreign entry to boost competition.

Transparently-formed, productivity-led growth strategy

Concerns about the CA position highlight the importance of wide-ranging and comprehensive policy reforms to improve the structure of the economy. In the medium to longer term, building a stronger more flexible economy can help achieve prosperity and equality, and avoid the middle-income trap.

Indonesia's demographic dividend, which will continue over the next decade, provides an opportune time for substantial reforms to be undertaken. It can also be viewed as impetus for reform – future prosperity will be more difficult to achieve as the demographic dividend wanes.

One of the primary means through which Australia has achieved successes in policy transparency has come through enshrining the independence of key bodies, such as the Reserve Bank of Australia and the Productivity Commission. Additionally, commitments to comprehensive and forward-looking public documents such as the *Intergenerational Report* unambiguously highlight challenges and risks that extend beyond the immediate political cycle.

Considering areas of policy reform, Indonesia's policymakers are well-aware of the importance of ongoing infrastructure investment to economic growth. Strengthening mechanisms for independent assessment and prioritisation of infrastructure needs, coupled with rigorous economic assessments to advise the Indonesian Government on projects would likely improve the cost-effectiveness of infrastructure delivery, as well as improve Indonesia's external competitiveness by removing internal impediments to growth.

In terms of education policy, attendance rates have improved dramatically over the past decade. The next step in enhancing Indonesia's considerable human capital is to focus on improving the quality of education outcomes, while maintaining quantity, perhaps with a focus on facilitating cooperation between the education sector and industry. The IMF has recently noted the importance of education as a 'bridging' element between the present and future sources of economic growth and competitiveness. Improving the link between tertiary education and training, and the needs of industry may assist this transition.

Finally, beyond encouraging more deeply-integrated foreign investment into Indonesia as a source and signal of stability, there is evidence that Indonesia's capital market lacks diversified financial products and depth to support the growth of its industries and services. As the World Bank has noted, there is significant evidence that enterprises in Indonesia are credit constrained – limiting their ability to expand and drive growth. Current efforts by the Indonesian Government to better clarify and coordinate linkages between financial authorities should be welcomed. Seeking to strengthen the bank and non-bank financial system, they recognise that the Indonesian banking industry could benefit from deregulation and, in particular, increased competition from foreign banks. Beyond this, the Government could assist in building a capital market with more diverse products by considering investment requirements, high underwriting costs and weaknesses in the execution regime (which may be addressed through bank consolidation, where appropriate). As with

Australia's experience, an Indonesian banking sector that is strong enough to intermediate a significant share of the CAD can directly increase its stability by ensuring positions are hedged.

Conclusions

There are obvious differences between Australia's and Indonesia's experiences with their CADs. However, there are also some similarities. Indonesia faces many of the same perceptions about the riskiness of the CAD such as fears around capital flight, exchange rate volatility and fiscal sustainability that Australia experienced in the 1980s.

Since the GFC, Indonesia has proved to be an attractive destination for international investment as perceptions of risks have been offset by the market's search of higher returns. This investment has produced the financial inflows, particularly portfolio inflows, necessary to finance Indonesia's CAD. However, the eventual normalisation of global monetary policy is likely to prompt markets to re-evaluate riskiness of various investments. In this environment, Indonesia may be subject to periods of investment withdrawal, subsequent currency volatility and uncertainty about financing its CAD – similar to that experienced in mid-2013.

Indonesia has shown that it is well equipped to use monetary policy and currency reserves to counter short-term risks to its economic stability. In the longer-term, these approaches will have limited effectiveness. By generating imbalances elsewhere in the real economy they are likely to unintentionally worsen the CAD, distort investment and counter Indonesia's objective of avoiding the middle income trap insofar as they weigh on economic growth. In contrast, measures that improve an economy's efficiency, such as the recent decisions taken by the Indonesian Government to reduce the diesel subsidy and remove the gasoline subsidy, will have long-term positive effects on economic growth and the CAD. They also send a clear signal to investors on the Government's genuine intent to transform the Indonesian economy.

Australia's experience of policy reform demonstrates that there are further strategies that Indonesia can adopt to mitigate possible instability arising from its CAD, removing the need for continual short-term management aimed at the headline figure itself. Australia has improved market perceptions by an extensive agenda of general economic reform, which does not include policy measures to target its external position. While some of these reform measures helped to reduce Australia's CAD, many did not – though all contributed to the flexibility and productivity of the macroeconomy. This ensured that the CAD was driven by sound foundations. These reforms provided the freedom to sensibly exploit Australia's comparative advantages which contributed to the sustainability and stability of the external position.

It is important that the Indonesian economy is allowed to develop in such a way that natural comparative advantages assert themselves, and at the same time policy is transparent and foreseeable to investors. A well-articulated and transparent framework for policy (and its formulation) is crucial to facilitating this.

Many general macroeconomic reforms are available to Indonesia – some of which may contribute to reducing the CAD in the short-term. Recent developments relating to fuel subsidies are an impressive and substantial first step. Taxation reform (such as the removal of unnecessary tax incentives and strengthening both tax policy and administration) and the balancing of the Government's budget are steps that can be taken in the short-term and which will further build on the recent reforms to fuel subsidies. Such reforms would provide investors with confidence in the Government's approach to domestic and international investment. This certainty will be important to change market's perceptions about the risk of investing in the Indonesian economy. Such commitments and reforms

will benefit the CAD, benefit the Indonesian economy through providing further fiscal space for needed infrastructure and social spending, and benefit market perceptions of the Indonesian Government and economy.

In the longer term, while the process of reform may be difficult, promoting structural reform to build a flexible and productive economy will be crucial to prevent the CAD from becoming a restraint on growth. Through this lens, while the CAD is not a problem in itself, it can be an important motivation for reforms that are worth doing in their own right – be it financial system reform, prudent fiscal policy or improving the quality of public and private investment. Through these reforms, Indonesia can building a stronger more flexible economy, achieve prosperity and avoid the middle income trap.

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