Economics

ID: Fiscal prudence still warranted

DBS Group Research

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- Public debt has fallen sharply as a percentage of GDP since the 1997-98 Asian financial crisis. Public debt/GDP stood at 26% in 2013, down from 95% in 2000
- Foreign reserves are equivalent to 87% of public external debt. Other Asian countries with similar credit ratings have ratios above 100%
- Fiscal prudence is still warranted

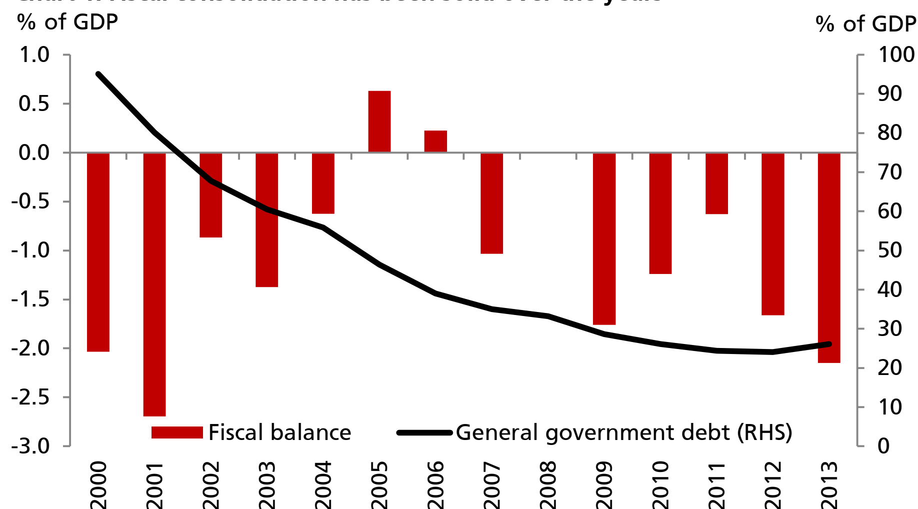
The issue of public debt has been a contentious issue in the run-up to the 9 July presidential election. Part of the issue is the proposed infrastructure overhaul and the funding needed for it. The two questions are: is there enough funding for the country's huge infrastructure needs? And if not, should the government borrow more to meet the funding needs?

How much infrastructure funding is needed?

Assuming new infrastructure needs of 5% of nominal GDP per year, based on current growth trend, the amount comes to about USD 60bn per year (at 2014 prices and exchange rate). This is the lower floor of the USD 60-10bn estimated by the Ministry of National Development Planning (Bappenas) in the current 2025 economic master plan.

How big is the funding hole? New foreign and domestic private investments have averaged about USD 20bn per year in the 2009-2013 period. Less than 40%, or USD 8bn, of this has gone to new infrastructure projects. Meanwhile, budgeted capital expenditure averaged about USD 12bn per year in the same period. Going by the current trend, even if the government can fully utilize its

Chart 1: Fiscal consolidation has been solid over the years



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capital expenditure budget, there is still a substantial shortfall in funding needs of about USD 40bn per year. That adds up to USD 200bn over the next 5 years.

As a comparison, total assets in the banking system amounted to about USD 300bn as of FY2013. Of this amount, liquid assets constitute USD 60bn, including USD 25bn in cash and its equivalent.

Public debt consolidation has been pretty solid

Can the government afford to borrow more?

Public debt as a percentage of GDP has fallen sharply since the 1997-98 Asian financial crisis (Chart 1, previous page). Government debt/GDP ratio (or the public debt ratio) stood at 26% as of 2013, down from 95% in 2000. In the same period, annual fiscal deficit has been relatively modest, at about 1% of GDP. The bulk of this improvement occurred in the 2002-2007 period, driven by rising commodity export earnings. Current account (C/A) surplus averaged 3% of GDP, among the highest in history, excluding 1998 and 99 in the immediate aftermath of the crisis.

Can the government afford to borrow more? Yes, but there are good reasons to maintain fiscal prudence going forward.

We look at how public debt has fared over the years and how this compares to different countries with a similar macro risk profile. In this “control group”, we include countries rated on the same level as Indonesia by at least 2 main credit rating agencies (S&P, Moody’s and Fitch) [1]. Some findings are interesting to discuss.

Compared to the control group, the picture looks pretty good. Currently at 26%, the public debt ratio is about 10 percentage points lower than the average (Chart 2). The consolidation phase has also been impressive. Back in 2000, the public debt ratio was the highest, when compared to all countries in the control group. Currently, only 1 of the 7 countries in the control group has a lower public debt ratio.

But foreign reserves amount to less than 100% of public external debt

The picture of external debt is somewhat different. The public external debt/GDP ratio is just slightly above the group average (Chart 3). But, foreign reserves/public external debt ratio is currently at 87%, the only one in the group seen below the 100% mark [2]. This has exposed some vulnerabilities of the economy and was a factor behind market selloff in mid-2013. Little wonder that Bank Indonesia (BI) has continued to caution over rising external debt level in the economy.

Not that the economy faces an external liquidity problem in the immediate future. As it stands, debt service ratio to exports of goods and services and

Chart 2: Public debt compared to control group

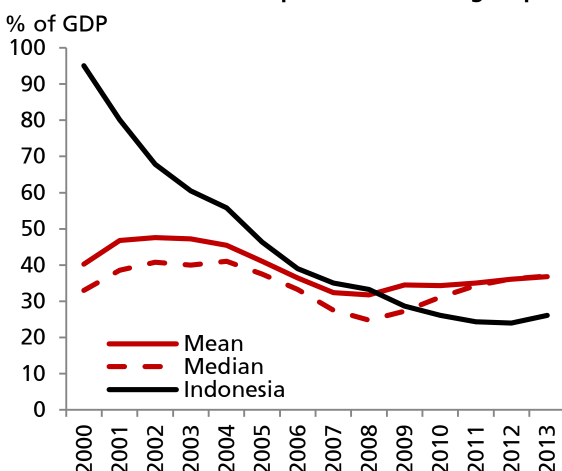
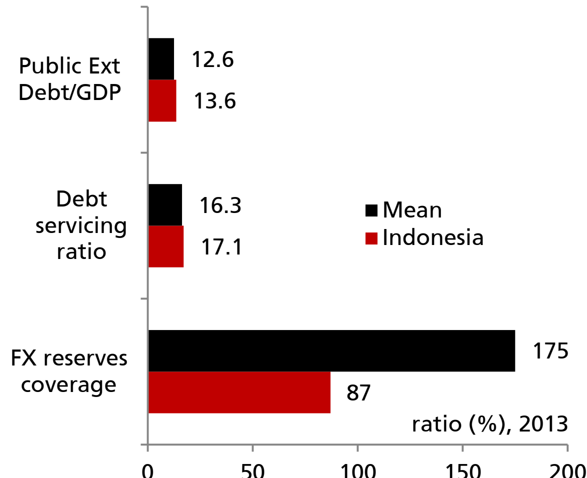


Chart 3: A closer look at external debt



primary income is currently circa 17%. And foreign reserves coverage of short-term external debt (even after including from the private sector) stands at over 200%.

Still, prudence is still warranted. The loan-to-deposit ratio currently sits just above 90%, a record high. Both government and corporates may need to continue tapping into financial markets for funding, which could potentially mean higher external debts going forward. As appetite improves, foreign ownership of Indonesian bonds has gone up substantially in recent years. For example, foreign ownership of IDgov bonds is currently at about 35%, from 15% in 2009.

The outgoing government has not changed its prudent fiscal policy stance despite GDP growth momentum slowing since 2H13. The latest revision to 2014 budget still targets deficit below 2.5% of GDP. Some adjustments are necessary to narrow the C/A deficit to a more sustainable level. Meanwhile, a tight monetary policy, foreign reserves accumulation and monitoring debt issuance remain key priorities for the central bank this year.

Public-private partnership is crucial

Whether or not the government needs to raise borrowing, a public-private partnership is the preferred way to finance the infrastructure overhaul. The annual budget for the central government is currently circa USD 100bn, with 50% typically allocated to operational expenditure.

The fiscal policy priority should be to tweak budget allocation

That said, a tweak in the budget allocation can be beneficial. We have previously noted that budget allocation on capital expenditure has typically been less than 50% of the amount set aside for fuel subsidies [3]. Encouragingly, both the presidential candidates have hinted of plans for gradual changes to the current fuel subsidy scheme. Fuel subsidy cuts would release more money to fund infrastructure.

It is also worthy to have a closer look at the next government's position on foreign investment. The economy has the potential to attract about USD 35-40bn in FDI per year, as compared to the USD 28.6bn (a record high) seen in 2013. While there has been a lot of talk about rising economic nationalism, both presidential hopefuls have asserted their position on being pro-business and pro-growth. At this juncture, we believe that economic pragmatism will remain the order of the day. A more in-depth look into this matter will follow the formation of the next government in October.

Notes:

[1] The countries included are Azerbaijan, Costa Rica, India, Philippines, Namibia, Romania, and Turkey.

[2] Including the private sector, foreign reserves/total external debt ratio is currently at about 40%. In the control group, both Romania and Turkey have lower ratios of 35% each.

[3] "Indonesia: The to-do list", DBS Group Research, 21 April 2014.

Sources:

Data are sourced from CEIC, the IMF and the World Bank and forecasts are from DBS Group Research.

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