

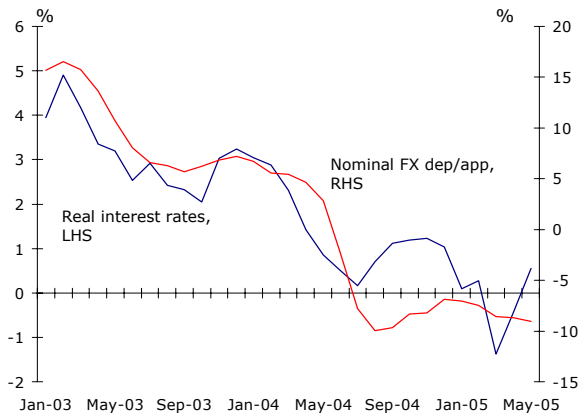
# Indonesian rupiah update

## Rupiah will remain weak, for now

- We are shifting our forecast on the rupiah to indicate short-term weakness, to end September at Rp9,550/USD (Rp6,828/AUD) and end December at Rp9,300/USD (Rp6,138/A\$).
- This forecast assumes a steady rise in real interest rates to combat creeping inflation, with the one-month SBI potentially needing to rise by 200 bps to 9.5% by December. Failure to do so will encourage higher CPI and prolong currency weakness.
- We still view fundamentals as positive and forecast a medium term strengthening trend for the rupiah, to Rp8,900 at end-2006 (Rp5,785/AUD), assuming rates rise.
- The new FX regulations announced mid-June are likely to reduce liquidity in the short-term FX market and thereby raise FX volatility.

The rupiah has weakened steadily this year, from a high of Rp9,135/USD in January to Rp9,660/USD currently. Our review of the factors that brought about this deterioration have led us to revise our rupiah forecast for this year to Rp9,550/USD for end-September and Rp9,300/USD for year-end. On the cross rates, our forecasts are Rp6,828/A\$ for end-September and Rp6,138/A\$ for year-end. Although we are still positive on Indonesia's fundamentals and expect a medium term strengthening trend to Rp8,900/USD (Rp5,785/A\$) for end-2006, this expectation as well as our forecasts for the remainder of 2005 have risk to the downside if Bank Indonesia does not act swiftly to further raise interest rates.

**IDR appreciation/depreciation and real interest rates**



Source: Datastream

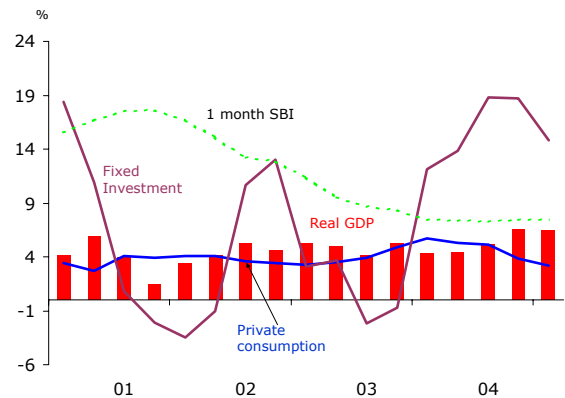
## Low interest rates are the problem

The main cause of the recent currency weakness can be seen in the chart above, where monetary policy has not kept up with rising inflation. While CPI rose from 6.4% in December to 8.8% in March, the one-month SBI rose by 1 bps, allowing real interest rates to decline from 1% to -1.3% in the first quarter.

This is reminiscent in the second quarter of last year – also seen in the chart – when real interest rates fell below 1% and the currency similarly weakened before the one-month SBI was consistently raised from 7.3% in April 2004 to 7.4% by October 2004. Over the second quarter this year, the SBI has risen by 75 bps and real rates are now positive, albeit still below 1%. The currency has responded by depreciating less rapidly, but unlike 2004 there has not been an appreciation as yet.

Given Indonesia's relatively recent experience with a floating currency and sustained levels of strong growth, difficulty in identifying a neutral monetary policy stance can be understood. BI has been hesitant to slow the economy as it is experiencing its first period of sustained growth – and investment – since the crisis.

## Investment and growth



Sources: Datastream, Bank Indonesia

The one-off inflationary impact of fuel subsidy reductions has also been a complication factor. Nonetheless, BI will have to remain vigilant if it is to firmly establish its monetary policy credentials, and may well have to raise rates by as much as 200 bps to reach its target inflation band of 6-7% for 2005 through 2007. BI plans to move to an explicit inflation targeting framework in the next

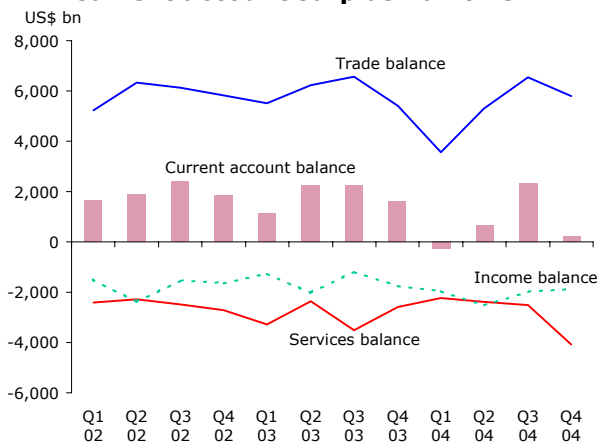
month that will remove the SBI as the benchmark for monetary policy.

**Pertamina is not to blame**

There has been substantial discussion in the local press to the effect that the weakness in the rupiah can be blamed on the state oil company, Pertamina, and its mandate to buy oil. Pertamina earns foreign currency receipts with oil exports. However, those receipts are converted to rupiah upon entry into the country, and Pertamina receives a rupiah allocation from the government's budget to buy oil that is required to supplement domestic consumption. Large import bills and lumpy dollar demand have thus been blamed for the rupiah's weakness.

However, a closer look at the balance of payments data does not lend full support to this argument. Although Indonesia is a net oil importer, its gas receipts have grown and it remains a net energy exporter. The issue is one of timing in relation to Pertamina's US dollar demand, and efforts by the authorities to smooth these purchases will be welcome. However, this demand in itself is insufficient to explain why the rupiah has remained so weak.

**Current account surplus narrows**



The above chart shows that the current account surplus has narrowed, but this is largely due to a widening in the services deficit. In particular, the "other" component within the services balance, which includes financial, insurance and telecommunications services among others, deteriorated in the second half of 2004. The current account performance so far this year also does not appear to be behind a weaker currency, as the surplus increased from US\$316 mn in the fourth quarter of last year to US\$2.5 bn in the first quarter of this year; for the first four months of this year, the trade surplus was US\$8.6 bn, or

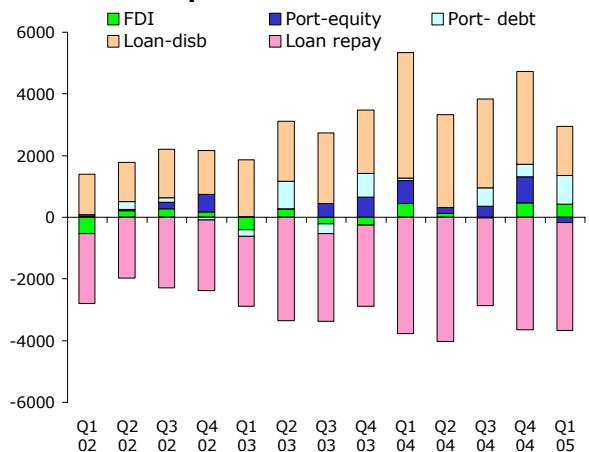
US\$2.1 bn more than the first four months of 2004.

**The capital account is more important**

Rather than the current account, it is the capital account that has impacted the rupiah with a surplus of around US\$1 bn in both the third and fourth quarters of last year shifting to a deficit of more than US\$600 mn in the first quarter of this year. A deficit of US\$690 mn in Q2 2004 also corresponded with last year's rupiah weakness.

The factors behind the Q1 2005 capital account deficit included net portfolio equity outflows (versus inflows in the previous periods) as well as declines in foreign currency loan disbursements and increases in foreign currency debt repayments, as seen in the chart below. A return to positive interest rates could well see another shift toward positive portfolio equity inflows, as was the case in 2004.

**Capital account flows**



FDI inflows have picked up significantly since Q4 2004 – supporting our long-term favourable view of the economy – but the pickup in FDI has not overcome net outflows in other areas. The decline in foreign currency borrowing can, however, be viewed positively in terms of creditworthiness even though it is not supportive of the capital account balance in the short term. Disbursements may well pick up in the months ahead as more aid for the reconstruction of Aceh streams in, which would provide some support for the rupiah.

**New regulations will introduce volatility**

On 16 June, the central bank announced new restrictions on certain types of foreign exchange transactions to take effect from 14 July. The regulations are highlighted below.

### Highlights of new FX regulations

Foreign exchange derivative transactions with foreign parties are limited to a maximum of US\$1 mn (or equivalent value) per institution. Previously, the restriction was only on forward sales of foreign currency, set at a limit of US\$3 mn. Forward purchases were not capped.

There are exceptions applied to derivative transactions and hedging in the case of: an investment in Indonesia with a time frame of a minimum of 3 months; imports and exports by means of letters of credit; and domestic trade by means of domestic letters of credit. The 1-month and 3-month SBI certificates issued by BI are not considered underlying instruments and so are excluded for short-term hedging purposes.

A foreign party is allowed a 1-month hedge if short-listed in an investment bid. This one-month hedge will be allowed to be extended for another month, substantiated by supporting documents.

The fact that the rupiah weakened further in the days following the announced changes suggests that the position takers who were the target of these restrictions were actually long the rupiah. While BI is right to point out that those interested in investing in real assets in Indonesia's economy should not be affected by these restrictions, the regulations will likely reduce liquidity in the FX market and likely increase the market's volatility.

In addition, the sudden nature of the announcement has led to concern that more changes could be in the pipeline – eg, an unwelcome sense of policy instability has been introduced. This alone could damage sentiment on the currency and create uncertainty around foreign currency profits from investments made in rupiah.

### Fundamentals still strong in medium term

All of the above being said, we still remain positive on Indonesia's fundamental trends and expect that the rupiah will strengthen over the medium term. Factors supporting the currency include:

- Confidence in the SBY administration, regardless of the slow pace of change, that should continue to see the net repatriation of Indonesian savings;
- Increased foreign direct and equity investment on the back of a strong growth

story and an improving investment and operating climate;

- Improved creditworthiness as the government establishes a good fiscal track record and reduces its debt burden;
- Increased depth in the local debt and equity markets, in part because of the ongoing extension of the yield curve; and
- Progress on the authorities' efforts to coordinate Pertamina's dollar purchases as well as to use the inflation target to manage inflation expectations.

The risk to our rather bullish longer term forecast is that BI keeps real interest rates depressed, thus allowing inflation expectations to continue an upward trend. Given the BI's lack of track record on monetary policy, any reluctance to target inflation rather than growth is likely to do long-term economic damage.

### Forecast table

	2004	2005f	2006f
Real GDP growth (%)	5.0	6.0	6.5
Inflation (yr av, %)	6.1	7.5	6.0
Exchange rate (eop)			
IDR per USD	9,290	9,300	8,900
IDR per AUD	7,236	6,138	5,785
Interest rate (1-month SBI, % pa) (eop)	7.4	9.5	8.0

Sources: Asia Pacific Consensus Forecasts, ANZ Bank

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