A balancing act

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> **There appear to be signs that demand–side pressures are abating domestically, in turn placing less stress on Indonesia's current account deficit**

We look for Indonesia to grow a robust 6.1 per cent this year and the next. Most of this expansion will come from domestic demand, with net exports expected to deduct nearly 3pp from overall growth this year, and another 1pp in 2013.

On the face of it, there appear to be signs that demand-side pressures are abating domestically, in turn placing less stress on Indonesia's current account deficit. Since April 2012, imports have fallen by more than 18 per cent on a cumulative basis. Meanwhile headline inflation as of September was at a six-month low of 4.3 per cent year-on-year.

But other indicators suggest that domestic demand pressures actually remain relatively robust, posing continued risks to inflation and the current account. If we decompose the cumulative decline in imports since April, we find that the bulk of this owes to a drop in demand for raw materials, which are primarily used as inputs for manufacturing and exports. This suggests that the decline in imports is more a reflection of external, rather than domestic, weakness.

Meanwhile overall retail sales remain in double-digit territory, supported by sales of household appliances, as well as cultural and recreational goods. This, even amid a noticeable cooling in demand for motorcycles and motor vehicles after Bank Indonesia imposed down-payment rules in mid-June. Consumer confidence remains firm, with Indonesians indicating greater optimism over employment, income and economic prospects.

Significant upside: HSBC Indonesia's headquarters in Jakarta

On the inflation front, price expectations have stabilised in recent months, but at elevated levels. The same can be said of money supply and credit growth; at nearly 18 per cent and 24 per cent year-on-year respectively as of August, they continue to pose latent upside risks to inflation.

Against this backdrop, we are heartened to see Bank Indonesia in a gradual tightening mode. In addition to the macro-prudential measures in June, efforts are also being made to soak up excess rupiah liquidity, by offering higher interest rates on monetary instruments such as central bank bills and IDR term deposits. In August the central bank announced a package of measures to take the current account deficit to more sustainable levels, including a 25bp hike in its deposit rate for excess reserves (FASBI) to 4 per cent, and a stabilisation of the rupiah "in accordance with its fundamental conditions."

This approach to tightening is likely to continue. Since the August package, authorities have shown a greater willingness to let exchange rate weakness help to adjust external imbalances. In the coming quarters, we believe this will be interspersed by the occasional FASBI hike, until BI's policy corridor is once again symmetric with its lending and deposit rates at an equal 100bps spread to the current reference rate of 5.75 per cent.

Ongoing external imbalances will necessitate such a policy response, if not more. Despite the recent improvement in Indonesia's trade balance into a small surplus, HSBC's Purchasing Managers' Index surveys regionally continue to suggest a more pronounced decline in exports ahead, particularly in key markets such as China. As it stands, Indonesia's commodity-heavy exports have been underperforming the region since August 2011, when Asia's export cycle last peaked. As a result, net exports deducted 1.3pp from first-half growth – double the drag we had initially projected for the full year. It now looks as if net exports could subtract nearly 3pp for 2012, and deduct 1pp next year.