Investigating the Current Account Balance Movement of Indonesia

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Nur Amalia Gustyara
(Indonesia)

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Members of the Examining Committee:

Dr. Howard Nicholas
Prof. Dr. Peter A.G. van Bergeijk

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Inquiries:
International Institute of Social Studies
P.O. Box 29776
2502 LT The Hague
The Netherlands

t: +31 70 426 0460
e: info@iss.nl
w: www.iss.nl
fb: http://www.facebook.com/iss.nl
twitter: @issnl

Location:
Kortenaerkade 12
2518 AX The Hague
The Netherlands
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<th>Description</th>
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<tr>
<td>BI</td>
<td>Bank Indonesia (The Central Bank of Indonesia)</td>
</tr>
<tr>
<td>BOP</td>
<td>Balance of Payments</td>
</tr>
<tr>
<td>BPS</td>
<td>Badan Pusat Statistik (The Central Bureau of Statistics of Indonesia)</td>
</tr>
<tr>
<td>CA</td>
<td>Current Accounts</td>
</tr>
<tr>
<td>FDI</td>
<td>Foreign Direct Investment</td>
</tr>
<tr>
<td>GDP</td>
<td>Gross Domestic Product</td>
</tr>
<tr>
<td>IMF</td>
<td>International Monetary Fund</td>
</tr>
<tr>
<td>NPISH</td>
<td>Non Profit Institutions Serving Households</td>
</tr>
<tr>
<td>OECD</td>
<td>The Organisation for Economic Co-operation and Development</td>
</tr>
<tr>
<td>SNA</td>
<td>System of National Accounts</td>
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Acknowledgement

I would like to present my sincerely gratitude for my supervisor, Dr. Howard Nicholas. I am really grateful for your patience in guiding me through many obstacles and up-down during this writing process. You have been more than an academic supervisor, but also a mentor as you gave me many insights, encouragement and aspiration for my future. I would never forget all the knowledge I have gained from you during the regular class and especially the extra classes you gave for my batch! It is a lifetime experience for sure!

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Abstract

Indonesia as one of the largest emerging market in Southeast Asian has continuously received attention from the global market. However, despite its optimistic economic growth, the country still experiences a deteriorating current account balance in the recent years. This study aspires to investigate the important factors which could explain this long-term weakness in Indonesia’s current account balance, with the sub-objective being to explain the period of relative strength in the current account balance from 1998-2003. The research uses two approach from monetarist and structuralist. In order to support the analysis, this paper use several secondary data from Government and International Organizations. The study finds that trade account possessed a vital role of the overall current account balance. But in some period, especially in the weakness period of current, the primary income surpasses the trade balance.

Relevance to Development Studies

An issue of current account balance in Indonesia have been studied a lot by many scholars, including the local government and International Organization. The research has covered many issues of the balance; for instance, the determinants, threshold, and financing resources for the imbalances. Thus, given to that this paper seeks to provide a comprehend investigation of the changes in current account balance in 1981 until a recent year in 2018 by particularly investigating the relative strength and weakness of the current account balance. It is considered that the findings could contribute to the common literature for a developing country case, and for Indonesia.

Keywords

Current account, trade, primary incomes, exchange rate, Indonesia
Chapter 1
Research Overview

1.1 Introduction

The balance of payments is a record of the financial transactions of the residents of one country with the rest of the world. It is generally accepted that the balance of payments is an important barometer of the health of a developing country. Therefore, its study is considered to be important, especially when the balance of payments happens to be weak and causes both foreign exchange reserves to fall to low levels and the currency to weaken continuously.

The balance of payments comprises three major accounts; the current, capital and financial. Of these three, the current account is considered to be the most important driver of the overall balance of payments over the long-term. If a country’s current account is relatively weak compared to its neighbours or competitors, or if it is in continuous deficit for a long period of time, it is usually taken by the relevant authorities as cause for concern. As figure 1.1 below indicates, from 2011 to the present (2017) Indonesia has not only had a weak current account balance compared to its neighbours, but it has been consistently negative over this period.

Figure 1.1
Indonesia’s current account balance movement in comparison with some other Southeast Asia countries from 2001 – 2017 (current account in the percentage of GDP)

Source: World Development Indicators, updated on July 10th, 2019. Data was accessed on July 12th, 2019 and charts were processed by the author.

In fact, as the paper will show later, since 1981 Indonesia has experienced continuous weakness in its current account balance, with only one period, from 1998-2011, when there was a significant improvement in this balance. An important question that needs addressing when considering the weakness of Indonesia’s current account balance, is what explains the period of relative strength in this balance, which coincidently was just after the “Asian crisis”.

The main objective of the paper then is to look at the important factors which could explain this long-term weakness in Indonesia’s current account balance, with the sub-objective being to explain the period of relative strength in the current account balance from 1998-2011. The corresponding major research question being addressed is what explains the long-term weakness of the current account balance. In this context the important sub-question is what role has been played by the trade balance and the real exchange rate. The core argument of the paper in respect of these research objectives and related research
questions is that the observed long-term weakness in Indonesia’s current account balance is explained by the long-term weakness in the trade account balance, with this long-term weakness in turn explained by the structure of the economy and the overvaluation of the currency. It will be argued that it is the real value of the currency that also explains the period of relative strength in the current account balance, from 1998-2011.

1.2 Data and Methodology

The paper will make use of data collected from secondary sources, mainly international organisations and government websites. The secondary data is the core part in several sections, but mostly in analytical section to cover the macro-economic analysis. The time period for the analysis is 1981 until 2018. The starting date is chosen because it is when most of the reliable macroeconomic data is available, and the end year is because it is the last year for which the relevant data is available.

The paper uses simple graphs and tables to make the relevant empirical points, with this evidence supported by a critical review of the relevant academic literature and an appraisal of government policy documents.

1.3 Scope and Limitation

The research paper focuses on the period from 1981 to 2018 due to data availability and not because of any economic rationality. The focus will be on explaining the weakness of the current account balance and not the overall balance of payments. Use will be made of the real exchange rate in this explanation, but there will be no attempt to explain trends in this variable, even though this is considered an important subject in itself. Lastly, although the trade balance is considered to be an important determinant of the overall current account balance, the focus is not limited to the explanation of this account alone.

1.4 Structure of the Research Paper

The paper will comprise four chapters, apart from the introduction, as follows;

- Chapter 2 will conduct a review of the literature on the determinants of current account balances beginning with a critical review of the mainstream monetary approach, and then considering alternative approaches that stress the structure of the economy. Consideration will be given to the empirical evidence provided by each approach and the manner in which this evidence is presented.

- Chapter 3 will provide the necessary background information on the Indonesian economy to undertake the empirical analysis of the current account balance trends in the following chapter. The last part of the chapter will focus on government policy with respect to the current account balance, with a view to getting a sense of the official view of its determinants.

- Chapter 4 will attempt to provide data to verify the major arguments of this paper, showing how the findings relate to the general literature and those specifically on Indonesia.

- Chapter 5 will summarise the major findings of the paper and consider the policy implications arising from these.
Chapter 2
Literature Review: The Mainstream and Alternative view of the Current Account

The aim of the chapter is to review the literature pertaining to the determinants of movements in the current account balance. The first section will look at what is widely regarded as the standard theory on the subject, the monetary approach. The critical review of this body of literature will be used as a basis for looking at alternative approaches that focus on the structure of the economy in explaining trends in current account balances.

2.1 The Monetary Approach of the Current Account

It becomes clear in many approaches that the current account is considered as the most vital account in the balance of payments; especially its ending balance whether surplus or deficit. Dornbusch (as cited in Helmers 1988: 1) expresses that current account surplus could be understood as several appearances; (a) the national income exceeds the expenditure, (b) the number of exports is greater than imports, and (c) “the net increment to nation’s foreign asset holdings”, and vice versa. The ending balance of current account also indicates that the reserve of foreign exchange assets position is increased or deteriorated (Helmers 1988: 1). But briefly, a surplus in the current account balance implies an excess supply of goods, or of trade products; goods and services to be more comprehensive.

The classical economists’ view about the balance of payment mostly considers it as a monetary phenomenon. Although, the focus of the discussion merely centred in the current account or trade. It studies the changes of money supply eventually bearing to the current account. Frenkel and Johnson (1976: 21-22) argued the ending balance of current account (particularly a good account) analyses about the relationship between domestic income and consumption (absorption) in the economy, and then how its “accumulating claims on future income (assets)” from the international market.

The monetary approach acknowledges the money stock in the economy is as an exogeneous variable, where the excess of the money stock tends to create a rise in the expenditure. The rise in the excess demand of money overflows to the inflation rate or “general price level”, which Frenkel and Johnson (1976: 23-24) mentioned it does have an important level to influence “the real value of nominal assets—money”. To be clear, the broad money stock in the monetary approach is derived using below identity (Easterly 2002: 7):

\( MV = PQ \)

where in the model, M refers to money supply, V is the velocity of money stock, P is the price level and Q is the real output or real GDP. To solve the model for Inflation rate, Easterly (2002: 7) creates first log differences as follow:

\( \Delta \ln P = \Delta \ln V + \Delta \ln M - \Delta \ln Q \)

As the velocity of money is assumed as a constant variable, “then inflation will have a unitary elasticity with respect to “excess money supply growth”, i.e. the excess of nominal money supply growth over real output growth” (Easterly 2002: 7).

At the same effect, the rise in the expenditure accumulates the demand for imports in domestic market, and at some point, it overcomes the demand for export from the
International market. The monetary approach picks out a part of the approach, where emphasis the process of accumulating and decumulating of the foreign assets.

Considering that current account is included in the monetary principle, the “structural” imbalances deficits or surpluses, for instance a deficit occurs in the “weak” economies, merely could not be existent, he mentioned (Johnson 1977: 227). Still, the deficit is accepted if the real changes are accompanied by policies that contain a decreasing in international reserves. Johnson (1977: 227) added that any imbalances problems could be corrected using the domestic monetary policies, without any exchange rate changes. Yet, “import quotas, tariffs, exchange controls and other interferences with trade and payments” could be beneficial to the balance of payments if the purpose is to boost money demand, by increasing the price level in domestic market (Johnson 1977: 228). He claimed that the rapid growth of a country economy will enhance the overall balance of payment “by increasing the demand for money”, even though the progress might contain a trade deficit funded by the foreign fund sources (1977: 228).

In addition, the approach disputes that there are two exogenous variables influence the inflation and productivity growth, which in the end could create an imbalance problem. Ghosh et al. (1996: 2) found the evidence that there is a causality effect between inflation and fixed exchange rate; the country experiences a low inflation rate could manage better its exchange rates, whereas the country adopts a fixed exchange rate tends to have a lower inflation. The fixed exchange rate policy is observed to have a correlation as well with the output growth of the country. As if the authority employs an exchange rate “engenders greater policy confidence, it can foster higher investment”, even though the productivity is lower than the country with a floating exchange rate (Ghosh et al. 1996: 2). Moreover, the productivity growth in the economy is “reflected in faster growth of external trade” (Ghosh et al. 1996: 11). They added that the surplus of trade transactions (where export exceed the import growth) is “almost 3 percentage points higher under floating rates” (Ghosh et al. 1996: 11). To the extent that the approach seems suggesting a floating exchange rate regime to be implemented in the country that experiences a current account deficit.

2.2 The Alternative View to Understand the Movement of the Current Account

In previous section, the classical monetarist explores the imbalances key problems by observing the change of money supply, which then affect the behavioural spending of the domestic buyer. This section studies the other view of the current account, which is structuralist with its terms-of-trade theory. Terms-of-trade approach observes the current account with larger spectrum, where each sub-account presumes having a substantial role in certain economic structure. The influential scholars of the topic are Prebisch and Singer in 1950s. The study suggested that the commodity prices would be worsened through the years and does not inelastic supply as the classical economists’ belief. Besides, Santos-Paulino (2010: 855) mentioned that “the impact of terms of trade shocks on a country’s current account balance is also a key issue in International economics”.

Prebisch-Singer thesis was about the price of raw materials commodities have a tendency to decline and it might strike continuously. The prices fall could be arisen in particular in developing or less-developed countries due to some factors; but most important are (1) the technological changes with its different rapidity benefits more for the manufactures product and (2) the manufactured-product tend to be in the less competitive markets, and monopolized by more dominant side, which is industrialized and developed countries.
Hence, the decision making of a country adopts more raw materials as the export products does not merely but beyond its ‘competitive’ advantages.

In addition, the yield of technical progress on the terms-of-trade will based contrarily on the developed countries that have the investment sources for the less developed countries as well. To sum up, it creates dependency relation of the investment host to the home country. Singer (1950: 477) discussed that the specialization on food and raw materials of the less developed to the developed (“industrialized”) countries, fundamentally due to the influence of the latter through investment capitalized in the former countries. The condition has been disadvantage for the less-developed country’s economy, as it dissuaded the country to apply a more technology-advanced production and even lessen the advantage of the country received for the “foreign trade-cum-investment” due to its specialization on the export of food and natural resources products (Singer 1950: 477). Singer (1950:478) added that “technical progress in manufacturing industries showed in a rise in incomes while technical progress in the production of food and raw materials in underdeveloped countries showed in a fall in price” and also in the form of lower prices for the customer as added by Sarkar (2001: 441).

The fluctuation of the terms-of-trade in the developing countries is greater than in the developed countries due to the country’s reliant on commodity exports (Broda and Tille 2003: 2). Broda’s study in 2003 (as cited in Broda and Tille 2003: 2) complemented the argument by exclaiming the developing country have a lesser power over their product prices in the global market; “by contrast, developed countries and oil exporters can exert a substantial influence on export prices”. Singer assumed that the relative price of food and raw materials would decreased alongside with the technological progress, while Prebisch added that the manufactures products prices would be increased more than raw material products in the developed countries, and deteriorate less than in the developing countries (as cited in Hadass and Williamson 2001: 10).

In their research, Broda and Tille (2003) explained how the logic of the terms-of-trade theory is. Assumed that there was a drop in the price of export products for each country with fixed and floating exchange rate, which will cut the income of the export players in the countries. The condition then presumably causes the industries slowing down their production, thus creates a reduction in employment as well. As there is lesser foreign currency flowing into the country as the reduced of export trading, the market tends to preserve the foreign currency as its response to the shortage supply of the currency, thus it is appreciated. The government of both country with each currency system then will react differently to the condition; the one with fixed exchange rate might intrude the market by absorbing the local currency in exchange of the foreign one. This attempt will pull out many domestic funds out of the money market, “reducing the amount of money and credit available for business investment and expansion” (Broda and Tille 2003: 2). Eventually, Broda and Tille (2003:2) found that it can “lead to a costly construction in output”. On the other hand, a fall in the country’s export prices will suggest the domestic currency to be depreciated and by adopting the flexible exchange rate regime the government will let it be. Such depreciation enables exports to be more competitive in the world markets, thus increasing the demand. The demand itself encourages the production in the export companies, “cushioning the adverse impact of terms-of-trade shock on output” (Broda and Tille 2003: 2).

2.3 Empirical Studies from the Central Bank of Indonesia

Since 1981 until 2018, there were a short period where Indonesia booked a surplus balance on its current account; it was after the crisis of 1998 until 2011. But it was only up to 2003
the surplus has a relative high figure approximately 5%. It has been said that trade balance is the main driver of CA, yet there are other contributors as its stimulus. Sahminan, Ibrahim and Yanfitri (2009) conducted a study to find the determinants of Indonesia current account using data from 1994 until 2004 based on the intertemporal approach. They founded that current account was significantly influenced by three components; consumption, investment and real effective exchange rates during the period; and one percent increase in those three in respect to GDP ratio created a lower current account to GDP by 0.38 percent, 0.39 percent and 0.07 percent, respectively (Sahminan, Ibrahim and Yanfitri 2009: 20). Adding to the findings, Sahminan, Ibrahim and Yanfitri (2009: 20) claimed that the threshold of current account to GDP ratio is ±2 percent, where an excessive consumption spending, investment and Indonesia appreciation will lead to an unsustainable current account balance. On a different direction of causality, Nugroho et al. (2012: 32) found that when the current account deficit to GDP exceeds the threshold of ±2 percent, the exchange rate will be depreciated around 12.7% (m-o-m) with a delay effect approximately 4 months.

As a developing country which experienced a deteriorating in its external balance for most of the time, it could not be neglected that the role of external financing is necessity to CA. Widodo et al. (2013: 31) argued that during the period of 1970 until 2012 and ARDL method, especially in the short-term, the imbalances are considered as a sustain one if it is supported by capital inflow to the capital and financial account. Moreover, the investment climate in the country must ensure a support system to attract FDI, other investment (loan), and portfolio investment to handle the short-term pressure in the imbalances (Widodo, Tobing and Yuwana 2013: 31). In accordance to that, Tobing et al. (2014: 40) agreed that FDI in particular is the most influence component of capital and financial account toward the current account balance and the economic growth in general. Yet, it resulted many payment outflow from the country than to remain in the country to support the export production. They added (Tobing et al. 2014: 41) that a financing of current account deficit using FDI is not sustainable, unless it is invested into an export-oriented sector.

In brief, it seems that there has been a constantly issue on how the economic structure addresses the imbalances problem in the country. It could not be denied as well that external financing, or FDI in particular is required to fix the imbalance problem. But the fund must be well invested in a productive sector; manufacture than natural resources sectors. Even more, the expansion of the export-oriented production has to be centre of the policy where the external finances as the support system not the other way around.
Chapter 3
The Drivers of Indonesian Economy

We would like to have breakthroughs and to synergise between all ministries, therefore there are more job opportunities available. We would like to suppress current account deficit, trade balance deficit and develop industrialisation, which is export-oriented and import-substitution.

(Joko Widodo, President of Indonesia for 2019 – 2024, his speech on October 23rd, 2019 during the announcement of the new ministry cabinet)

3.1 Indonesia’s Economic Structure

Indonesia, as one of the largest economies in Southeast Asian, has been a continuous attention in the global for both its potentials and problems in several discourse; social, politic, culture, economy, natural resources and many more since its Independence Day in 1945. Based on that, numerous cooperation has been established within bilateral, regional, and multilateral level to improve and strengthen the country’s economic condition. On October 8th – 14th, 2018, Indonesia became the host of an important annual meeting of International Monetary Fund and World Bank (IMF-WB) in Nusa Dua, Bali Region (Bank Indonesia 2019: 65-66). Particularly in the finance topic discussion, Indonesia raised four focus; (1) reinforce the international cooperation for the monetary system, (2) infrastructure financing, (3) digital and (4) sharia economy and financing. The current President, Joko Widodo, since his first year in 2014 he focuses principally in the development of infrastructure with intention to boost the economic production activity.

![Figure 3.1](image)

Indonesia’s Gross Domestic Product (Current Price, in Million USD)

Sources: Data extracted from World Development Indicators on October 24th, 2019. Charts were created by the author.

The trend of gross domestic product of Indonesia presents an upward through the years in Figure 3.1, even though in certain years it experienced some drop off due to an external factor; such as Asian crisis in 1997. Moreover, particularly during the period of the Asian
crisis the main reason for a significant drop of GDP was triggered by the depreciated value of Indonesian exchange rate 244,18% from IDR 2,909,38 to IDR 10,013,62. GDP as the main indicator of a country’s economic condition, it could be analyse based on several lenses. One is the expenditure approach; GDP is composed by household and NPISH consumption, government consumption, investment (fixed capital formation and changes in inventories), and trade (export and import) in the approach. Each year, the final consumption constantly gives the largest contribution with approximately 50 percent of total GDP between other components; investment, trade, and government. The consumption itself is categorized into two type of consumers; households and NPISH, the contribution of households spending has constantly dominated with percentage of 56, 56,31 and 56,66 percent in 2014, 2015, and 2016 respectively out of other components (BPS 2019: 11). It is indeed a proof that the economy of the country is led by the domestic demand.

Yet, the absorption has still to be supplied by the import activities to fulfil the domestic demand. For the past three years, the trade transactions contribute 37 percent of the total GDP. It would be seeming right for Indonesia, as a country that has diverse natural resources compares to its country neighbours; for instance, Singapore and Malaysia, to conduct an export-oriented economy structure. Mostly year, the trade of raw materials booked a positive net export. The country is a raw materials producer, although it also has manufacture production. The manufactures shares are considerable larger than the raw materials in the total of merchandise trade; 45 and 66 percent for manufactures exports and imports in 2018. The manufactures exports have experienced an aggressive expansion from 3 to 51 percent in 1981 and 1996 respectively, which was one year before the Asian crisis emerged in 1997.

<table>
<thead>
<tr>
<th>Table 3-1</th>
<th>Agricultural raw materials and manufactures shares in percentage of merchandise exports in particular years.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1981</td>
</tr>
<tr>
<td>Agricultural raw materials exports (% of merchandise exports)</td>
<td>8,22</td>
</tr>
<tr>
<td>Agricultural raw materials imports (% of merchandise imports)</td>
<td>3,20</td>
</tr>
<tr>
<td>Agricultural raw materials net exports (% of merchandise exports)</td>
<td>5,02</td>
</tr>
<tr>
<td>Manufactures exports (% of merchandise exports)</td>
<td>3,02</td>
</tr>
<tr>
<td>Manufactures imports (% of merchandise imports)</td>
<td>68,95</td>
</tr>
<tr>
<td>Manufactures net exports (% of merchandise exports)</td>
<td>-65,93</td>
</tr>
</tbody>
</table>

Sources: Data extracted from World Development Indicators on October 29th, 2019. Number was calculated by the author.

Since then, the growth rate was slower and slightly fall from 57 percent in 2000 to 34 percent in 2011. Despite of its larger shares than raw materials in exports, manufactures trade booked a negative net exports in many years due to the greater import transactions. It might be occurred owing to the fact that the structure of Indonesian economy has a substantial agriculture, forestry and fishing production. The share of manufacture production has not sufficient yet to cover the entire domestic demand, which promotes more imports enter the country.
In the recent years, there are three main drivers in the economic growth; agriculture, industry, and services. Based on Figure 3.2, industry and services sector perform larger role

1 The definition of each indicator is based ADB Key Indicators’ definition. Agriculture refers “hunting, forestry, and fishing”. Industry sector refers “mining, manufacturing, construction, electricity, gas, steam and air conditioning supply”. Services refers “wholesale and retail trade, transport and storage, accommodation and food service activities, financial and insurance activities, real estate, and professional and technical services”. https://kids.adb.org/kidsb/references/definitions
than agriculture sector, with an average of 44,5 percent, 41,3 percent and 14 percent, respectively between 2000 and 2018. Nevertheless, there was a shifting period when industry sector started to weaken by having the closest gap with services sector in 2010 due to a significant drop from the previous year and eventually be passed in 2014. It is also confirmed by gradual decline of manufacturing output to GDP from 22,63 percent in 2010 to 20,70 percent in 2018. It was followed by the mining and quarrying as well, although since 2016 the graph shows a slightly improvement from 7,45 percent to 8,42 percent in 2018. But, the percentage is still below 10,74 percent in the year of 2010.

To support the domestic production, it is certainly need investment to expand and accelerate the real sector. The liberalization era of Indonesian financial sector (especially in banking) was started on October 27th, 1988; where the regulation of bank establishment lessening accelerated the massive emerge of new banks in the country, and also the central bank of Indonesia assigned a lower banking reserve requirement. Besides, back in 1967 the Government issued the Law No. 1 about Foreign Direct Investment application in Indonesia. It started the country’s openness attitude to the International market, where previously the foreign investors were restrained by the nationalisation mechanism of the country’s economic structure (Sahminan, Ibrahim and Yanfitri 2009: 7).

Figure 3.4 informs about the net inflow of foreign direct investment that be obtained by calculating the new investment deducts with the disinvestment in the country. The financial sector liberalization of Indonesia began in October 1988, where the government eased the banking reserve requirement from 15 to 2 percent and the bank establishment permit for new bank. Besides, the massive emerged of banks were accompanied as well by the advancement of financial instruments; “negotiable certificate of deposits, commercial papers, promissory notes, Automatic Teller Machines” (Wariyo and Solikin 2003: 38). The deregulation of economic policy to provide more supportive climate for larger role of private actors in 1983 – 1996, which was proven by the rise of FDI inflow to the country. The growth of foreign direct investment net inflows were significantly improved by 975 percent from 576 to 6.194 Million USD (BOP, current price). The rise in FDI was also caused by the rise in textile and garment industry, which was a result from the labour-intensive industry relocation from Taiwan and Korea (Widodo, Tobing and Yuwana 2013: 26).

**Figure 3.4**

*Foreign direct investment, net inflows (% of GDP)*

![Graph showing foreign direct investment, net inflows (% of GDP)](image)

Sources: Data extracted from World Development Indicators on October 31st, 2019. Graph was created by the author.
The boom of foreign inflow to the country, it was used to cover the saving-investment gap of the country. The fund was mostly in the form of foreign private loans and had a short-term maturity. However, it invested in a private long-term project in the country, which did not match with the loan maturity and currency (Warjiyo and Solikin 2003: 38–39). That condition was suspected as the main trigger of crisis struck in Indonesia in 1997.

Afterwards, the foreign direct investment plumped down from 2.72 to minus 2.76 percent of GDP, which the net FDI inflow was minus 4.5 billion USD (BOP, current price) at the lowest in the year of 2000. Facing the crisis of financial sector, the government initiated a loan-restructure for private banks and non-banks in order to ease the condition. Later on, the financial sector was improved owing to the success of private loan restrutures and the increasing of capital inflow as the result of privatization of state-owned companies and divestation of banks within the Indonesian Bank Restructuring Agency (Badan Penyehatan Perbankan Nasional/BPPN) (KKBP 2017: 30). During 2002 until the recent years, the investment net inflows has rather volatilities. Nevertheless, the FDI indicated an increase trend of the investment amount from 414 million to 1.51 and 12.05 billion USD in the period of 1970-1980, 1980-1997 and 2004-2015 respectively (Hastuti and Dewati 2017: 48).

The motives of foreign fund sources are invested in a developing economy could be some-how tricky. Dunning (as cited in Hastuti and Dewati 2017: 13) categorized the aim of multinational company’s direct investment into 4 characteristics; (1) to expand markets for new product –market seeking oriented–, (2) to access natural and human resources in order to guarantee the production’s inputs –supply-seeking oriented–, (3) to maximize profit through rising its production efficiency –efficiency oriented– and (4) to protect or accelerate the ownership advantage through portfolio investment, or merger-acquisition on other foreign or domestic-owned companies to reduce the competitor –strategic asset-seeking oriented–. It has been a challenge for Indonesia to shift the investment direction from market-oriented to export-oriented (Hastuti and Dewati 2017: 73).

3.2 The Trends of the Balance of Payments and its Sub-Accounts

Current account justifies the movement of goods, services, primary income, and secondary income (also known as current transfers) that occur between one resident to non-resident(s) (IMF 2009: 9). Each transaction will be presented using “double-entry basis” accounting; credit and debit. Credit is applied for transactions are related with “exports of goods and services, income receivable, reduction in assets, or increase in liabilities”; whereas debit is for recording “imports of goods and services, income payable, increase in assets, or reduction in liabilities” (IMF 2009: 10). Moreover, IMF acknowledges that the current account (or also entitled external balance) is the most important account between others in the BOP structure. Likewise, the current account in percentage of the country’s gross domestic product is commonly understood as the country competitiveness position compares to other countries. The Indonesian current account appears to have a negative ending balance for the past seven years. As the Monetarist observes the current account imbalance as a trade account problem, the Structuralist argues that there might be a structural problem on which sub-account is dominating on particular period.
If we observe the CA graphs in Figure 3.5 using a helicopter view, it gives some idea that the changes of CA since 1981 until the recent years presume having three periodical cycles; 1981 – 1997, 1998 – 2011, 2012 – 2018. It was grounded on the assumption of the surplus or deficit balance of the account. Yet, it is required more comprehensive analysis to conclude it, which it will be investigate in the remainder chapters.

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<tbody>
<tr>
<td>Current Account/GDP (in Percent)</td>
<td>(2,92)</td>
<td>2,43</td>
<td>(2,48)</td>
</tr>
<tr>
<td>Trade/GDP (in Percent)</td>
<td>0,72</td>
<td>5,58</td>
<td>0,10</td>
</tr>
<tr>
<td>- Goods/GDP (in Percent)</td>
<td>4,86</td>
<td>9,65</td>
<td>1,07</td>
</tr>
<tr>
<td>- Services/GDP (in Percent)</td>
<td>(4,14)</td>
<td>(4,07)</td>
<td>(0,97)</td>
</tr>
<tr>
<td>Primary Incomes/GDP (in Percent)</td>
<td>(3,96)</td>
<td>(4,17)</td>
<td>(3,11)</td>
</tr>
<tr>
<td>Secondary Incomes/GDP (in Percent)</td>
<td>0,31</td>
<td>1,02</td>
<td>0,53</td>
</tr>
</tbody>
</table>

Sources: Data for Current Account extracted from IMF Data Warehouse on September 12th, 2019; GDP (current price, USD) extracted from World Development Indicators on October 24th, 2019. Number was prepared by the author.

There are three sub-accounts that drive the movement of current account balance; trade account, primary incomes, and secondary incomes (or transfer) account. Each account records specific transaction; for example, exports-imports in the trade account, reinvested earnings in the primary incomes, and remittances in transfer account. The ending of each account forms the final current account balance. Assumed that there is an imbalance account, it could be financed through foreign resources (foreign direct investment, aid, bilateral or
multilateral loan) or national resources (government budget account, economic structure adjustment).

In order to conduct an analysis for the changes of CA, table 3-2 elaborates the sub-accounts within three periodical cycles. Particularly, there are two accounts that stand out as the main drivers for CA; trade and primary incomes account. Each account dominated alternately between all sub-accounts in different periods; 1981-1997 and 2012-2018 were the period of the primary incomes hold approximately a larger figure than the trade account, meanwhile in 1998-2011 it was led by the trade account. Especially during the time when trade account in charge, it alleviated the current account to have a surplus ending balance.

Conversely, there was one point that should be highlighted from table 3-2; primary incomes account constantly performs deficit balance through the years with the lowest was 8.58% in percentage of GDP in 1998. The largest contribution of the primary incomes debit post in 1998 was other investment interest payment, direct investment interest payment and dividends as percentage 64.9%, 23.7% and 11.3% respectively. It could be recognized during the emerge of Asian Crisis in 1997, where numerous foreign investors with its money left the country in the next couple years. Notably, this could be an issue to be more considered whether the foreign fund that invested in the country is in short or maturity term; and whether the authority’s approach in financing its imbalance is depending on the foreign fund, such as direct investment, portfolio or loan, rather than expanding the economies to outdo the current account deficit.

3.3 Policy Attitude

To carry on the previous issue, this sub-chapter attempts reviewing to what extent the authorities responding to the deteriorating condition of the country current account and what kind of policy they generally applied in previous years.

3.3.1 Before the Asian Crisis in 1997

After its independence, Indonesia faced many struggles in economy; a significant drop in the production capacity, lack of productive asset as the result of the post-wars, high inflation due to products scarcity, unmanageable money circulating in the market, export-import blockaded by Netherlands, several version of money circulated in the market (based on Indonesian, Japanese, and Netherlands Government) and lastly, large inter-regional migrations (KKBP 2017: 4). The ruled Government at that period conducted a massive Nationalisation: on most crucial assets for the country; agriculture companies, trading companies, industrial and mining companies, banking sector (including the Central Bank), merged the private-owned electricity, and transportation companies into state-owned companies to rebuild the country again.

Before 1980s, Indonesia has been blessed by the high price of the world oil. However, there was a declining in the world oil price in the early of 1980s, which led to the emerge of the world recession. The stabilization of Indonesian economy suffered toward the recession; as the national income was weakening, it limited the government spending to help the domestic economy.

In order to recover from the ‘dark times’, the government conducted massive deregulation, de-bureaucratization, and even liberalization in many layers of economic sectors; banking, finance, trading and investment (Warjiyo and Solikin 2003: 36). In particular, the era of Indonesia banking and financial sector liberalization started on October

2 Changing the ownership from private-owned to state-owned.
27th, 1988. It was the moment when the banking reserve requirement was decreased from 15 to 2 percent and the new bank establishment permit regulation was lessening (Warijiyo and Solkin 2003: 38). The money market instruments were evolved as well in accordance with the banking system; “negotiable certificate of deposits, commercial papers, promissory notes, Automatic Teller Machines”. One of the result can been from an increase of gross domestic saving of GDP percent from 10,6 percent in 1970 to 30,7 percent in 1989.

However, Indonesia experienced a long-term current account deficit since 1981 until 1997. To encounter the deficit on the CA and promote the International competitiveness, “the government devalued Rupiah exchange rate by 27.6% and 31% in 1983 and 1986, respectively” (Sahminan et al. 2009: 8). The government at that time also applied a development policy with focus on food self-sufficiency and raw materials processing industry (for example steel, fertilizer, cement and paper as the output products) (KKBP 2017: 17).

### 3.3.2 Indonesia After the Crisis: 1998 onwards

Before the crisis emerged, there was a boom of foreign inflow entered the country to cover the saving-investment gap of the country (Warijiyo and Solkin 2003: 37-39). The fund was mostly in the form of foreign private loans and had a short-term maturity. However, the fund was invested in a private long-term project in domestic, which did not match with the loan maturity and currency. When the crisis finally reached Indonesia, the country overwhelmed with its current external debt stocks.

#### Table 3-3
**External Debt Stocks and Domestic Exchange Rate from 1996 - 2000**

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<tbody>
<tr>
<td>External debt stocks (% of GNI)</td>
<td>58.30</td>
<td>65.10</td>
<td>168.20</td>
<td>117.37</td>
<td>93.49</td>
</tr>
<tr>
<td>Exchange Rate (in Rupiah)</td>
<td>2.342,30</td>
<td>2.909,38</td>
<td>10.013,62</td>
<td>7.855,15</td>
<td>8.421,78</td>
</tr>
</tbody>
</table>

*Source: Data extracted from World Development Indicators on November 11th, 2019. Table was prepared by the author.*

In facing the problem, government considered that price stabilization and exchange rates are the main requirement to drive the economy (Bank Indonesia Annual Report 1999: 7). With IMF, the country set the base money target, including net international reserves, net domestic assets and Indonesian bank liquidity assistance (or Bank Lintasitas Bank Central/BLBI). BLBI is a financing assistance scheme for banking that experiences liquidity problems during the monetary crisis in 1997. A massive restructuring of banking industry and its assets in particular also conducted through National Bank Restructuring Agency (Badan Penyehatan Perbankan Nasional/BPPN).

Also, the government focused on paying the foreign debts, in order to reopen the access of international trading financing, where on June 4th, 1998 the delegates of Indonesian Government reached the agreement with foreign creditor that represented by the Bank Steering Committee (Bank Indonesia Annual Report 1999: 10). In supply side, mostly the business industry experienced a contraction due to a falling in global market demand. Business industry decided to restructure its debt problem first before expanding and waiting for the global market recover. It was the major reason why imports fell significantly about 30 percent in 1998; especially for raw materials support. The outcome of a falling in raw materials and consumption goods in the trade account, it delivered a surplus in the CA for several years ahead.

Since the 4th quarter in 2011, the current account balance shifted from surplus to deficit again due to the strong domestic demand could not be supported by the domestic market to provide the goods, and the increasing of Indonesia’s dependency towards fuel imports (Bank
Indonesia Annual Report 2012: xix). A sharp drop in exports, as a result of global economy contraction, caused the CA to GDP ratio experienced a large deficit of 2.66 percent. Still, the investment and working capital credit was assumed still quite high to boost the economic capacity onward. To support the economic growth, government applied a reduction of banking lending rates (Bank Indonesia Annual Report 2012: 41).
Chapter 4
Analysis of the Views

It has been clear from the previous chapters, that there was several years of current account surplus throughout 1981 until 2018; which was in 1998 until 2011. This chapter will attempt to address on what could explain the long-term weakness of the current account in Indonesia.

4.1 Findings on the Monetary Approach

In the classical view of the monetary approach, an increase in the import activities, as a reflection of growth on goods and services expenditure in the country, are caused by an excess money stock expansion. Money changes as an exogenous variable will stimulating the behaviour spending of expenditure, which is to rise in line with the excess money. Particularly, it should be reflected on a raise in prices and deteriorate in current account balance.

To capture the relationship between excess money and the movement of CA to GDP, this paper calculated the excess money (broad and narrow term) by subtracting a change of money and GDP (current price) in percentage and compared it with CA/GDP (in percentage). As the theory predicted, the money stock expansion in figure 4.1 seems to move in opposite direction with the changes in current account. However, the degree of changes between excess money and CA was not similar, especially between the period of 1998 – 2011 and 2012 – 2018. Hence, there should be other variables influence the movement.

Figure 4.1
Comparison of Excess Money (in Broad and Narrow Term) with CA/GDP

Sources: Data for M1 and M2 extracted from Bank Indonesia on November 7th, 2019; Current Account extracted from IMF Data Warehouse on September 12th, 2019; GDP (current price, USD) extracted from World Development Indicators on October 24th, 2019.

3 Lecture 10c notes of Howard Nicholas, last update on 15 September 2012
Figure 4.2
Comparison of Excess Money in Broad Term with The Changes of Exchange Rate and Inflation Rate

Sources: Data for M2 extracted from Bank Indonesia on November 7th, 2019; Exchange Rate and GDP (current price, USD) extracted from World Development Indicators on November 12th, 2019.

But with the excess demand, it appears that the effect of excess money, in particular M2, with the change in exchange rate and the percentage average of inflation provide a different story with the monetary theory. The graph in 4.2 indicates that the effect of money supply expansion on nominal spending did not transpire in all three periods, as an increase in the excess money was followed by a drop in the inflation rate. Besides, even though a rise in price in the period of 1998 – 2011 was accompanied by the exchange rate depreciation as the theory mentioned, the changes of inflation rate was in line with the current account improvement. The latter provides a contradictory information to comprehend the monetary theory.
4.2 Findings on Alternative Approach

The findings in the sub-chapter 4.1 have indicated an open debate on what justifies the movement of CA in Indonesia. It is undeniably that the trade account performs a vital role in CA balance, where the change in trade balance is aligned with CA. But, in the period of shifting from a current account surplus to deficit, primary income had held the same or even bigger role like trade account based on the magnitude changes.

Figure 4.3
The Movement of Trade and Primary Incomes in Percentage of GDP from 1981 to 2018

Sources: Data for Current Account extracted from IMF Data Warehouse on September 12th, 2019; GDP (current price, USD) extracted from World Development Indicators on October 24th, 2019. Charts were prepared by the author.

The structuralist approach distinguishes the current account balance especially between the agriculture (or raw materials) with the manufacture exporter. It argues that the dependency of a country towards more natural resources production will put its position more vulnerable to the global market changes. Hence, this paper conducted a testing on the argument by comparing the movement of manufacture products net exports with current account balance. In figure 4.4, it appears that the performance of manufactures net export is in line with the changes in current account. It briefly validates that it is necessary for Indonesia as a growing country to support and expand the production of its manufactures industries.

Figure 4.4
The movement of Manufactures Product Net Export/GDP and Current Account/GDP in Percentage for Indonesia
Sources: Data for Net Exports Manufactures from WTO Data Portal extracted on November 11th, 2019; CA from IMF extracted on September 12th, 2019. Graphs were created by the author.
The CA of Indonesia is significantly influenced by the trade account during the time of the current account surplus and the primary incomes account for during the shortfall. In general, the movement of Indonesia CA shares similarity especially with Malaysia and Philippines. There was a weakening in CA balance for those three countries, with the largest gap in Indonesia and Malaysia. In the context of manufactures shares in the economy structure, Malaysia and Philippines also share the same issue with Indonesia. The direction of manufactures net exports was fairly aligned with the changes in CA; except for 2008 when there was a drop in CA while a manufacture net exports in Malaysia was decrease and Philippines was increase.

Figure 4.5
Current Account Balance (in Percentage of GDP)

Malaysia and Philippines also share the same issue with Indonesia. The direction of manufactures net exports was fairly aligned with the changes in CA; except for 2008 when there was a drop in CA while a manufacture net exports in Malaysia was decrease and Philippines was increase.

Figure 4.6
The movement of Manufactures Product Net Export/GDP and Current Account/GDP in Percentage for Malaysia and Philippines

Sources: Data was extracted from WTO Data Portal on November 11th, 2019. Number was calculated by the author.
4.3 How Competitive the Real Exchange Rate of Indonesia

Figure 4.7
Comparison of the changes in Real Effective Exchange Rate with the Current Account/GDP in Percentage

Sources: Data for Current Account were extracted from IMF Data Warehouse on September 12th, 2019; Real Effective Exchange Rate was extracted from Bank for International Settlements on November 7th, 2019. Graphs were created by the author.

The current account balance moves closely with changes in the REER. It appears that Indonesia has been consistently experiencing an overvalued exchange rate. This is typically the case for raw material-oriented economies and low-technology of manufactures producer. Periodically, Indonesia has shifting from raw-materials oriented and oil-producer into manufactures producer. However, it seems that the country is still heavily depending on other countries manufacturing products, which proved by the percentage of manufactures net exports deteriorating in the recent years and relying on the net export of services and agriculture products as presented in table 3-1 and figure 3.3 in chapter 3. It also indicates that the manufactures products are less competitive than other countries in the market.
Chapter 5
Conclusion and Policy Implication

This paper addressed the question on what factors explain the long-term imbalances in the current account in Indonesia in 1981 until 2018. We began by noting the monetary approach of economic theory concerning an excess of money supply and its implications to the current account balance. The theory addresses that an excess in money supply will lead to a rise in expenditure the economy. It will be indicated by an increase in inflation and a deficit in trade balance; as the imports exceed the exports transactions. On the other hand, an alternative approach from structuralists argue that the terms-of-trade issue affects the direction of current account balance. The theory distinguishes a country by its sector production exports; where it assumes that a raw-materials oriented export will be unfavourable sector as it contains more barriers on the global market and more disadvantage compare than the manufactures production.

This paper found that the movement of Indonesia current account could be classified into three periods; 1981 – 1997, 1998 – 2011, and 2012 – 2018. A relative current account surplus in 1998 – 2011 was accompanied by a drop in excess money in broad and narrow term, as it is suggested by the monetary approach. Furthermore, the relative stronger current account balance was also accompanied by the exchange rate depreciation as the theory mentioned, and in line with the changes of inflation rate. The latter provides a contradictory information to comprehend the monetary theory. In the context of structuralist approach, the structure economy of Indonesia appears to have a shifting from raw materials (including oil producer) to manufactures producer. However, the country is still heavily depending on the import of manufactures products, which impacts the deteriorating of current account deficit in most of the years. It also appears that the country is experiencing an overvalued currency. The other issue arises from primary incomes account, where consistently reported a negative ending balance. Especially, in the period of 2012 – 2018 the country suffered a huge deficit in the primary incomes account and did hurt the current account balance.

Therefore, the main policy implication that the author would like to arise in this research is in regard to the link between manufacture sector to the foreign direct investment in particular, and foreign fund inflow in general. Since 1981, the primary incomes account contributed a deficit ending to the overall current. It does not per se that the foreign financing is harmful to the economy. In fact, it boosts the economic growth in general. But, it should be taking into account about on which sector the money is invested, which should be better in the manufactures sector as it benefits for the improvement in the country’s current account.

Table 5-1
The Investment Realization Based on the Economic Sector in Indonesia

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<tbody>
<tr>
<td>Farming, Forestry and Fishing</td>
<td>3,88%</td>
<td>3,91%</td>
<td>8,15%</td>
<td>6,07%</td>
</tr>
<tr>
<td>Industry</td>
<td>69,44%</td>
<td>39,32%</td>
<td>45,63%</td>
<td>57,61%</td>
</tr>
<tr>
<td>Trading</td>
<td>9,16%</td>
<td>4,30%</td>
<td>3,04%</td>
<td>2,31%</td>
</tr>
<tr>
<td>Transportation, Warehousing and Communication</td>
<td>7,90%</td>
<td>33,05%</td>
<td>10,52%</td>
<td>2,59%</td>
</tr>
<tr>
<td>TOTAL</td>
<td>93,88%</td>
<td>100,00%</td>
<td>100,00%</td>
<td>100,00%</td>
</tr>
</tbody>
</table>

Sources: Data was extracted from Indonesian Investment Coordinating Board on November 2nd, 2019. Table was created by the Author.
References


