



The Rupiah

"Getting it right"

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Getting the rupiah
“right” matters for
both economic
stability and
development ...

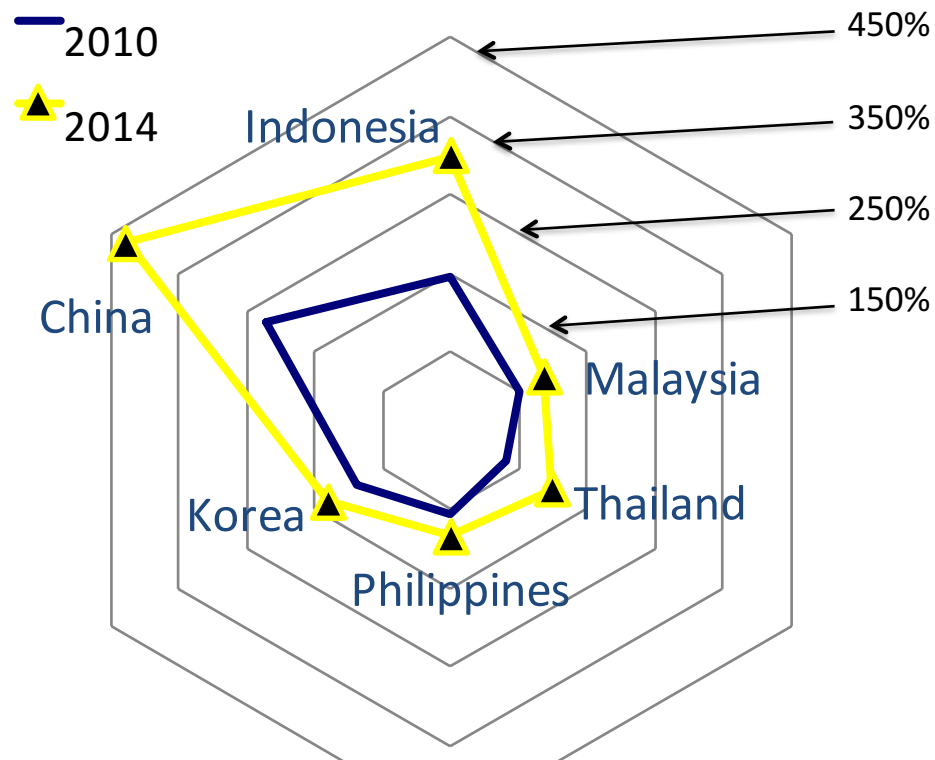
There has been a tendency for ...

- Overvaluation of the real exchange rate and undue volatility
- Growth potential and formal employment have suffered as a result
- Calling for some key and challenging policy choices

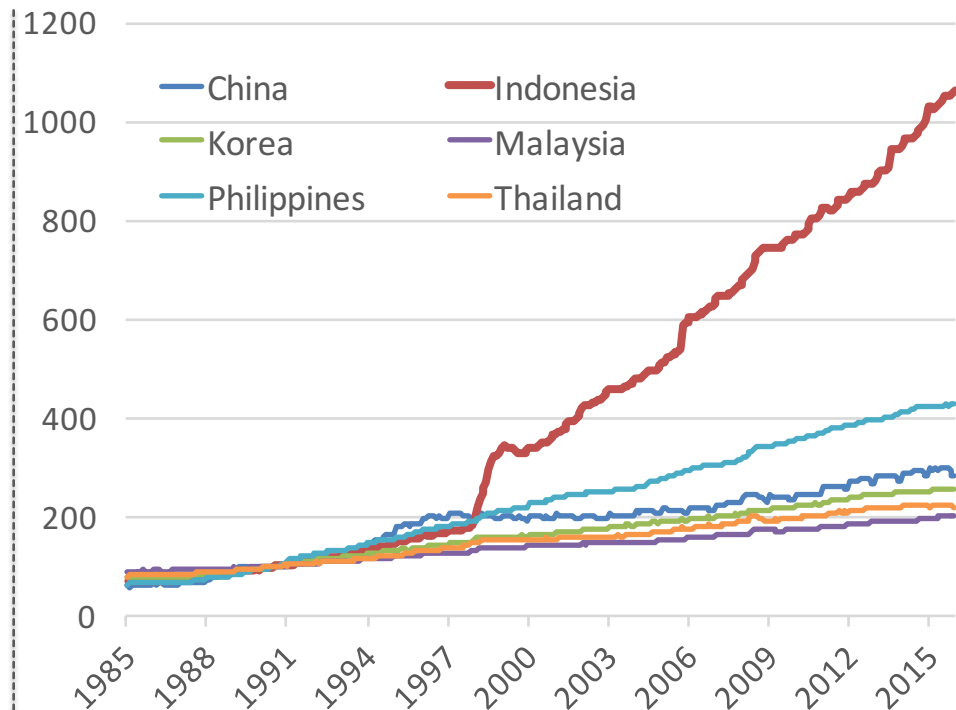
COMPETITIVENESS

Rupiah overvaluation and volatility

What has happened to Indonesian manufacturing competitiveness?

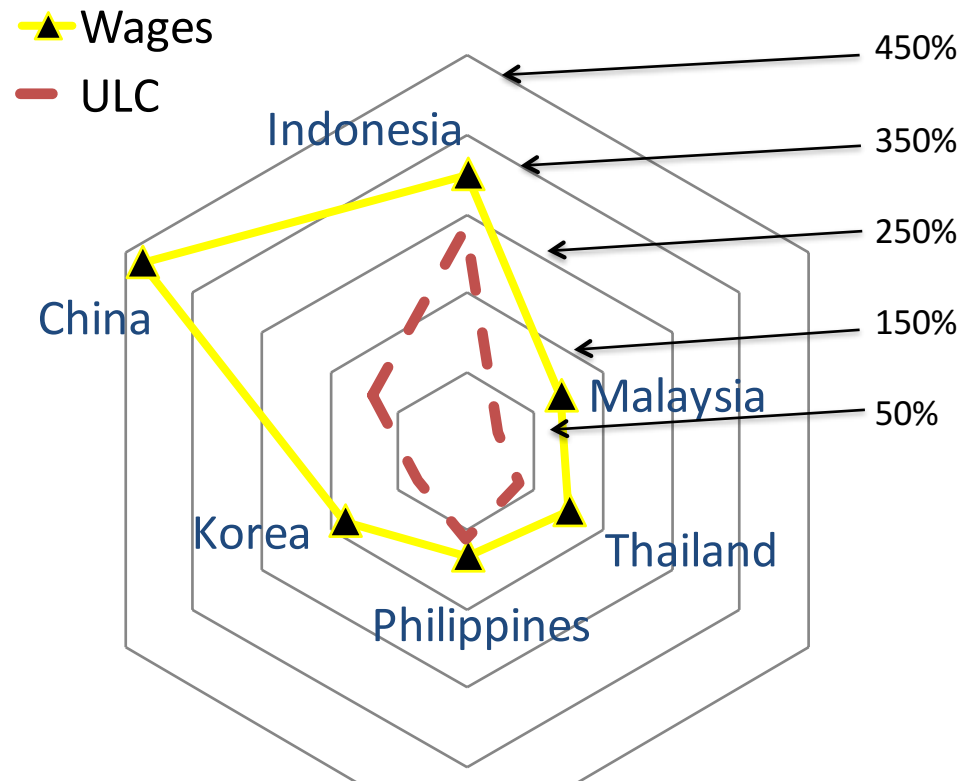


Nominal manufacturing wage growth since 2001

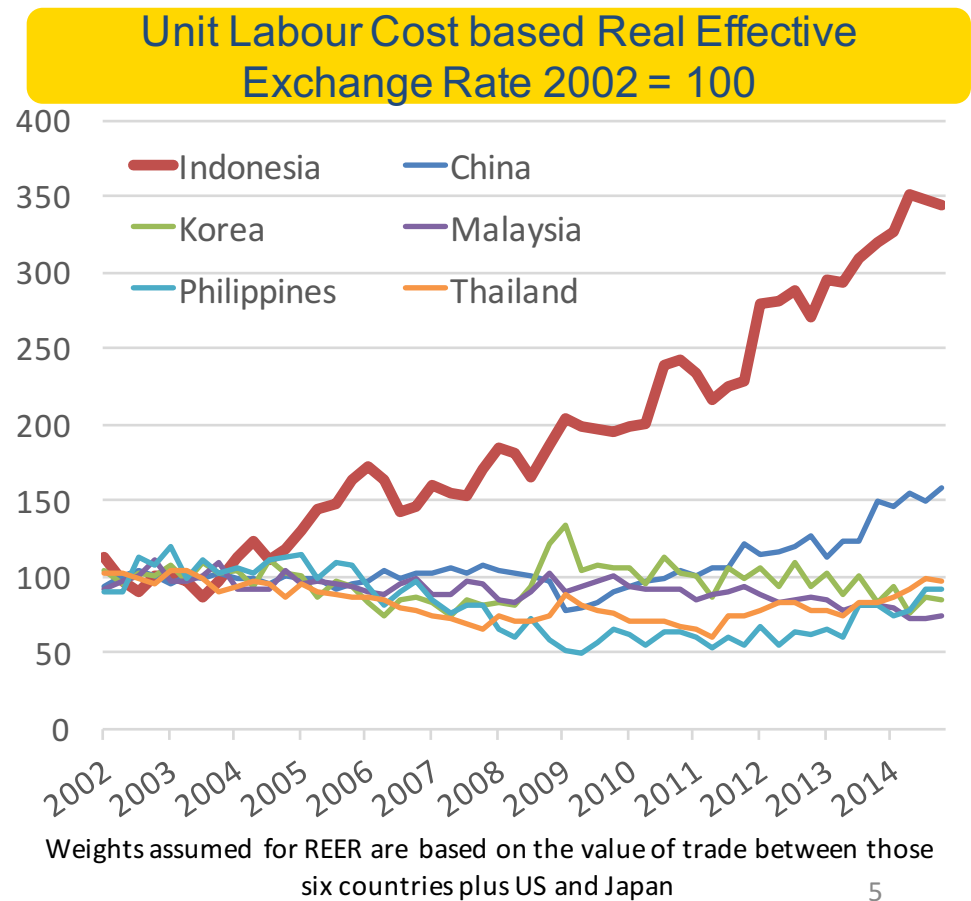


Inflation 1990 = 100
Up 142% over 2001 – wages up 300%

... wage growth not offset by productivity and Rupiah

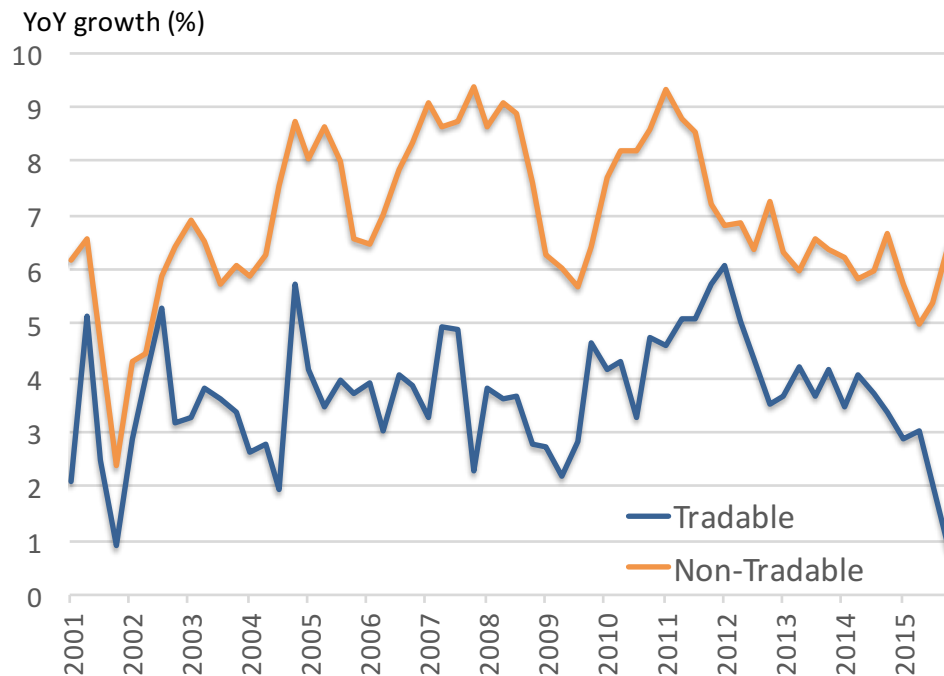


Unit labour cost growth since 2001



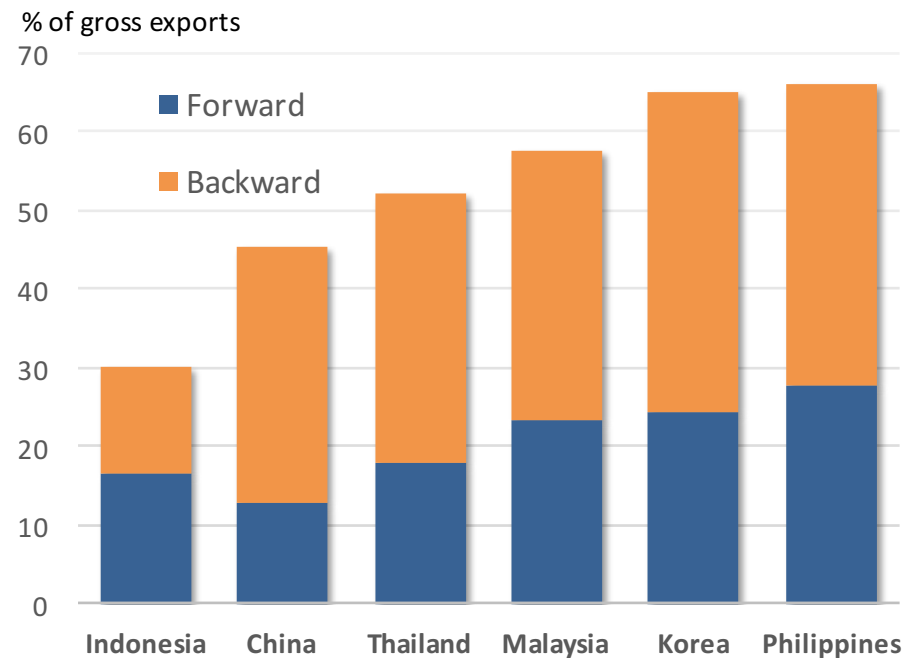
Consequence: “malls are winning versus factories”

Tradable v's Non-Tradable Growth



Tradable sectors: agriculture, mining, and manufacturing;
Non-tradable sectors: Construction, Finance, Transport and Communication, Utilities, Trade & Hospitality, and Services

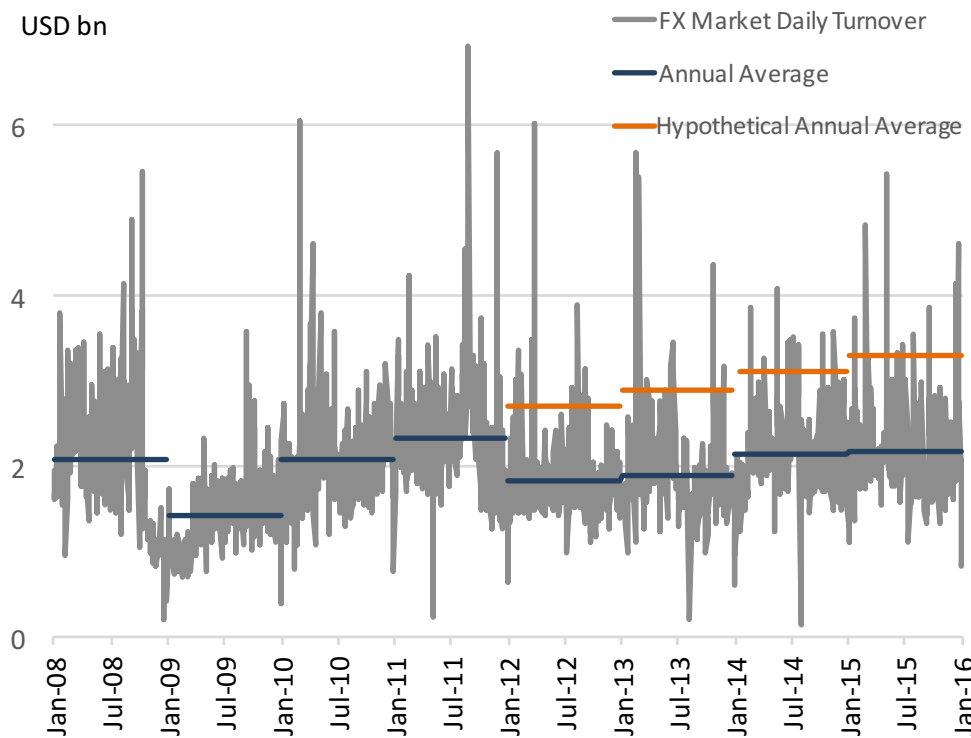
Total GVC Participation



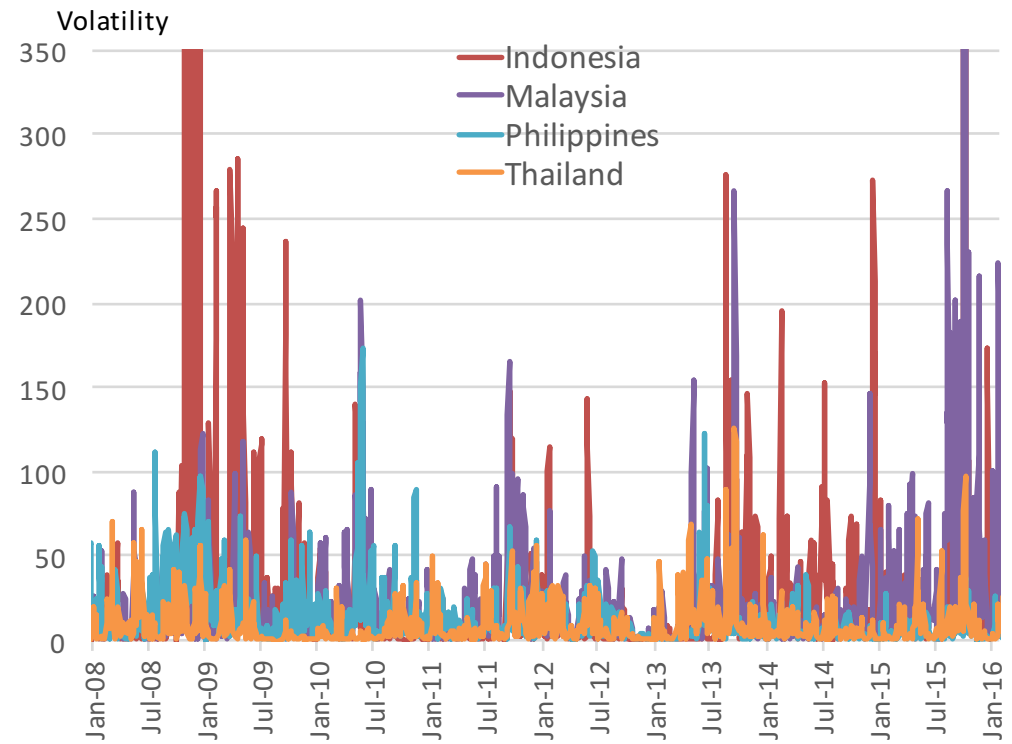
Excluding Mining and Quarrying
Source: OECD GVC Indicator May 2013 (2009 data)

And rupiah volatility has been high in a thin market

Low FX Daily Turnover



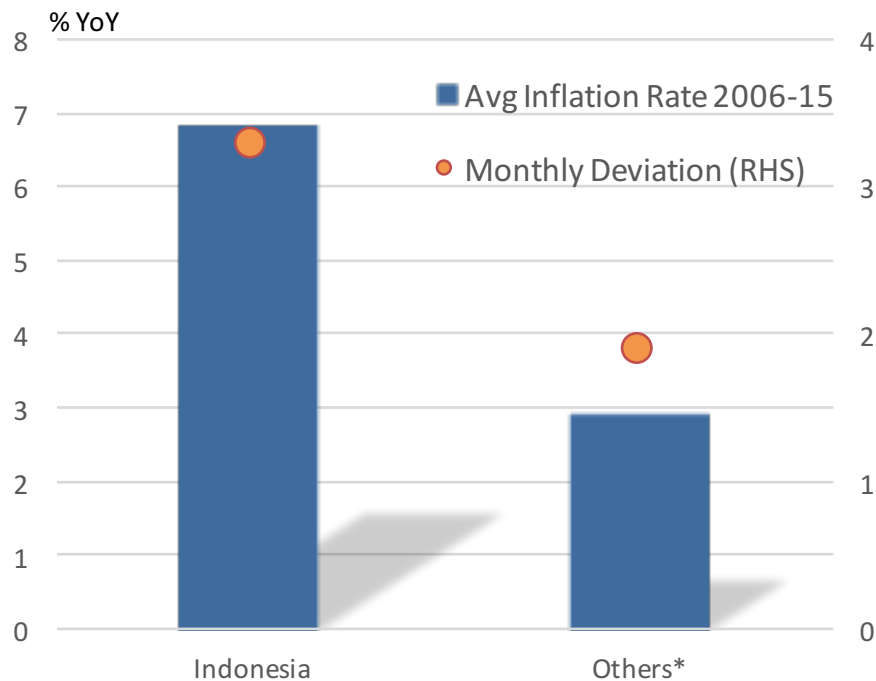
Increases Rupiah Volatility



Volatility: one week variance of logarithmic form of the exchange rates

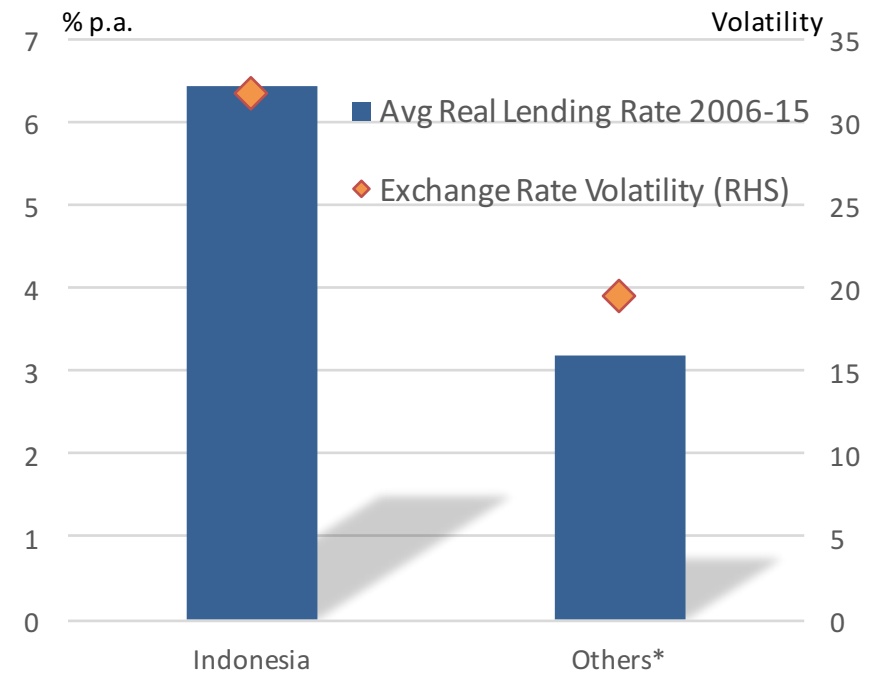
Contributing to high real interest rates

High and Volatile Inflation



*Others constitute China, Korea, Malaysia, Philippines, and Thailand (simple average)

High Real Interest Rates



Exchange Rate Volatility: one week variance of logarithmic form of the exchange rates

More than an export story

Competitiveness

- Tradables sector - suffers institutional weaknesses resulting in over investment in non tradables such as real estate
- A second best method of offsetting market failures in the tradable sector (Rodrik)

Investment

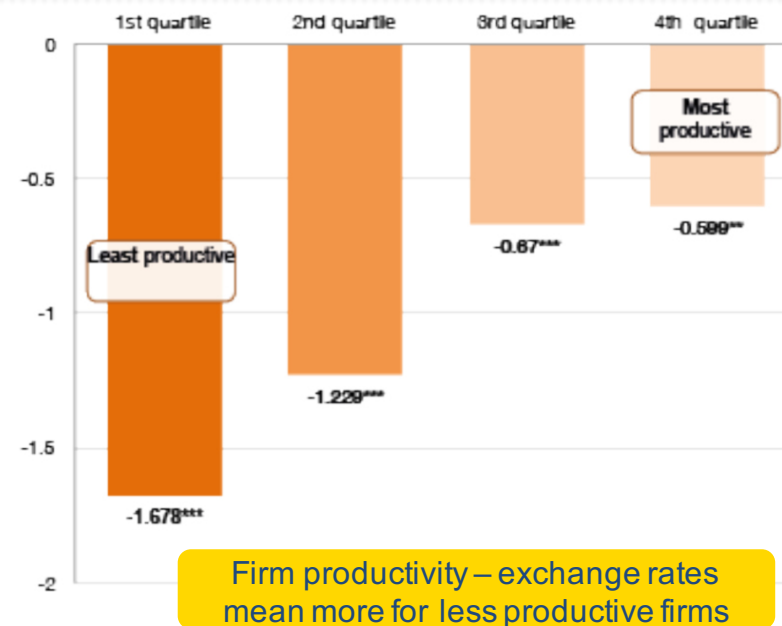
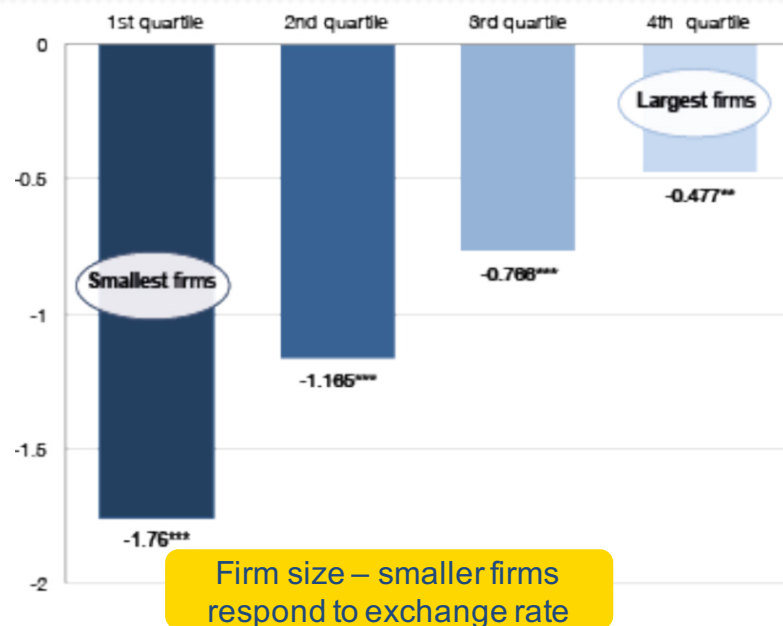
- Higher profitability makes investment more attractive
- The lower relative price of assets, especially perceptions of undervaluation that might be reversed, make a more attractive destination for investors.

Structural change

- Promotes structural change and reform in desirable directions
- Product development and new technologies.

For Indonesia the exchange rate (among other things) still matters

- Export competitiveness – Rodrik's arguments apply to Indonesia's tradeable sector
- Starting point – Indonesia's low participation in GVCs so scope to gain market share even if low elasticity
- Trade (and FDI) diversion – addressing risks arising from TPP
- Emerging business and SMFs – small and less productive enterprises respond most to exchange rates



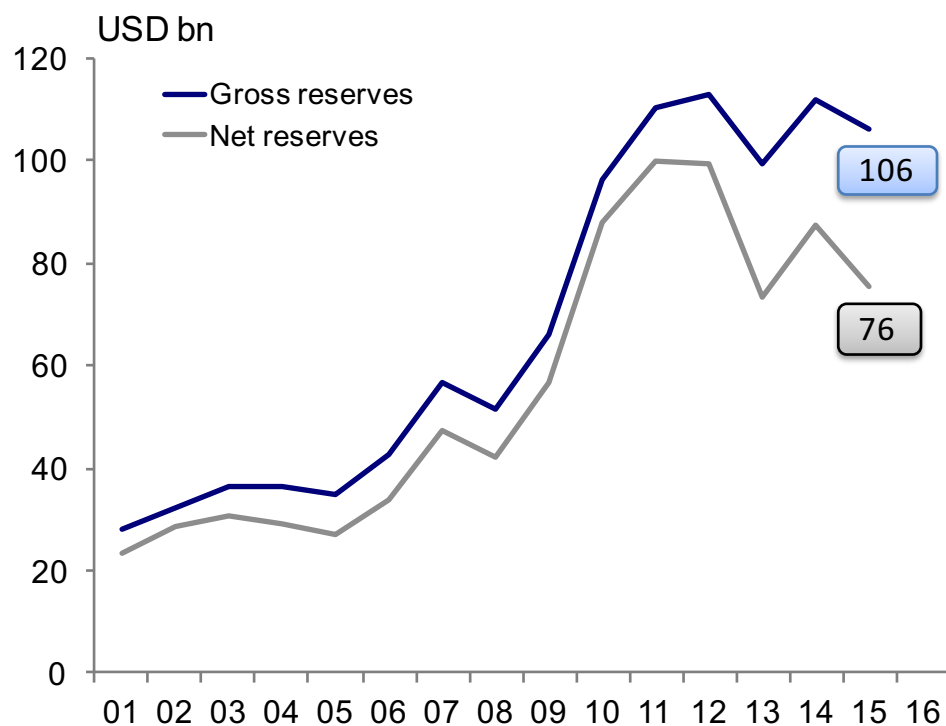
Source: Berthou and di Mauro, Exchange Rate Devaluations: When They Can Work and Why, CEPR 2015

POLICY CHOICES

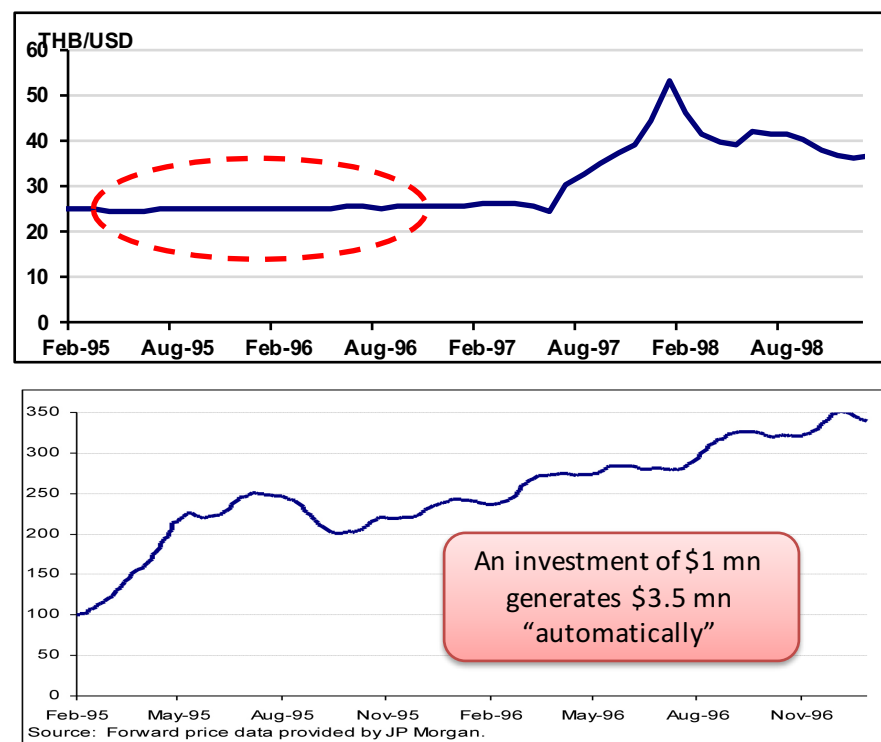
Limited scope to directly manage the rupiah rate

Peg not an option & “artificial” stability sows seeds of instability

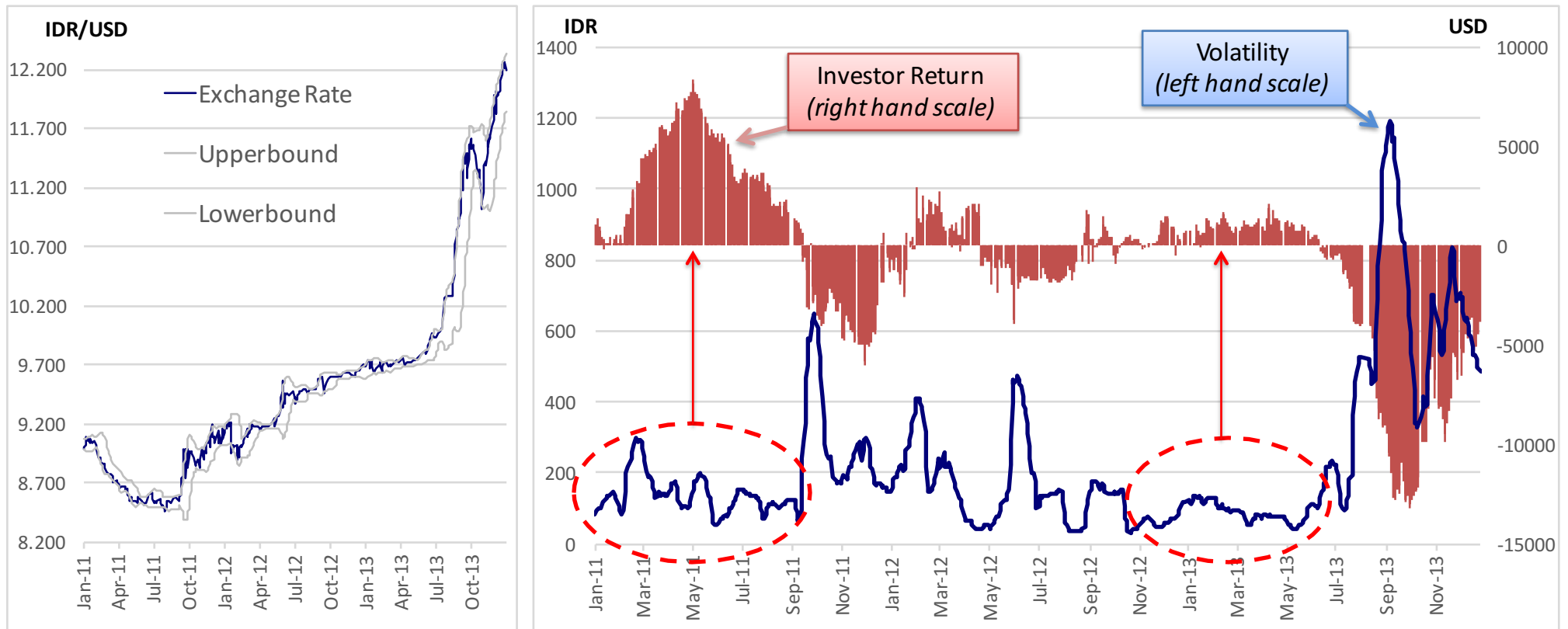
Indonesia's Reserves



Thailand 1997



.... can encourage hot money



Volatility is measured as the gap between the Bollinger band (grey line) in the LHS chart. Return in the RHS chart is for an investor who, each day, sells USD and buys one billion rupiah. The rupiah is invested in a three month SBI at 6.5% p.a. The investor sells the rupiah proceeds and buys USD at the end of the three months.

Low volatility and high returns ¹³

Role of controls

Can you “manage” prices?

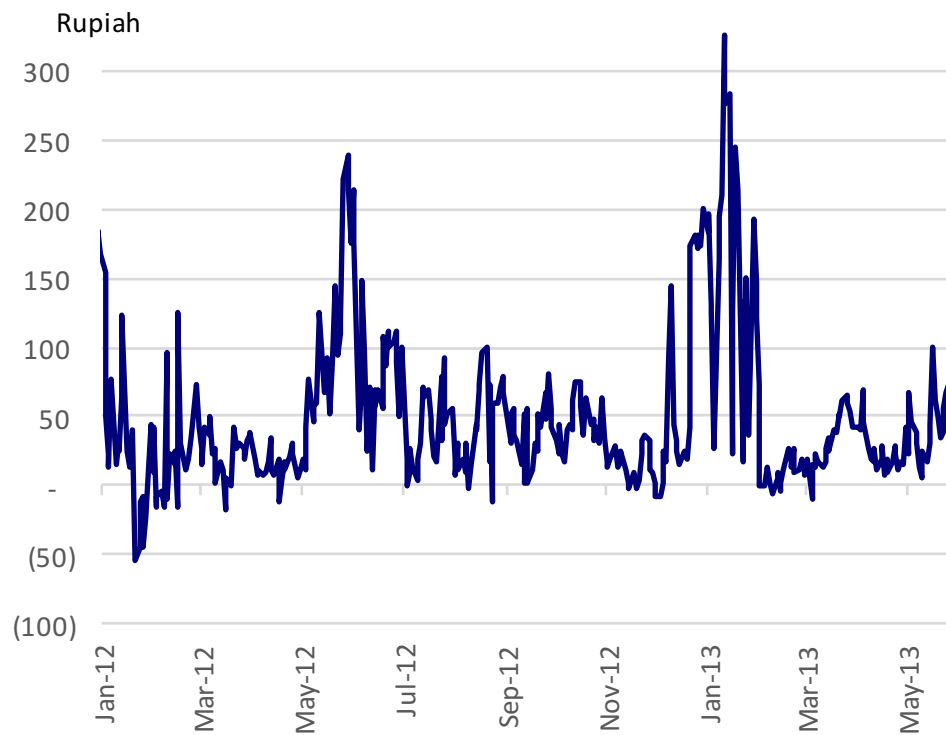
- Currency – capital controls make the local rupiah price different to the world price. Capital controls are difficult whatever their merits. Money is like water it escapes by finding the point of least resistance.
- “I have only eight seconds left to talk about capital controls. But that’s ok. I don’t need more time than that to tell you: they don’t work, I wouldn’t use them, I wouldn’t recommend them ...”
Agustin Carstens, Governor, Bank of Mexico and former Minister of Finance

Might you want to manage prices – the policy choice?

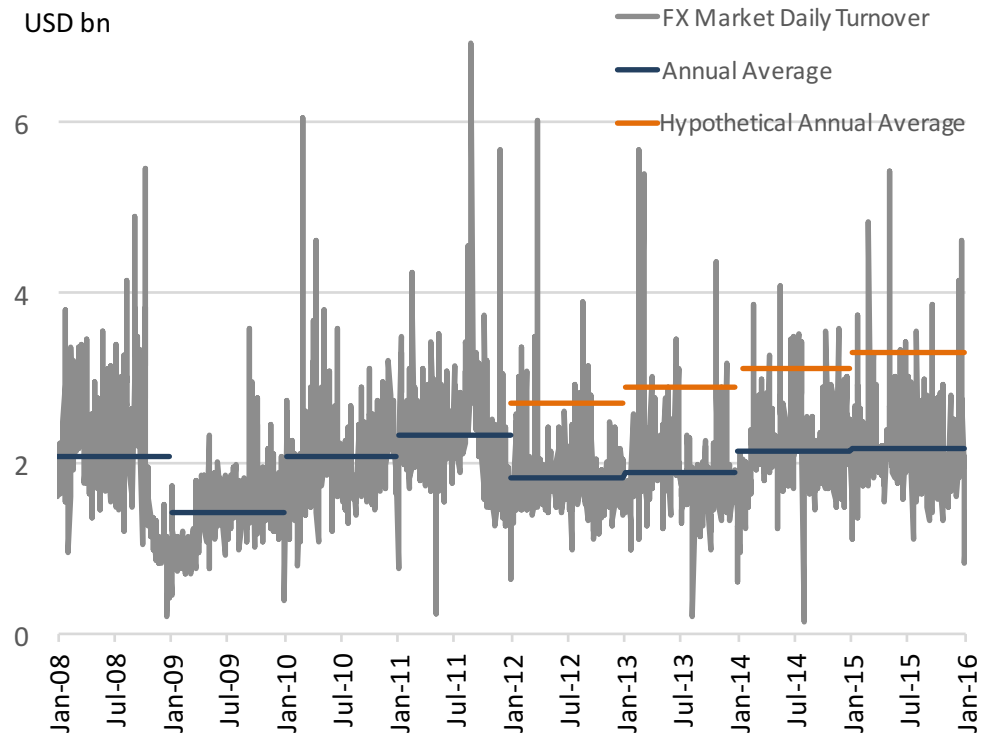
- Policy choices and consequences – fixing a price means quantity adjusts so that supply equals demand.
- GDP growth (quantity) will fall more if the rupiah rate is fixed in the face of an economic shock. A flexible exchange rate is a shock absorber - helps stabilize growth.
- Price-based controls, such as Chilean type, look more attractive but still give rise to costs through a higher cost of capital

Controls have consequences

Offshore – Onshore Rupiah Spreads



Low FX Volumes



CONCLUSION

A policy framework for avoiding overvaluation and promoting stability

Avoiding overvaluation

A “competitive” rate matters

- A “competitive” exchange rate matters for development
- A competitive rate driven by fundamentals will be sustainable and consistent with global obligations

Broad based payoff
– not just an export led model

- A more competitive position in export markets but also ...
- More efficient and innovative domestic industry
- Attractive investment destination

And even if the world has changed still matters for Indonesia

- Indonesia's starting point – scope to growth market share in GVCs
- Managing trade diversion risks
- Building a more resilient environment for start ups and SMEs

Delivering Stability

Two –way risk/bet

- Stability is desirable but it has to be the consequence of other policy.
- A “stable” rupiah policy goal, independent of economic and market developments, sows the seeds for instability.

Pegging the rate – not an option

- The level of reserves has to be “credibly” high – they are not
- The country has to accept higher swings in economic growth

Controls part of the toolbox but ...

- Administratively challenging
- Assessment of the costs needs to be made
- Market perceptions of this policy can create their own instability

Monetary policy still the anchor

- The assessment takes you back to the role of monetary policy as the anchor of financial policy leaving the exchange rate to function as the stabilizer

Policy framework choices and the exchange rate

Delivering a rupiah that supports a robust manufacturing sector

- Target inflation in line with the region
- Tighter fiscal policy / lower domestic financing
- Labour market reform including linkage of labour costs and productivity
- Supply side policy (to enable 1, 2, and 3 to work)

Managing “regime” change

- a comprehensive framework
- policy sequencing
- reducing cost of policy trade offs

- Investment in central bank policy credibility
- Medium term revenue reform and role of private sector
- Packaging a social compact e.g. BJPS and wage policies
- Targeting measures to defined goals