

# Capital inflows into Indonesia

## *Managing risks, maximizing opportunities*

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*Indonesia Country Director*  
**World Bank**

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COUNTRY PARTNERSHIP STRATEGY FOR INDONESIA FY2009-2012

**Investing in Indonesia's Institutions**  
for Inclusive and Sustainable Development

# Capital flows into Indonesia

## *Managing risks, maximizing opportunities*

- ▶ **Indonesia, like many emerging economies has experienced a surge in capital inflows in the last two years**
  - ▶ **...and much of it has come in the form of PORTFOLIO inflows**
  - ▶ **...which have benefited Indonesia but do raise macroeconomic and prudential concerns and exposure to future disruptive outflows**
  - ▶ **These portfolio flows have to be MANAGED, NOT DISCOURAGED**
  
- ▶ **The medium-term challenge is to SUPPLEMENT portfolio flows with MORE STABLE forms of financing and this will entail:**
  - ▶ **DEEPENING Indonesia's financial markets**
  - ▶ **Attracting further FOREIGN DIRECT INVESTMENT by:**
    - ▶ **Addressing INFRASTRUCTURE bottlenecks**
    - ▶ **Enhancing REGULATORY TRANSPARENCY and CERTAINTY**



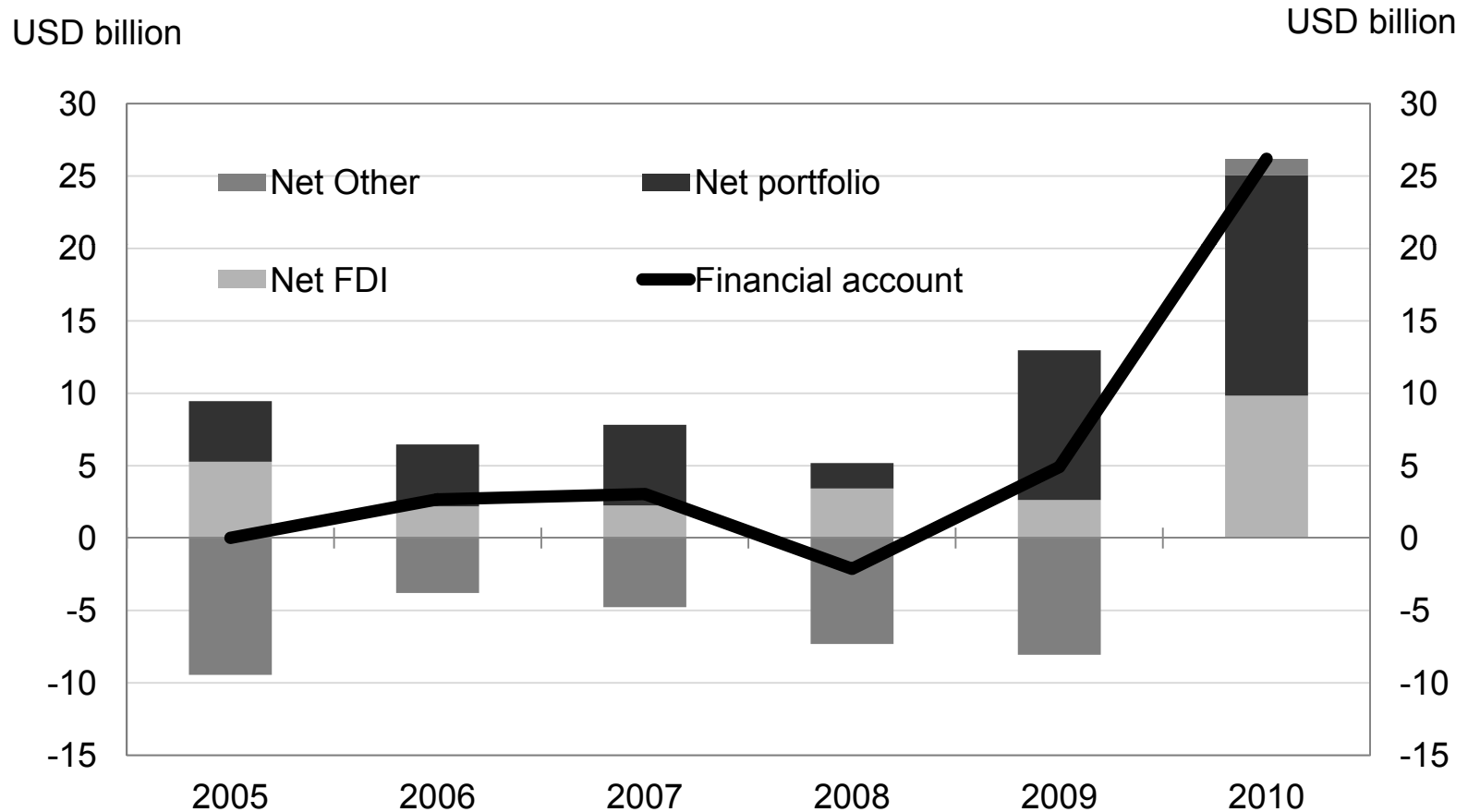
# Capital flows into Indonesia

## *Managing risks, maximizing opportunities*

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# Capital inflows have increased sharply ...with portfolio inflows dominating



Source: BI



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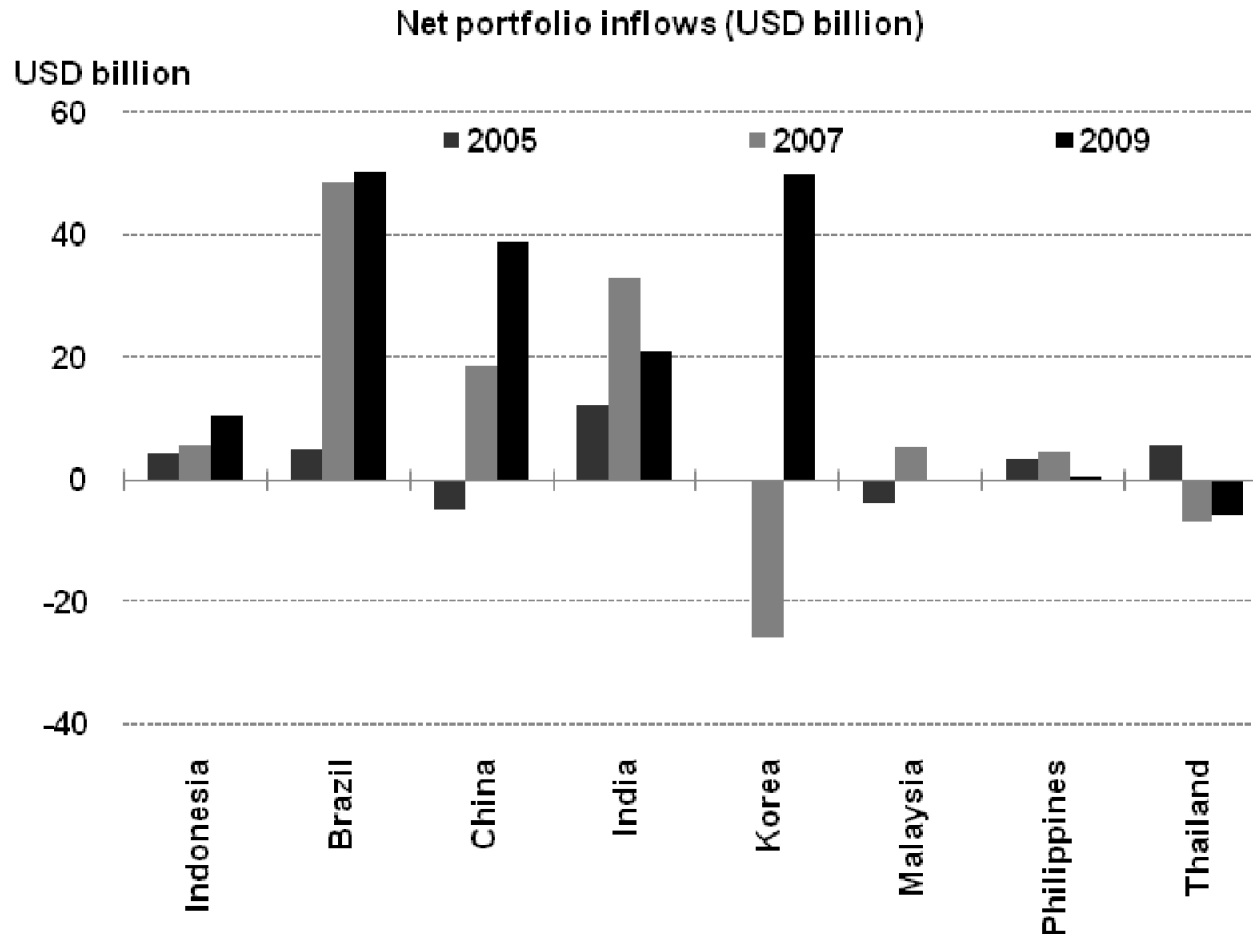
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# Portfolio inflows into Indonesia

*...still relatively limited in absolute terms*

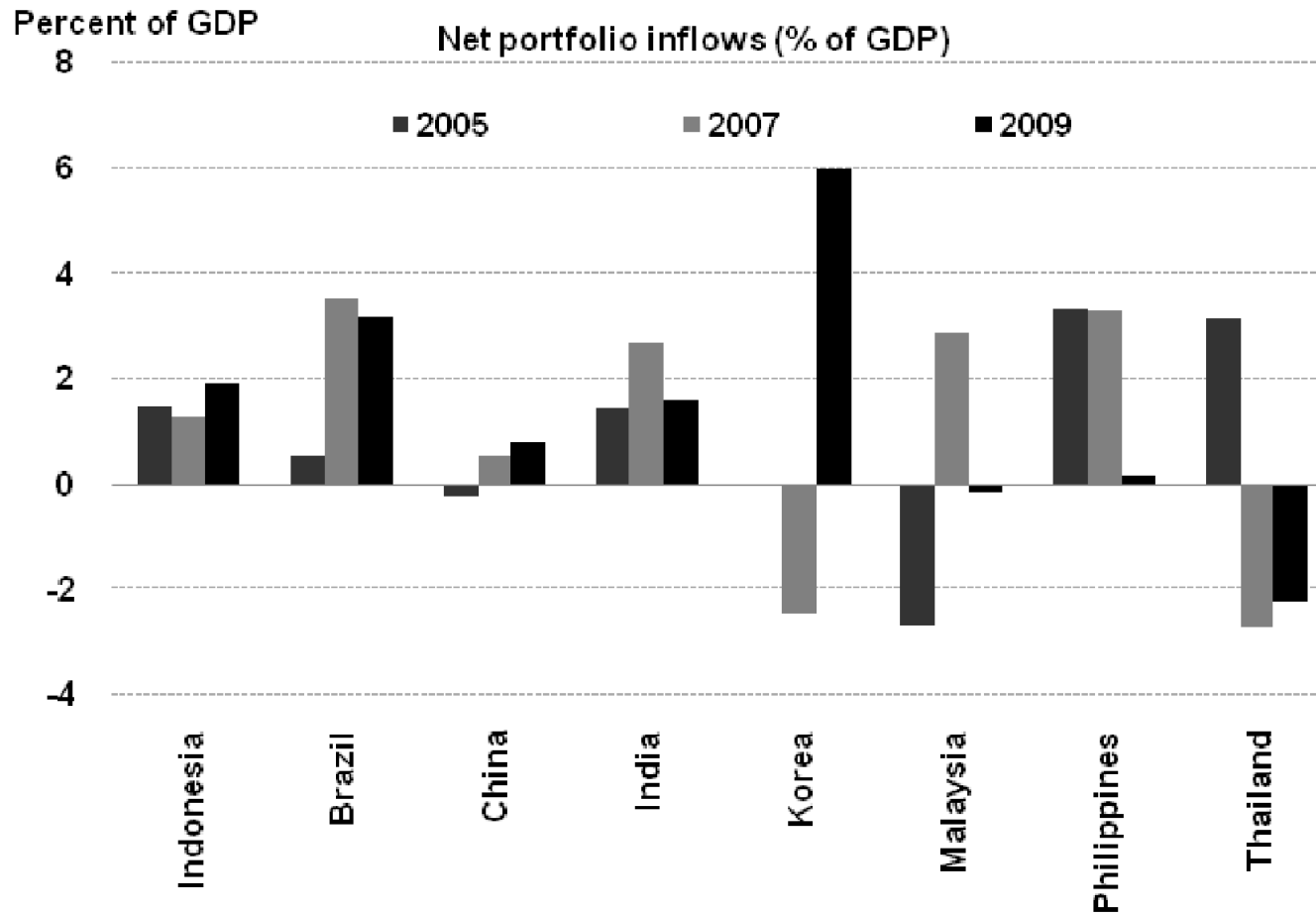


Source: CEIC, BI, BPS



# Portfolio flows into Indonesia

*...and relatively limited as a share of GDP*



Source: CEIC, BI, BPS



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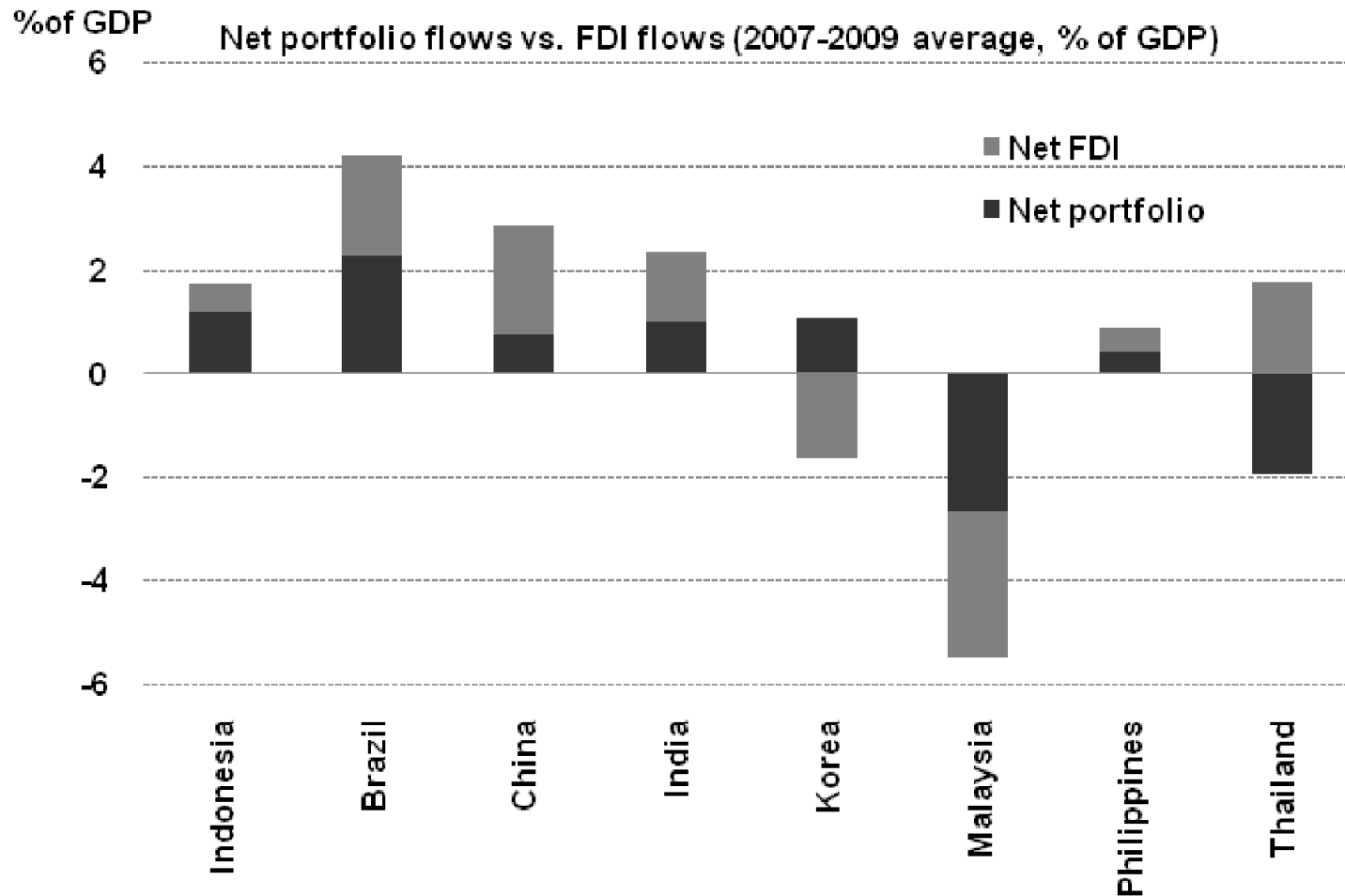
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# Portfolio flows into Indonesia...

*...but high relative to FDI flows*



Source: CEIC, BI, BPS



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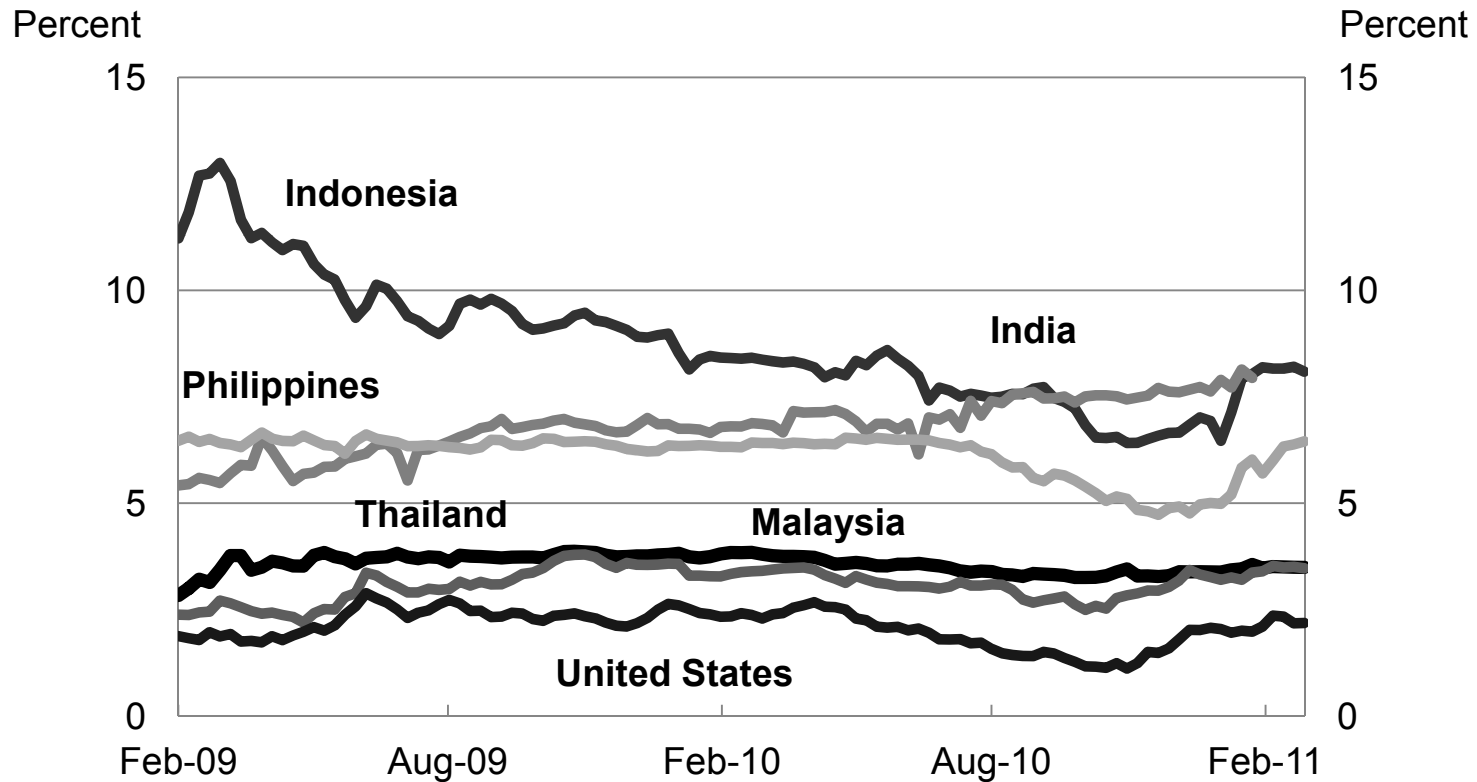
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# Portfolio flows into Indonesia... ...have lowered the cost of government borrowing

Local currency government bond yields (5-year)



Source: CEIC, World Bank



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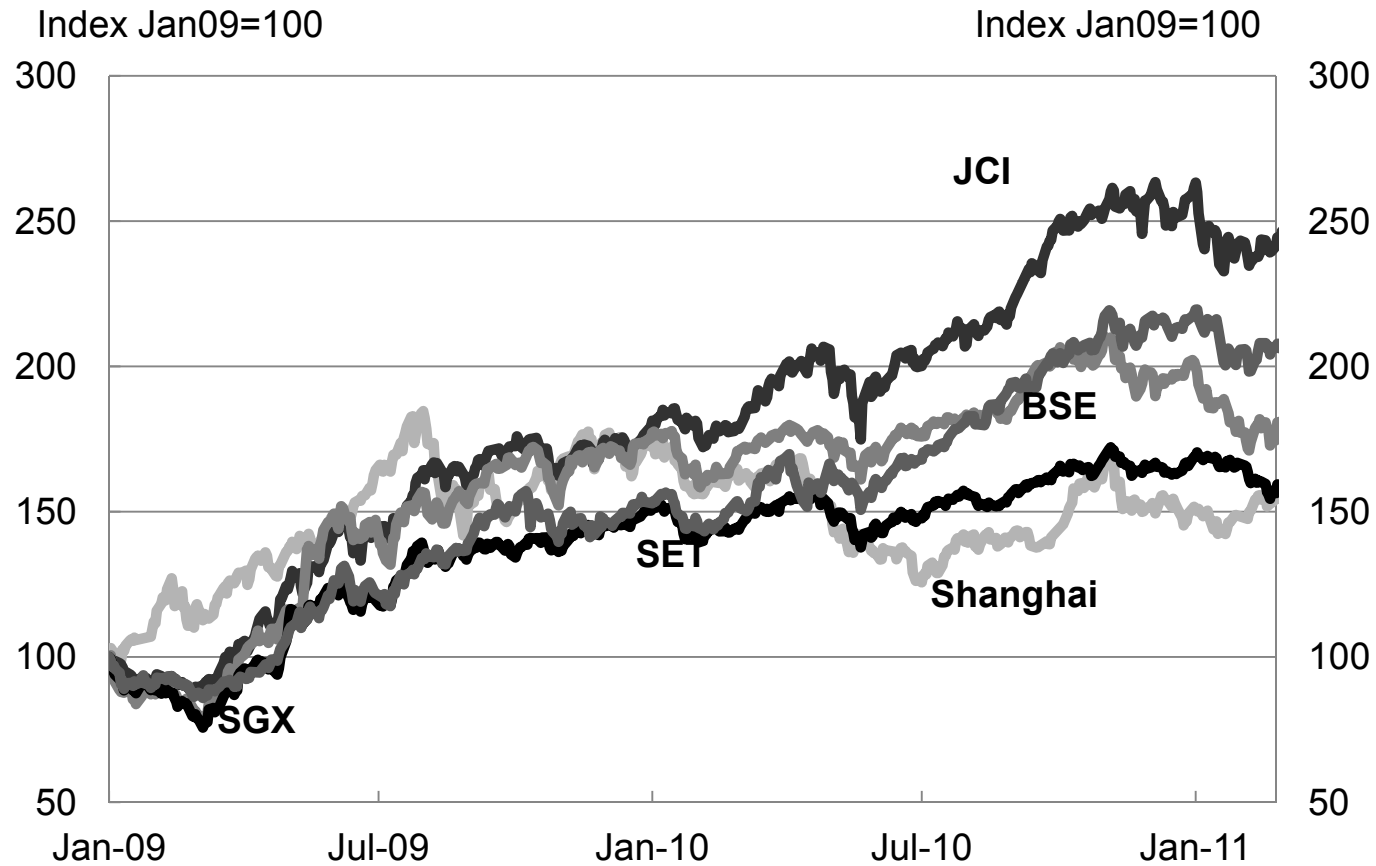


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# Portfolio flows into Indonesia... *...have supported a rise in equity prices*

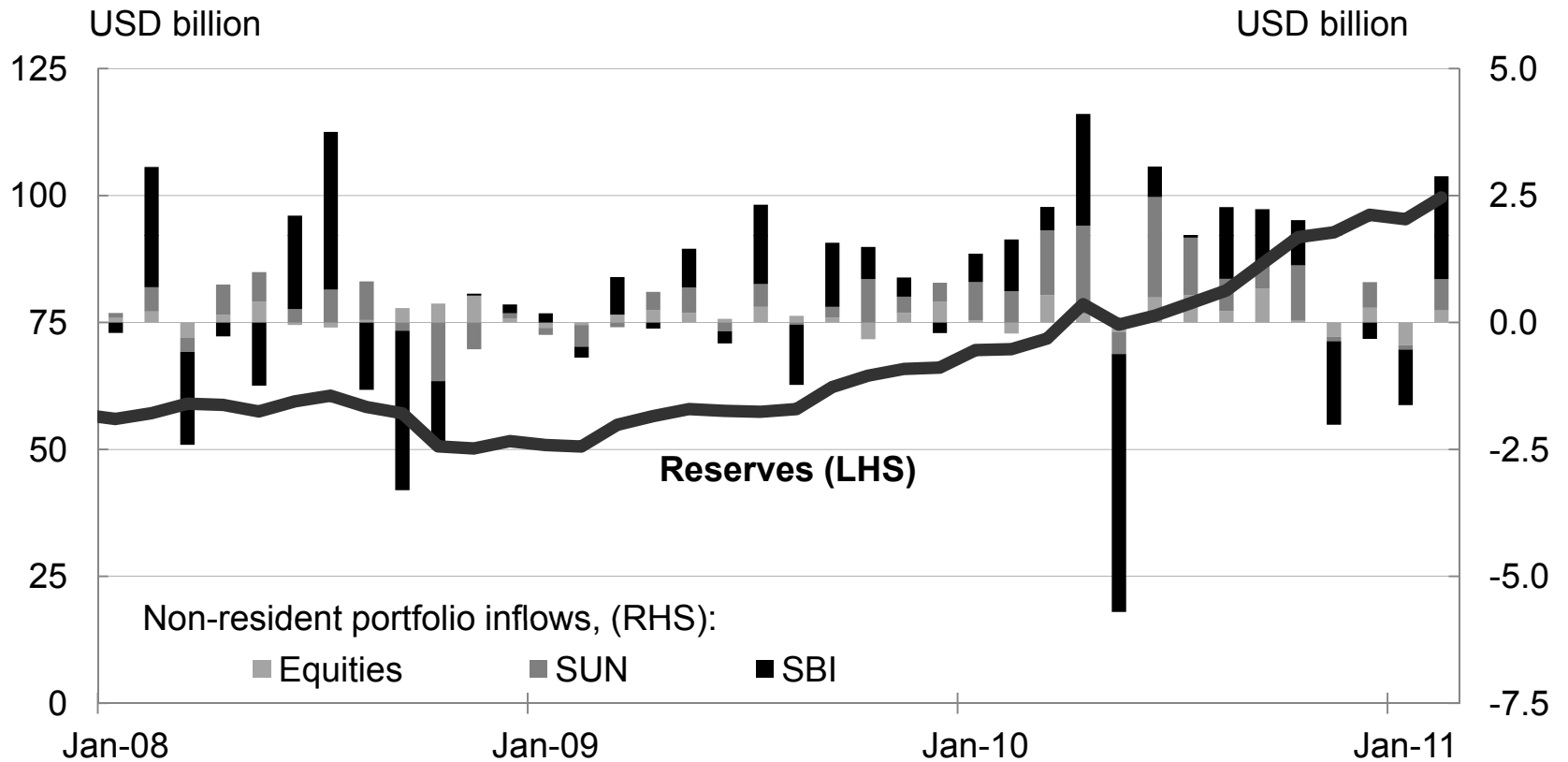


Source: CEIC, World Bank



# Portfolio flows into Indonesia... ...have been volatile

- ▶ With the majority of portfolio flows going into government securities



Source: BI, CEIC

Note: "Flows" for SUN (government securities) and SBI (BI certificates) indicate change in holdings



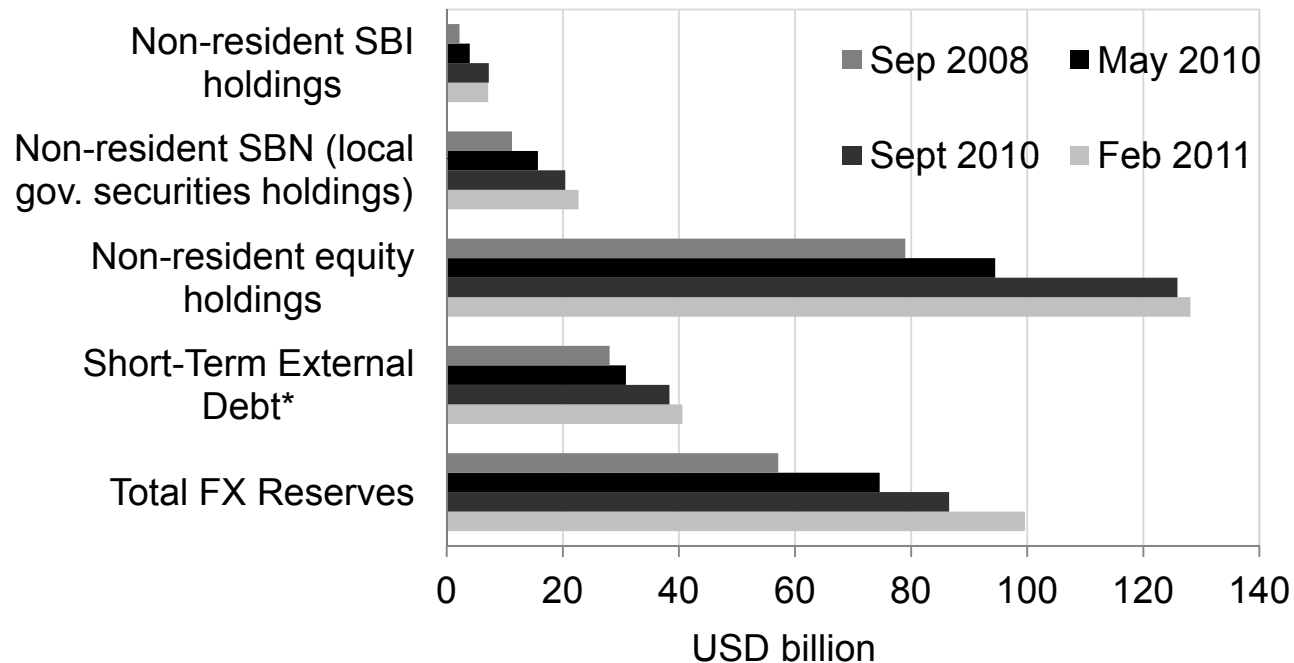
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# Foreign reserves have gone up... *...but so has exposure to disruptive outflows*



Note: \* External debt is as of end-Dec 2010. Short-term debt on remaining maturity basis  
 Source: BI, CEIC,

# Capital flows into Indonesia

## *Managing risks, maximizing opportunities*

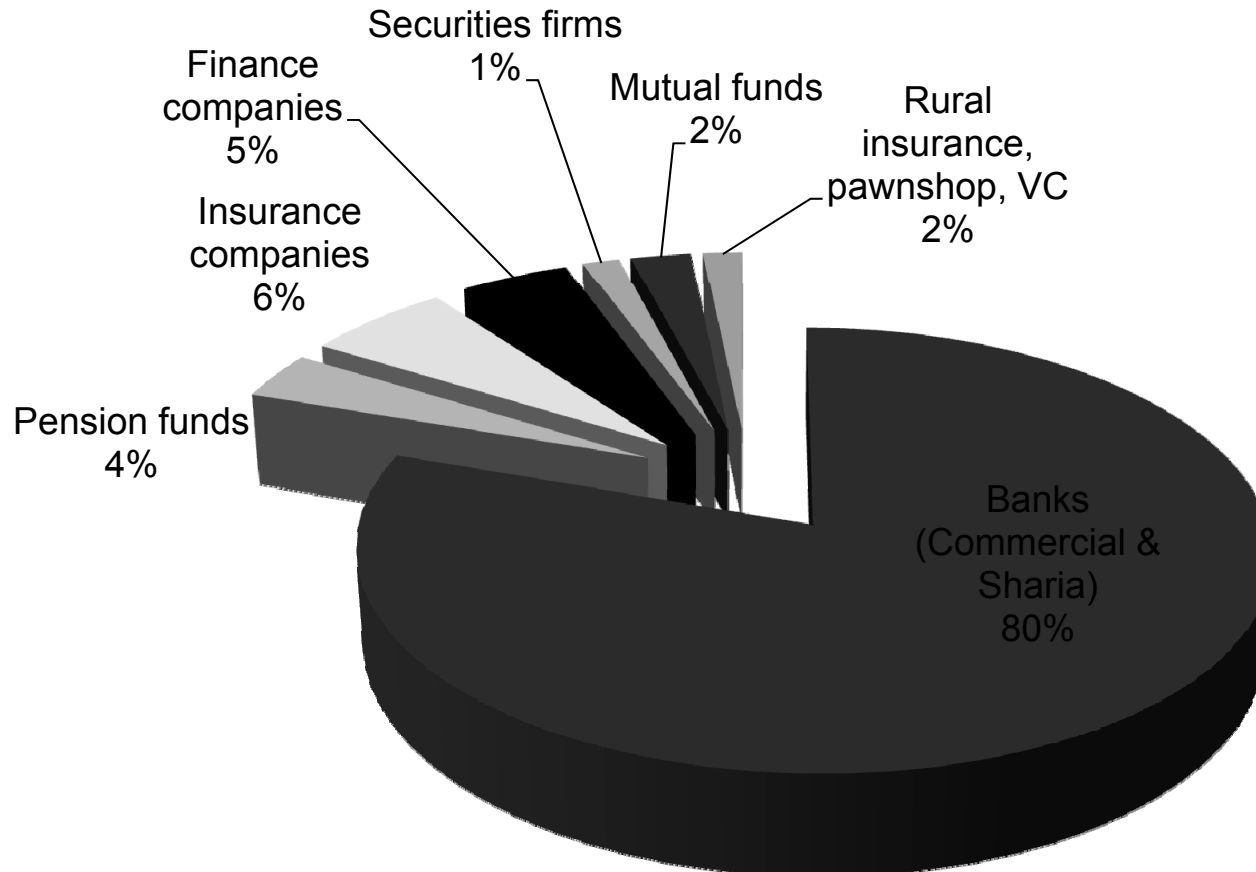
- ▶ Indonesia, like many emerging economies has experienced a surge in capital inflows in the last two years
  - ▶ ...and much of it has come in the form of PORTFOLIO inflows
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  - ▶ These portfolio flows have to be **MANAGED, NOT DISCOURAGED**

- ▶ The medium-term challenge is to **SUPPLEMENT** portfolio flows with **MORE STABLE** forms of financing and this will entail:
  - ▶ Deepening Indonesia's financial markets
  - ▶ Attracting further foreign direct investment by:
    - ▶ Addressing infrastructure bottlenecks
    - ▶ Enhancing regulatory transparency and certainty



# Indonesia's financial sector

## *Commercial banks dominate*

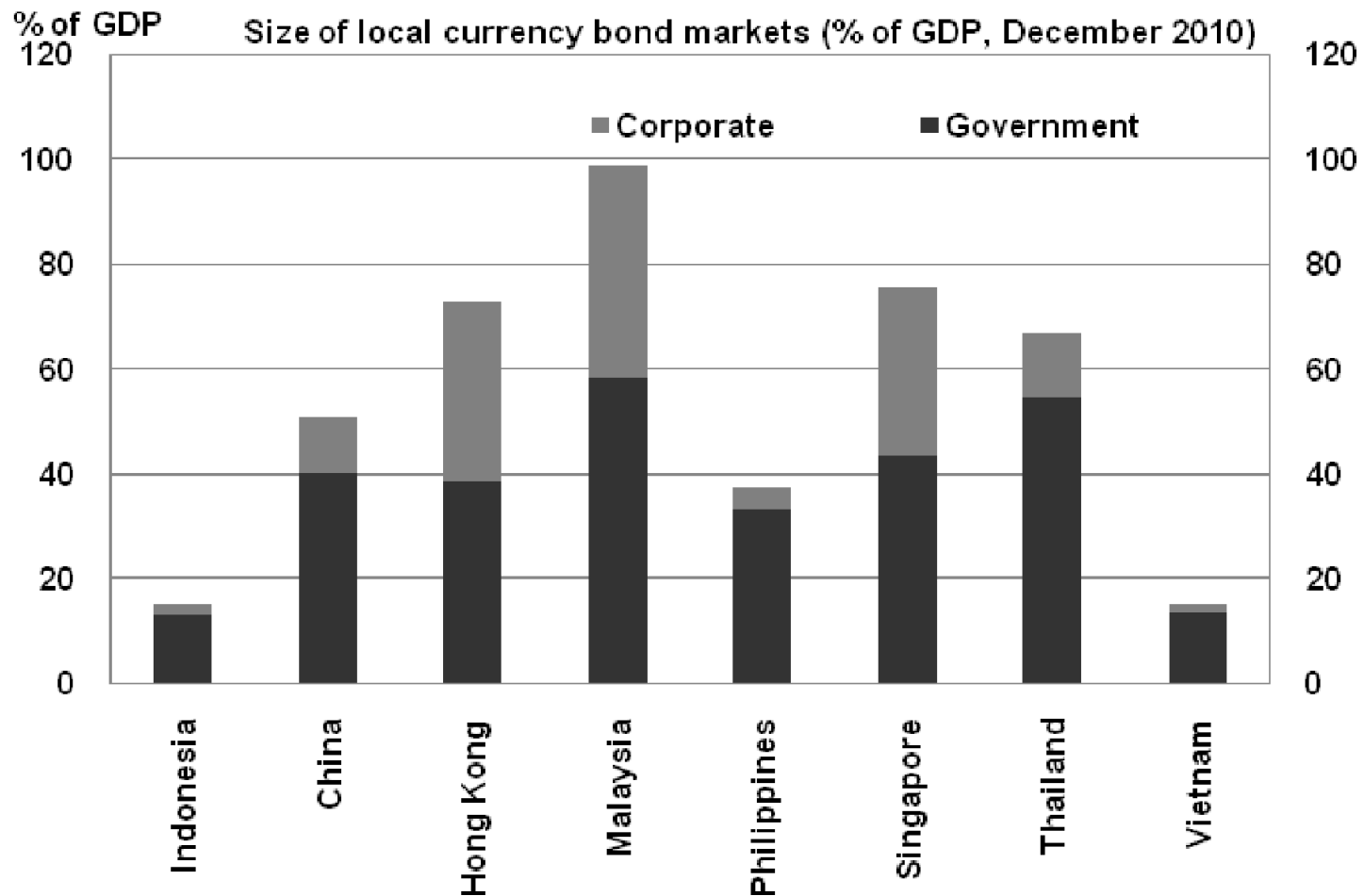


**The Indonesian financial sector:  
Share (%) of assets  
in different categories of financial institutions**

Sources: Bank Indonesia, Bapepam -LK, and World Bank

# Indonesia's financial sector

## *Under-developed local bond market*



Sources: ADB Asian Bonds Online

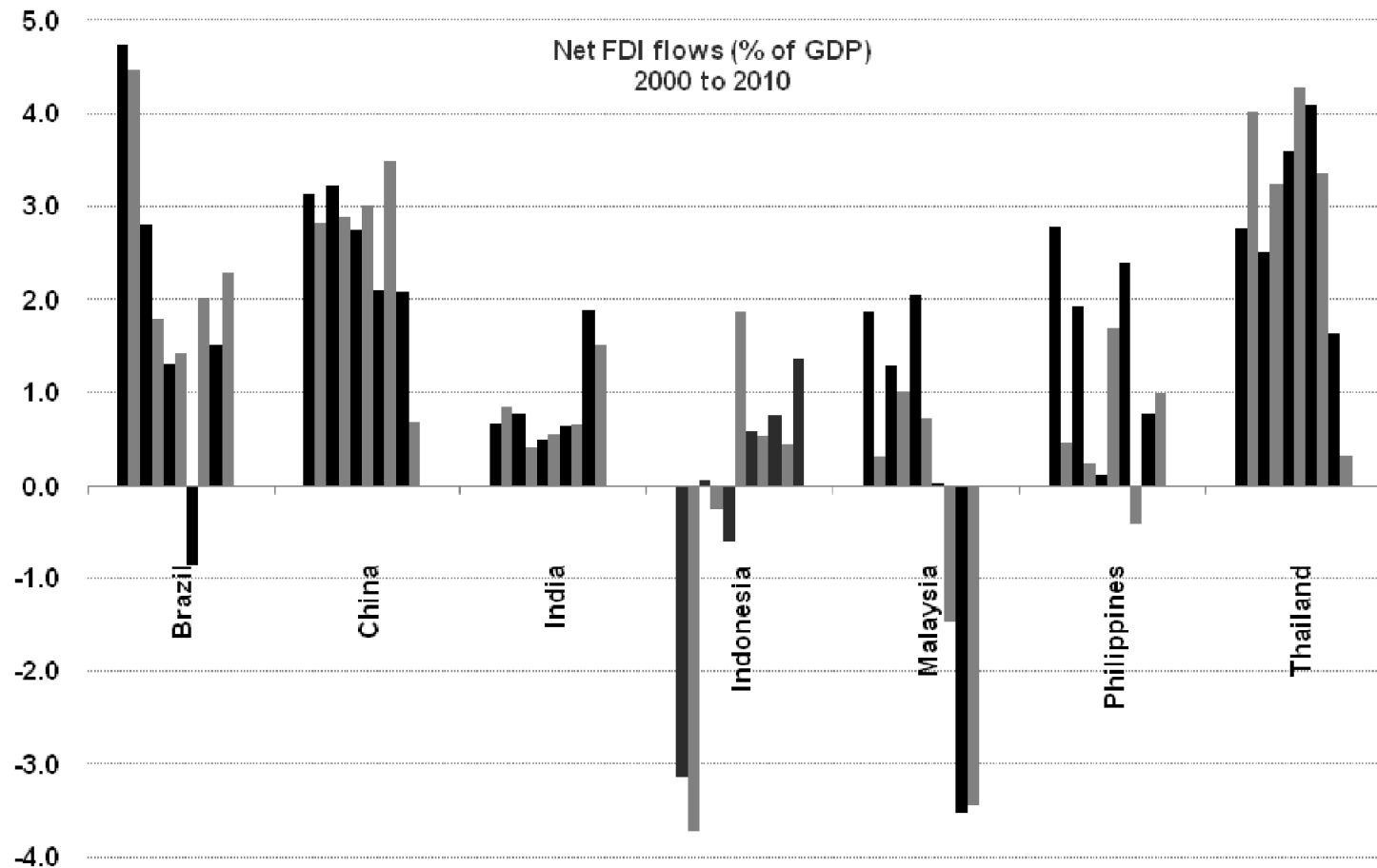
# Financial markets reforms

## *...deepening and harmonization*

- ▶ **Deepen Financial Markets**
  - ▶ **Share of pensions funds and insurance funds assets in Indonesia very low**
  - ▶ **These are typically long-term investors with domestic resources – and can help absorb rupiah liquidity**
  
- ▶ **Issue long-term corporate and infrastructure bonds**
  - ▶ **Short-term portfolio flows can be converted to long-term flows by issuance of higher yielding long-term bonds**
  - ▶ **However, this requires improvements in corporate governance, disclosure, legal certainty for enforcement of creditor rights, and improved bankruptcy procedures – a medium-long term agenda**
  
- ▶ **Harmonize tax treatment**
  - ▶ **At present domestic investors investing in Indonesian securities have to pay higher taxes than foreign investors investing in the same securities**
  - ▶ **In an environment of an open capital account, this creates incentives for “round-tripping” – Indonesian money going abroad and coming back as “foreign” money**
  - ▶ **Leveling the playing field will help address this issue**

# Foreign direct investment into Indonesia

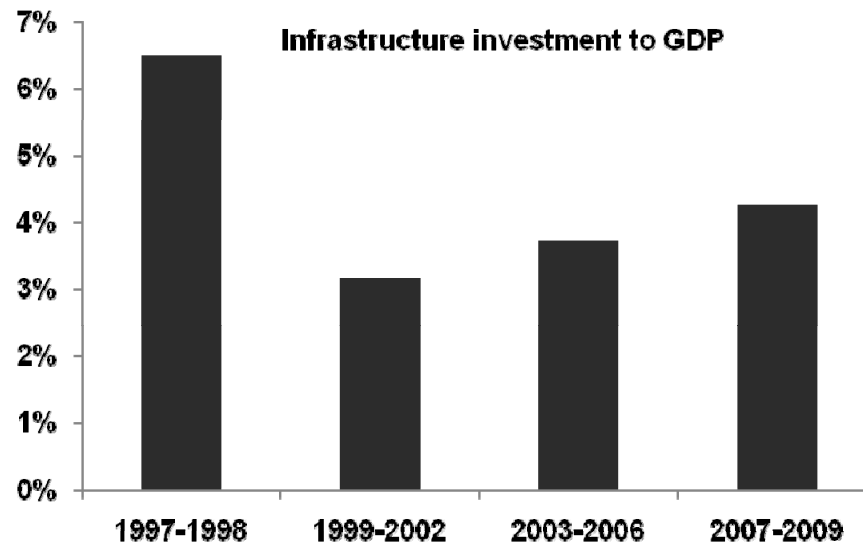
*Rising but still relatively low in comparative terms*





# Attracting foreign direct investment

*Investing in infrastructure, especially transport and urban*



- ▶ **Building world-class cities by investing in urban infrastructure (mass transport, housing, water and sanitation) in the key cities that drive Indonesian competitiveness**
- ▶ **Easing transport and logistics bottlenecks and connecting and integrating Indonesia's domestic markets and regions...**

# Attracting foreign direct investment

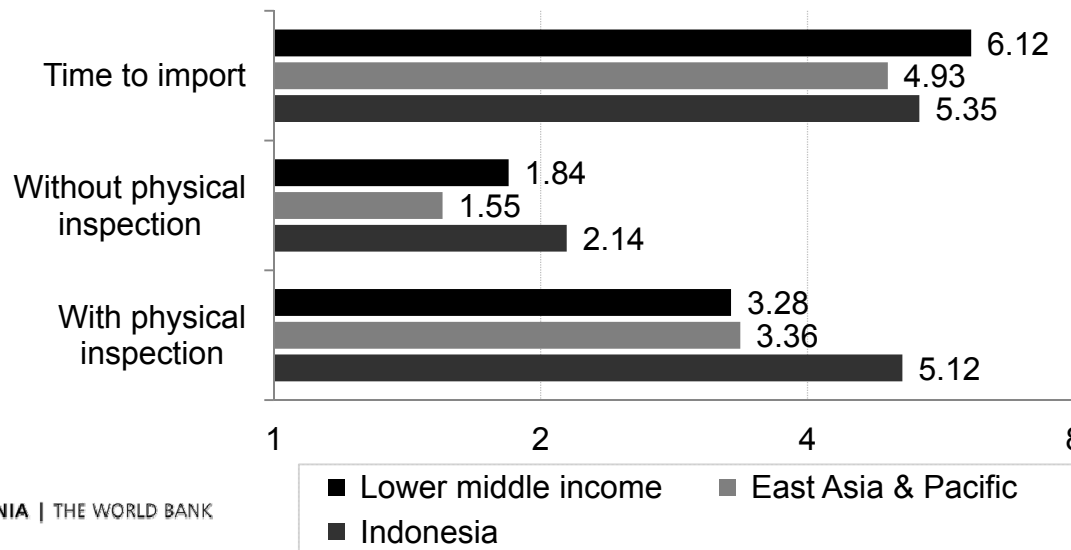
## *Improving transport and logistics*

Country Main Airport	Optimum Passenger (mil)	Optimum Cargo (tons)
Jakarta	22	300,000
Manila	25	600,000
Kuala Lumpur	40	1,200,000
Bangkok	45	3,000,000
Singapore	73	3,000,000

Source: PT Angkasa Pura II, other airports, media reports (Standard Chartered)

Country Main Seaports	Container handling (box per hour)	Vessel berthing (h)	Vessel waiting (h)
Jakarta	23.3	50-57	2
Surabaya	10	65	2
Thailand (LC)	35	8	0.4
Manila	28	NA	NA
Singapore	31.3	Varies	2

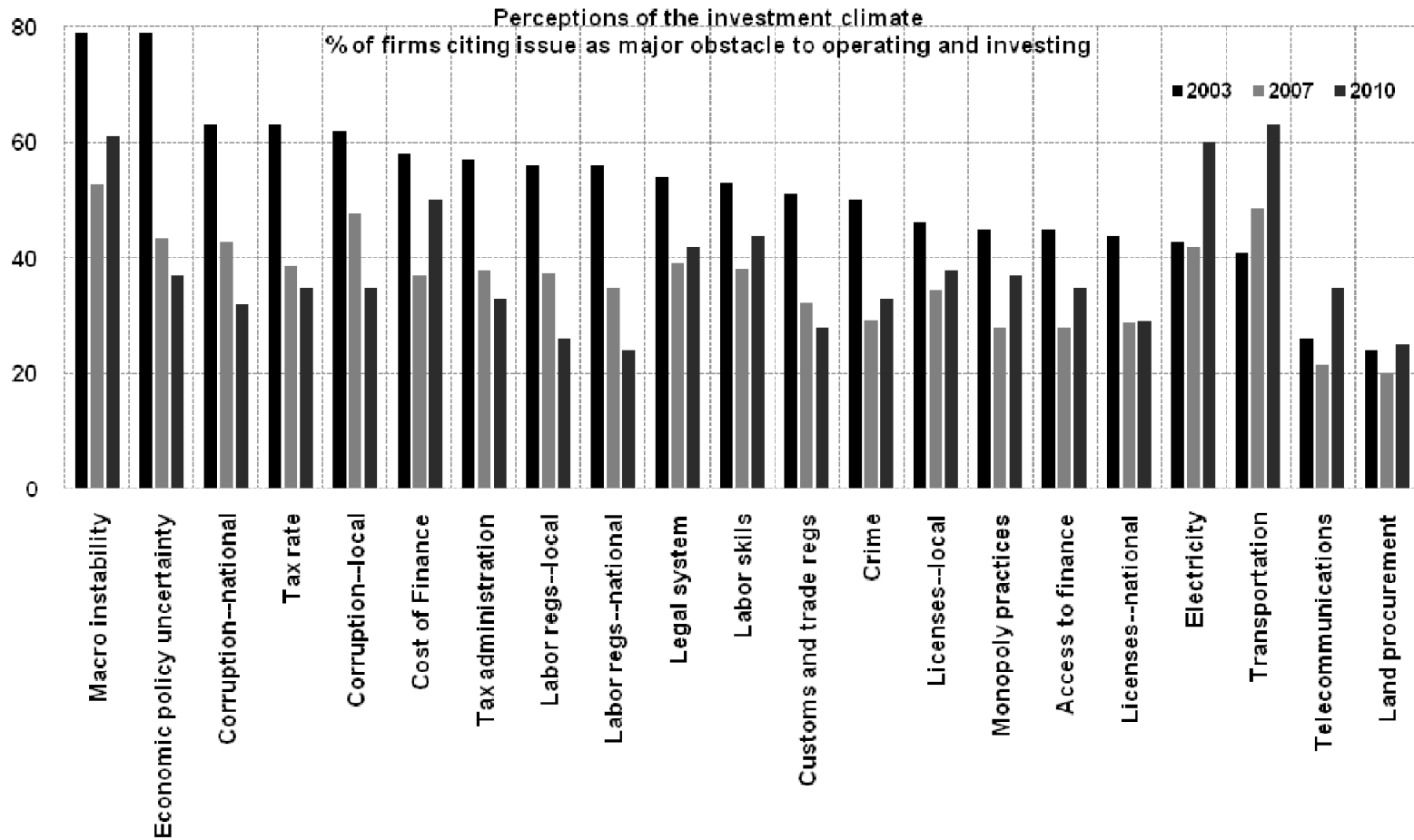
Source: ASEAN Ports Association (Standard Chartered)



Source: LPI 2010 (World Bank)

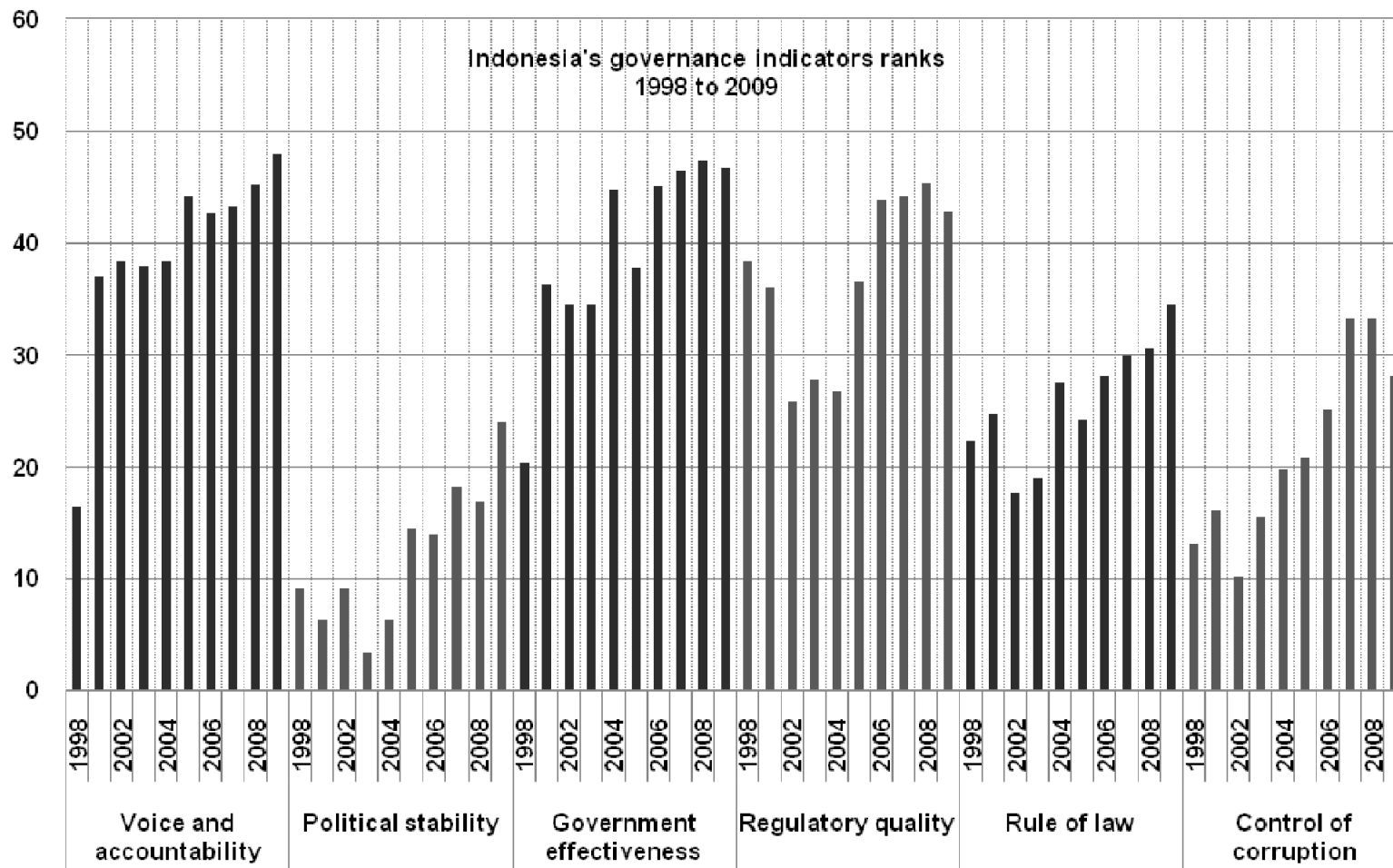
# Attracting foreign direct investment...

## *...improving the business environment*



Source: World Bank-LPEM-UI firm-level investment climate surveys.

# Attracting foreign direct investment... ...strengthening overall governance



# Attracting foreign direct investment

## *Enhancing regulatory transparency and certainty*

- ▶ **2007 INVESTMENT LAW**
  - ▶ Covers both domestic and foreign investment and aims to provide greater legal certainty
  - ▶ Provides for national treatment and potentially greater land use rights and longer work permits for foreign personnel
  - ▶ Reduction in administrative burdens through creation of an integrated one-stop licensing facilities
  - ▶ Opens all sectors to foreign and domestic investment unless contained on investment negative list
- ▶ Major step forward, but..
  - ▶ New investment negative list (DNI) although more transparent also appears more restrictive than in past
  - ▶ Implementing regulations cause legal uncertainty and examples of inconsistencies between Investment Law and other laws and ministerial decrees
  - ▶ Disconnect between INTENT and IMPLEMENTATION of investment policy
- ▶ Need for a **REGULATORY REFORM COMMISSION** with a broad mandate and authority to balance interests, address policy, coordination and implementation issues

# Capital flows into Indonesia

## *Managing risks, maximizing opportunities*

- ▶ **Portfolio flows have to be MANAGED NOT DISCOURAGED, but this is admittedly challenging when a country has a convertible currency and an open capital account**
- ▶ **The medium-term response should therefore be to SUPPLEMENT portfolio flows with MORE STABLE forms of financing by:**
  - ▶ **Deepening financial markets**
  - ▶ **Attracting foreign direct investment**
- ▶ **Institutional development, ability to adapt fiscal and monetary policies, and coordination are all essential**
- ▶ **A number of institutions and agencies need to work together—no single institution can do this alone**
- ▶ **A common shared objective and vision is critical**