

Highlights of the week



Prabowo's political map

With his coalition still shaky, presumptive nominee Prabowo Subianto's political map is as yet unfinished. His meetings on Monday, July 30, with Democratic Party chairman Susilo Bambang Yudhoyono (SBY) and Prosperous Justice Party (PKS) chairman Sohibul Iman however, have shed some light on Prabowo's ruse, particularly regarding his potential vice presidents.

Kalla, Jokowi and democracy in peril

Jusuf Kalla's legal battle over Article 169 of the 2017 Elections Law may bear a wider relevance than just his pursuit for vice-presidency. The tight countermotion from a group of academics and activists against United Indonesia's Party (Perindo) on July 30, indicated a bigger implication for Indonesia's democracy.

Flip-flopping DMO regulation

The recent Domestic Market Obligation (DMO) regulation flip-flopping is a bad precedent to the investment seeking Indonesia. DMO price cap elimination announcement on Monday and its cancellation on the next day reflected government's inconsistency and unthorough planning.

Tsingshan's game changer investment in Morowali

Chinese government announced anti-dumping probes on stainless steel import from the European Union, Japan, South Korea and Indonesia in July 23. The Indonesian case is particularly interesting, as it highlights how far competition between Chinese companies can go.

POLITICS

Prabowo's political map

With his coalition still shaky, presumptive nominee Prabowo Subianto's political map is as yet unfinished. His meetings on Monday, July 30, with Democratic Party chairman Susilo Bambang Yudhoyono (SBY) and Prosperous Justice Party (PKS) chairman Sohibul Iman however, have shed some light on Prabowo's ruse, particularly regarding his potential vice presidents.

Background: President Joko "Jokowi" Widodo's arch rival Prabowo Subianto is one step closer to securing his coalition ahead of the 2019 presidential election. Prabowo's own Gerindra Party was initially the only party supporting his presidential bid, while the Prosperous Justice Party (PKS) kept dangling its support over Prabowo's head because of his lack of approval for its vice-presidential nominee.

Nevertheless, Prabowo's July 27 meeting with SBY triggered some speculation as to the Democrats' interest in the Prabowo coalition. SBY's suggestion that Megawati Soekarnoputri, the chairwoman of the ruling Indonesian Democratic Party of Struggle (PDI-P), had masterminded the difficulties the Democrats faced in joining the Jokowi coalition in turn fueled speculation that SBY would shift the party's focus to the Prabowo camp.

The Prabowo-SBY meeting caused a chain reaction, with PKS chairman Sohibul Iman scheduling separate talks with SBY and Prabowo on July 30. It was strongly believed that the meetings aimed to explore possible running mates for Prabowo.

Assuming that the remaining party, the National Mandate Party (PAN), will eventually align with the Prabowo coalition, the Democrats' and the PKS' allegiance will be seminal to the coalition; Prabowo's potential running mate will likely come from these two parties. The Democrats and the PKS will thus likely steer Prabowo's path to the presidency.

Insight: Prabowo's success in amassing support from these political parties is a double-edged sword: on one hand, it enhances his political standing in the upcoming election, yet on the other, his coalition parties are competing against each other in nominating his running mate. Prabowo is now trapped in the same political predicament as Jokowi: how to appease the parties' differing objectives without causing the coalition to crumble.

In joining Prabowo's coalition, the Democrats has suggested pairing him with SBY's eldest son, Agus Harimurti Yudhoyono (AHY). With SBY's political prominence and zeal in pushing AHY's political career, it is no surprise that the price for the Democrats' support is the vice-presidential slot. Indeed, it has been rumored that granting the slot to AHY is a must to obtain the Democrats' support, a condition that was reportedly behind the Jokowi coalition's rejection of the Democrats.

Two scenarios may arise as a result of the Democrats joining the Prabowo coalition. First, Prabowo may pick AHY as his vice president, a scenario that is deemed highly likely for a number of reasons. In terms of electability, an Indikator survey showed that AHY's electability in May 2018 was 16.3 percent, much higher than the 3.4 percent electability of PKS chief patron Salim Segaf Al Jufri. Furthermore, choosing AHY as his running mate will allow

Prabowo to secure the Democrats' support. Considering that the Democrats won 10.19 percent of seats in the House of Representatives in the 2014 election, its support will have enormous significance for Prabowo's standing in the race.

Nevertheless, this scenario is risky, as it may prompt disapprobation from the PKS. Considering the PKS' persistence in pushing its cadres for vice president, the PKS may not accept Prabowo choosing AHY. In the worst case, the PKS may exit the Prabowo coalition to establish a third coalition of its own – a rumor that followed the PKS' announcement on its intent to nominate Jakarta Governor Anies Baswedan for president if Prabowo failed to support the party in realizing its objectives. The rumor has been fueled further by Prabowo's statement that he would happily support another challenger against Jokowi, indicating that the possibility remains open for Prabowo to pave the way for another presidential contender.

Regardless, the PKS' quest for a third coalition appears unlikely, since it has insufficient House seats to meet the presidential threshold, even with PAN's support.

Even if forging a third coalition is next to impossible, this does not guarantee the PKS' unwavering loyalty to the Prabowo coalition. On Aug. 2, the PKS issued a thinly veiled threat that it would abstain in the presidential election if Prabowo ignored the party's demands.

Considering the tribalistic culture of Indonesian politics, it remains unlikely that the PKS will make good on its threat and emerge as an independent player in the presidential race.

The second scenario is Prabowo picking a running mate from the PKS, a party that is often associated with Muslim conservatives. This could benefit Prabowo by boosting his Islamic credentials and softening his military image. Furthermore, those who question AHY's minimal political experience might be attracted to Salim's political prowess, particularly after AHY's failure in last year's Jakarta gubernatorial election.

One particular issue in this scenario, however, is the PKS' lack of resources, which may disadvantage Prabowo in the long run. One of Prabowo's main considerations in choosing AHY as his running mate is reportedly the Democrats' vast resources and logistical capacity, which could facilitate his presidential campaign.

In reading Prabowo's unfinished political map, it can be concluded that to maintain their coalitions' stability, both Prabowo and Jokowi must address the underlying issue of the parties' propensity for switching their allegiance. In particular, Prabowo, whose coalition remains relatively fragile, must find a solid incentive aside from the vice-presidential ticket to guarantee the parties' loyalty. Both candidates must determine a win-win solution for how their coalitions can benefit them, but also how they can benefit the parties in their coalition.

One way to foster this mutually beneficial relationship would be to look at opportunities for boosting the parties' electability in the upcoming legislative election and thus the number of House seats the parties might gain.

What we've heard: PKS has threatened to leave Prabowo if he cannot be decisive about the future of his coalition, especially in regard with his running mate candidate and power sharing in his cabinet later.

PKS' spokesperson Suhud Aliyudin has sparked a brouhaha in the opposition coalition when he openly said to the press that the party would leave the coalition if Prabowo was "mencla mence [indecisive]" on Thursday although he retracted his statement after he was reprimanded. PKS still insisted to endorse party chief patron Salim Segaf al-Jufri as Prabowo's running mate.

Meanwhile, the Democratic Party has proposed two requests to Prabowo: 1. Party chairman Susilo Bambang Yudhoyono as a senior minister (whose jobs description to be formulated later) 2. Yudhoyono's son AHY to be a vice presidential candidate.

Prabowo's inner circle however has been approaching popular Muslim preacher Abdul Somad to be named one of Prabowo's potential running mate candidates. Somad however has turned down the offer. In one of his conversation to Prabowo's wing man, Somad said that he was open to support Prabowo's presidential bid, but was unwilling to run with him.

Kalla, Jokowi and democracy in peril

The legal battle over Article 169 of the 2017 Elections Law is ongoing. Following the United Indonesia Party's (Perindo) motion to review the article, a group of academics and activists filed a countermotion on July 30.

Although the legal battle jeopardizes Vice President Jusuf Kalla's chance of seeking a third term as vice president, it bears wider relevance on the current state of Indonesia's democracy amid the political dynamics ahead of the 2019 elections. It may also have the potential to affect President Jokowi's political moves just days before the candidate registration closes for the presidential election.

Background: Article 169 of the 2017 Elections Law, which prohibits a president or vice president from a third term in office, is the sole obstacle Kalla faces in becoming Jokowi's running mate, as he has already served two terms as vice president: one term under SBY and another under the current administration.

The petition Perindo filed with the Constitutional Court initially improved the outlook for Kalla's reelection. The petition urges the court to review the legal interpretation of "consecutive order" under the article, specifically whether a third term would still be deemed illegal following two nonconsecutive terms in office. The petition argued that the article's wording was ambiguous, a point of contention that could favor Kalla's interest in pursuing a third term as vice president.

The Constitutional Court has yet to issue a ruling, leaving Kalla in political limbo. Regardless, the recent countermotion from six academics and activists, among them Titi Anggraini of the Association for Elections and Democracy (Perludem) and constitutional law scholar Feri Amsari, could be an indication that even if the Court accepted Perindo's motion, the public does not view Kalla's nomination in a favorable light. In their petition, the six academics and activists urged the court to reject Perindo's petition, as it was contrary to the spirit of reform.

The countermotion indicates growing public awareness of democratic values as well as the public perspective on apposite electoral candidates.

Insight: Perindo's motion to review Article 169 of the 2017 Elections Law has provoked objections from several quarters. Six academics and activists filed a countermotion in response, arguing that the disputed article of the law complied with the country's democratic stance.

Perindo's motion is being viewed as a political maneuver to achieve its own agenda. As the disputed article regulates not only the presidential and vice-presidential terms but also other high-ranking positions, it is feared that if the court accepts the motion for review, this would give carte blanche for other officials to prolong their terms in office, ultimately undermining leadership regeneration and making way for the potential return of a dictatorship.

The countermotion, however, may signal increasing public discontent over the unconstrained power of prominent politicians in amending the nation's laws. A separate *change.org* petition that has garnered more than 1,500 signatures also urges the court to reject Perindo's motion to protect political integrity and the country's legal system. This suggests a changed in the public mindset regarding political legitimacy.

The mounting opposition against Perindo's motion may impact Kalla's political future. The widespread public criticism may prompt Jokowi to reconsider pairing with Kalla in his reelection bid.

Meanwhile, pairing with Kalla offers the greatest benefits to Jokowi, as it would free Jokowi from his current predicament of choosing a running mate from among his coalition without breaking up the coalition. Furthermore, Kalla's aptitude in providing political stability and continuity could help Jokowi realize unmet goals. However, choosing Kalla could implicate Jokowi in the legal furor and damage his electability.

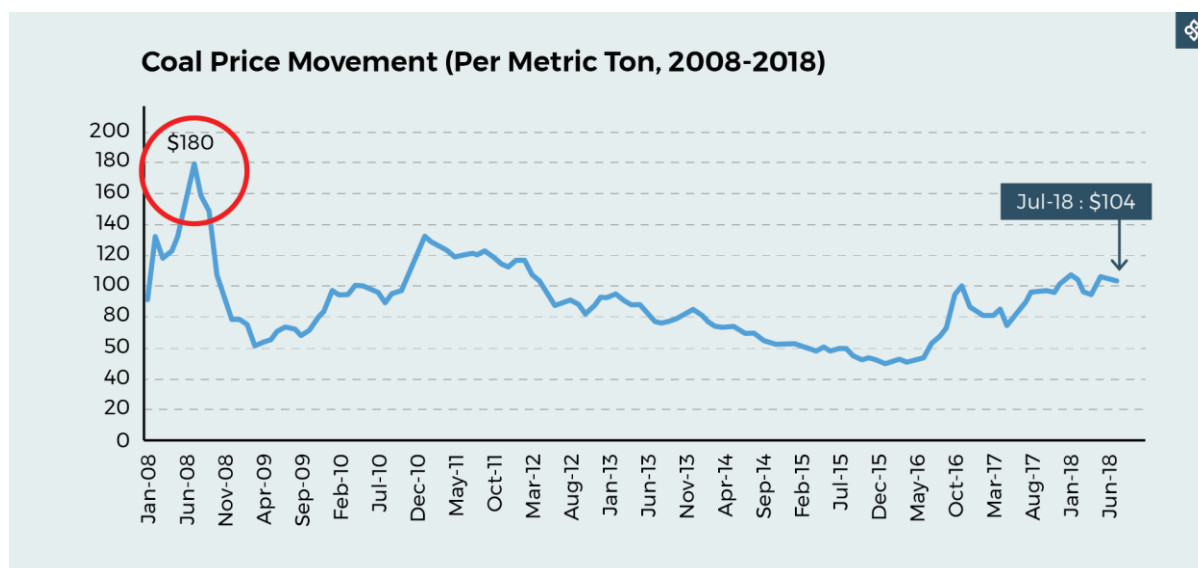
A country's democracy is often tested ahead of a national election amid the resulting political turmoil and maneuvering. How Kalla and Jokowi address the legal battle will determine the future of Indonesia's democracy and legal legitimacy.

BUSINESS & ECONOMIC POLICY

Flip-flopping DMO regulation

The government announced on Monday, July 30, that it might eliminate the price cap in the coal Domestic Market Obligation (DMO) to boost coal exports and boost foreign exchange reserves. The government said that it would instead establish a new institution to collect coal export levies. But on Tuesday, the government announced it had scrapped the plan because of the policy's widespread implications for PLN, the government and the people.

Background: In March, through Energy and Mineral Resources Ministerial Regulation No. 1395 K/30/MEM/2018, the government set a price ceiling of US\$70 per metric ton for coal sold to state-owned electricity company PLN after the global coal price skyrocketed. On July 3 coal price in the international market even touched \$120 per metric ton¹.



The regulation, referred to as the Domestic Market Obligation (DMO), has helped PLN to save up to Rp 30 trillion² between March and July. Therefore, when the idea to scrap the DMO was floated on Monday, it prompted widespread public objection on expectations that PLN would increase electricity rates for coal businesses to enjoy the ensuing windfall. The response prompted President Joko “Jokowi” Widodo to cancel the plan. However, the government seems unaware of the impact of backtracking on its policy plans.

Insight: Amid the trade deficit increase projected for the year, it was believed that abolishing the coal DMO/price cap would increase exports and foreign currency inflows to Indonesia. Therefore, the proposal to increase coal exports by lifting the DMO caught the government's attention.

¹ Afreuters.com, “Australian Newcastle spot coal prices hit \$120 for 1st time since 2012,” 3 July 2018
<https://tinyurl.com/y74ggh6h>

² Bisnis.com, “Jika penghapusan DMO diberlakukan, PLN akan rugi lebih dari Rp 30 Triliun,” 31 July 2018
<https://tinyurl.com/y88hmvp4>

But scrapping the coal DMO/price cap could cause a hike in the cost of raw materials for PLN, the primary user of domestic coal. Another burden that PLN faces in managing its production costs is the rupiah depreciation. Meanwhile, the government stated that the basic electricity tariff (TDL) would not increase until 2019.

PLN's financial report shows that the company maintains a deficit and that fuels and lubricants have contributed the largest expenses over the past two years at 43% of total operating costs, with the anomalous expense beginning at the end of 2015. A separate burden arose from the rupiah depreciation and debenture payments made in US dollars and yen, which have been rising. Yet, the situation was understandable because the government had forced PLN to impose a lower TDL to make electricity more affordable. As a result, PLN was dependent on government subsidy.

Summary of PT PLN Financial Position (In Trillion Rupiah)

	2014	2015	2016	2017
Revenues	193.42	217.35	222.82	255.29
Operating Expenses	-247.81	-225.57	-254.45	-275.47
Operating Income Before Subsidies	-54.39	-8.23	-31.63	-20.2
Government Subsidy	99.3	56.55	58.04	45.74
Operating Income After Subsidies	44.92	48.32	26.42	25.56
Other Revenues - Other Expenses	-29.91	-64.24	-12.84	-17.02
Tax Benefit (Expenses)	-3.94	21.94	-5.43	-4.2
Income for the Year	11.07	6.03	8.15	4.43

Source: PT PLN Annual Report

Therefore, abolishing the coal DMO/price cap would only increase PLN's burdens. The tables below provide a simplified illustration of possible scenarios if the government voids the DMO policy in 2019.

Scenario 1: Only Abolish Ceiling Price Rule

	If export duty around 2-3 USD Per Ton	If export duty around 6-7 USD Per Ton
PLN Demand for Coal	96 Million Metric Ton	96 Million Metric Ton
Additional Cost for PLN	\$1,920 Million - \$2,400 Million	\$1,920 Million - \$2,400 Million
Income from Export Duty (Production: 400 Million Ton)	\$600 Million - \$900 Million	\$1,800 Million - \$2,100 Million
Income from Export Duty (Production: 481 Million Ton)	\$721.5 Million - \$1,082 Million	\$2,165 Million - \$2,525 Million
Additional Export	None	None

**Scenario 2: Abolish Domestic Quota and Ceiling Price Rule
(Firm Export All Coal Production)**

Export Duty: 2-3 USD Per Ton	
PLN Demand for Coal	96 Million Metric Ton
Additional Cost for PLN	Additional Cost to Find Other Source of Fuel
Income from Export Duty (Production: 400 Million Ton)	\$800 Million - \$1,200 Million
Additional Export	\$962 Million - \$1,443 Million
Additional Export	\$10,822 Million - \$11,424 Million

Even if the government established a separate body to collect levies of \$2 to \$3 per metric ton of coal exports, and assuming that all collected tax was rechanneled to PLN, it would not help PLN much. However, if the coal levy was set at a much higher rate, say \$6 to \$7 per metric ton, it could alleviate the losses to PLN from cheap coal supplies.

The takeaway: The government needs to thoroughly consider alternative policies before announcing the elimination of the coal DMO/price cap. The export levies are attractive, but they must be better formulated toward alleviating a possible increase in the PLN subsidy or in electricity prices.

What we've heard: The idea to boost coal exports was first raised during a Cabinet meeting with 45 businessmen and tycoons at Bogor Palace on Thursday, July 26, 2018. President Jokowi asked for the businessmen's inputs on how to raise as much foreign exchange as possible from exports amid the rupiah depreciation. The President was concerned about the rupiah depreciation's impact on the widening current account deficit. According to several sources, improving palm oil exports was proposed initially, but was rejected as many at the meeting deemed it "too difficult", considering the European Parliament's stance against Indonesian palm oil products. Moreover, the plan's success would require intensive and time-consuming lobbies to India and China.

After prolonged brainstorming and discussions, the choice narrowed down to coal exports because of the bullish price trend. Coal businessmen at the meeting noted that increased coal demand from Japan, China, Korea and India had rallied the coal price. They also pointed out that coal was a major foreign exchange contributor during the 2008-2009 monetary crisis. To ensure foreign currency inflows to Indonesia, the businessmen proposed to use foreign banks with Indonesian subsidiaries. For this purpose, one coal businessman called for export "ease and convenience".

The Bogor Palace meeting did not specifically focus on abolishing the coal DMO/price cap. Instead, the President first floated the plan after a meeting the next day with Coordinating Maritime Affairs and Resources Minister Luhut Pandjaitan, Energy and Mineral Resources Deputy Minister Archandra Tahar and Environment and Forestry Minister Siti Nurbaya at Jakarta's Merdeka Palace. Coal producer Adaro Energy boss Garibaldi Tohir was also present to represent coal businesses.

According to some State-Owned Enterprises Ministry officials, several businessmen

exploited the idea to boost coal exports to eliminate the DMO price ceiling. The \$70 per metric ton price cap was too low compared to the international price of more than \$100. When the price cap regulation was enacted in March, foreign coal buyers called for renegotiating the ceiling price, referring to Indonesian businessmen's "acceptance" of the administered price for the domestic market, which angered local businesses.

Other sources said that some coal producers had not fulfilled their DMO despite the March regulation. This caused state-owned coal producer PT Bukit Asam (PTBA) to bear the consequences of fulfilling the "missing" supplies, supposedly through several private companies. The government then instructed PTBA to recover the supply shortage from non-compliant companies, which included Aburizal Bakrie's Kaltim Prima Coal.

Concurrently, Energy and Mineral Resources Minister Ignatius Jonan threatened to sanction companies that had not fulfilled their DMO quota by not approving their draft corporate budget and by cutting their coal production quota for next year. The companies that had not met the obligation felt threatened, and viewed the idea to boost coal exports as a means to eliminate the DMO/price cap and thus escape sanctions.

Several government sources also confirmed that the announcement to abolish the DMO/price cap prompted a proposal to increase the reference price for domestic coal. Jonan, who was in London at the time, sent several messages objecting to the plan to the Cabinet's WhatsApp group, citing references on the negative impacts of abolishing the DMO/price cap. Among the Cabinet, Jonan is said to often disagree with Luhut. Jonan was also the first minister to publicly announce that the DMO price cap would be maintained until next year.

**Indonesian Coal Production, Export, DMO
(Million Ton)**

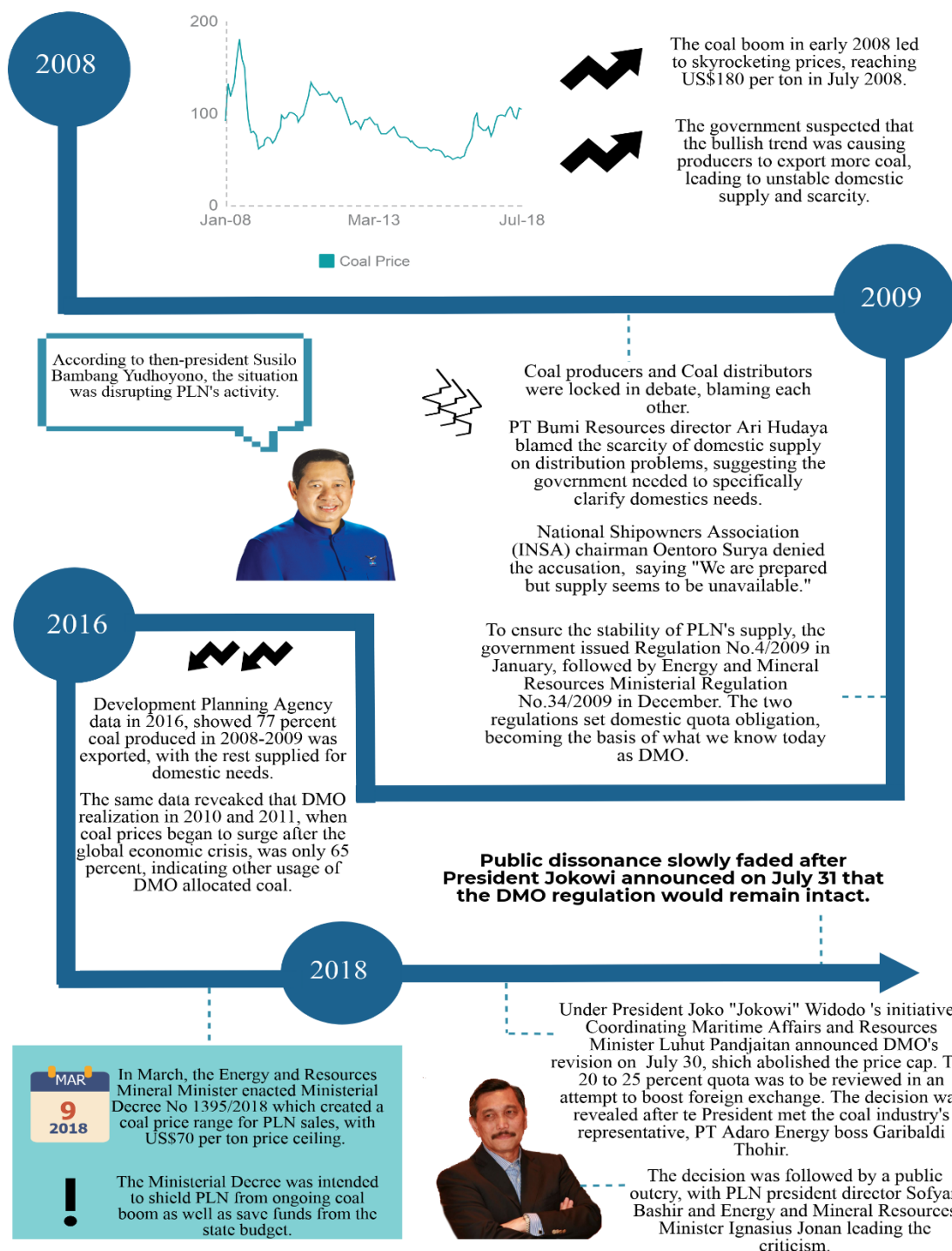
Year	Production	Export	Domestic	%DMO
2010	275	210	65	17
2011	353	287	66	15
2012	407	340	67	14
2013	421	349	72	17
2014	458	359	76	17
2015	461	375	86	19
2016	456	366	90	20
2017	461	364	97	21
2018 (January - July)	158	102	56	35

Source: Bappenas and Energy and Mineral Resources Ministry



TWIST AND TURNS DMO

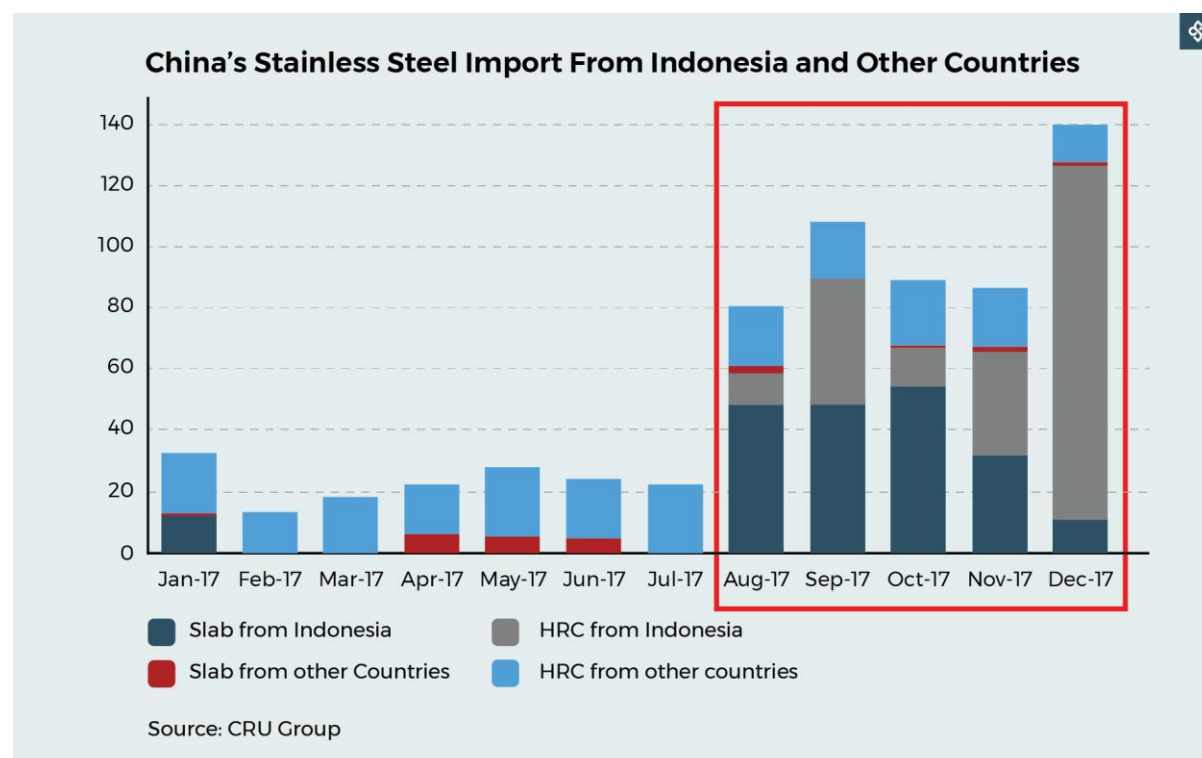
What do you need to know: The Domestic Market Obligation (DMO) is eventually older than we all might think and rife with conflict of interests.



Tsinghan's game changer investment in Morowali

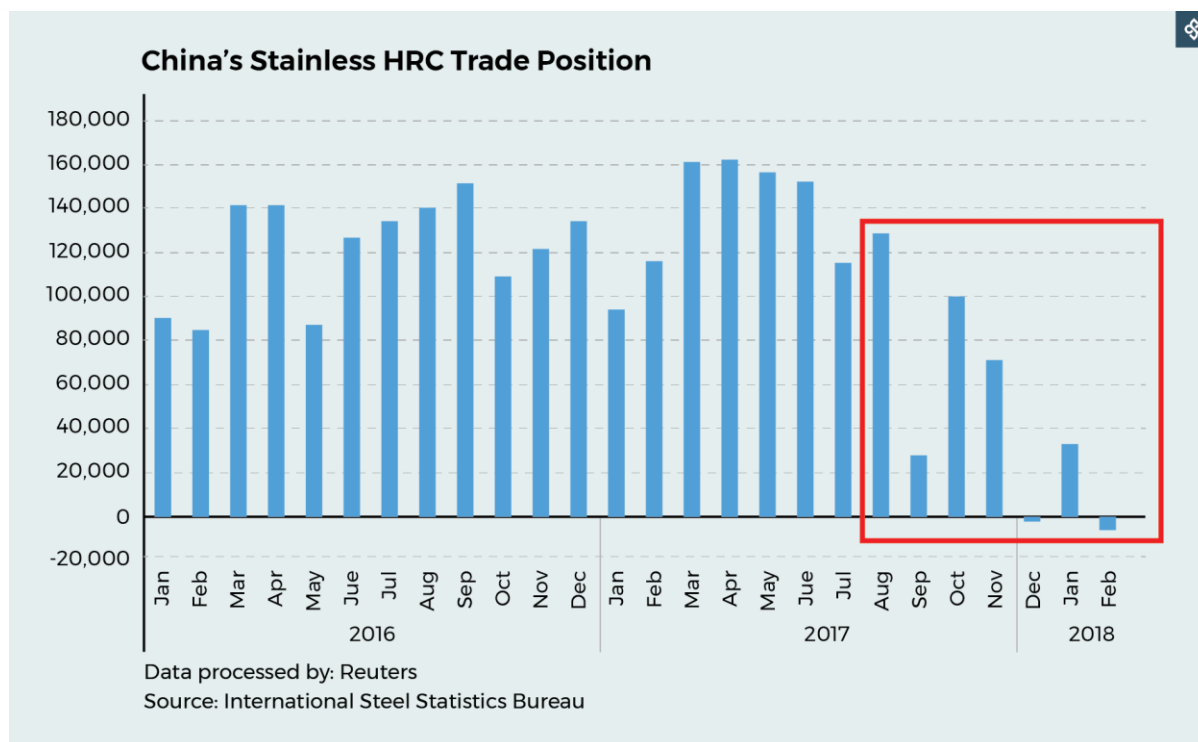
In July 23, China announced anti-dumping probes on stainless steel import from the European Union, Japan, South Korea, and Indonesia.

Background: China's dumping allegation is quite strange, because the accused is a mill in Morowali owned by Chinese steel company, the Tsingshan Group. Indonesian officials tone down this issue as just business dispute between Chinese companies,³ but the data shows that China has legitimate concern on this issue.



Since August 2017, China stainless steel import from Indonesia has increased significantly (see the Figure above). Moreover, this increase is followed by deterioration in China's stainless steel trade position, from net exporter to net importer (see the Figure below).

³ Bisnis.com, "China selidiki praktik dumping stainless steel asal Indonesia, ini komentar pemerintah RI," 24 July 2018 <https://tinyurl.com/ybta552l>



Insight: In the public eye, Chinese investment in Morowali Industrial Park is known for its illegal Chinese workers story,⁴ rather than the success story of Tsingshan's investment that turns Indonesia from nobody into a major player in Asia stainless steel market.

The story began with Tsingshan investment plan. In Morowali, Tsingshan planned to build an integrated stainless steel plant to solve its capacity problem in producing hot-rolled annealing and pickling (HR-AP) stainless steel. Unlike its Fu Jian plants that produce stainless steel slab and HR-AP in different facilities, Tsingshan's Morowali plant integrates these facilities, resulting in lower production cost and more competitive price for consumers (see the Table below), with production capacity of 3 metric tons per year.

Stainless Steel Price in Asia

11-Jul-2018	Price per tonne	
	304 - Stainless CRC	304 - Stainless HRC
East Asia	\$2,210 - 2,300	\$2,120 - 2,200
China & Taiwan	\$2,210 - 2,450	\$2,120 - 2,135
Tsinghsan Indonesia	\$2,180	\$2,050

Source: Metal Bulletin

In addition to the facilities above, Tsingshan plans to build cold-rolled stainless steel plant with 0.7 metric ton per year production capacity, making the Morowali plant bigger than Tsingshan's other plants in China (see the Table below). To complement its investment in

⁴ TheJakartaPost.com, "Govt to probe rumors about Chinese workers in Central Sulawesi," 23 November 2017 <https://tinyurl.com/ybj5k5u2>

Morowali, Tsingshan is currently converting some of its Chinese production facilities from stainless to carbon steel production such as in its Guangqing plant in Guang Dong.⁵

Tsingshan's Group Stainless Steel Capacity (Million Tonnes)

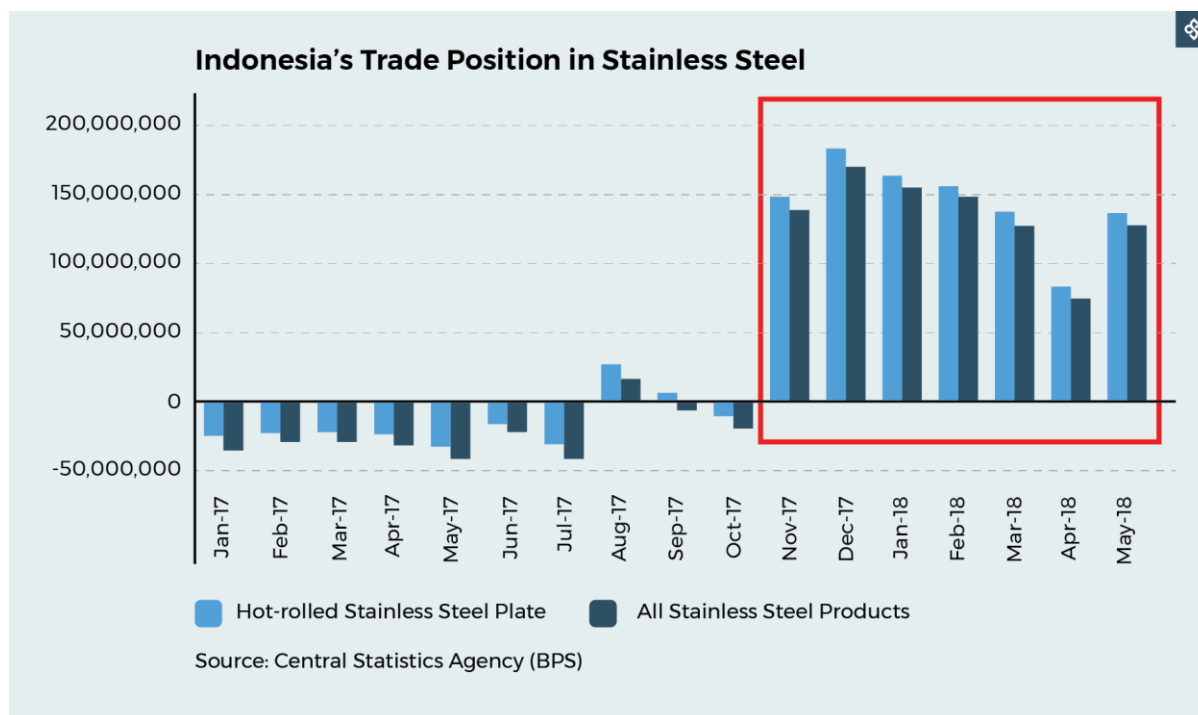
Plan	Location	Smelting	Slab	Billet	Hot Rolled Annealing & Pickling	Hot Rolled Longs	Cold Rolled
Guangqing Metal Tech	Guangdong	2	1.7	0.5	2*	-	-
Zhejiang Ruipu Tech	Zhejiang	-	-	-	-	0.3	-
Zhejiang Tsingshan Iron & Steel	Zhejiang	0.4	-	0.4	-	-	-
Fujian Dingxing Industry	Fujian	0.85	0.85	-	1	-	-
Fujian Dingxing Nickel Industry	Fujian	3	3	0.8	-	0.8	-
Fujian Dingxing Tech	Fujian	-	-	-	3	-	0.3
Tsingtuo Special Steel	Fujian	2*	2	-	-	-	-
Tsingtuo Shangke Stainless	Fujian	-	-	-	-	-	0.3*
Indonesia Guangqing Nickel & Stainless	Fujian	2	2	-	3	-	0.7*
Total		10.25	9.6	1.7	9.0	1.1	1.3

* = Planned Investment

Source: CRU Group

Tsingshan's Morowali plant has been in commission since the mid of 2017. The operation of this plan has propelled Indonesia's position from net importer into net exporter in Asia stainless steel market, specifically in hot-rolled stainless steel plate. Between November 2017 and May 2018, Indonesia has recorded an average of US\$ 132 million trade surplus per month (see the Figure below).

⁵ CRUGroup.com, "The world's largest stainless steel producer just got bigger," 6 September 2017
<https://tinyurl.com/yasws89x>



Tsingshan's investment success holds the potential to breed another series of success. Other players in the industry may follow suit by investing in Morowali or other places in Indonesia such as Hebei Bishi Steel Group's US\$ 2.5 billion investment in Kendal, Central Java.⁶ The investment in Morowali is the most important,⁷ because it holds the potential to become the engine of industrialization in Eastern Indonesia.

The takeaway: Tsingshan's investment success in Morowali is unprecedented. It catapults Indonesia to become a major player in Asia stainless steel market and holds the potential to become the driver of industrialization in Sulawesi as well as in Eastern Indonesia.

Macroeconomic Update: Foreign reserves depletion and widening CA deficit alarms Jokowi

In the opening of July 31st closed meeting with his economic ministers, President Joko "Jokowi" Widodo announced his new macroeconomic priorities for this year: improving Indonesia's current account (CA) position and strengthening the foreign reserves to stabilize the Rupiah.

Background: The President's announcement marks a U-turn in his macroeconomic policy stance earlier this year, from previously pro-growth to pro-stabilization.⁸ President Jokowi changes his policy stances as a response to rapid decline in Indonesia foreign reserves stock, specifically from US\$ 132 billion in January to US\$ 119 billion in June (see the Figure below).

⁶ Antaranews.com, "Perusahaan baja China investasi 2.54 miliar dolar di Kendal Jateng," 25 July 2018
<https://tinyurl.com/y7h77x76>

⁷ Beritasatu.com, "Tujuh perusahaan baja investasi US\$ 4.7 miliar," 12 March 2018
<https://tinyurl.com/yczjcv5z>

⁸ Kompas.com, "Jokowi optimistis pertumbuhan ekonomi pada 2018 capai 5.4 persen," 6 December 2017
<https://tinyurl.com/ybtqecnw>



Bank Indonesia uses the reserves to stabilize the Rupiah from capital outflow pressure in the capital market (see the Figure below). Since early of this year, financial investors have been converting their Rupiah-denominated assets to foreign currency-denominated assets mainly in US Dollar, motivated by the Federal Reserve and the European Central Bank's decisions to normalize their monetary policy (external factor) and the prospect of widening current account deficit from US\$ 17 billion to US\$ 25 billion in 2018 (internal factor).

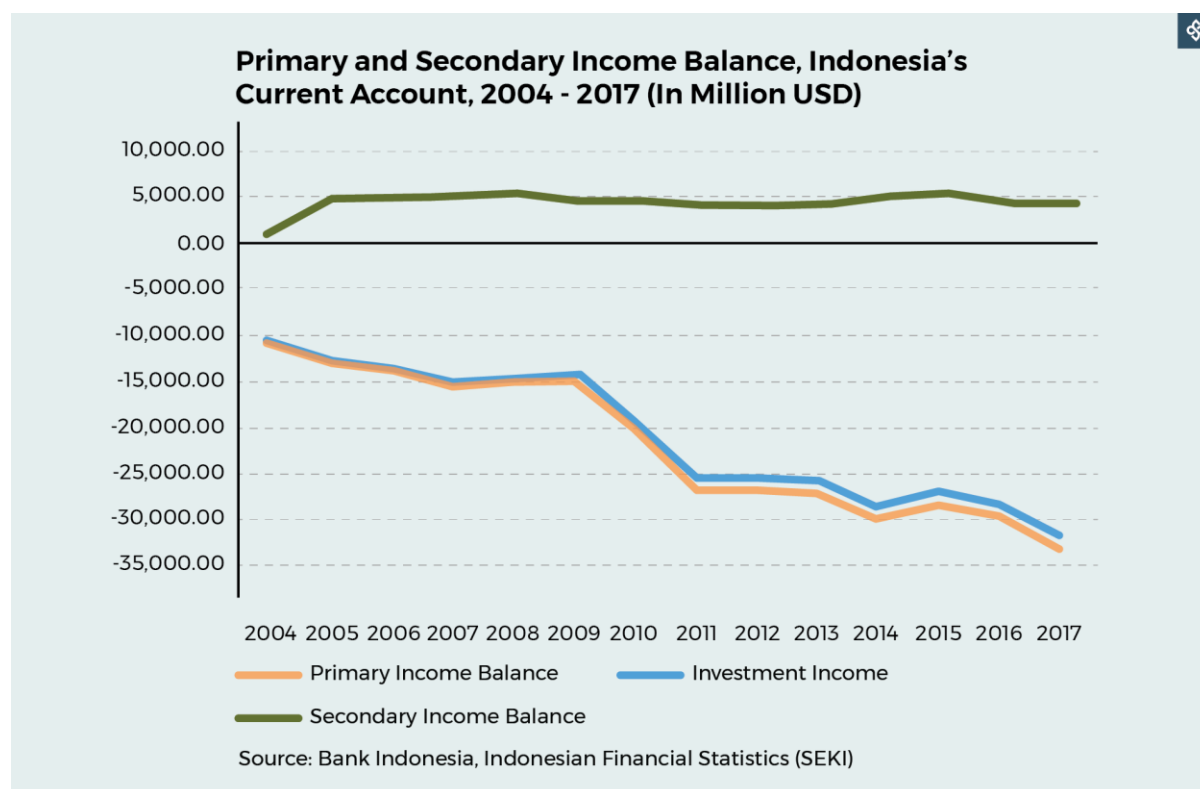


Insight: President Jokowi has made improving Indonesia's CA position his main macroeconomic objective to prevent further capital outflow in the capital market. In achieving

this objective, the President has outlined a simple economic strategy: controlling the flow of import while strengthening export performance.

Although the President's strategy sounds appealing, his strategy is incomplete because it does not address the fundamental problem of Indonesia's CA deficit, deteriorating primary income balance that is driven by growing deficit in investment income (see the Figure below). Investment income reflects the payment of returns made to foreign investors who hold Indonesian assets and Indonesian investors who hold foreign assets; hence, growing investment income deficit means growing imbalance in assets holding toward foreign investors.

There are two sources of investment income: payment of returns made for direct and portfolio investment. In 2009-2017, the numbers of foreign direct investment in Indonesia had increased by more than seven-fold, from US\$ 2.6 billion to US\$ 19 billion. As a result, Indonesia direct investment income deficit swelled by US\$ 12 billion to US\$ 20 billion in 2017 (see the Figure below).





Meanwhile, the amount of portfolio investment doubled to US\$ 20.6 billion, which results in mounting portfolio investment income deficit by US\$ 5.6 billion to US\$ 8.8 billion (see the figure above).

To solve Indonesia's CA deficit, President Jokowi needs a more specific solution, attracting foreign direct investment that can generate sufficient export income to cover the payment of returns made to the investors such as Tsingshan's stainless steel investment in Morowali Industrial Park, Central Sulawesi (see the story in this issue).

Nonetheless, attracting this kind of investment will be challenging because most foreign direct investors in Indonesia is attracted by the country's large domestic market rather than its potential as a production hub for international market.⁹

The takeaway: The source of Indonesia's CA deficit is growing deficit in primary income balance, which reflects growing payment of returns for foreign investors' direct and portfolio investments in Indonesia. To solve this problem, the government needs to attract export-oriented direct investment, but doing so will be challenging as most foreign investors is attracted by Indonesia's large domestic market rather than its potential as a production hub for international market.

⁹ EUInd-tcf.com, "Global value chains – some strategic directions for Indonesia," 14 March 2015
<https://tinyurl.com/y8s5773p>

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