Effective Capital Allocation Necessary for Indonesia To Harness Interest Rate Cuts

Jakarta's interest rate cuts should help stimulate the economy in the short term and facilitate the government's pursuit of its 5.2% growth target, but in the longer term cheaper capital if allocated ineffectively could weigh down the economy when interest rates eventually increase. In 2016, Bank Indonesia, the country's central bank, cut interest rates 25 basis points on six occasions, and in late September, the bank cut interest rates 25 basis points for the second time in 2017, bringing its benchmark rate to 4.25%.

- Bank Indonesia is reducing interest rates to help expand lending, which has grown slowly and resulted in the bank revising downward the country's loan growth target to 8-10%, according to press releases from the central bank in August and July. Indonesian banks have been slow to expand lending as they contend with a high-rate of non-performing loans (NPL), according to The Jakarta Post.

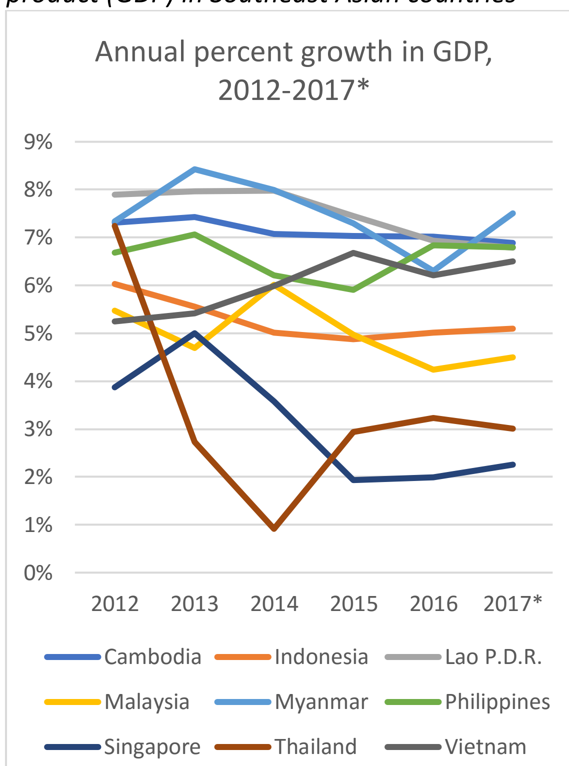
Figure 1.1: Benchmark interest rates in select Southeast Asian countries as of late September

Country	Rate
Indonesia	4.25%
Malaysia	3.00%
Philippines	3.00%
Thailand	1.50%
Vietnam	6.25%

Source: Respective central banks

- In addition to decreasing interest rates to stimulate the economy, the Indonesian government also is launching special economic zones and investing in infrastructure. For 2017, the government plans to spend around USD 29 billion on infrastructure, and in 2018, approximately USD 30 billion, according to The Jakarta Post.

Figure 1.2: Percent growth in gross domestic product (GDP) in Southeast Asian countries



**Date is from the International Monetary Fund (IMF). Figures for 2017 are IMF estimates.*

Increasing the money supply could dampen future economic growth if companies use the cheaper capital for unproductive projects that do not exceed their cost of capital, which could lead to a rise in NPLs.[1] NPLs undermine economic growth because they reduce banks' capital and require banks to isolate additional money to compensate for the debt loss, both of which reduce the money available to lend and grow the economy.

- Several industries within the Indonesian economy already are hampered with high rates of NPLs. As shown in figure 1.3, from January 2016 to July 2017 at least four sectors of the Indonesian economy—which together averaged almost 72% of total loans during this period—saw growth in implied NPLs exceed growth in total loans, based on data from Bank Indonesia.[2]

Figure 1.3: Percent growth in total and non-performing loans (NPL) for select Indonesian industries

Variable	W*	M	F	H
Total percent loan growth, 1/16-7/17	9.2	5.1	21.8	13.7
Total percent implied NPL growth, 1/16-7/17	24.4	25.1	34.8	24.2
Average monthly y-o-y percent loan growth, 1/16-7/17	6.7	5.1	11.4	8.5
Average monthly y-o-y percent implied NPL growth, 1/16-7/17	20.1	41.9	54.8	10.3
NPL rate at 7/17	4.6	3.3	0.8	1.9

**"W" is Wholesale and Retail sector; "M" is Manufacturing sector; "F" is Financial sector; and "H" is Household sector.*

- Additionally, the number of restructured loans, which often devolve into NPLs, have increased from 3.3% in December 2015 to 4.6% in December 2016, according to a Moody's assessment from late August.

Efforts to streamline Jakarta's 118 State-owned Enterprises (SOE) might mitigate the risk of capital misallocation. As of December 2016, the 20 publicly listed SOEs comprised more than 25% of the Indonesia Stock Exchange's total market capitalization, according to Export.gov, indicating SOEs constitute a large portion of the Indonesian economy.

- As of December 2016, DBS Vickers assessed SOEs were the primary source of loan demand in Indonesia, suggesting the efficiency in which SOEs allocate capital will influence Indonesia's future economic performance.

- Twenty percent of Indonesian SOEs suffered losses in 1H2017, according to The Jakarta Post. One of those SOEs, flag carrier Garuda Indonesia, recorded a loss of USD 282 million, possibly because of its management or investment decisions, according to Indonesia's finance minister, as reported in The Jakarta Post.

- Recently, Jakarta began merging the country's SOEs under holding companies in six sectors, which the government believes will make SOEs

[1] In the near term, an increase in loans will reduce the rate of non-performing loans (NPL) because the total number of loans will grow at a faster rate than NPLs, according to a working paper from the European Bank for Reconstruction and Development.

[2] We calculate each sector's implied NPL by multiplying its monthly total loans by its corresponding monthly NPL rate.

more competitive, efficient, and transparent, according to The Insider Stories' interview in September of the SOE minister.