# Mizuho Economic Outlook & Analysis

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# *India, Indonesia and the Philippines: Will their current account balances continue to deteriorate?*

**< Summary >**

◆ In 2018, a broad range of emerging market (EM) currencies fell against a backdrop of US interest rate hikes. In particular, there was a significant depreciation of currencies among India, Indonesia and the Philippines which are subject to current account deficits.

◆ The main factor for the deterioration in current account balances is the increase in imports of goods, which stems most likely from the increase of investment in addition to the rise of crude oil prices. The Philippines was the sole country among the three countries that exports were sluggish, affected by the decline in prices of IT-related products.

◆ Looking ahead, the Philippine current account balance may continue to deteriorate. In the event the US dollar appreciates in the future, the market will focus once again upon the country's current account deficit.

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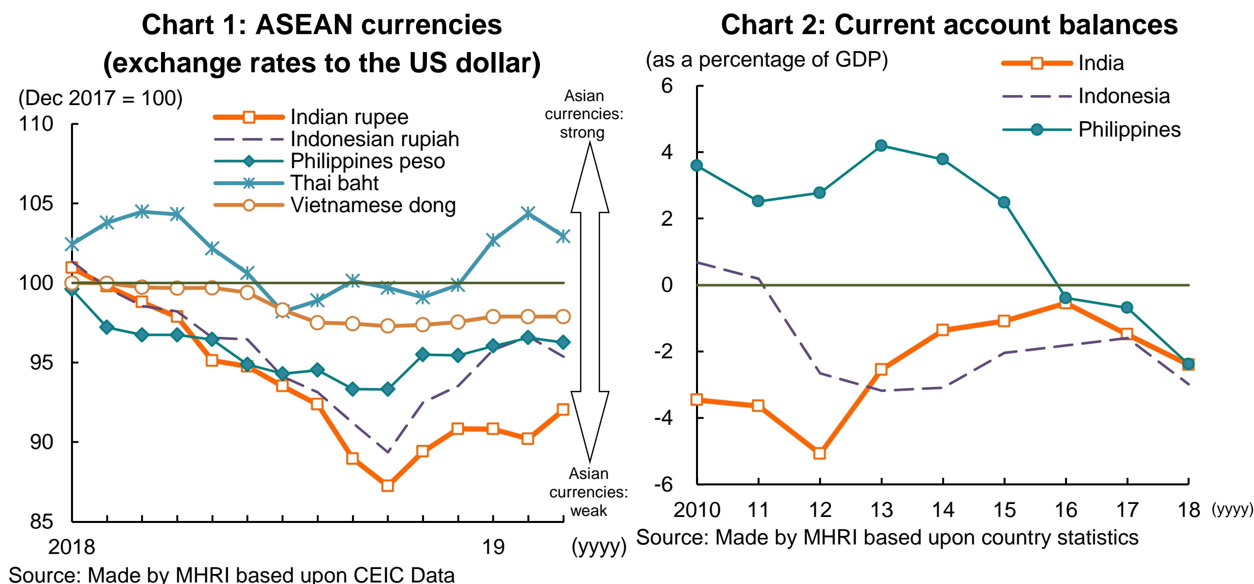
## 1. Introduction

In 2018, a wide range of currencies in emerging market (EM) countries, including Asia, fell against the US dollar in light of a series of interest rate hikes in the United States. Among major Asian countries, the drop in currency value was particularly noticeable in India, Indonesia and the Philippines (**Chart 1**). Looking closer at the background, it should be noted that the current account is not merely in deficit in these three countries, but that the deficits widened in 2018 (**Chart 2**).

In the latter half of 2018, the unilateral rise of the US dollar came to an end, as EM countries implemented interest rate hikes (**Chart 3**) and it became clear that the pace of interest rate hikes in the United States was moderating. Then, as the view took hold that the US would not raise interest rates in 2019, Asian EM countries saw growing calls for monetary easing, and India carried out an interest rate cut ahead of other countries in January. While the focus of attention upon the current account balance has abated in contrast to focus upon monetary policy, the current account balance will gather attention once again in the event the US dollar appreciates.

Accordingly, in this paper we would like to consider why the current account balances of these three countries have deteriorated after the period of the strong US dollar and whether that deterioration will continue in the future.



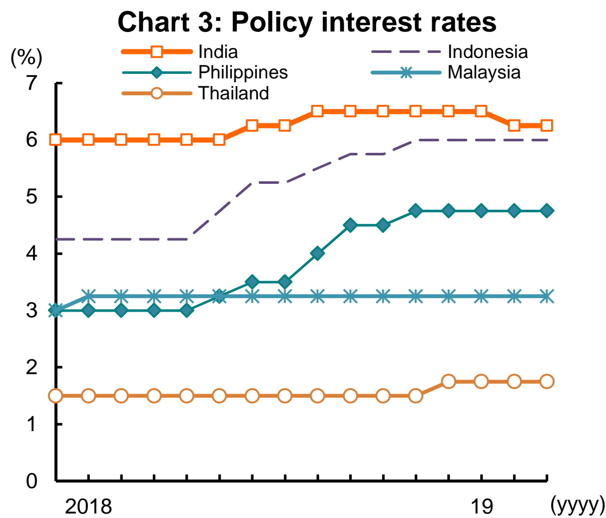

## 2. Why did the current account balances deteriorate in 2018?

### (1) Current account variable factors for each country

Looking at the causes of the deterioration of the current account balance in 2018 using the breakdown of the international balance of payments, imports of goods have been increasing in India (**Chart 4**). Other items represent minor plus factors in the current account balance. In

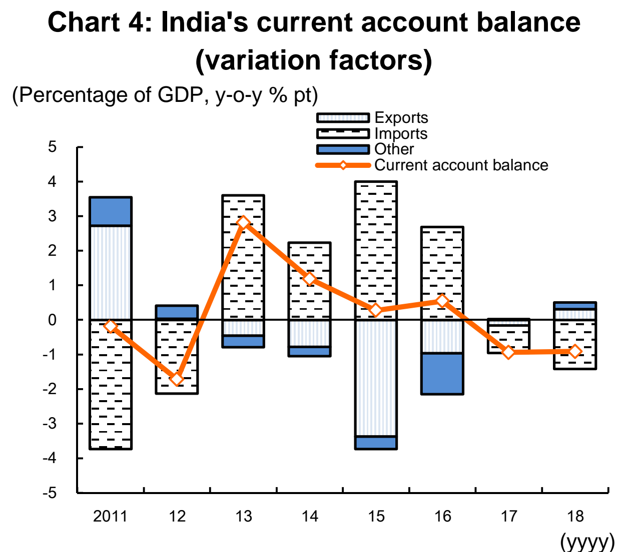
Indonesia as well, increasing imports of goods has been the main factor (**Chart 5**). Given the growth of goods exports, and steady growth of income receipts and services exports, "Other" in **Chart 5** for Indonesia is contributing positively. In the Philippines, the increase in imports of goods as the main cause of the deterioration in the current account balance is a feature shared with the other two countries, but a slowdown in the exports of goods has also had an impact (**Chart 6**).

**Chart 3: Policy interest rates**



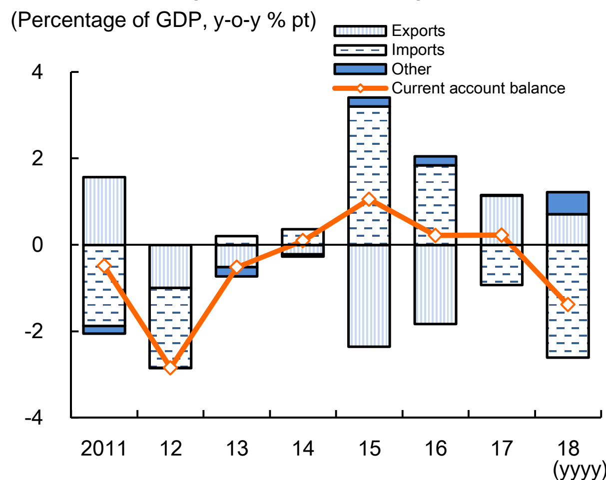

Source: Made by MHRI based upon country central bank data

**Chart 4: India's current account balance (variation factors)**



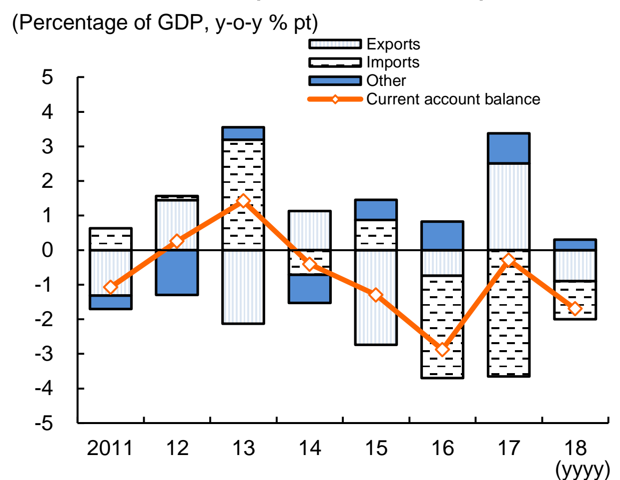

Source: Made by MHRI based upon Reserve Bank of India and the Central Statistics Office statistics

**Chart 5: Indonesia's current account balance (variation factors)**




Source: Made by MHRI based upon statistics from Statistics Indonesia and Bank Indonesia

**Chart 6: The Philippine's current account balance (variation factors)**




Source: Made by MHRI based upon statistics from the Philippine Statistics Authority and the Bangko Sentral ng Pilipinas

### (2) India

The deterioration of the current account balance in India is mainly due to the rise of energy prices. As mentioned before, while India's current account balance has deteriorated due to the

increase in imports of goods, an analysis of contributing factors reveals that it can be explained to a large extent by the increase in mineral fuels (**Chart 7**). This is followed by the chemicals and metals group, and then by machinery. Under chemicals and metals, items such as chemicals, plastics, steel and nonferrous metals are growing evenly, and under machinery, the contributions of electronic machinery and general machinery are high.

The background to the increase in imports is economic recovery. In India’s case, the rate of economic growth accelerated to 7.4% in 2018 (**Chart 8**), in a reaction to the subdued rate of growth in 2017 (+6.9%) due to economic confusion stemming from factors such as the demonetisation of high-value banknotes (November 2016). Particularly noteworthy is that exports of goods and services and gross fixed capital formation grew significantly.

However, with regard to the increase in imports of mineral fuels, the rise of energy prices was the main reason, even though there was an increase in demand due to the economic recovery. Imports of mineral fuels in 2018 grew +36.0% y-o-y, while according to World Bank data, crude oil and other energy prices rose at an average rate of 27.8% in 2018.

**(3) Indonesia**

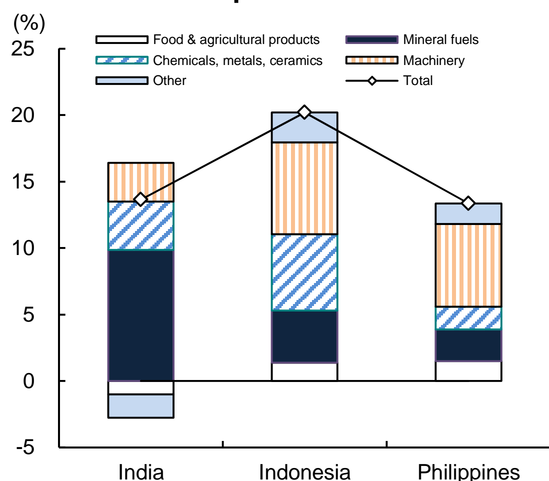
Machinery is the largest contributor to Indonesia's increase in imports. A look at the breakdown of machinery shows that general machinery and electrical machinery account for the majority of the increase. The next largest contributors to imports are chemicals and metals, with a breakdown showing that steel and steel products are growing particularly strongly, followed by plastics and organic chemicals. The contribution of mineral fuels is also large.

Looking at GDP by demand item, while gross fixed capital formation and personal consumption accelerated in 2018, it is generally believed that gross fixed capital formation has a larger import-inducing effect. The government's infrastructure investment as a percentage of GDP shows that 2018 was lower than 2017, which probably means heightened private capital investment activity.

Furthermore, since the volume of mineral fuel imports is decreasing, the increase in the amount of imports is not due to the increase of domestic economic activity but the rise of energy prices. Given that Indonesia is a net exporter of energy, the rise of energy prices is a key factor in the improvement of the trade balance. However, because the amount of production and exports of natural gas and other energy products has stagnated due to the dampening of investment caused by delays in the amendment of the country's oil and gas law[1], the rise in energy prices has served to worsened the trade balance.

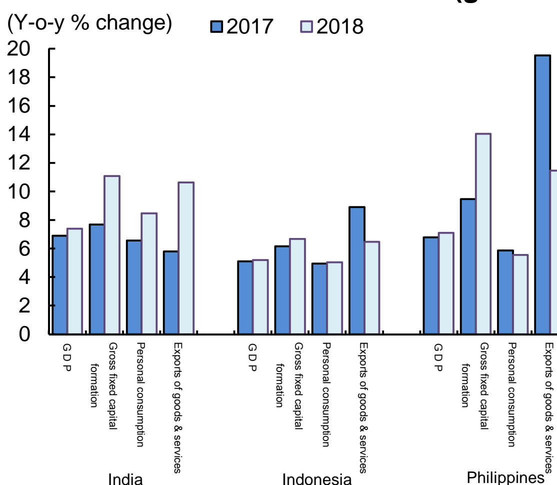
[1] Regarding Pertamina, Indonesia's state-owned oil company, the aim is to transfer jurisdiction from the Ministry for State-Owned Enterprises to the direct control of the president, and to designate the company as a special business operator that oversees upstream and downstream operations of oil and gas.

**Chart 7: Contributions of customs-cleared imports in 2018**




Note: India's "Chemicals, metals and ceramics" does not include ceramics due to statistical limitations.
Source: Made by MHRI based upon country statistics

**Chart 8: Real GDP demand items (growth rate)**




Source: Made by MHRI based upon country statistics

## (4) The Philippines

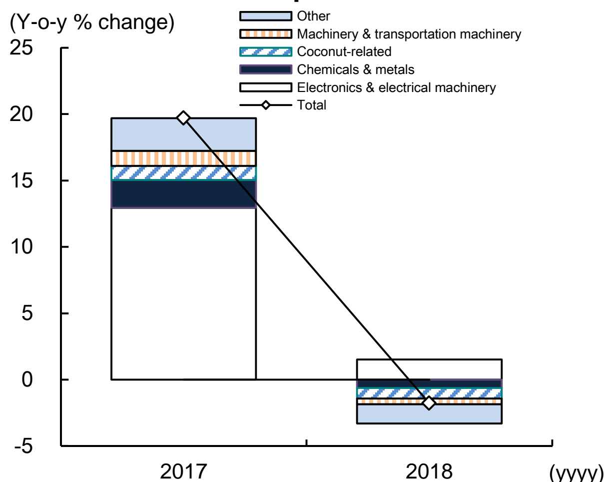
Among the Philippines' top import items, the increase in machinery is striking. The main items include electronic components & semiconductors, transportation machinery, industrial machinery, communication equipment. Although further details are unknown, electronic components & semiconductors are expected to be directed to exports, and other machinery items are expected to be used mainly in domestic investment, which has performed well. While the contribution of mineral fuels is the second largest after machinery, it is smaller compared with India and Indonesia. As in Indonesia’s case, the volume of imports of mineral fuels is decreasing, leaving the rise of energy prices as the cause of the increase in the value of imports. The contributions of chemicals, metals and ceramics are not very large, but a breakdown shows that the contribution of steel is high.

Looking at GDP by demand item, gross fixed capital formation has been accelerating. Given the Philippine government’s stimulation of infrastructure investment under its plan dubbed "build-build-build", it appears that this has boosted imports of transportation machinery and steel etc.

As mentioned previously, the export slump is another factor in the deterioration of the current account balance in the Philippines. Customs-cleared exports (denominated in US dollars) showed strong growth of +19.7% y-o-y in 2017, but fell sharply to -1.8% y-o-y in 2018 (**Chart 9**). On the other hand, real exports of goods in GDP statistics grew +12.4% y-o-y (**Chart 10**). In other words, despite the double-digit growth of export volume, the value of exports has declined, suggesting a significant fall of export prices. In 2018, market prices for electronics, electrical machinery and coconut oil, which are the Philippines main export items, may have been particularly weak.

Having said so, it should be noted that in 2018, the Philippines was the only country among major Asian countries that customs-cleared exports decreased. The stagnation of exports in a wide range of items not only limited to electronics, electronical machinery and coconuts may stem from the strength of domestic demand which has left the product supply system for exports under-developed. In the run-up to the second comprehensive tax reform in which the reduction of preferential taxation of foreign corporations is under consideration, foreign export-oriented firms may be backing off from capital investment.

**Chart 9: The Philippines' customs-cleared exports**




Source: Made by MHRI based upon statistics from the Philippine Statistics Authority

**Chart 10: Customs-cleared exports and GDP-based exports**

(Y-o-y % change)

| | Currency | India | Indonesia | Philippines |
|---|---|---|---|---|
| Exports (customs statistics) | US dollar | 8.8 | 6.7 | -1.8 |
| Nominal exports (GDP statistics) | Domestic currency | FYstatistics only | 13.5 | 8.7 |
| Real exports (GDP statistics) | Domestic currency in real terms | FY statistics only | 6.5 | 12.4 |
| Nominal exports of goods & services (GDP statistics) | Domestic currency | 14.1 | 13.4 | 10.4 |
| Real exports of goods & services (GDP statistics) | Domestic currency in real terms | 10.8 | 6.5 | 11.5 |

Note: India's fiscal year runs from April to March
Source: Made by MHRI based upon country statistics

## 3 Outlook for 2019

### (1) Common factors affecting the current account balances in all three countries

In this section we consider the factors common to all three countries that affect the current account balance in 2019.

First of all, looking at the key factor for the improvement of the current account balance, energy prices, which rose in 2018 and led to the rise of imports in the three countries, have fallen mainly with respect to crude oil since the end of 2018. Despite a mild upturn from 2019 onward, the momentum is weak. Prices are likely to be sluggish compared to 2018, in view of the capacity for US shale oil production and the slowdown of the global economy. In addition, since all three countries have raised interest rates in 2018, there is a strong possibility that private investment will be subject to downward pressures of varying degrees in each country, which in turn will lead to restraints upon imports.

One of the causes of the deterioration of the current account balance is the weakening of the export environment due to the global economic slowdown. With regard to global demand for IT-related products in particular, the stagnation may be prolonged due to inventory adjustments.

Furthermore, even though the US dollar is not a direct factor of the deterioration of the current account balances, the end of the unilateral appreciation of the US dollar due to its *de facto* end of interest rate hikes will serve as an indirect factor causing the current account balances to deteriorate. This makes it easier for countries to acquire US dollars and finance its deficits.

For each country, we examine below how strongly they are affected by these factors and also the effects of individual factors in each country.

**(2) India**

As we have already seen, the biggest factor that has worsened the current account balance in India is the rise of energy prices. While India's current account deficit in 2018 was 2.4% of GDP, if energy prices stay flat versus 2018, it is estimated that this alone would lead to the improvement of the current account balance by 1.35%pt. Furthermore, in addition to restraints upon the government's infrastructure investment, reduced slightly from the FY2018 budget (3.17% of GDP) to the FY2019 budget (3.08% of GDP), the overall economy is also slowing down. The relatively large decline in the value of the rupee in 2018 can also be expected to improve the trade balance. In view of the foregoing factors, India's current account balance is likely to improve.

**(3) Indonesia**

Turning to Indonesia, there are many factors which may curb imports in 2019. In addition to the decline in energy prices, it is expected that capital investment by private companies will slow down due to the successive interest rate hikes in 2018. Furthermore, the government's budget for infrastructure investment has also been reduced from 2.8% of GDP in 2018 to 2.6% in 2019. Due to the small proportion of IT-related products in exports, the negative impact of the global stagnation of IT demand is likely to be limited. As mentioned earlier, despite concerns regarding stagnant energy production and exports, there is a high possibility that Indonesia’s current account balance will improve.

**(4) The Philippines**

The Philippines is different from the other countries in that the government aims to increase infrastructure investment. While it is somewhat unclear whether infrastructure investment will actually increase in FY2019 due to the delay in the passage of the budget[2], if it does increase as desired by the government, a rise of imports may cause the current account to deteriorate. Also,

[2] A budget bill approved by both houses of Congress on February 8 was amended in the House of Representatives but was opposed by the Senate.

the export environment is likely to be the most severe of the three countries. The reason is that, as mentioned earlier, the ratio of IT-related products to exports is high, and there is a possibility that the ability to supply products for export is decreasing due in part to strong domestic demand and delay in foreign capital investment.

As in Indonesia's case, the fall of energy prices is expected to have the effect of restraining imports and private sector capital investment is expected to slow down due to the interest rate hike in 2018. However, the former effect is smaller than in the case of Indonesia (**Chart 7**). In addition, the central bank governor Nestor Espenilla died in February 2019 and his successor, Benjamin Diokno, who is considered to be doveish, was appointed in March. If interest rates are cut quickly under the new governor, the slowdown in capital investment may be limited.

Despite the lingering lack of clarity regarding the passage of the government budget, it is quite possible that the current account balance will continue to deteriorate in 2019.

### (5) Summary: Caution required in the case of the Philippines

Summarizing the above, although the current account balance will improve in India and Indonesia in 2019, it may deteriorate further in the Philippines depending on the outcome of the budget process. However, given the widespread view that the US will not raise interest rates in 2019, as mentioned at the beginning of this paper, even if the Philippines' current account balance deteriorates to some degree, we do not expect the peso to be subject to large-scale sell-offs as in 2018.

From 2020 onward, the current account deficit will gather attention again in the event the US dollar starts to appreciate. The deficit in the Philippines was 2.4% of GDP in 2018, but if it increases further it will approach the level of 3.7% (IMF forecast) in Argentina, which experienced significant problems when the currency plunged in 2018. Note also that the Philippine government plans to boost investment in infrastructure up to 7.3% of GDP in 2022 (it was 5.1% in 2018). This means that in the near future, the possibility of the current account balance deteriorating to the same extent as in Argentina is not necessarily low. There are views that there is no need to be excessively concerned since the deterioration of the current account balance caused by the increase in infrastructure investment may lead to the entry of export-oriented companies along with the improvement of the investment environment. However, as mentioned earlier, given that there are moves to reduce the preferential treatment of foreign firms, the attraction of export-oriented companies may not proceed smoothly. For the time being, it will be necessary to keep a close eye upon the current account balance of the Philippines.

## Reference

International Energy Agency (2019), *Oil 2019 – Analysis and forecast to 2024*