KFW ECONOMIC RESEARCH

Emerging Markets Spotlight

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Indonesia – scaling back subsidies remains a tricky hot topic

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Economic situation

	Rating	Trend
Real growth	good	worse
Growth in private consumption	good	stable
Inflation rate	good	worse

The plus points – high growth and monetary policy leeway

Indonesia's economic growth has slowed somewhat recently, but on the whole it remains impressive. This is largely driven by private consumption and stable domestic demand. The central bank is keeping its key interest rate at a high level to prevent any acceleration of inflation and an exodus of capital. But it does have some leeway with interest policy, if the economy needs it.

Growth financing

	Rating	Trend
Current account balance	neutral	improved
External debt/GDP	neutral	worse
Real effective exchange rate	neutral	stable

External financial contributions stable, no reason for concern

The current account balance has shown a deficit since 2012 but is under control (currently 2.8 % / GDP) and largely financed stably by foreign direct investment. Although foreign debt is rising moderately in absolute terms and relative to GDP, debt servicing is easily manageable. The rupiah has tended to depreciate in real terms since 2010, which has boosted competitiveness.

Growth resources

	Rating	Trend
Investment rate	good	stable
Labour force participation rate	neutral	stable
Share of renewable resources in energy use	good	worse

Potential can and must be harnessed more

The investment rate is higher than in other emerging markets, and Indonesia has translated this into impressive GDP growth. However, more secondary education is needed alongside high labour market participation to keep this momentum going. One positive aspect in terms of sustainability is that 25 % of energy consumption comes from renewable resources. Fact is though that 88 % of electricity is generated from coal, oil and gas. The high potential of renewable energies is underutilised in the electricity sector.

Economic relations with Germany

	Rating	Trend
German share in goods exports	weak	much improved
German share in goods imports	very weak	worse
Inbound FDI from Germany	weak	much improved

Long-term rise in trade and FDI, but Germany falling behind in relative terms

There has been a sharp long-term rise in bilateral trade volumes. Yet other trade partners have performed far better in this context, which means Germany's share in total foreign trade with Indonesia is now just around 2 %. German FDI rose to EUR 2.6 billion (as of 2012), but only accounts for 1.6 % of total FDI in Indonesia.

Legend (for detailed explanation of methodology see p. 4)

excellent	good	neutral	weak	very weak
much improved	improved	stable	worse	much worse

Investment climate: assessment by our local experts

Indonesia's comparatively stable growth in recent years has been impressive. Significant economic reforms have markedly improved the investment climate. Yet there are still structural weaknesses. Newly-elected President Widodo has announced improvements to overall economic conditions by means of additional reforms. German companies would also benefit from this as investors or exporters.

Continued on p. 2

Focus: fuel price subsidies

The government fixes fuel prices at a low level and uses a fifth of its budget for related subsidies – more than for government investment. While the price increase on 18th November 2014 did alleviate this somewhat, it is not enough. Subsidising fuels is questionable in various respects: it is partly responsible for significant traffic problems, it benefits the wrong target group and diverts funds from other areas.

Continued on p. 2

Investment climate: assessment by our local experts

Since the crash during the Asian crisis, Indonesia has developed well. Until 1997/98 Indonesia was one of the "Asian tigers", but then it suffered an extreme recession (GDP sank by 13 % in 1998) coupled with a drastic devaluation of its currency and a slump in exports, rising unemployment, etc. The crisis revealed severe structural weaknesses. Indonesia eventually found its feet again from an economic perspective following targeted reforms. Until the global financial crisis in 2008 the Indonesian economy grew steadily and even at rising rates of up to 6 % p. a. The impacts of the global financial crisis were limited, but a slump in growth was inevitable in 2009. Between 2010 and 2012 growth once again topped 6 %, dipping slightly in 2013/14 to 5–6 %.

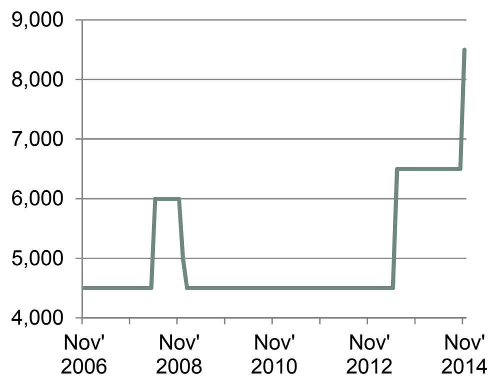
The country has considerable economic strengths. During the global economic boom years, Indonesia benefited from its wealth of natural resources and the rise in relevant prices on the global market, managing to boost exports to industrialised countries but also and especially to other emerging markets in Asia. The stable, broadly-based domestic demand, however, has always been a fundamental pillar of the economy. The market of this country with its 250 million inhabitants is massive, and a large middle class has emerged that enjoys steady growth in purchasing power. Thus the growth prospects for the consumer goods industry (textiles, processed foods, etc.), vehicles, infrastructure development (see below) and industrial modernisation in general are very good. This provides opportunities for German investors and suppliers too.

Yet considerable weaknesses should not be overlooked either. In spite of the reforms, improvements still have to be made to the economic policy framework in many respects. The economic infrastructure is inadequate (roads, ports, airports, etc.), while the unpredictable time requirements and high costs of transport/logistics are a competitive disadvantage for Indonesia. The skills and qualifications of the workforce are not consistent with the needs of the economy. Complaints are often voiced regarding the cumbersome bureaucracy, unreliable legal framework and corruption. Recently elected President Widodo has planned a comprehensive agenda of reforms and it will be interesting to see whether he obtains the necessary backing in Parliament and from the general public. The recently approved reduction in fuel price subsidies (see below) is a positive sign here.

Based on an interview on 25th November 2014 with Paul Heinemann (Head of DEG Office in Indonesia). ■

Focus: fuel price subsidies a significant drag on the budget and highly questionable overall

Figure 1: Price of petrol in IDR



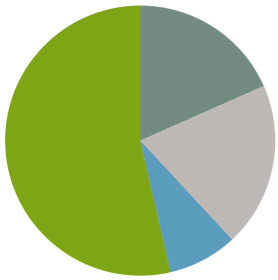
Source: CEIC, Pertamina

Government keeps fuel prices low. Fuel prices in Indonesia have always been politically driven. Until the middle of 2013 one litre of petrol in Indonesia cost the equivalent of only 36 eurocents. Since then it has been raised twice (latterly on 18th November 2014) to its current level of IDR 8,500 (Figure 1), or 56 eurocents. According to World Bank estimates, this current price is still much lower than a price without state intervention.

Huge impact on budget. Since the prices come nowhere near to covering the costs, even after the recent increase, the government has to subsidise them. Indonesia has its own oil resources and is also an oil exporter, but overall it is a net importer of the commodity. This means that the considerable decrease in the global market price for crude oil in recent months has relieved the pressure on the subsidy budget. However, said trend is countered by the devaluation of the rupiah. Fuel price subsidies exert a negative influence on the national budget in two ways. Firstly, they account for 20 % of total central government spending, and are therefore higher than the total volume of state investment (Figure 2)[i]. Secondly, the state passes up on the chance to have road users participate in the costs for building and maintaining road transport infrastructure by means of a tax on fuel, and it only has other (scant) tax proceeds available for this, which are in no way sufficient. In this respect, the capacity problems referred to with infrastructure are closely related to the topic of fuel price subsidies.

Adverse impacts on transport. Cheap fuel has undoubtedly contributed to the rapid increase in motorisation and the congestion of the road network in Indonesia. Traffic jams, noise, poor air quality, etc. are common urban problems, impair quality of life and are harmful for both the environment and the economy. Furthermore, fuel price subsidies result in transport shifting from the rail to the road. The volume of transport services by rail – a more economically efficient mode of transport – has tended to fall in recent years because of this competitive disadvantage, in spite of strong economic performance.

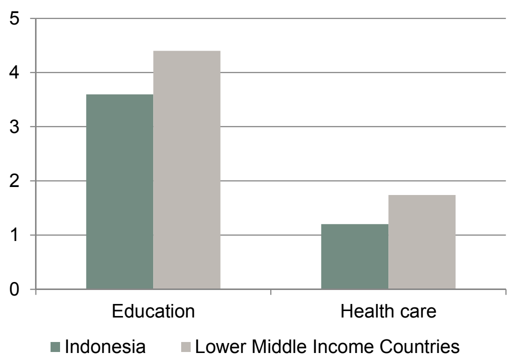
Figure 2: Central government budget structure 2014



Source: CEIC, Directorate General of Budget, author's calculation

Cost-benefit analysis clearly negative. In contrast to its objective, the subsidy policy does not primarily benefit the poorer parts of the population, and instead it helps those who are better off. Funds are also then lacking elsewhere. While Indonesia is considered en emerging market, it still has a huge development deficit that requires more commitment from the state to overcome. Some 40 million Indonesians still live in poverty (16 % of the population). Social disparities have grown sharply: the Gini coefficient, which measures income inequalities, has risen 13 percentage points since 2000, which means the poor are not profiting enough from the economic upswing. This makes it all the more urgent for the state to take countermeasures now through the targeted comprehensive promotion of education and health care in particular. In these sectors, government spending in Indonesia has so far been much lower than in other comparable countries (Figure 3).

Figure 3: Government spending for education and health care (as per cent of GDP, last available figures)



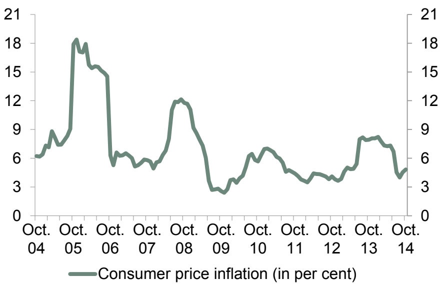
Source: World Bank

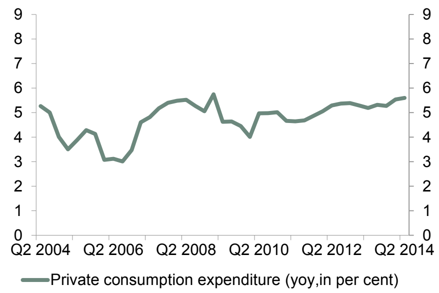
Government aware of problems, but latest price hike is not enough. For all that, the government under new President Widodo admits that the system of subsidising fuel is questionable. Although there have been no major protests yet since the recent price increase and the government did inform the public in advance of an impending change, the topic is still politically sensitive. To soothe public opinion there have been debates recently about compensating for cuts in subsidies through direct *cash transfers* and limiting the sale of subsidised fuel to those really in need. That said, it will likely be difficult to design such a system for the right target group and without any undesired side effects. A convincing radical reform requires political courage, commitment and good communication (by presenting a step-by-step reform plan for example). The reform would make Indonesia more attractive overall as an investment location. ■

[i] These figures are based on information prior to the increase in fuel prices on 18th November 2014.

Overview of figures

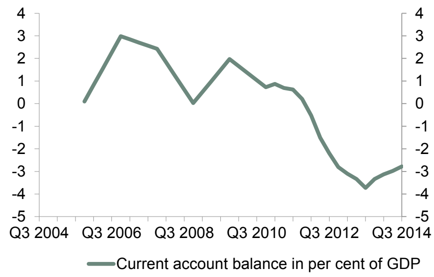
Economic situation

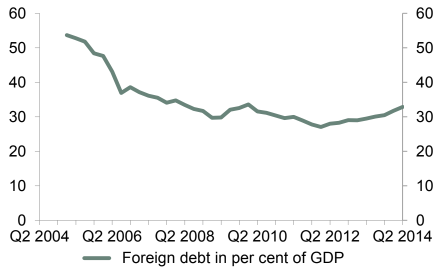


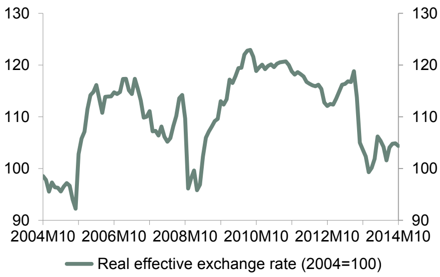


Source: Datastream; OECD, Statistics Indonesia; own calculations.

Growth financing

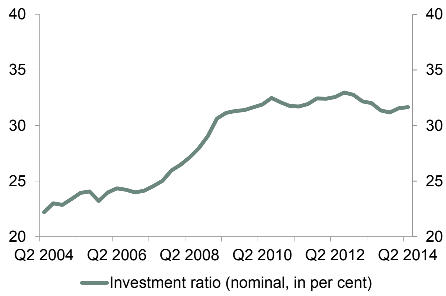


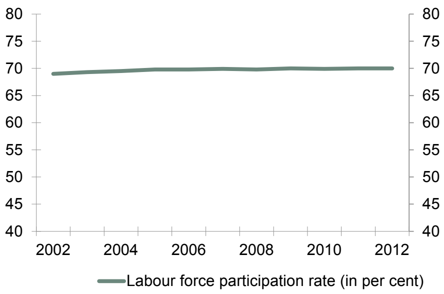


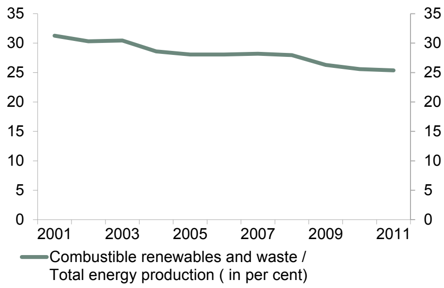


Source: Datastream; IMF; Worldbank; BIS; own calculations.

Growth resources

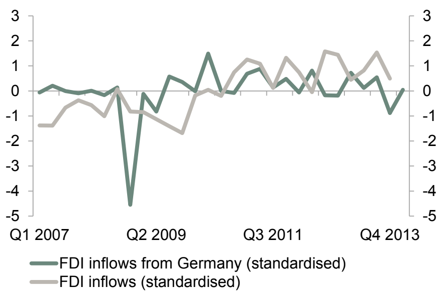






Source: Datastream; OECD, Worldbank; own calculations.

Economics relations to DEU



Source: Deutsche Bundesbank; Datastream; IMF, OECD; own calculations.

Methodology

In the Emerging Markets Spotlight, a selected country is analysed based on various macroeconomic indicators. These indicators are grouped into four categories: economic situation, growth financing, growth resources and economic relations with Germany.

Firstly, the development of the indicators over time is examined for the country itself. As a rule, the analysis is based on the last ten years. The direction of arrow is determined by the current change in comparison to the previous period. An improvement in the indicator is shown with an arrow pointing upwards, while a deterioration is shown with an arrow pointing downwards. A horizontal arrow indicates that the variable is practically unchanged. For example, a higher inflation rate compared to the previous period signals a deterioration, and – depending on the extent of the change – is labelled with an arrow pointing diagonally or straight downwards. The magnitude of the absolute change compared to the average historical absolute change determines the extent of the change and therefore the direction of the arrow.

⇧ Strong improvement in the given indicator: > 3/3 of the historical absolute change

⬀ Improvement in the given indicator: 1/3 – 3/3 of the historical absolute change

⇨ Slight change in the given indicator: <1/3 of the historical absolute change

⬂ Deterioration in the given indicator: 1/3 – 3/3 of the historical absolute change

⇩ Significant deterioration in the given indicator: > 3/3 of the historical absolute change

Secondly, the indicators are used to compare the country's situation with its peers. The group comprises Brazil, China, India, Indonesia, Mexico, Russia, South Africa and Turkey. The comparison is based on a quintile ranking in five categories, which are labelled in different colours:

Quintile 1
Quintile 2
Quintile 3
Quintile 4
Quintile 5

The country is assigned to a quintile of the country group for each indicator analysed. The best quintile may be different for each indicator. For example, higher growth rates are better, so here the upper quintile is coloured dark green, but higher debt rates are a negative factor, so here the upper quintile is coloured dark red.

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