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PERSPECTIVE

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Key Economic Challenges Ahead of Indonesia's Presidential Election in 2024

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People queue to purchase cooking oil provided by the local government in Surabaya on 18 February 2022, in an effort by the government to stabilize prices due to shortages. Photo: JUNI KRISWANTO/AFP.

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ISSUE: 2023 No. 27
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EXECUTIVE SUMMARY

- The three most significant economic concerns of Indonesians are inflation, unemployment and growth.

- Job layoffs are occurring in several industries at the moment, compounding the challenges faced by Indonesia's policymakers.

- The use of higher interest rates to combat inflation is constrained by its impact in terms of burdening borrowers and hurting the country's already weak economic recovery.

- Bank Indonesia may raise interest rates further to stabilise the Rupiah, especially if the US Federal Reserve continues to revise its rates upward.

- The Indonesian government may have to rely more on using costly subsidies and price controls on key items to control inflation, even though this is not sustainable in the long run.

- Economic challenges will affect the next presidential election scheduled for 2024.

ISSN 2335-6677

INTRODUCTION

The Indonesian economy grew by 5.3% in 2022, exceeding the 3.7% growth rate achieved in 2021 (Figure 1). With the Covid-19 pandemic reasonably under control and business activity returning to normal, the government remains optimistic about reaching a 4.5-5.3% growth target in 2023 and further to 4.7-5.5% in 2024.[1] Consumption is slowly picking up, and higher-than-expected commodity prices have raised Indonesia's exports and generated windfall gains for the government's fiscal revenues. While there is optimism about this year's outlook, there remain considerable economic challenges ahead.

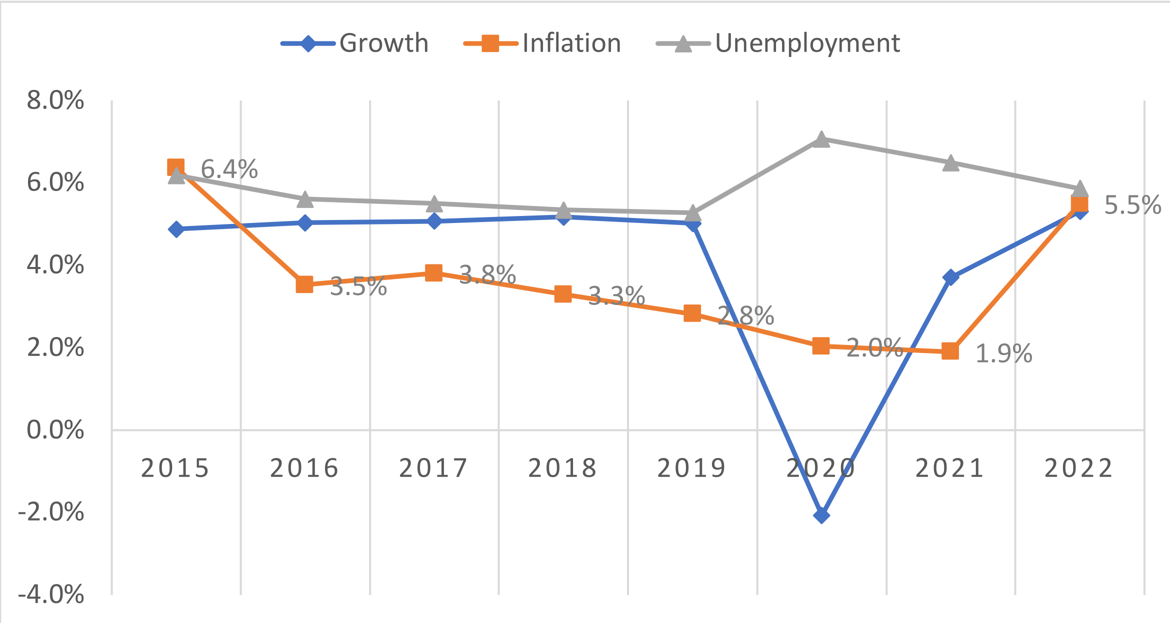
The three key economic challenges for the Indonesian government, highlighted by a recent ISEAS survey, are controlling inflation, providing job opportunities through investments, and maintaining growth. External events are creating additional pressure. The US Fed's tight monetary policy, which forecasts a further interest rate hike, may put further pressure on Bank Indonesia to follow suit and to further increase its own benchmark interest rate to stabilise its exchange rate. A prolonged war in Ukraine will continue to put upward pressure on energy prices as well as domestic energy subsidies. Finally, should the current recovery in the country's major export markets weaken, Indonesia's exports could be adversely impacted.
Indonesia's economic outlook, therefore, remains uncertain. This essay draws on ISEAS National Survey 2022 to provide a micro-level analysis of the population's concerns about inflation, unemployment and growth. Insights from such a micro-level analysis are important given that these are likely to become critical issues in Indonesia's election in 2024.

TWO PRESSING ECONOMIC ISSUES

In July 2022, ISEAS conducted an Indonesian National Survey Project (INSP), involving face-to-face interviews with 1,620 respondents across all 34 Indonesian provinces. The survey asked respondents to list their three most important economic concerns. With the country still recovering from the pandemic, economic issues dominated the public's response. Unemployment tops the list (43.7%), followed by price stability and inflation (35.9%), as well as economic management and its impact on growth (33.0%) (Figure 2).[2]

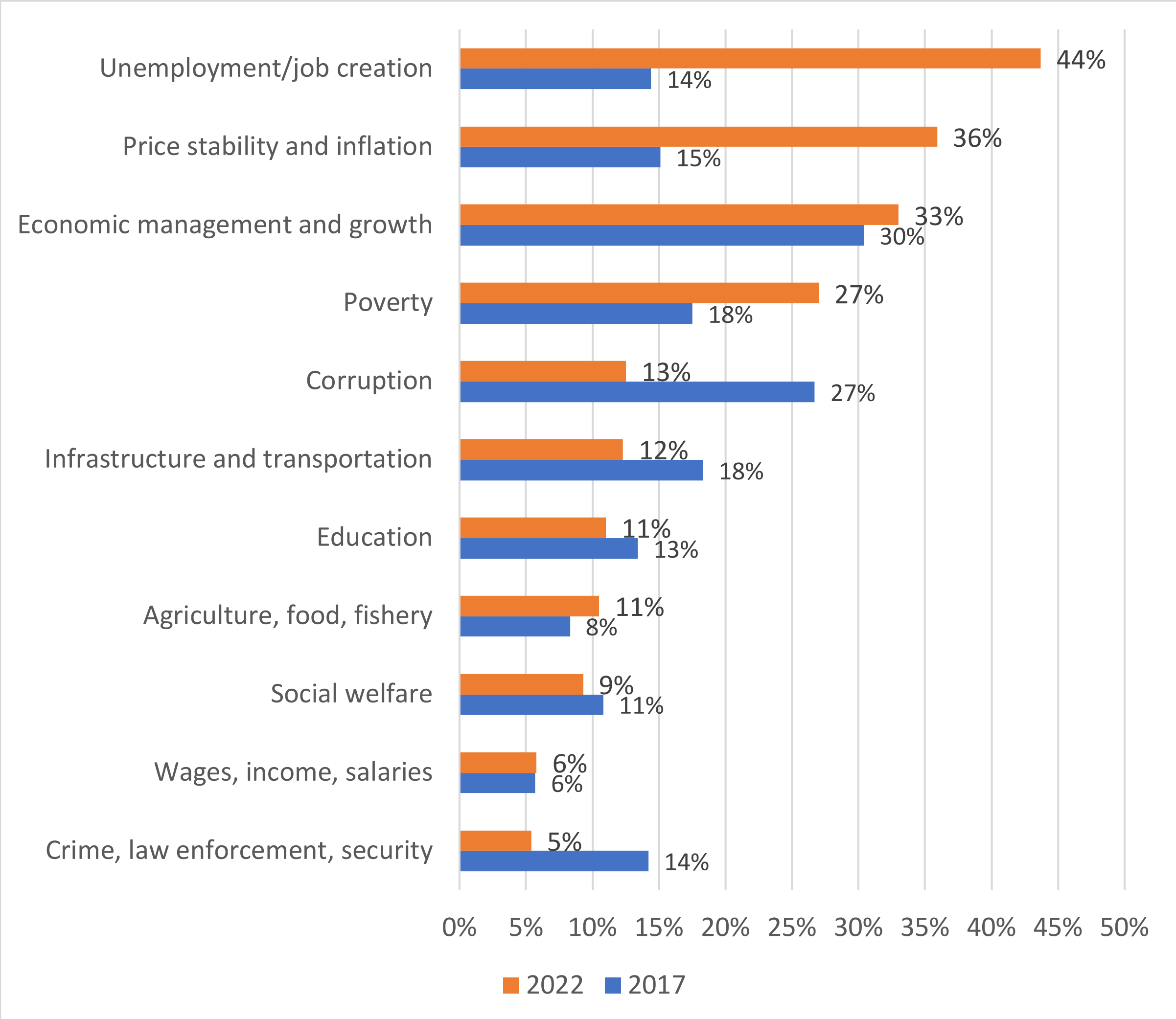
ISSN 2335-6677

Figure 1: Indonesian Growth, Inflation and Unemployment Trends 2015-2022



Source: Statistics Indonesia (BPS)

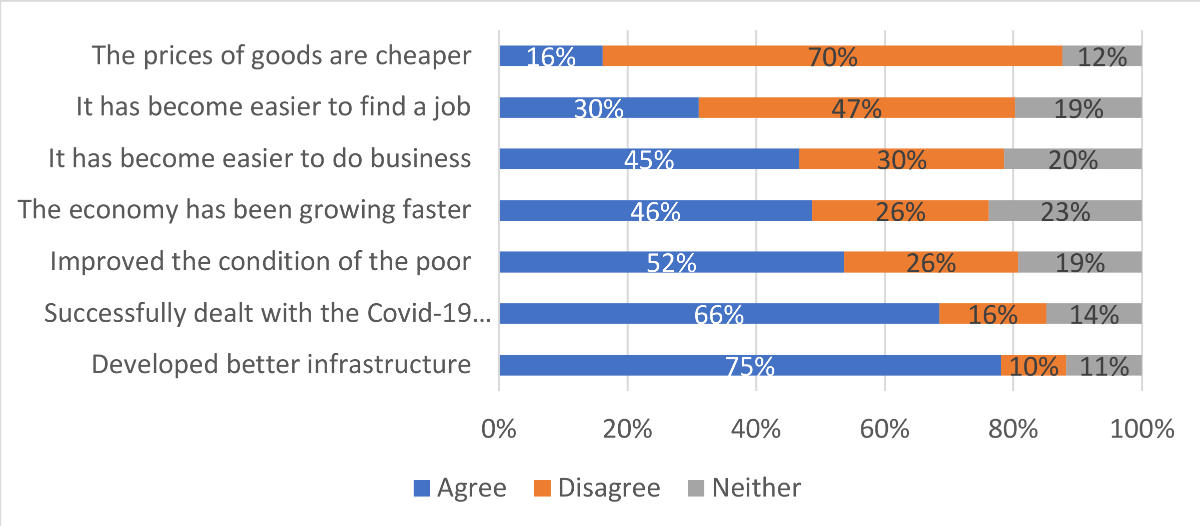
Figure 2: What are the three MOST important issues for Indonesia right now?



It is interesting to note that the majority of survey respondents agree that President Jokowi has developed better infrastructure (75%), dealt with the Covid-19 pandemic crisis successfully (66%), and improved the welfare of the poor (52%) (Figure 3). However, they disagree that prices are lower (70%) and that jobs are easier to find (47%).

ISSN 2335-6677

Figure 3: How is President Jokowi handling economic issues?



Compared to the 2017 survey, there is a significant increase in unemployment and inflation concerns. This is likely due to the pandemic's economic impact over the last 2-3 years.

INFLATION TRENDS AND POLICY RESPONSES

For 2022, Indonesia's inflation (consumer price index) rose to 5.5% from 1.9% a year earlier (Table 1). This was driven in part by higher imported inflation from rising global food and fuel prices. The prolonged war in Ukraine is one factor behind the rising world fuel price trend. But ongoing tensions between China and the US, causing trade barriers, coupled with lingering Covid-19 restrictions, raised trade costs and limited trade volume of certain goods. Ultimately, this created supply chain disruptions and higher import costs across the Southeast Asian region. Food price increases were also driven by domestic distribution problems.

In addition, the government's September 2022 fuel subsidy cuts raised fuel prices and added inflationary pressure on prices nationwide. After the fuel hike, CPI inflation increased from 4% in August to 6% in September (Figure 4). Rising inflation adversely affects people's purchasing power, which puts economic growth at risk.

Higher inflation also adversely impacts poor and vulnerable communities, given that for lower-income households, food expenditure accounts for 64% of total income.[3] Based on recent Statistics Indonesia data, the number of people classified as poor has risen slightly to 26.4 million from 26.2 million between March and September 2022 due to higher food and fuel prices (BPS).[4]

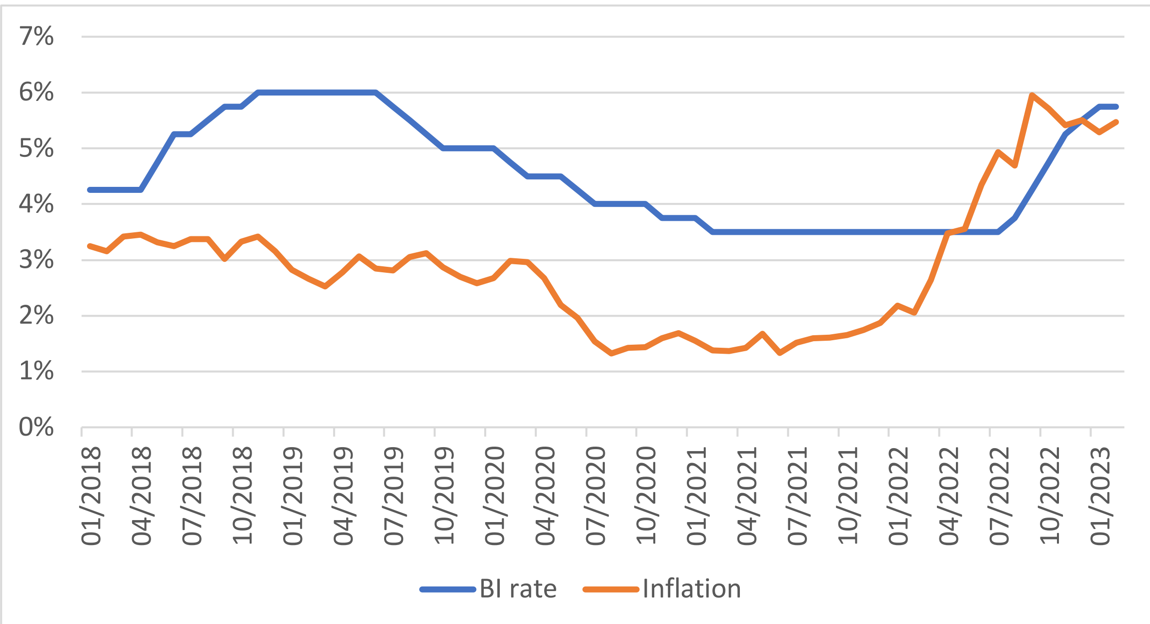
In the second half of 2022, Bank Indonesia responding to a rise in inflation, began raising its benchmark interest rate (7-day Repo Rate) rapidly from 3.5% in July 2022, then to 5.5% in December 2022 (Figure 4) and further to 5.75% in January 2023. This was to dampen inflationary pressures, but it was also done to defend the weakening Rupiah with investors shifting to higher-yielding USD investments. Rupiah deposit rates have been the first to rise, with lending rates remaining flat. The lagging rise in Rupiah interest rates behind USD interest rates has resulted in a steady weakening of the currency from its previous level of Rp 14,500 per USD in early 2022 to Rp 15,592 per USD by December 2022 (Table 1).

Table 1: Banking Sector Interest Rate Trends vs BI Benchmark Rate

(in %)	2018	2019	2020	2021	2022
Working Capital Lending Rate	10.4%	10.1%	9.2%	8.6%	8.6%
3-month Deposit Rate	6.8%	6.0%	4.2%	2.9%	3.9%
BI 7-day Repo Rate	6.0%	5.0%	3.8%	3.5%	5.5%
Inflation Rate	3.1%	2.7%	1.7%	1.9%	5.5%
Rp per USD year-end	14,481	13,901	14,105	14,278	15,592

Source: Bank Indonesia and Financial Services Authority (OJK)

Figure 4: BI policy rate and CPI Inflation (%)



Source: Bank Indonesia

Inflation rates peaked in September 2022 at 5.95%, and dropped to 5.47% in February 2023. On 16 March 2023, Bank Indonesia Governor, Perry Warjiyo, announced that the Central Bank's benchmark Rupiah interest rate would remain at 5.75%. The Governor noted that the current BI rate remains sufficient to bring down the country's inflation from its current 5.47% level to BI's inflation target range of 2-4% in the second half of 2023.[5]

This decision brought some breathing room to businesses that were worried that their Rupiah loan rates would be adjusted upwards in line with BI's upward benchmark rate trend. It was also a relief to those Indonesian banks that were carrying a sizable Indonesian government bond portfolio, which drops in value whenever the interest rate rises, thus keeping their unrealised losses from expanding further. Government bonds accounted for 15.7% of the banks' earning assets by the end of 2022.

However, not long after Bank Indonesia kept its 5.75% benchmark rate, the US Federal Reserve raised its rate by another 25 basis points and with the coming of the seasonal inflationary month of Ramadhan, there remains a potential further rise in Bank Indonesia's benchmark interest rate.

Aside from Bank Indonesia raising its benchmark interest rates to ease inflationary pressures, the government has also moved to control the price of critical food items, such as rice and cooking oil, by ensuring sufficient supply and market availability.

The government allocated a significant budget to subsidise fuel prices and electricity tariffs in response to higher international energy prices. These subsidies increased significantly in 2022, reaching Rp 551 trillion (US$ 48 billion), or 21% of state revenue, due to the surge in global energy prices. This has been critical to dampening inflationary pressures but it is not sustainable for a country with a tax-to-GDP ratio of only 10-11% of GDP.[6]

Arguably, the fuel subsidies helped to maintain political stability and the government's favourable approval rating. Subsidies, however, remain a highly political issue, and with next year's presidential election, they will continue to occupy the government's fiscal space. The country's fiscal deficit is currently at 2.7% of GDP, but during the 2020 pandemic year it widened to as high as 6.1% of GDP.

Longer term, market-driven prices will be important, on one hand, to limit energy demand and, on the other, to stimulate supply. Maintaining price controls, subsidies, or export bans will be fiscally costly, leading to excess demand and insufficient supply, thus leading to misallocation of resources. A case in point is energy subsidies in 2022, where the government spent Rp 555 trillion (US$ 37 billion), or about 21% of the state revenue, to absorb higher fuel and electricity tariffs.[7] It is preferable to protect the most vulnerable groups through more targeted and temporary money transfers as the economy recovers.

ISSN 2335-6677

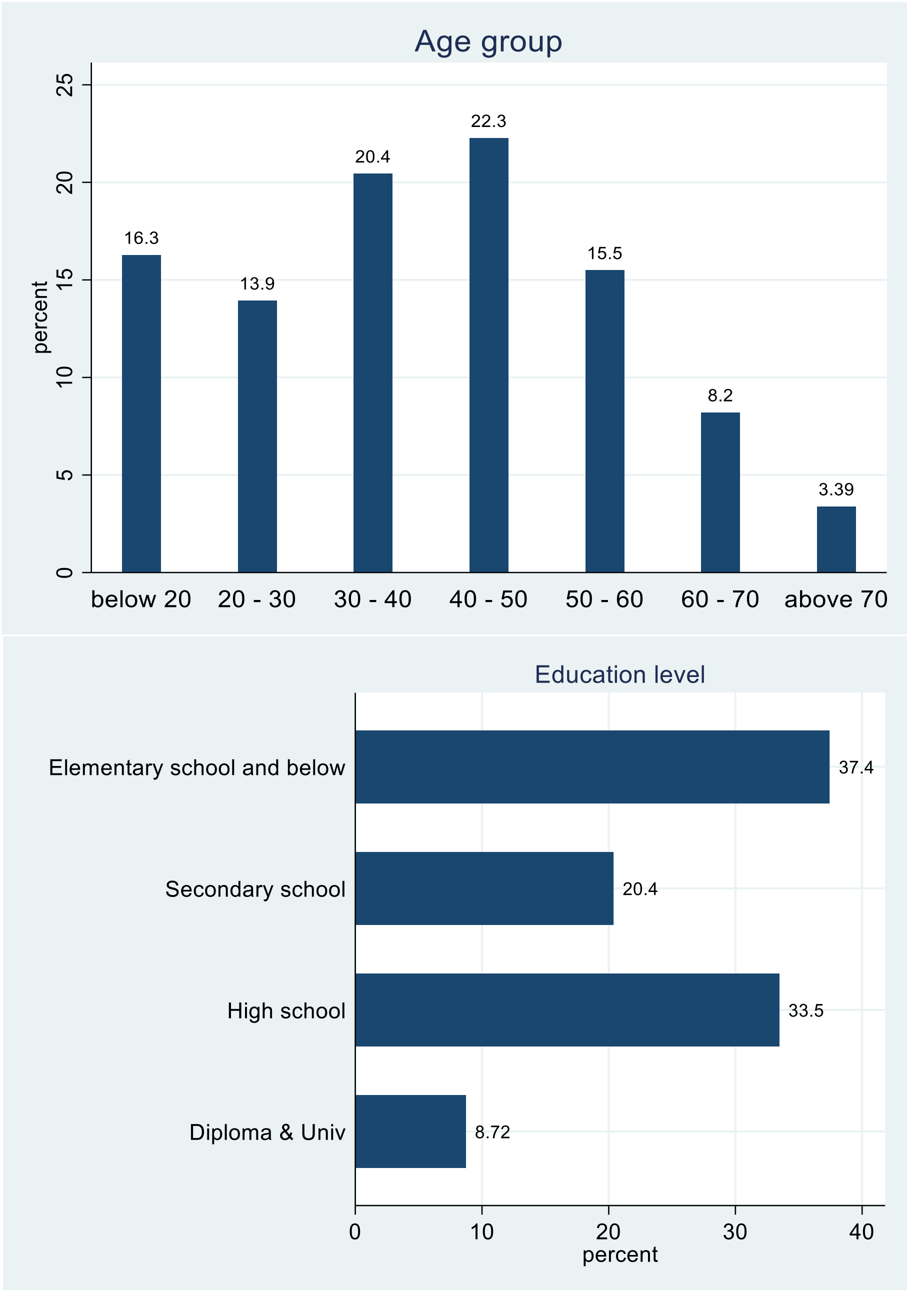
UNEMPLOYMENT TRENDS AND POLICY RESPONSES (BEFORE, DURING AND AFTER THE PANDEMIC)

Slowing global growth has affected certain industries more than others. Textiles, garments and footwear had to reduce production due to declining orders, resulting in sizable layoffs.[8] Even the promising technology sector has been affected. The country's leading e-commerce group GoTo recently announced a second round of 600 layoffs following last year's 1,300 job cuts.[9] Likewise, some labour-intensive industries, such as textile, garment and footwear, also reported significant layoffs. According to the Indonesian Textile Association (API), almost 100 textile and garment factories laid off around 30,000 workers in November 2022. This was due to a weak export market resulting in decreased production volume.[10]

This grim reality is reflected in the 2022 survey, which highlighted concerns about unemployment. The issue of jobs is particularly salient among the country's younger population, especially those aged 40 and below (Figure 5). The 2022 survey also found that more females (53%) than males (47%) reported difficulty finding jobs. About 54% and 46% of the urban and rural respondents have difficulty getting employed, respectively. Figure 5 further shows that the majority of high-school and lower-educated Indonesians reported difficulty finding jobs.

ISSN 2335-6677

Figure 5: Who disagrees that it has been easy to get a job?

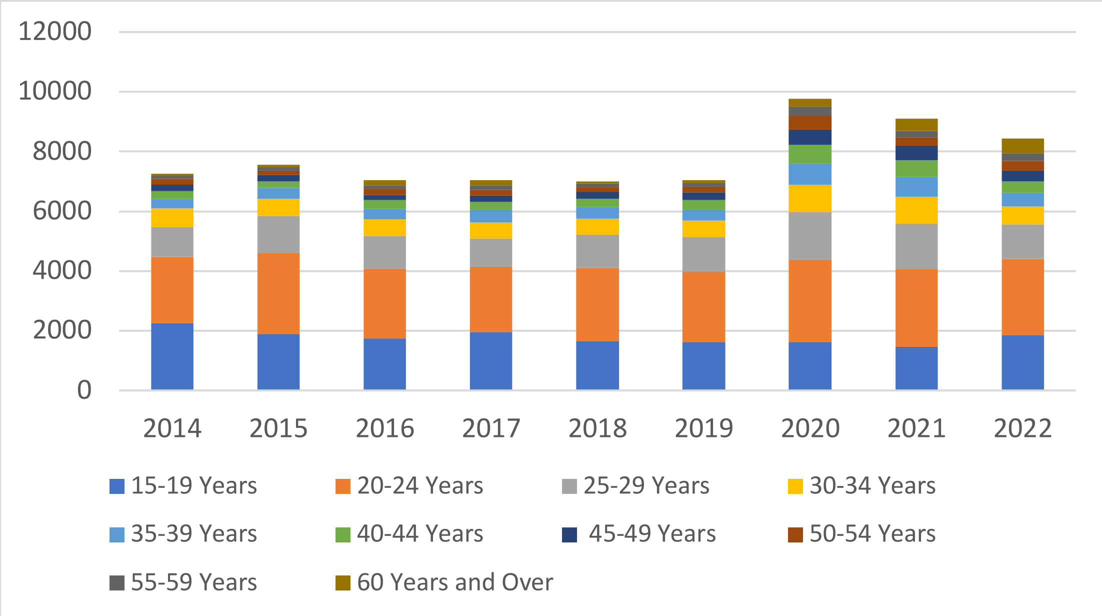


These findings reflect structural problems in Indonesia's labour market, i.e., higher youth unemployment. Based on data from the BPS, those unemployed mostly come from the age group of 15-24 years, which accounts for 3.9 million people or 46% of the total national unemployment (Figure 6).[11]

ISSUE: 2023 No. 27

ISSN 2335-6677

Figure 6: Unemployment by age group (thousand)



Source: Statistics Indonesia

One reason behind the country's high youth unemployment is that it takes a longer time for them to find suitable jobs at their preferred wage structures. Those coming from poorer families, with relatively lower educational backgrounds (below secondary school), cannot afford to be unemployed and so, most of them end up working in the informal sector, earning a lower income, working shorter hours and thus are less productive. In contrast, those coming from wealthier families tend to be relatively choosy and more willing to wait a bit longer to find their preferred employment. [12]

The demand for manual workers has also been adversely impacted by rising minimum wages, automation as well as digitalisation. As the jobs market tightens, many young workers have moved to lower-productivity services. [13] This shift has been accelerated because of the pandemic causing a slowdown in industrial activities.

Extended unemployment and under-employment, especially skill-based or skill mismatch, have become major labour market problems. Naturally, youth unemployment is always higher than older workers because they are just entering the labour market, or are more able and inclined to change jobs. Some youths are unemployed for long stretches, while some end up in jobs that do not match their skill. Both are critical issues for policymakers to deal with.

To address these unemployment issues, the government has come up with several policies. The job creation law passed by the government in October 2022, is one major step toward addressing the unemployment issue. It is meant to streamline investment procedures and improve the investment climate, thus creating more job opportunities. The law encourages the setting up of local industries including services related to Micro, Small and Medium enterprises (MSMEs).

ISSN 2335-6677

Policies to support businesses, particularly MSMEs, which account for 96% of total employment in the country,[14] have also been introduced. These include credit guarantees, interest subsidies for MSMEs and targeted tax incentives for some businesses and industries.

Furthermore, the government has promoted education and skill training programmes to improve the quality of human resources. These include pre-employment cards (Kartu Pra-Kerja), one of President Jokowi's flagship programmes. Kartu pra Kerja involves training assistance (amounting to Rp 3.5-4.2 million or approx. US$250) for those (18 years of age and above and not currently at school or college) who want to acquire or improve their skills, thus raising their likelihood of finding a better job. The programme is not only for those looking for a job but also for workers. During the pandemic, the programme has been redesigned as social assistance for those losing their jobs due to the Covid-19 pandemic. There has been some criticism concerning the effectiveness and transparency of the programme, however.[15] Nevertheless, preliminary evidence points out some benefits to programme recipients, including increased financial inclusion and a higher likelihood of them starting a business and finding a new job.[16]

Finally, the government together with the private sector, has regularly organised training, certification, and job fairs to provide job information and facilitate job seekers meeting with potential employers.

CONCLUSION: POLICY LIMITATIONS BEFORE AN ELECTION YEAR

With next year's presidential election, 2023 will be a politically challenging year, which makes it difficult to implement unpopular, but necessary, government policies, for instance, raising interest rates further to stabilise the Rupiah and control inflation, or coming out with legislation that would make the labour market more flexible to stimulate investment and thus create jobs. There is also a government tendency to play a more interventionist role as opposed to a passive market approach, as this plays better politically.

On inflation, the challenge is for the government not to just focus on domestic price increases, but also to stabilise the Rupiah, as a weak Rupiah raises imported inflation. With USD interest rates and the USD-Rupiah interest rate differential rising, it is important to keep the Rupiah stable. So far, the 25 basis points rise in USD-Rupiah interest rate differential towards March-end has not impacted the Rupiah much, as it hovers around Rp 15,300 per USD. But should further USD interest hikes occur weakening the Rupiah and, should inflation remain high after Hari Raya in late April, then Rupiah interest rate hikes may need to follow.

Given the political sensitivities of fuel subsidies, the focus would be to change them from being a blunt instrument to one that is more targeted and thus has a better impact at a lower cost. The government is already moving in this direction, implementing direct money transfers to assist more vulnerable lower-income groups. The system is not perfect, with the list of deserving recipients needing much further accuracy improvements, but it is an important start and needs

ISSUE: 2023 No. 27
ISSN 2335-6677

further fine-tuning to ensure that the government's financial assistance reaches those who most need it.

Fuel subsidies are also now more targeted. Pertamina, the state oil company that distributes the subsidised fuel, Petralite, requires eligible lower-income motorists to register their national ID card and upload a photo of their vehicles, with their license plates, in its MyPertamina mobile application, and having to have this screened before being allowed to buy its subsidised fuel.[17]

On unemployment, the government early this year quickly came out with a regulation in lieu of law (Perppu) on job creation (Perppu No. 2/2022).[18] The new regulation replaces the Job Creation Law, which was declared conditionally unconstitutional by the Constitutional Court (MK) not long after the Job Creation Law came out. The court ordered the government to amend the law within two years, or it would be deemed unconstitutional.

Coordinating Economic Minister Airlangga Hartarto explained that the MK ruling had affected investors' confidence domestically and abroad, which was why the government quickly issued the Perppu. [19] However, the Association of Indonesian Trade Unions (Aspek) still argues that the Perppu does not provide legal certainty for workers as the employment provisions reduce workers' job security rights, wage guarantees and social security.[20]

Government initiatives on addressing unemployment through increased investment and growth are long-term in nature and will take some time to generate the desired impact. It is important to reevaluate the effectiveness of the pre-employment card programme, which was redesigned as a social assistance programme during the pandemic year. Ultimately, the public wants to know if the programme is effective or not in addressing unemployment and creating jobs, as initially promised by the government.

Given the Indonesian voters' key concerns pertaining to unemployment and inflation, it will be interesting to see whether presidential candidates will come up with alternative and innovative economic policies to provide more effective solutions.

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ISSUE: 2023 No. 27
ISSN 2335-6677

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