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PERSPECTIVE

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Positioning for Elections Amidst Uncertainties: Indonesia's 2019 Budget

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EXECUTIVE SUMMARY

- The Indonesian economy is facing domestic and external pressures in the run-up to the April 2019 general elections. President Joko Widodo's chances of winning a second term will depend significantly on how well he handles the country's economic issues.

- The global economic outlook has weakened, with trade prospects becoming more subdued, global liquidity looking tight, and the geopolitical situation becoming more uncertain. Emergency spending due to natural disasters would further strain fiscal resources. The government has formulated a conservative budget focussed on economic stability rather than seeking expansionary growth. There is some concern that the state revenue projections may be somewhat optimistic.

- The budget's emphasis on social spending (especially education and poverty amelioration) and controlling inflation (e.g., through energy-related subsidies) should help Jokowi's chances of winning the presidential election again.

- However, key indicators show that the Indonesian economy is unlikely to suffer a crisis similar to that in 1998. Overall, the country's economic fundamentals remain resilient despite some strong headwinds.

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INTRODUCTION

Indonesia is to hold general elections on April 17, 2019, and as things now seem, President Joko 'Jokowi' Widodo's chances of getting re-elected for a second term will be dependent on how he handles the economics of the country. External factors, such as China's economic slow-down and the trend of trade protectionism have put pressure on Indonesia's trade balance. The tightening of monetary policy in the US and other advanced economies has triggered capital outflows from emerging markets, including Indonesia. These developments have strained Indonesia's current account deficit and weakened its currency. Moreover, the rise in world oil prices and the weakening rupiah have impacted the economy, putting pressure on the state budget and on domestic prices. Internally, the government has to tackle issues like the widening fiscal deficit, slow investment growth, sluggish manufacturing sector performance, and the increase in the borrowing cost for businesses.

The situation has been increasingly challenging recently, after the two major disasters that recently occurred in Lombok, West Nusa Tenggara and Palu, Central Sulawesi. At the time of writing, according to Indonesia's disaster mitigation agency, more than 2,000 people have died, 2,500 people have been injured and 66,000 homes damaged. There are more than 70,000 internally displaced people at 141 sites.[1] It is difficult to imagine the amount of resources needed to rebuild the areas. Those challenges have already spread the government resources thin, and will likely affect public perception of the capacity of the Jokowi government in handling multiple crises simultaneously.

Against the above backdrop, the government has come up with a new budget proposal, which is designed to maintain economic stability and resilience. This short essay aims to analyse what the key economic challenges for Indonesia are and how far the new budget tries to address those challenges. It also discusses the likely effects of the budget on the 2019 elections.

KEY ECONOMIC ISSUES

A recent poll conducted by *Indikator Politik Indonesia* in September 2018 finds 31 per cent of Indonesians thinking that the current economic condition is good, while 44 per cent thinks there has been 'no change', and 24 per cent thinks it is bad.[2] When considered together with the survey conducted by ISEAS in May 2017, people optimism toward the economic situation seems to have declined. The 2017 ISEAS survey had 41.5 per cent thinking that the economic condition was "better" as compared to the previous year, while 34.4 per cent thought that there was "no change" and 24.2 per cent thought that it had become "worse".[3]

In line with rising public pessimism about the economic situation, Jokowi's political opponents have criticized him of mismanaging the economy. They have argued that he is responsible for the country's stagnating growth and for the rising external debt that has increased the country's financial vulnerability. They also claim that the government has failed in managing the national currency by allowing the rupiah to depreciate beyond the so-called psychological barrier of Rp 15,000 per US dollar. And this was despite the Bank Indonesia having raised its benchmark interest rate five times since May, to 5.75 per cent.

The question then, is how strong Indonesia's economic fundamentals actually are.

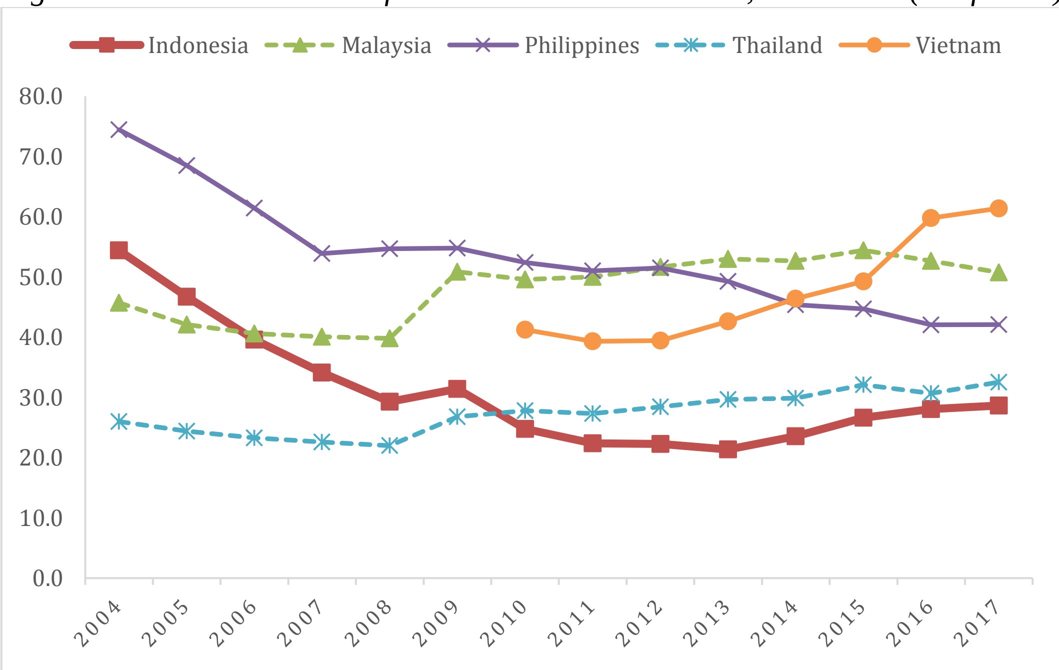
Table 1: Indonesia's Key Macroeconomic Indicators during Crises, 1998-2018

	1998	2008	2013	2018
Growth (%)	-13.1	6.0	5.6	5.2
Inflation (%)	82.4	12.1	4.4	3.2
Rupiah depreciation (%)	-197	-35	-25.7	-8.1
Foreign reserve ($ billion)	17.4	50.2	93.9	118.3
Non-performing loan (%)	30	3.8	1.7	2.7
Government debt/GDP (%)	100	27.4	21	29.2
External debt/GDP (%)	116.8	33.2	29.1	34.3
Current account/GDP (%)	3.1	0.1	-3.1	-2.6
Fiscal deficit/GDP (%)	*NA*	-0.1	-2.2	-2.3

Note: 2018 figures are as of Q2-2018
Source: Ministry of Finance

Table 1 compares some key macroeconomic indicators during the 1998 Asian Financial Crisis (AFC), the 2008 Global Financial Crisis (GFC), the 2013 Taper Tantrum (TT), and the recent emerging market crisis. Overall, economic growth, inflation, foreign reserves, debt as a share of GDP, non-performing loan, and currency depreciation do not indicate any reason for concern. Compared with the situation during AFC, GFC or TT, the current economic growth is relatively stable, the inflation rate is low, and the foreign exchange reserve is higher. Moreover, Indonesia's external debt level is also relatively low, at 34 per cent of GDP, compared with 116 per cent during the 1998 AFC.

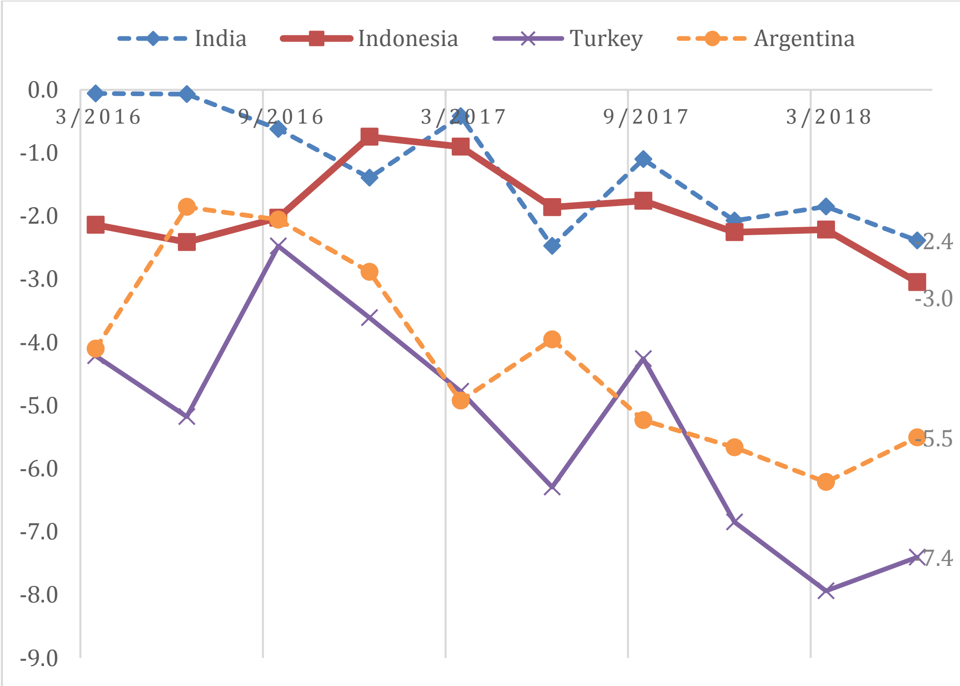
Figure 1: Government Debt of Selected ASEAN Countries, 2004-2017 (% of GDP)



Source: CEIC, ASEAN section

Figure 1 shows that Indonesia's public debt as percentage of GDP has risen during the Jokowi era. This has been caused by an increase in the amount of national debt (partly to finance a number of infrastructure projects) and the weakening rupiah at the same time. Nevertheless, the country's debt level is still much lower than that in comparable countries. Moreover, unlike the situation in 1998, Indonesia's foreign debt is currently hedged against currency fluctuations.

Figure 2: Current Account Deficit (% of GDP) of Select Emerging Economies

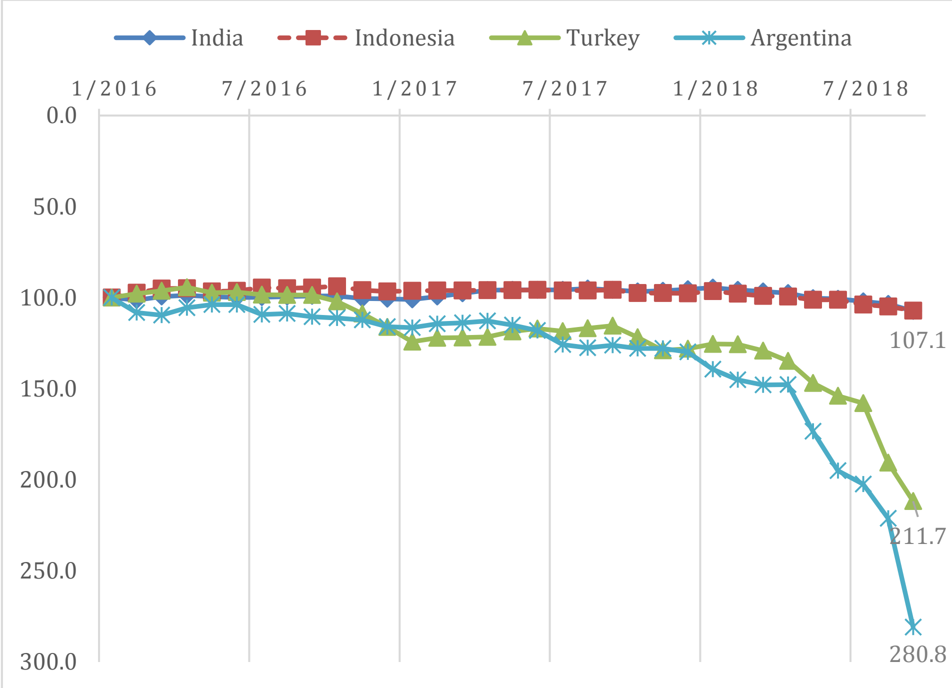


Source: CEIC

There is however one potential source of vulnerability in the economy, and that is its expanding current-account deficit (Figure 2). The tightening of monetary policy in the US and Euro area, together with general tightening of financial conditions have exerted considerable pressure on the financial stability of emerging market economies, including Indonesia. Portfolio investors have been withdrawing their investments from these markets, particularly those with a large current account deficit, such as Argentina and Turkey. Both have seen their currencies plummet since the beginning of this year (Figure 3). To a lesser extent, Indonesia is vulnerable to this type of capital outflow since a large proportion of its current-account deficit is financed by portfolio investment. Failing to manage its current-account deficit will certainly put Indonesia under increased risk of financial instability.

What are the factors driving Indonesia's current account deficit? If we look at the country's balance of payment (Table 2), its current account deficit has increased due to weak exports performance. The large depreciation of the rupiah had not helped to boost exports. This is partly due to the export structure relying on commodities export (in particular crude palm oil or CPO and coal, which is currently experiencing weak global demand). At the same time, there was a large increase in imports (a significant portion is for intermediate inputs, capital goods, and oil imports).[4] Another source for concern is the increasing trend in international oil prices combined with the weakening rupiah. These two factors will increase trade deficit further if Indonesia fails to control its oil imports.

Figure 3: IDR against USD, Monthly Average (January 2016=100)



Source: CEIC

Table 2: Indonesia's Balance of Payment, 2016-2018 (US$ million)

	2016	2017	2018-Q1	2018-Q2
Current Account: Goods	15,318.0	18,892.1	2,324.0	288.9
Goods: Exports	144,469.8	168,886.8	44,374.4	43,769.7
Goods: Imports	-129,151.8	-149,994.7	-42,050.3	-43,480.7
Current Account: Services	-7,083.7	-7,863.7	-1,554.1	-1,789.6
Services: Export	23,323.5	24,668.2	6,864.0	6,488.6
Services: Import	-30,407.2	-32,531.9	-8,418.0	-8,278.2
Current Account:				
Primary Income	-29,647.0	-32,837.9	-7,900.4	-8,154.9
Investment: Direct	-17,592.9	-20,189.1	-4,792.1	-4,158.5
Investment: Portfolio	-8,318.2	-8,906.9	-2,341.3	-2,951.3
Current Account Balance	-16,952.3	-17,527.7	-5,716.8	-8,028.4
Capital Account	40.7	46.2	57.9	3.0
Financial Account	29,305.6	29,834.4	2,390.1	4,014.8
Direct Investment	16,135.9	20,151.4	2,930.7	2,487.4
Portfolio Investment	18,995.6	20,662.1	-1,151.3	53.1
Overall Balance	12,088.9	11,586.0	-3,854.7	-4,308.7

Source: BI

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The biggest contributor to Indonesia's current account deficit is primary income outflows, which has increased from $29.7 billion in 2014 to $32.8 billion in 2017. And in the first half of 2018, primary income outflows reached $16 billion. This shows that the amount of payments made by overseas investors, whose assets are held in Indonesia, exceed the returns held by domestic investors in foreign countries. It is important to note that 40 per cent of government bonds are held by foreign portfolio investors. So, any increased in negative sentiment regarding the economy will probably lead to a sudden capital outflow.

THE NEW BUDGET AND KEY PROGRAMMES

Against the above backdrop, the government has proposed a new budget aiming to maintain economic stability (as opposed to achieve higher growth rate). Moreover, the Jokowi government perceives that the maintenance of economic stability through stable growth and low inflation is critical, especially since the country is facing increased global economic uncertainties and an election year at the same time.

As can be seen in Table 3, economic growth for 2019 has been targeted at 5.3 per cent (slightly higher than the 5.2 percent outlook for 2018). This growth target is much lower than the 7 per cent that President Jokowi promised during the first year of his presidency. The inflation rate is forecasted to be 3.5 per cent for 2019, similar to this year's target.

The rupiah exchange rate is assumed to significantly weaken from this year's outlook of Rp 13,973 to Rp 15,000 per US dollar. This assumption seems more realistic compared to the initial forecast (Rp 14,400 per US dollar), given that the currency has been traded slightly above Rp 15,000, at the time of writing. The trends of further depreciation seems more likely as Indonesia's current-account deficit remains high at almost 3 per cent of GDP.

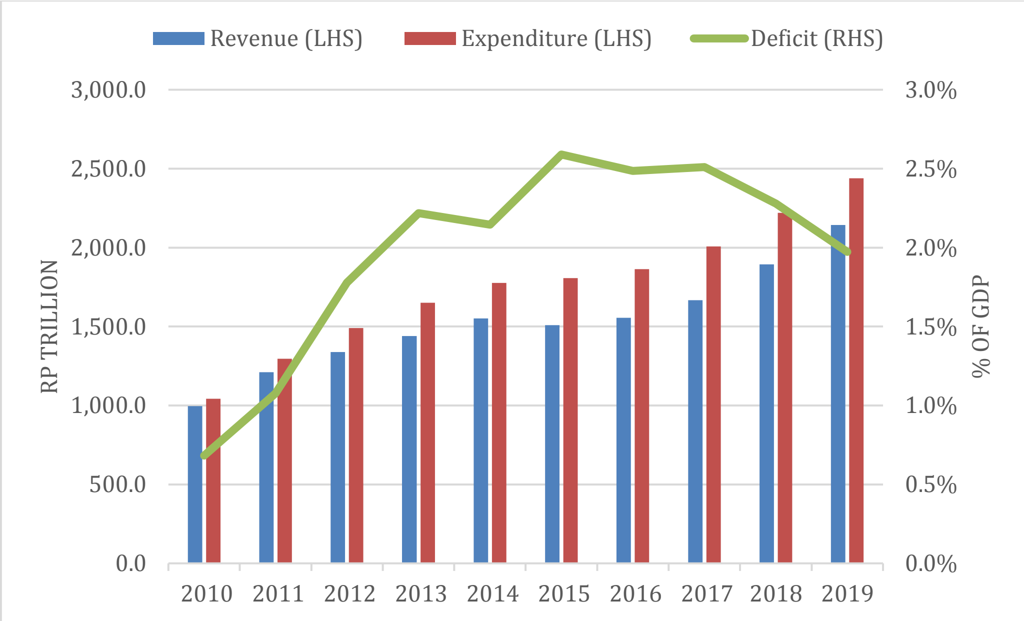
Table 3: Indonesia's Key Macroeconomic Indicators, 2016-2019

	2016 Actual	**2017 Actual**	**2018 Outlook**	**2019 Budget Forecast**
Growth (%)	5.0	5.1	5.2	5.3
Inflation (%)	3.0	3.6	3.5	3.5
Rupiah per US $	13,307	13,384	13,973	15,000
Three-month treasury bills (%)	5.7	5.0	5.0	5.3
Budget deficit (% of GDP)	2.46	2.5	2.12	1.84
Oil price (US$/barrel)	40	51.2	70	70
Oil lifting (000 barrel/day)	825	804	775	775
Gas lifting (million boe/day)	1.19	1.14	1.12	1.25

Source: Ministry of Finance

Moreover, the new budget projects a smaller deficit of 1.84 per cent of GDP compared to this year's outlook of 2.12 per cent (Figure 4). State spending is set to increase by 10 per cent from this year's target, reaching Rp 2,439.7 trillion ($167.1 billion). Meanwhile, state revenue is projected to increase by 13 per cent to reach Rp 2,142.5 trillion (Figure 4). The revenue target also seems quite optimistic, since the average state revenue growth for the period of 2014-2018 is only around 5 per cent annually. The assumption is that the government will be able to increase its tax revenue to Rp 1,781 trillion next year, up from the 2018 target of Rp 1,548.5 trillion. Achieving this 15 per cent increase in tax revenue collection will not be easy given the country's weak tax administration system.[5] Moreover, next year's economic growth may not be as high as expected due to tight liquidity and high borrowing costs.

Figure 4: Government Budget and Fiscal Deficit, 2010-2019 (Rp Trillion)



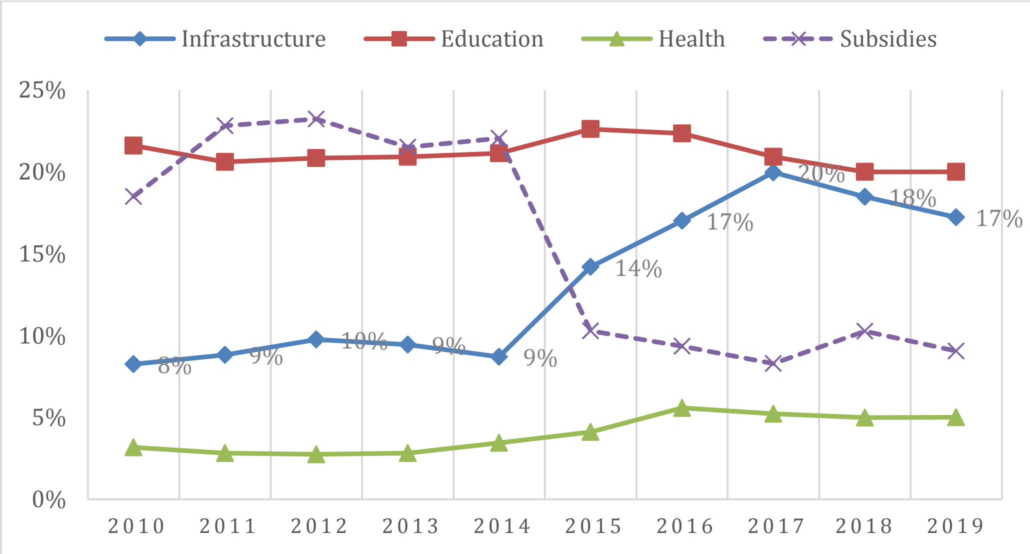
Note: Deficit is expressed as percentage of GDP (right axis)
Source: Ministry of Finance

If we look at the budget composition by programmes, in 2019, the government is giving top priority to education spending (Figure 5). It allocates 20 per cent of total spending to the sector as mandated by the law. Infrastructure development remains a priority under the Jokowi government. For 2019, infrastructure spending will increase by 2.4 per cent from this year's spending to Rp 420.5 trillion ($28.8 billion). While there is an increase in nominal terms, there is a slight decline relative to total government spending. The proposed Rp 2,439.7 trillion state budget means that around 17 per cent of total government spending will go to infrastructure development, which is lower than 20 per cent figure in 2017.

In 2019, as widely expected, the government gives priority to social assistance programmes. It has proposed a 32.8 per cent increase on social spending compared to this year's budget, reaching Rp 381 trillion ($26 billion). This fund will cover various social assistance programmes, such as the Family Hope Program (*Program Keluarga Harapan*), the National Health Insurance Program (*Jaminan Kesehatan Nasional*, or JKN), and the Small Business Credit Program (*Kredit Usaha Rakyat*, or KUR). These social programmes are deemed important to keep Jokowi's popularity.

Concern about price hikes has made the government decide to maintain its energy-related subsidies despite the rise in world oil prices. It has allocated Rp 156.5 trillion ($11 billion), a 65.6 per cent increase compared to the 2018 budget, to subsidise energy prices, including those for fuels and electricity. This is expected to protect the people's purchasing power and keep the inflation rate in line with what was projected in the state budget. From now until April 2019, rising inflation will be harmful to Jokowi's chances of being re-elected.

Figure 5: Government Expenditure as % of Total Budget, 2010-2019



Source: Ministry of Finance

Given the rise in global oil prices and the weakening rupiah, an increase in energy-related subsidies will put huge pressure on the state budget and state-owned enterprises. Particularly, Pertamina and PLN, both SOEs in charge with energy and electricity supply, have to bear the burden of subsidizing fuel and electricity purchases at below-market prices. Nonetheless, it is clear that the government will avoid taking risks and is willing to let SOEs carry this burden.

CONCLUSION

Several key indicators show that there is no grounds for fearing that the Indonesian economy will collapse the way it did in 1998. Overall, Indonesia's economic fundamentals remain resilient in the face of strong headwinds. There have been some notable progress in developing infrastructure, controlling inflation and reducing poverty. In addition, the 2019 budget also shows the government's commitment to maintaining economic stability. It also places emphasis on social protection and subsidies to protect people's purchasing power and to keep inflation low. The budget is likely to boost Jokowi's chances for re-election. However, some challenges loom ahead for the administration, even in a second term.

First, it must find ways to deal with the current account deficit. A large current account deficit dominated by portfolio investments makes for economic vulnerability. The government's efforts to attract FDI needs to be complemented with reforming regulations that constrain the expansion of its manufacturing sector and export performance, including revision of the 2003 labour law to boost the growth of labour-intensive exports.[6]

Second, given the expected tighter fiscal space, the government should re-evaluate all projects listed as national strategic projects and be more selective in prioritizing them, in particular those related to infrastructure and to energy subsidies. Going forward, it needs to consider to adjust gradually the domestic price of fuel following changes in global oil prices. To cushion the social impact, the government will need to provide social assistance to those most impacted

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by the price adjustment. At the same time, the government needs to signal that fuel subsidies are no longer viable, particularly when oil prices are increasing and the rupiah is weakening. Finally, the government must carefully implement and monitor its import restriction policy, including the local content requirement (TKDN) policy and the mandatory use of a 20 per cent blended biodiesel (B20) mix.[7] Local content requirement if too restrictive may adversely affect industrial performance and its competitiveness. A more buoyant environment for export should be prioritised. The B20 policy also needs to be supported by a clear implementation strategy for fear of it failing as in the past.

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