Economic Analysis

Jokowi keeps his pledge to cut fuel subsidies

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Indonesia's new Jokowi-led government kept its pledge to reduce the economy's fuel subsidy overhang and in turn free budgetary space to rev up investment spending by announcing the much awaited cut in fuel subsidies of IDR 2,000 per litre, effective today. The move translates into a 30% price hike in gasoline from IDR 6500 currently to IDR 8500 and a 36% price hike in diesel from IDR 5500 to IDR 7500.

The magnitude of fuel subsidy cut was cushioned by a sharp decline in global crude oil prices, which have fallen 20% since mid-June 2014. Looking ahead, a combination of benign international oil price scenario and a stable rupiah can lead to substantial reduction in Indonesia's fuel subsidy burden from a sizable nearly 3% of GDP. Such favorable commodity-currency interplay could create room for Jokowi to reallocate the savings to fund the government's priority program especially the infrastructure and the maritime sector development.

Efforts to stem fuel subsidies underscores Jokowi's commitment to reforms: While the timing and quantum of subsidy cuts was in line with consensus and our expectations, the move signals a strong intent by Indonesia's newly elected reform-minded President Joko Widodo to revive Indonesia's flagging growth prospects through hard reforms **(See our recent Economic Watch 'Taking stock of the challenges ahead for Indonesia's new President')**. Last week, Fitch re-affirmed Indonesia's sovereign credit rating at BBB- with a stable outlook citing 'strong commitment of the new Government in continuing structural reforms and improving the investment climate' as one of the key factors.

Bank Indonesia to look through temporary inflation spike: We expect the fuel price hike to cause a temporary pickup in inflation in the near to medium term and weigh on private consumption. That said, the ongoing momentum in structural reforms presents a steadily improving growth outlook for Indonesia in 2015 (BBVA GDP Est. 5.5% y/y vs. 5.1% in 2014). Meanwhile Bank Indonesia is expected to look through temporary inflation spike (year end CPI at around 7.0% to 7.4% y/y) and keep interest rates unchanged this year at 7.5%.

Given a hostile legislature, Jokowi faces tougher challenges ahead to push structural reforms: While Jokowi's efforts towards fuel price rationalization are very encouraging, Indonesia's deep rooted challenges warrant much to be done on the reforms front. These include 1) measures to boost infrastructure development, 2) initiate labour reforms that make labour laws more flexible, 3) expedite land acquisition process, 4) ease process to secure business permits, 5) tackle corruption and other governance issues, 6) banking sector liberalization, 7) reap Indonesia's demographic dividend by improving education attainment levels, and 8) prop up alternative growth engines by enhancing the competitiveness of the manufacturing sector to compensate for an unwinding global commodity super cycle. In the wake of a hostile legislature that could hamper the efficacy of nationwide policymaking, we believe that the Jokowi government faces even bigger challenges in coming months.