EABER East Asian Bureau of Economic Research
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Newsletter

Welcome to the East Asian Bureau of Economic Research (EABER) and South Asia Bureau Research (SABER) Newsletter.

EABER and SABER strive to be the premier economics research forums and to provide a single point of reference for the economics, finance and governance research community throughout the region and beyond. Through building research capacity and partnering initiatives, EABER and SABER facilitate high-level analysis and forward thinking on issues of importance to the East and South Asian economies.

Analysis

Indonesia: bad politics meets a good economy

Maria Monica Wihardja

Indonesia came out of the 2008–09 global financial crisis fairly unscathed; its banks only had to deleverage themselves from a small portion of debt. But now its strong position is in danger: government meddling could cause a good economy to go bad. The government should eschew populism and fix Indonesia's structural issues, including burgeoning fiscal subsidies and inward-looking trade policies, which pose a big threat to the country's financial and monetary stability.

Rising oil demand in Indonesia due to a growing middle class has made Indonesia a net importer of oil for some years now. For years, the government responded by subsidising fuel and electricity. The problem is that this expenditure will take up as much as 25.1 per cent of the 2013 budget. This is far too much. Only 6.7 per cent of the budget goes to social programs; and capital expenditures, which are mostly spent on infrastructure, constitute only 15.7 per cent of government spending. Having a large fuel subsidy restricts Indonesia's capacity to spend in these growth-enhancing areas.

And ballooning oil subsidies are not just a fiscal problem. Giving away fossil fuels to all the population increases inequality, degrades the environment, discourages innovation in renewable energy and is a drain on Indonesia's balance of payments.

What's more, Indonesia's dependence on oil and gas imports has made its trade deficit worse. Indonesia's current account went into a 2.7 per cent deficit in 2012. Through mid-2012 most of the decline came from the rapidly shrinking volume of exports in the non-oil and gas sector, followed in more recent months by a widening of the oil deficit. The resultant trade deficit in 2012 was Indonesia's first since at least 1998.

The decrease in export growth across the economy is also due in part to government policy. Indonesia recently banned rattan exports, put an export tax on minerals and enacted some inward-looking import policies. That imports on finished goods have become more restricted is actually a problem for Indonesian exports. This is because about a third of what Indonesia imports it later exports after manufacturers add value to the product domestically. Indonesia is enmeshed in global supply chains, so it depends on import availability for the performance of manufactured exports.

Trade policies have also contributed to skyrocketing prices on basic food items. In the spirit of 'self-sufficiency', since 2010 the government gradually re-introduced import quotas on a range of agricultural products. The new licensing system and port-entry restrictions led food prices to soar. For example, the prices of shallots climbed from US$1.20 a kilogram to $7 in March alone, while the price of garlic tripled from around Rp.20,000 per kilogram in January to Rp.60,000 in March. The garlic price increase shows just how distortionary government policies are. Because almost 90 per cent of

Paper of the Month

The most downloaded paper for the month of July 2013 was A Note on Defining the Dependent Population Based on Age by Racehl H Racelis and JM Ian S Salas.

Latest News

EABER hosted a conference on *China's Global Investment & its Reguation* in Canberra on July 10 2013.

Crawford's China Economy Program held its annual *China Update* in Canberra on July 11-12 2013.

EABER and the *Australian Financial Review* held a panel on Chinese Investment in Sydney on July 12 2013.

EABER will be hosting a conference on *Asian Trade Arrangements and Strategies* in Canberra on September 18-19 2013.

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Indonesia's garlic comes from overseas, a domestic quota was always going to cause a supply shortage and inflation.

Protectionist policies are especially unwise given weak external demand. In 2012, exports to China alone declined by 5.6 per cent from 2011 levels — a huge turnaround, since China's demand for Indonesian products had been growing significantly for a long period of time. One reason could be that China recently put restrictions on imports of low-quality coal, which makes up about one-third of Indonesia's coal export to China. In the context of this restriction and China's new growth model, Indonesia's weak export performance could be a structural problem.

These policy decisions have already had broader social and economic effects. The across-the-board increase in food prices led the poverty basket inflation rate up from its near three-year low of 5.3 per cent in November 2012 to 6.1 per cent in February 2013. And Standard and Poor's downgraded its outlook on Indonesia's credit rating based on the continuing pressures on the fiscal budget from fuel subsidies, the threat of inflation and the widening current account deficit.

As a reaction to threats to macroeconomic stability — including downgraded growth, which the World Bank projects will be less than 6 per cent in July 2013 — some government agencies and the central bank have begun to reverse some of their policies. But merely backing away from protectionism is not enough. Indonesia needs to bring systemic change to its economy.

Indonesia's economy remained insulated from the 2008–09 crisis, but whether that was good economic management or pure luck is uncertain. Now, Indonesia's economy is exposed to the destabilising effects of populist domestic politics and a lack of leadership. A bad economy is said to cause political instability. But Indonesia shows that causation goes both ways: bad politics can lead to economic instability.

Maria Monica Wihardja is a researcher at the Centre for Strategic and International Studies, Jakarta, and a lecturer at the Department of Economics, University of Indonesia. She is also Associate Editor at the East Asia Forum Indonesia desk.

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