High oil prices undermine Indonesian government

John Roberts
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Just a year after former general Susilo Bambang Yudhoyono won the Indonesian presidential election, skyrocketting global oil prices are compounding the country's economic difficulties and placing his administration under serious political strain.

The spokesmen for international finance capital are demanding that Yudhoyono slash state fuel subsidies, which, due to high oil prices, are leading to a ballooning budget deficit. The failure of his administration to heed the warnings has led to sharp falls in the value of the rupiah to 11,800 against the US dollar on August 31—the lowest point in four years.

Yudhoyono's reluctance to cut subsidies stems from fears of a popular backlash. Fuel prices were raised by 29 percent in March provoking protests in all major cities. In response, the government was forced to promise that there would be no further rises this year. At the time, the price of oil was well below the current levels of $US65-70.85 a barrel.

While it produces significant amounts of oil, Indonesia is a net importer. State subsidies have kept the price of fuel low—currently petrol is 24 US cents a litre. Any cutback in subsidies will directly increase the price of transportation and kerosene, which is widely used by the poor for cooking. Over 40 million people in Indonesia live on less then $US2 a day and over 17 percent of the workforce lack full-time jobs.

The rapid increase in global oil prices has worsened the government's financial problems. The cost of state fuel subsidies is expected to rise from $US6.31 billion in 2004 to $US14 billion in 2005, or one third of all government expenditures. As a result, the budget deficit will rise to around $US4.3 billion, double the estimate in mid August.

The added cost of buying imported oil has also contributed to the fall of the rupiah as state oil companies, including Pertamina, have had to purchase extra US dollars. Oil imports cost $US1.6 billion in July, up from $US1.1 billion in January. The problem has been made worse by the lack of investment in the oil industry, which has led to falling domestic production even as consumption has been rising.

The country's central bank, Bank Indonesia, has been compelled to intervene to try to prop up the value of the rupiah, which has fallen 10 percent against the US dollar since the beginning of the year. Between April and mid-August, Bank Indonesia spent $US5 billion, 15 percent of its foreign currency reserves. The bank also hiked up its key interest rate twice in a week—by 0.75 percent and 0.5 percent—to 10 percent by September 6.

Estimates of Indonesia's growth rate for 2005 have been marked down. The global bank UBS revised its projection for the second half of the year from 5.2 percent to 4.7 percent and now forecasts a growth rate of just 4.3 percent for 2006. Other analysts put the growth figure for the year at between 5.5 and 4.8 percent. Reflecting deteriorating economic conditions, the Jakarta stockmarket by late August had dropped 13 percent from its record high in July.

Jakarta is under pressure to rein in the state budget and accelerate the program of economic restructuring, including the sale of state enterprises. IMF head Rodrigo de Rato recently demanded that Jakarta both reduce the fuel subsidies and lift interest rates. For big business and foreign investors, Yudhyono's ability to ram through a major cutback to oil subsidies has become a key political test of his administration.

The British-based *Financial Times* commented on September 3: "For foreign investors in Indonesia, Mr Yudhoyono's inaction on fuel subsidies has become a symbol of the frustration many are beginning to feel with his government's slow progress."

The *Australian Financial Review* on 31 August lamented the "slow pace of reform in attracting large-scale investment in infrastructure," pointing out that only 14 of the 91 regulatory changes promised in January had come into effect. Turning to oil subsidies, the newspaper declared: "If he is ever to make politically unpopular decisions, now is the time. This is the biggest policy test of his presidency, and so far he is flunking it."

In the first six months of this year, foreign direct investment rose by 70 percent, in part due to the administration's pro-business promises. Now this is under threat. Dresdner Kleinwort Wasserstein's Singapore based currency strategist Sabrina Jacobs told the *Bloomberg* website: "The government has lost credibility big time, and investors are getting out." Last week Standard & Poors downgraded Indonesia's sovereign credit rating from "positive" to "stable".

Yudhoyono has attempted to defer any decision. A series of cabinet meetings between August 30 and September 1 resulted in a vague proposal to cut fuel subsidies after October but only after a compensation package for the poor had been put in place. Two key members of the cabinet economic team—Vice President Jusuf Kalla and chief economics minister Aburizal Bakrie—were absent from the first meeting, prompting media speculation about a possible cabinet reshuffle.

The president is clearly nervous about the public reaction to fuel price increases. In a statement on September 3, his spokesman Andi Alfian Mallarangeng emphasised: "He is a leader of [210] million people. He has to make sure reducing the subsidy will not hurt them. He will increase fuel prices but he just wants to make sure the compensation scheme is ready."

Yudhoyono is well aware that Suharto's decision to raise fuel prices triggered angry protests that helped bring down the junta in 1998. Every subsequent president has faced widespread opposition over any attempt to increase fuel prices. In 2003, the administration of President Megawati Sukarnoputri was forced to back away from cutting subsidies following mass protests.

Under pressure from international markets, however, Jakarta has mooted substantial price rises. In an interview with the *Australian Financial Review* last Friday, Development Planning Minister Sri Mulyani Indrawati said that Yudhoyono was now "inclined" to cut oil subsidies next month despite the political risks. "He has observed the market reaction and the fiscal position of the budget," she said. The minister warned that anything less than a 50 percent increase in fuel prices would "not be enough to restore fiscal sustainability".

The government is yet to make a final decision. Yudhoyono won the presidential election last year by promising to improve the living standards of the poor and, at the same time, to implement the demands of big business. Having postured during the campaign as a decisive leader, in contrast to Megawati, he now finds himself caught in the same dilemma as his predecessor: how to impose an economic program in the face of opposition to its deeply unpopular consequences.

A similar predicament confronts governments across the region. In Indonesia, the gap between oil production and consumption is just 15 percent, but other countries are far more reliant on imported oil. Japan, Korea, Taiwan and Singapore import 100 percent of their oil needs, the Philippines 94 percent, Thailand 85 percent and India 71 percent. In a number of countries, including the Philippines and Sri Lanka, discontent over rising prices is a significant factor in the political problems facing the government.