Indonesia: Retail fuel prices hiked at last

Economists **Strategists**

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- Late Friday night, the Indonesian government announced retail gasoline and diesel price hikes of 44% and 22%, respectively, effective 22 June, which are at the high end of market expectations. This proactive policy move will likely lead to a temporary spike in inflation but should be positive for Indonesia's long-term economic fundamentals.
- As a result, we revise up our CPI inflation forecast in 2013 to 7.2% from 5.6%, and now expect Bank Indonesia (BI) to hike the policy rate by another 100bp this year (previously 25bp).
- We also trim our 2013 forecast for the current account deficit to 2.2% of GDP from 2.8%, and now forecast a fiscal deficit of 2.4% of GDP (versus our estimate of 2.8% of GDP, which excludes the fuel price adjustments).
- We, however, keep our 2013 GDP forecast unchanged at 6.1%, as growth will likely be supported by domestic demand, and especially by higher government spending ahead of the 2014 elections.
- FX Strategy: We expect the latest fuel price hike to be IDR positive given its constructive medium-term impact on fiscal and external accounts.

For the first time in over five years, the Indonesian government has raised retail fuel prices. The price of gasoline was raised by 44% to IDR 6500/litre, while diesel prices were increased by 22% to IDR 5500/litre (Figure 1). We had assigned a 65% probability of the retail fuel price hike materialising between June and July (see *Asia Insights: Indonesia: Fuel subsidy changes – haven't we seen this movie before?*, 22 May 2013).

The approval of the revised budget by Parliament on 17 June paved the way for this adjustment, as it accounted for IDR9.3trn in cash transfers to 15.5m households over a period of four months. These transfers will be made in two instalments in July and September, according to the Ministry of Finance. On 30 April, President Yudhoyono tied the implementation of retail fuel price hikes to this approval of cash transfers by Parliament.

The retail fuel price increase is positive in our view; we estimate from the size of the gasoline and diesel price hikes that the fiscal and current account deficits will decline significantly. We previously noted that our macroeconomic outlook, especially for H2 2013, is contingent on the magnitude of these expected fuel price increase (see *Asia Economic Monthly: The region has a lot riding on Abenomics*, 6 June 2013). Thus, following these adjustments, we have revised our forecasts.

Inflation

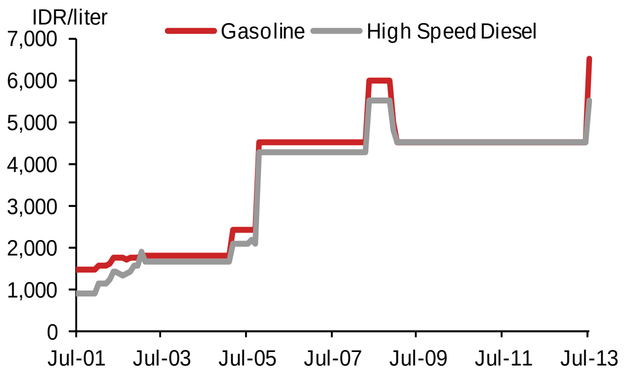
The immediate impact of the fuel price hike will be on CPI inflation, which will likely spike in the next two months. We estimate that the direct impact of this hike will add 1.7 percentage points (pp) to headline CPI in H2, which excludes any indirect impact (through second round effects and rising inflation expectations)[1]. We expect the full impact (from both direct and indirect channels) on headline CPI inflation to be complete by July (after which, we estimate CPI inflation on a y-o-y basis will remain elevated for five months). Thus, for 2013, we now expect headline CPI inflation to average 7.2% from 5.6% previously, with inflation averaging 8.7% y-o-y and 8.8% in Q3 and Q4, respectively.

The sharp rise in inflation will likely be reflected first in June's CPI inflation data, which we estimate will increase to 6.5% from 5.5% in May. This increase in June CPI inflation reflects not just the initial pass-through from the fuel price increase but also

[1] This was the pass-through estimated by Bank Indonesia (BI) following the 2008 fuel price increase; we expect a similar degree of pass-through during this round.

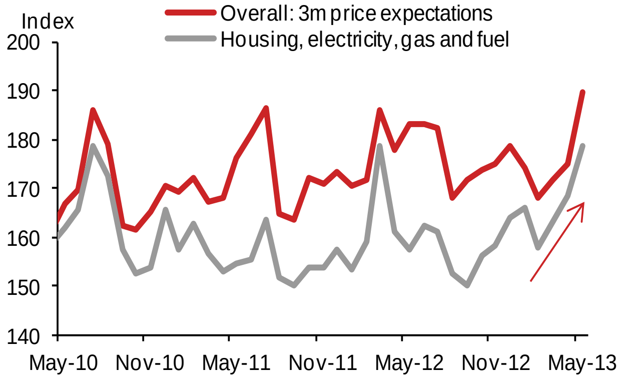
already-rising inflation expectations ahead of these hikes (Figure 2) reflected by the sharp increase in food prices in June from May[2].

Fig. 1: Retail fuel prices



Source: CEIC; Nomura Global Economics

Fig. 2: Inflation expectations



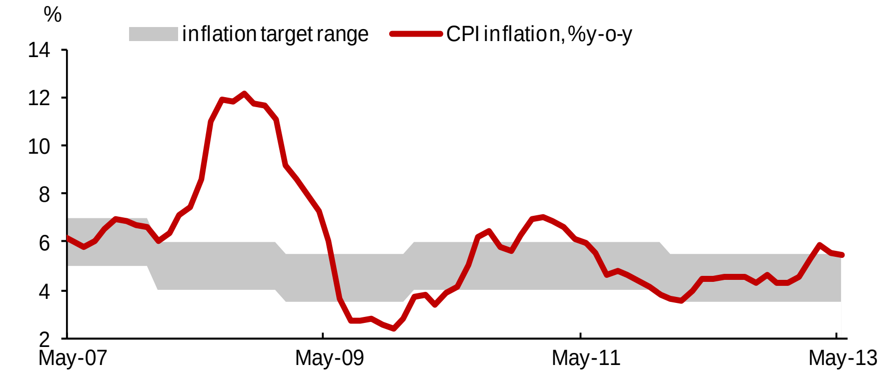
Source: CEIC; Nomura Global Economics

Monetary policy

In anticipation of these price changes, BI already increased the FASBI or the lower bound of the policy corridor (see *First Insights: Indonesia: Depreciating IDR triggers start of tightening cycle*, 12 June 2013) and the policy rate by 25bp (see *Asia Insights: BI raises the policy rate while BSP stays put*, 13 Jun 2013) earlier this month. In May, headline CPI inflation was 5.5% y-o-y, at the top end of BI's 3.5-5.5% target range. Therefore, with the prospect of inflation significantly exceeding BI's target (Figure 3), we expect decisive policy rate hikes.

We now expect BI to hike the policy rate by another 100bp this year, compared to our previous forecast of a 25bp hike. We expect a 50bp hike at the July meeting and another 50bp increase at August meeting, after the full effect of the hikes have been passed through to CPI inflation.

Fig. 3: Headline inflation and target range



Source: CEIC; Nomura Global Economics

Fiscal deficit

The narrowing of the fiscal deficit is clearly one of the biggest positives from raising retail fuel prices. Without this fuel price adjustment, the government estimated that the fiscal deficit could widen to as much as 3.83% of GDP, breaching the deficit ceiling of 3%.

After allowing for the retail fuel price adjustments and cash transfers of IDR9.3trn, the revised 2013 budget pegs the fiscal deficit at 2.38% of GDP versus its preliminary estimate of 1.65% (Figure 1), as both revenues were revised down and expenditures were revised up. The tax revenue target was revised down based on a lower GDP growth assumption of 6.3% versus 6.8% in the preliminary budget. In addition, upward revisions were made to government expenditure estimates for fuel and electricity subsidies.

We think the government will likely now meet its revised fiscal deficit target for the year. We had previously estimated that, under a scenario where gasoline and diesel prices increase by 44% and 22%, respectively, the fiscal deficit would be 2.3% of GDP (see again *Asia Insights: Indonesia: Fuel subsidy changes – haven't we seen this movie before?*, 22 May 2013). Although we had assumed a higher cash transfer of IDR14.0trn, this was offset by differences in the estimated consumption of subsidised fuel (revised budget: 48mn KL; Nomura: 47.2mn KL) and upward revisions to electricity subsidy expenditures.

[2] Weekly data from the Ministry of Trade show that prices of chilies (21.3% m-o-m nsa), beef (0.6%) and soybeans (2.4%) have already risen sharply in June versus May.

Fig. 4: Summary of revised 2013 budget

IDRtrn	2012 Actual	2013p Approved Budget Oct 2012	2013r Revised Bugdet June 2013
A. Total Revenue and Grants	1335.7	1529.7	1502.0
Domestic revenues	1331.7	1525.2	1497.5
Tax revenue	980.1	1193.0	1148.4
Non-tax revenue	351.6	332.2	349.2
Grants	4.0	4.5	4.5
B. Expenditures	1481.7	1683.0	1726.2
Central government expenditures	1001.1	1154.4	1196.8
Interest payments	100.5	113.2	112.5
Energy Subsidies	306.5	274.7	299.8
Fuel	211.9	193.8	199.9
Transfers to region	480.4	528.6	529.4
C. Overall balance (A-B)	-146.0	-153.3	-224.2
(% GDP)	-1.8	-1.7	-2.4
Key Assumptions			
Real GDP grow th		6.8	6.3
Year-end inflation		4.9	7.2
Average USD/IDR		9300.0	9600.0
Average Indonesia Crude Price per		100.0	108.0
Oil lifting (mn bpd)		0.9	0.8
Gas lifting (mn boepd)		1.4	1.2
Fuel consumption, mn KL		46.0	48.0

Source: Ministry of Finance, World Bank, Nomura Global Economics

Current account deficit

The external account will also benefit from these fuel price adjustments, in our view, since petroleum imports will fall as the elasticity of import demand to changes in fuel prices increases. Overall domestic demand should also be tempered by higher inflation and interest rates. We estimate that the savings on petroleum imports from this increase in retail fuel prices will be 0.6% of GDP. As a result, we have narrowed our current account deficit forecast to 2.2% of GDP from 2.8%. We now expect the current account deficit to narrow to 1.5% of GDP in H2 from 2.9% of GDP in H1. That said, we believe some external pressures will remain, especially from the export side as commodity prices (commodities constitute 65% of total Indonesian exports) remain weak.

However, we are leaving our 2013 GDP forecast unchanged at 6.1%, as we expect GDP growth to be supported by domestic demand, and especially by higher government spending ahead of the 2014 elections.

Fig. 5: Summary of outlook table

% y-o-y growth unless otherwise stated	**1Q12**	**2Q12**	**3Q12**	**4Q12**	**1Q13**	2Q13	3Q13	4Q13	**2012**	2013
Real GDP	**6.3**	**6.4**	**6.2**	**6.1**	**6.0**	6.0	6.1	6.2	**6.2**	6.1
Private consumption	**4.9**	**5.2**	**5.6**	**5.4**	**5.2**	5.8	5.7	5.5	**5.3**	5.5
Government consumption	**6.4**	**8.6**	**-2.8**	**-3.3**	**0.4**	8.0	10.0	12.0	**1.2**	8.4
Gross fixed capital formation	**10.0**	**12.5**	**9.8**	**7.3**	**5.9**	8.1	8.8	7.9	**9.8**	7.7
Exports (goods & services)	**8.2**	**2.6**	**-2.6**	**0.5**	**3.4**	3.8	7.2	9.0	**2.0**	5.9
Imports (goods & services)	**8.9**	**11.3**	**-0.2**	**6.8**	**-0.4**	4.0	5.5	8.0	**6.6**	4.4
Contributions to GDP (% points)										
Domestic final sales	**5.5**	**6.5**	**5.2**	**4.5**	**4.3**	5.8	6.1	6.4	**6.0**	4.9
Inventories	**0.2**	**2.9**	**2.2**	**4.1**	**-0.1**	-0.1	-1.4	-1.3	**1.8**	0.1
Net trade (goods & services)	**0.6**	**-3.0**	**-1.2**	**-2.5**	**1.8**	0.2	1.3	1.2	**-1.5**	1.1
Consumer prices	**3.7**	**4.5**	**4.5**	**4.4**	**5.3**	5.8	8.7	8.8	**4.3**	7.2
Exports (goods)	**5.3**	**-8.2**	**-13.0**	**-7.2**	**-6.0**	6.1	6.1	9.5	**-6.1**	3.9
Imports (goods)	**21.6**	**9.7**	**-0.7**	**4.9**	**-5.7**	6.0	10.1	9.1	**8.4**	5.9
Trade balance (US$bn)	**1.7**	**-2.1**	**0.7**	**-2.5**	**-0.7**	-2.2	1.6	0.6	**-2.2**	-0.6
Current account balance (% of GDP)	**-1.4**	**-3.6**	**-2.4**	**-3.5**	**-2.4**	-3.4	-1.2	-1.8	**-2.7**	-2.2
Fiscal Balance (% of GDP)									**-1.8**	-2.4
Bank Indonesia rate (%)	**5.75**	**5.75**	**5.75**	**5.75**	**5.75**	6.00	7.00	7.00	**5.75**	7.00
Exchange rate (IDR/USD)	**9146**	**9433**	**9591**	**9793**	**9710**	9700	9750	9850	**9793**	9850

Notes: Numbers in bold are actual values; others are forecasts. Interest rate and currency forecasts are end of period; other measures are period average. All forecasts are modal (i.e., the single most likely outcome). Table reflects data available as of 24 June 2013.
Source: CEIC and Nomura Global Economics.

FX Strategy: We expect the latest fuel price hike to be IDR positive given its constructive medium-term impact on fiscal and external accounts. If BI continues its recently adopted hawkish bias by consistently hiking rate (next BI policy meeting on 11 July), IDR performance will likely improve – as it did in reaction to the 30 September 2005 fuel price adjustment and rate hikes. With short-end IDR points, such as the 1-week, implying 64% annualised depreciation (a 4.2 standard deviation over the past 12-months), we establish a short 1W USD/IDR (see trade details below) with intention to roll this through the 11 July BI policy meeting. Our economists expect BI to hike by 50bp at this policy meeting, but even if BI were to hike by 25bp, it would still be a clear indication of BI's tightening bias. The key risk to this long IDR position is further capital outflows given Fed QE tapering concerns and Indonesia's vulnerability to bond and equity outflows (see *Asia Insights: How a US unwind of QE could affect Asia*, 28 May 2013) given the weak basic balance (-0.9% in Q1 2013). Since Bernanke's testimony on 22 May, foreign positioning in the government bond market has dropped by USD2.2bn (as of 18 June) while foreigners have pulled out about USD2.5bn from equities (as of 21 June). As such, we establish a long USD/INR position to offset some of this risk. INR is among the most vulnerable Asian currencies to bond and equity outflows given India's vast current account deficit (about USD5.4bn outflows from local debt since its 22 May peak). The risk to being short INR stems from authorities potentially announcing fresh measures like NRI bonds, a relaxation of FDI limits (already proposed by a government panel) etc. to attract capital inflows. Overall, we are establishing a long position in 1w USD/INR (notional: USD2mn) against our short in USD/IDR (notional: USD3mn).

Trade details:

Sell 1w USD/IDR at 10225 (notional: USD3mn, value date: 3 July 2013).

Buy 1w USD/INR at 59.89 (notional: USD2mn, value date: 3 July 2013).

Disclosure Appendix A-1

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