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Borsuk, Richard

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Battling Inflation: Jakarta Resists Standard Medicine

By Richard Borsuk

SYNOPSIS

Unlike scores of other nations, Indonesia has held off from raising interest rates in a bid to cool high inflation. But it may soon be forced to change its policy.

COMMENTARY

LIKE ALL countries, Indonesia is wrestling with inflation, which has climbed to its fastest pace level in years and battered consumers. Unlike most other nations, though, Indonesia has resisted -- at least so far -- taking the tough medicine that is the standard prescription for slowing down inflation: hiking interest rates.

Bank Indonesia (BI), the central bank, has kept its seven-day benchmark interest rate at a record low 3.5%. That's where it has been since February 2021-- one year before Russia invaded Ukraine, damaging pivotal supply chains and fuelling inflation globally.

Inflation Rate Likely to Keep Rising

For June, Indonesia reported annual headline inflation of 4.35%, the highest since June 2017 and exceeding BI's official target for this year of 2-4%. Particularly notable was that food prices were up 8.3% from a year earlier. In normal times -- it's hard to see when they will be "normal" again -- Indonesia imports sizable quantities of wheat and fertiliser from Ukraine.

With Russia's war against Ukraine raging, supply chains tangled and oil prices high (Jakarta is a net importer), Indonesia's inflation rate may keep rising. And that would make it extremely hard for BI to avoid swallowing the conventional medicine and raising interest rates.

Add in the mix of problems that interest rates in the United States are going up further as the Federal Reserve fights an inflation rate that is more than double the Indonesian one. The Fed raised rates 0.75 percentage point on 15 June 2022, and there could be a similar size hike at its meeting on July 26-27.

Hikes by the Fed attract money to the US, hurting currencies like the rupiah, which has weakened this year and is close to 15,000 to the dollar. To stabilise the rupiah -- BI's other main job along with stabilising prices -- an Indonesian rate hike will help.

Benchmark Rate to Change Soon?

BI's next monetary policy decision is due this week, on 21 July. UOB economist Wellian Wiranto thinks the central bank is unlikely to change its benchmark rate that soon, but feels it might happen at BI's August policy meeting, after it digests July inflation data coming out next month. Whatever the starting date, Wiranto does expect hiking soon; he predicts Indonesia will lift the rate 0.75 percentage points by the end of 2022.

Explaining why it has held the rate steady so far, BI has asserted that the country's inflation has been driven by supply shortages rather than the kind of excessive demand that often drives inflation, such as when more people than expected want to buy fewer-than-needed airline seats, making the price spike.

In not raising rates, the central bank is trying to support Indonesia's recovery from the economic battering it took from the COVID-19 pandemic. Indonesia, like so much of the world, fell into recession in 2020, and while there has been recovery, it's not robust.

The economy has been growing about 5% a year, like it did for years before COVID-19, and that level is not high enough to create the number of jobs Indonesia, which with a huge young population, needs.

The government of President Joko Widodo, which spent heavily to put a social safety net to cushion the impact of the pandemic on poor Indonesians, is helping keep inflation down by maintaining costly subsidies on electricity bills and lower grades of fuel.

Finance Minister Sri Mulyani Indrawati has expressed confidence that the deficit -- which ballooned to more than 6% in 2020 because of COVID-19 spending -- can remain under 4% of gross domestic product this year.

Tricky to Stay Under the Cap

Fortunately, the picture for Indonesia's external finances is a lot brighter than in 2020, when government revenue plummeted due to the pandemic. Thanks to a commodity boom in the past year, government revenue shot up. A chunk of that came from soaring exports of coal, whose price shot up this year.

Also were strong earnings from palm oil until Indonesia temporarily barred exports to try to reduce surging domestic price of cooking oil. Domestic prices eventually came down (much later than consumers wanted), but Indonesia's position with customers as a reliable exporter of cooking oil was damaged.

By law, Indonesia's fiscal deficit cannot exceed 3% of GDP. That was waived for three years to battle COVID-19, but the limit is due to apply again from 2023 -- and it could well be tricky to stay under the cap.

If oil prices remain high enough to force continued heavy subsidy spending and if Jokowi pushes for hefty spending on constructing a new capital city, in East Kalimantan, that would endanger the deficit limit.

He's very keen on the project, which has an estimated cost of US$33 billion (made before this year's inflation). But many Indonesians are cool to the idea, doubting that the government can afford it as this time.

The Paradox of Indonesian Inflation

Indonesia's central bank has accumulated a lot of experience battling inflation surges of differing sizes. Around 2006, the rate reached 13%, the highest in 15 years, and it got whittled down for a long time, falling to 1.6% in 2021. During the 1997-98 Asian Financial Crisis, when there was economic and political turmoil leading to President Suharto's fall, inflation at one point was around 80 percent.

And decades before that, Indonesia experienced one of the worst hyperinflations of the 20th century. In 1965, the economy was in complete shambles, and there was a grim shortage of food as the rice crop failed and there were no foreign reserves with which imports could be bought. The inflation rate topped 650%, according to Radius Prawiro, a government official named central bank governor in 1966.

In a book published in 1998, the late Prawiro wrote:

"…one of the great puzzles of everyday life in Indonesia was how the average citizen managed to survive … for most Indonesians, economic life had become a bewildering paradox: the economy was simultaneously overheating and lurching to a halt."

Richard Borsuk, the Wall Street Journal's Indonesia correspondent from 1987 to 1998, is an Adjunct Senior Fellow at the S. Rajaratnam School of International Studies (RSIS), Nanyang Technological University (NTU), Singapore. He is co-author of "Liem Sioe Liong's Salim Group: The Business Pillar of Suharto's Indonesia".
