Mizuho Flash: Indonesia

Economics & Strategy | Asia ex-Japan

21 March 2025 | Tan Jing Yi | Market Economist

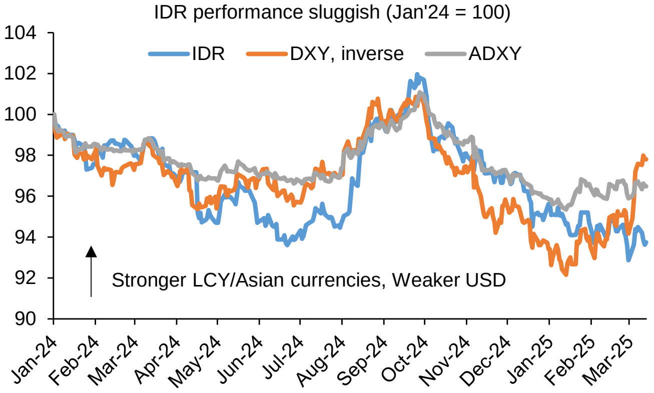
Indonesia: Mind the Gap

In a Nutshell:

- IDR's underperformance and equities sell-off are likely reflecting markets' apprehension towards Indonesia's fiscal outlook, as intense focus on spending programmes raises questions on revenues sufficiency. There is need for clarity for the funding of the free lunch programme which amounts to 0.4% of GDP.
- Revision to mining royalties and expanded scope of minerals taxed (e.g. diamond, cobalt) whilst could raise revenues, are **unlikely to plug the revenue-expenditure gap amid a soft commodity backdrop**. Meanwhile, savings from deep budget cuts by various ministries appear to be wholly channelled to the new sovereign wealth fund.
- While the fiscal deficit of 3% may still be maintained, these **gaps represent risks of potential climb towards this ceiling from the current 2.5% target** which is a clear discomfort and a stark departure from pre-pandemic times which peaked at 2.6%.
- Revisions to bills add uncertainties to political governance; while Bank Indonesia affirmed that the revisions to its mandate would not affect its independence, **any indications that may increase central bank's proclivity to buy bonds would impart further risk premiums**.
- In addition, despite lofty 8% growth targets, ongoing growth woes are epitomised by expectations of softer travel demand during the upcoming Eid festivities. Delayed clarifications surrounding possible movements of key personnel such as the Finance Minister also provide little cheer.
- Well-considered policy u-turns and/or more clarity on revenue measures, coupled with clear and effective public communications are likely pre-requisites to restore confidence.
- For now though, without a clearer fiscal outlook, USD/IDR may find it tough to go below 15,800 levels.

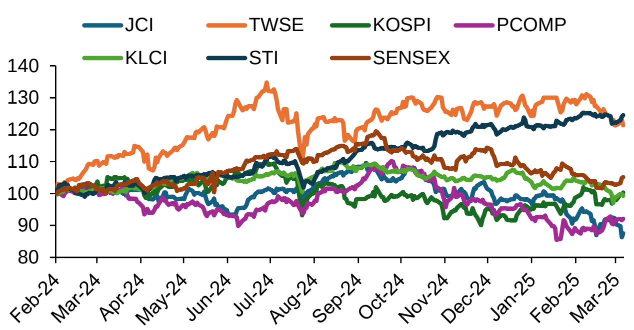
- The recent sell-off in Indonesian equities (on 18 March) certainly stole headlines. However, the equities sell-off did not occur in a vacuum. Instead, it is likely a reflection of an accumulation of various political and social-economic events over the past few months.
- Tellingly, IDR is the worst performing EM Asia FX on a YTD basis. Even as USD has been broadly weaker in recent weeks, USD/IDR remains hovering above 16,200 levels.

IDR performance sluggish (Jan'24 = 100)

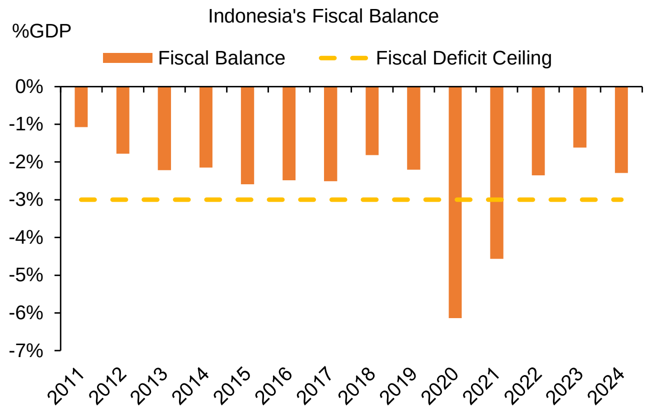


Sources: Bloomberg; Mizuho

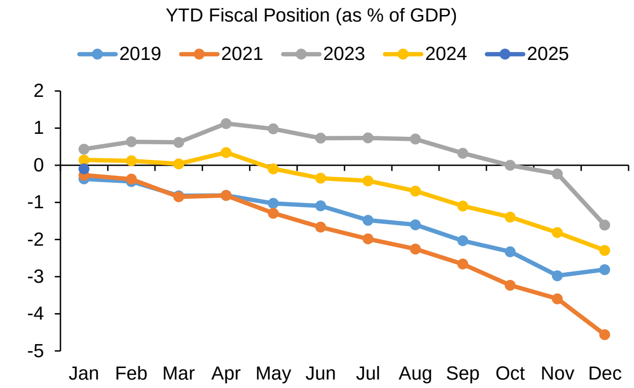
Equities Performance (Feb'24 = 100)



Note: Indexed to 14 Feb 2024, the day of Indonesian elections.
Sources: Bloomberg; Mizuho



Source: CEIC; Mizuho



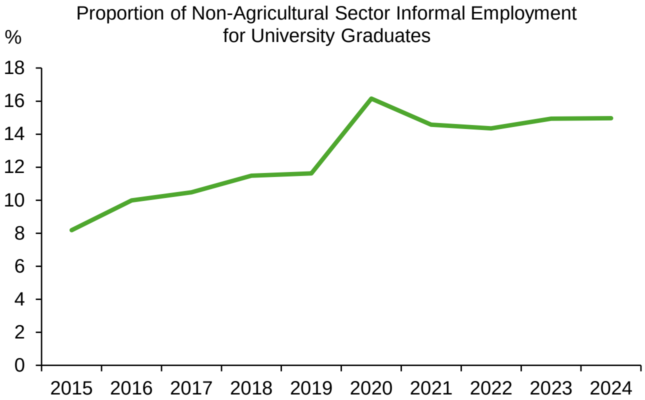
Sources: CEIC: Mizuho estimates

- **Fiscal woes are likely the biggest bugbear.** Point being, developments including since the start of the year have not imparted much confidence that the government is on track to meet the 2.5% fiscal deficit for this year, even as Finance Minister Indrawati has affirmed this target as recently as 13 March (see Table below for list of events).
- Based on our estimates, there appears to be at least an unexplained 0.3%-pt of GDP expenditure-revenue gap as the expenditure needs of the free lunch programme are not fully met by the increase in mining revenues (see Box A below), while the savings from the deep budgets cuts by the various ministries appear to be wholly channeled to the new sovereign wealth fund, Danantara. Admittedly, there is a large margin of uncertainty around these estimates given that commodity prices remain volatile and doubt over the slew of recent economic policy changes has already been incorporated into the fiscal baseline.

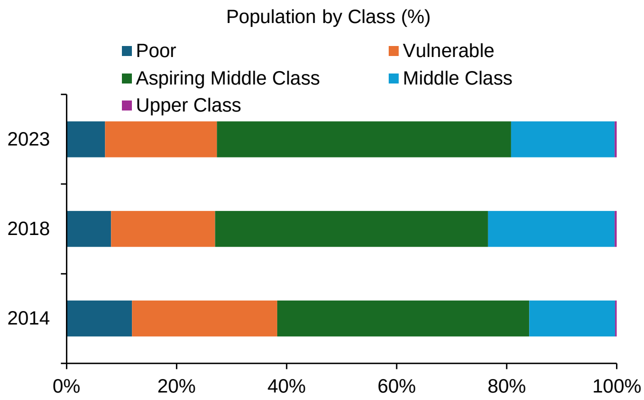
Events	Remarks
In December 2024, Finance Minister Indrawati announced a 50% electricity discount for January and February 2025, which would cost IDR12.15tn (~0.04% of GDP).	It is unclear whether the electricity discount was included in the original budget. Subsidies for electricity totalled IDR80.7tn in 2024 and the two-months discount represents a 15% increase in subsidies.
VAT tax hike was watered-down at the start of the year to apply to only luxury goods and services.	This effectively reduces potential tax revenue.
President Prabowo announced the intention to expand the free lunch programme to reach all 83m intended recipients by the end of the year.	Expansion of the free lunch programme is estimated to require an additional IDR100tn (~0.42% of GDP) on top of the original budgeted IDR71tn. Finance Minister Indrawati confirmed the expanded allocation on 13 March.
January budget balance registering a deficit early in the year, following a few weeks' delayed publication.	Budget balance showed a 26% drop in revenues YoY and 1% drop in expenditures. Here, **it is important to note that this deficit was mostly attributed to revenue shortfalls, and have yet to show indications of the much-feared surging expenditures**. The Finance Ministry attributed the revenue shortfall in part due to falling commodity prices and technical issue arising from the announced VAT tweaks hampering collections.
In February, President Prabowo directed the savings of slashed ministries budgets to the new sovereign wealth fund, Danantara.	The deep cuts by various ministries, including health (-19%), education (-24%) and public works (-73%) raise tail risks that extreme austerity could engender social unrest should the reduced expenditures be realised through removal of on-the-ground programmes rather than trimming inefficiencies. Notably, the deep cuts have led to "Dark Indonesia" protests in February. In addition, the reduction in expenditures could also have spillover effects to related industries. For example, state builders may run into cash flow difficulties on delayed government payments.

Rumours of Finance Minister Indrawati resigning or could be reshuffled were not promptly dismissed, but only denied following the equity sell-off on 18 March.	Indrawati has been widely recognised for her efforts in bringing Indonesia's fiscal deficit to within the 3% ceiling and her removal may worsen fiscal fears.
Public consultation published on 9 March to review royalty charges for the mining industry.	Revisions, if implemented, is expected to increase revenues by no more than 0.1% of GDP (see Box A for more details), and not likely to plug the expenditure-revenue gap. For illustration, non-tax mining revenue in 2024 accounted for 0.46% of GDP. Simply put, the cost to expand the free lunch programme would consume nearly the entirety of the 2024 non-tax mining revenue.

- **Political governance:** On March 20, the Indonesian parliament passed an amendment to the Indonesian Armed Forces (TNI) bill, which would allow military personnel to take on civilian posts.
- Under the previous law, military officers can only hold top positions in certain government agencies primarily related to security and defence, such as the Defence Ministry, the State Intelligence Agency and the National Narcotics Agency. To hold civilian positions in other government institutions, soldiers were expected to resign or retire from military service. The revised law now permits military officers to service in 14 state institutions, including attorney general's office. Military personnel are still prohibited from engaging in business activities.
- The concern is that the amendment could pave the way for shifting priorities towards more pro-growth initiatives, which may come at the expense of fiscal sustainability.
- **Ongoing growth woes:** Retail sales and consumer confidence have been softer, while loan growth has been slowing since July last year. The softer mood is also reflected in the Eid celebrations. Based on a survey conducted, the Ministry of Transportation estimated 146.48m people will be moving for the 2025 Eid Homecoming, a ~24% drop from the 193.6m recorded last year. It would also be the first decline post-pandemic.
- Further out, longer-term prospects are not encouraging. A report by University Indonesia in August 2024 showed that Indonesia's middle class has shrunk since 2018. Moreover, the proportion of university graduates engaging in informal employment has seen a structural upward shift post-pandemic, suggesting that structural unemployment (skills mismatch) may be entrenching deeper.



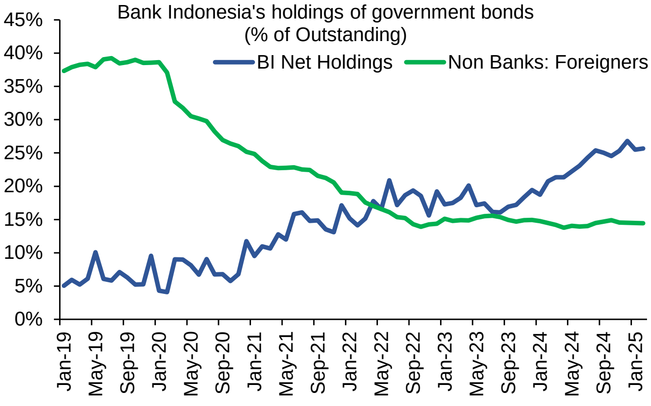
Sources: BPS-Statistics Indonesia; Mizuho



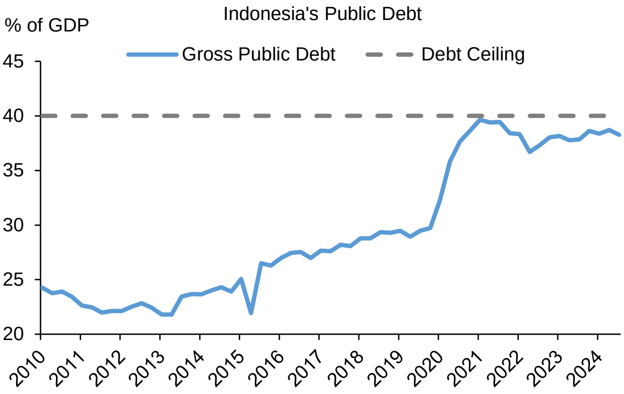
Sources: University Indonesia's estimates; Mizuho

- **Questions on Bank Indonesia Independence were slow to be clarified**: Questions on central bank independence arose on news that Indonesian lawmakers were debating on 11 March whether to **further expand the central bank's mandate.**

- Under the current law, the central bank is mandated to maintain rupiah stability, payment system stability, and financial system stability in order to support sustainable economic growth.
- Governor Warjiyo subsequently clarified on 19 March that planned law revisions will clarify the definition of BI's current mandate of supporting "sustainable economic growth" as encompassing stability, economic growth, and job creation.
- **Bond Buying Remains A Key Risk**: Nonetheless, another key risk in the revision is whether bond-buying power would be included in BI's mandate. At present, the central bank is only permitted to buy bonds in the primary market when the government declares a crisis.
- However, BI has bought, and is planning to buy more government debt in 2025. Last month, Bank Indonesia has committed to buy government bonds which were issued to fund Prabowo's ambitious housing programmes, in the secondary market. This would be on top of BI's statements in December 2024 that it would buy more than IDR150tn of government bonds in 2025, which is more than the IDR100tn Covid-19 bonds due to mature.
- The worry here is that BI's increasing holdings of government bonds raise unnerving investors who are concerned over moral hazard issues should it be viewed as excessive support from central banks in financing fiscal needs; or worse, cast doubts on the functionality of the debt markets.
- Notably, BI's rising share of **government bonds from already elevated** levels since 2024, after a period of brief stability in 2023. While this may in part be attributed to BI's interventions in the bond market as part of its toolkit to support the IDR, BI's holdings are due to rise even further with BI agreeing to buy more government debt.
- The situation could be worse if bond-buying power were to be included in BI's mandate, insofar as it could mean that BI may have to intervene in bond markets more aggressively going forward, and/or may have to be buy more government bonds at the primary market.



Source: CEIC; Mizuho Bank



Sources: CEIC; Mizuho

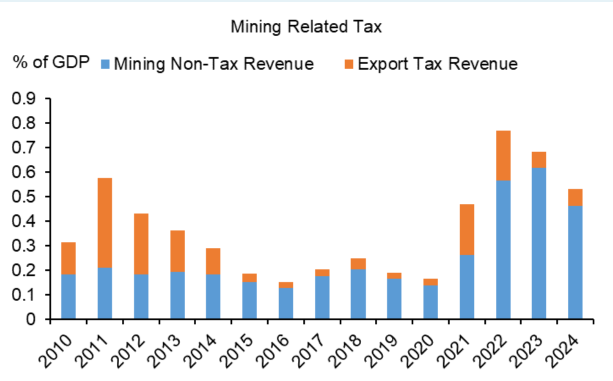
- **Outlook:** Evidently, confidence has been rattled, as seen from equity outflows and the sluggish rupiah. For inflows to return, drastic policy u-turns and/or more clarity on revenue measures would likely be pre-requisites. In addition, at such times, speculation/rumours surrounding key appointments have to be promptly squashed to provide assurances that things are in good order.

- For now though, without a clearer fiscal outlook, USD/IDR may find it tough to go below 15,800 levels.

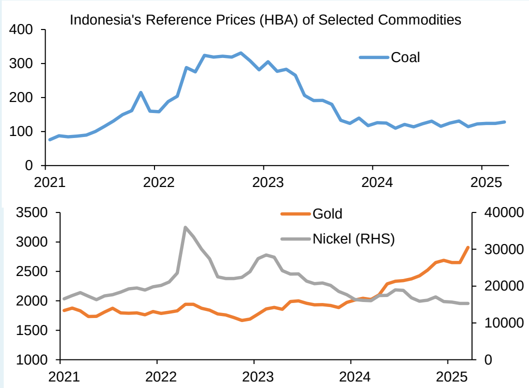
BOX A: Analysis of Royalties Revisions

- On 8 March 2025, the Energy and Resource Ministry (ESDM) issued a public consultation on plans to review royalty chances. Subsequently, on 20 March 2025, Energy Minister Lahadalia said the government is pushing ahead with its plans to raise royalties, and will soon issue revised regulations on the matter.
- Admittedly, the move should boost government coffers to some extent. The previous time royalties* were revised in April 2022, non-tax revenue from general mining, which comprises monies received from royalties, increasing by 0.26% of GDP in 2021 to 0.57% of GDP in 2022, a good ~0.3ppt of GDP increase. Prices of coal, which consist 54% of mining and quarrying sector's output, in 2022 were on average 163% higher compared to 2021. As such, most of the increase is likely attributed to the buoyant commodity prices.
- However, this time around, commodity prices are expected to remain soft amid slower global growth, bumpy China's recovery and trade headwinds. In addition, we expect Indonesia's mining production levels to see little to modest growth.
- Accordingly, should the revisions as proposed in the public consultation take effect, we expect a **revenue increase no higher than 0.1% of GDP:**
  i) Notably, the increase in revenues, is expected to come mainly from royalty revisions in minerals (in particular nickel and gold), and expanded scope of minerals coverage to include diamond, cobalt, silver nitrate etc.
  ii) This increase would be in part offset by a decrease in coal revenues, as the modest 1ppt increase in royalties for Mining Licenses (IUP) licenses should be outweighed by the tariffs cuts for Special Mining Licenses (IUPK) coal.

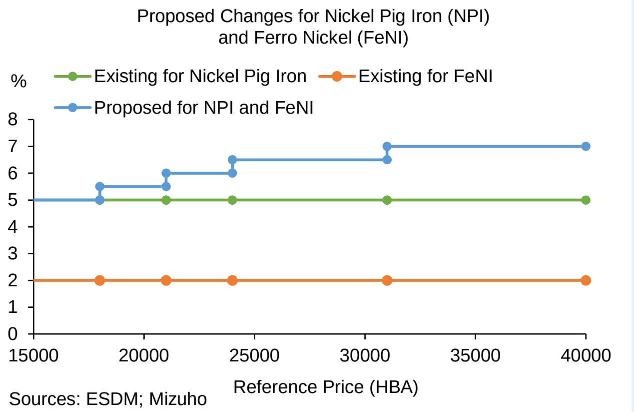
*Coal royalties was changed from a fixed rate of 13.5% to a progressive rate ranging from 14-28% depending on Indonesia's coal reference prices (HMA).



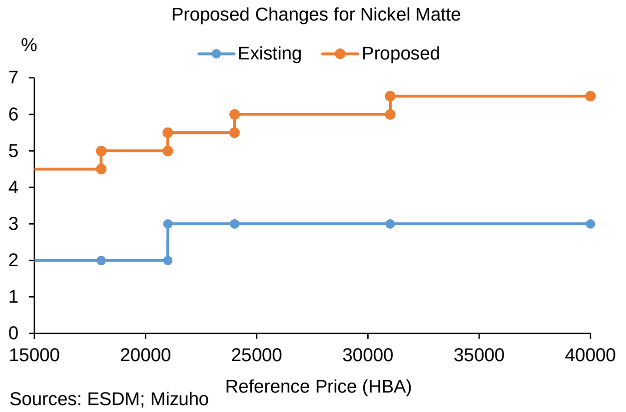
Sources: CEIC: Mizuho



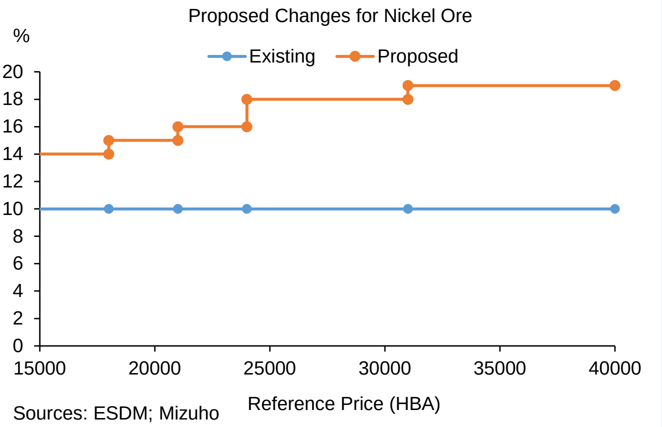
Sources: CEIC;Mizuho



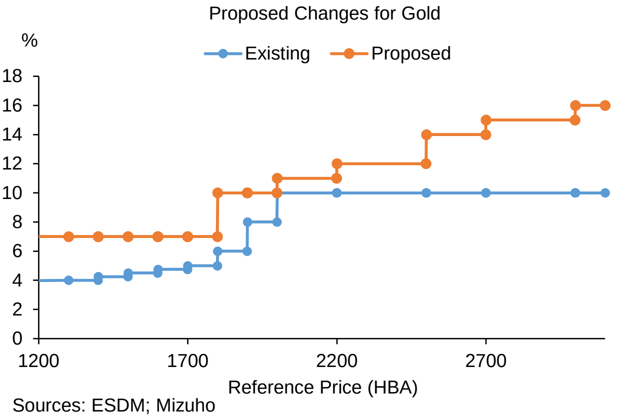
Sources: ESDM; Mizuho



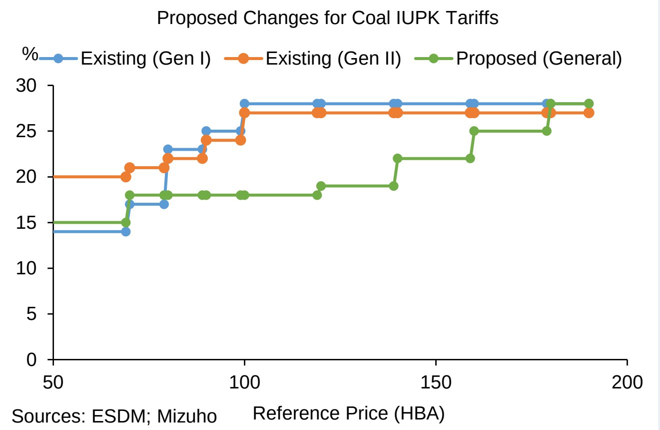
Sources: ESDM; Mizuho



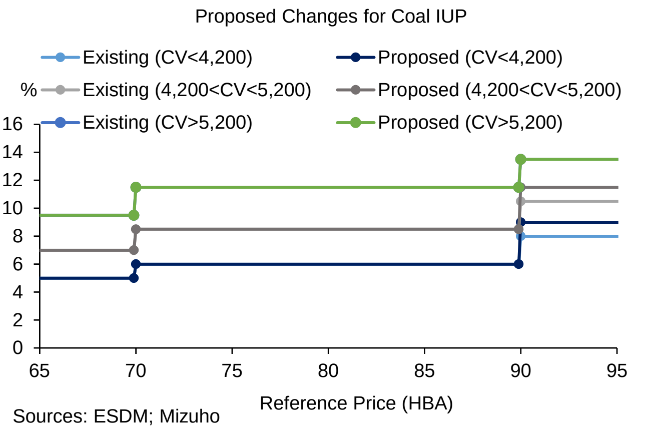
Sources: ESDM; Mizuho



Sources: ESDM; Mizuho



Sources: ESDM; Mizuho



Sources: ESDM; Mizuho

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