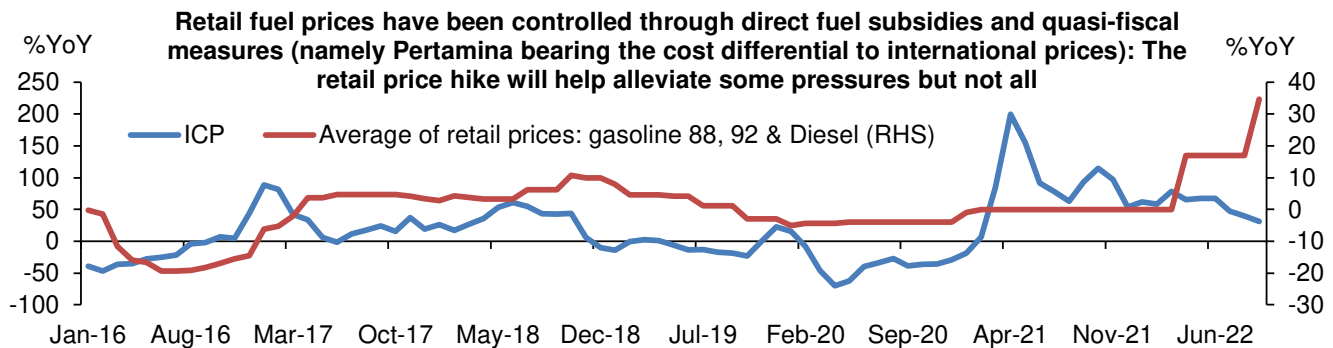


Fuel Prices Hiked

The government pulled the trigger on retail fuel price hikes on 3 September, after hinting that it would in late August. The heavily subsidised 'Gasoline 90' and diesel prices were raised by 30.7% and 32%, respectively. The non-subsidised 'gasoline 92' fuel was raised by 16%. Global Brent oil prices have averaged ~USD104/barrel so far this year, much higher than what was originally anticipated by the government of Indonesia. The government had pegged the domestic equivalent (Indonesia Crude Price Oil) at USD63/barrel for 2022.



Source: CEIC; Mizuho Bank

A Fiscal Necessity

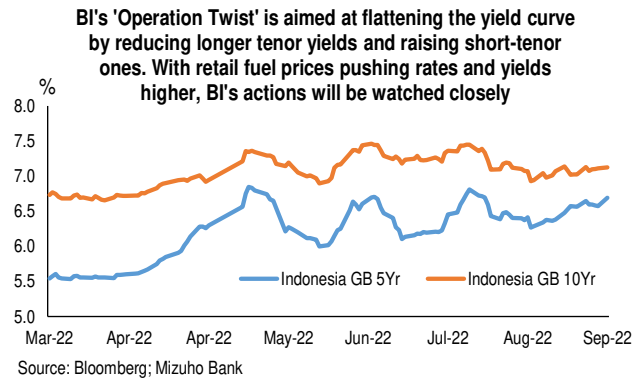
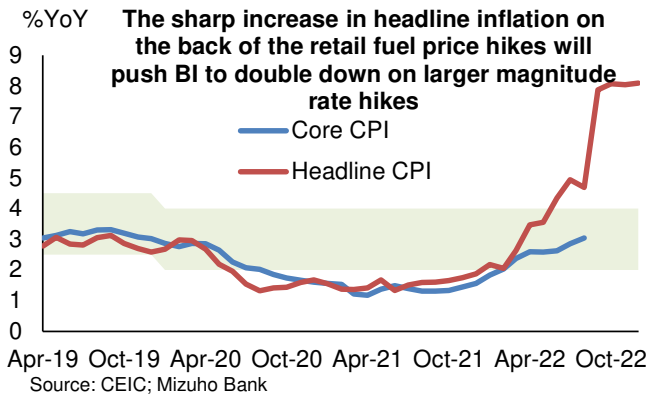
This large gap led to a significant build-up in fiscal pressure. With this in mind, the main impetus for the government to deliver these retail fuel price increases was to reduce the fiscal burden associated with keep fuel prices artificially lower, be in the form of fuel subsidies or quasi-fiscal support via compensation for the State Owned Enterprises of Pertamina and PLN.

But this is not to say that it will bring about a sharp narrowing of the fiscal deficit. In fact, even after these price hikes, the government stated that subsidised fuel remains more than 100% below the cost of production; specifically, ~135% for gasoline 90 and ~105% for diesel. According to FM, Sri Mulyani energy subsidies would be between IDR591trn (3.2% of GDP) and IDR649trn (3.5% of GDP) if global oil prices stayed between USD85-100/barrel levels. As such, the fuel price hikes at this point were essential to prevent even more pressure on the fiscal side.

Given Indonesia's status as net commodity exporter, **it has benefitted from a windfall in revenues which has provided it with some fiscal buffers in the net fiscal deficit equation.** We estimate that much of the revenue windfall will be directed towards energy subsidies and social assistance compensation (see [Mizuho Insights: 8 August 2022: Bank Indonesia's Fast Fading Mirage of Stability](#)). Furthermore, higher energy subsidies distract from essential capital expenditures: the revised 2022 budget details show that capital expenditure allocation was unchanged from the initial estimates. More importantly, disbursement is only at 28.5% in H1 2022 and has fallen 20.7% YoY. **The upshot is that the revised fiscal deficit target of 4.5% of GDP could be met but the underlying details would be far from optimal.**

But Inflationary Build-Up Inevitable Getting Bank Indonesia to Double Down

The most obvious impact of the retail fuel prices will be on price pressures. Taking into account first and second round effects, we expect headline inflation hit 8.0% by end-2022, **taking the full year average to 5.0% from our previous forecast of 4.0%.** With these rapidly building inflationary pressures, **we expect BI to double down on rate hikes.** Now clearly, the easing in headline inflation to 4.7% YoY in August from 4.9% in July is a blip. But with core inflation rising to 3.0% from 2.9% in July, there signs that underlying inflationary pressures will be jolted higher following the retail fuel price hike. **As such, we now expect BI to mitigate against this and hike its policy rate by 50bp at its 22 September meeting.**



BI's 'operation twist' will also be under the spotlight. Under this mechanism, BI will be look to flatten the yield curve by reducing longer-tenor yields (10 year) while allowing short-tenor yields (5yr) to rise. Since the announcement of the policy formally on 23 August, 5yr yields have risen sharply while 10yr yields have been range-bound. With inflationary pressures leading to sharper rate hikes, the risk for BI is that it has to sharp 'lean against the wind' on longer-term yields.

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