2023 State Budget:

A sufficient supply for the rainy days ahead

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Executive Summary

- The government stays true to the obligation to limit deficit below 3% comes 2023, with the 0.4% increase in state revenue coupled with a 4% decline in spending budget would equate to a 2.85% budget deficit.
- The 2023 macroeconomic assumptions may prove to be overly optimistic. The reduced subsidies spending and the prospect of fuel price hike threaten to slow down consumption which the government rely on to achieve the 5.3% growth target in 2023. Stagnating infrastructure spending also lead to reduced investment growth.
- Aggressive Fed rate hikes likely to maintain strong Dollar and sour investor appetite for emerging market assets, depressing the Rupiah beyond the assumed 14,750 level.

- The 2022 state address subsequent to Independence Day celebrations reflect the nation's relative optimism after two years of Covid-19 imbroglio. The president provides a testament to Indonesia's resilience in facing a volatile global environment: relatively low inflation, trade surplus and some populist overtures of the rather behemoth subsidies for fuel, gas, and electricity. This scent of optimism also carried in the proposed state budget, as evident from a 0.4% increase in state revenue coupled with a 4% decline in the spending budget that equates to the rather conservative 2.85% budget deficit; a considerable markdown to the 3.92% deficit expected in 2022. Still, it could not hide the gloomy outlook that the economy would face next year as external headwinds are widely expected to intensify and risks of global economic slowdown become more apparent.

- The proposed 2023 state budget has been crafted on the assumption that the global economy would slow down considerably in the next year. China's imploding property sector adds to the uncertainty regarding global supply chains currently crippled by the rather sclerotic zero-COVID policy and simmering geopolitical tensions. Outlook on the western economies is not very promising either, as crippled supply chains led to stratospheric inflation, shoehorning central bankers to tighten liquidity that snuff out demand for commodities. Cratering consumption has fueled speculation that the Federal Reserve will soon pivot to more dovish policy settings. However, with short and long-term inflation expectations still well above the 2% target, it may be best to assume that the Fed would hold its policy rate at considerably higher levels.

- These are the external conditions faced by the Indonesian economy in the coming year. As we mentioned in the previous report on Q2 GDP, a tight global monetary environment that gives strength to the US Dollar coupled with receding commodity prices is rarely kind to commodity-exporting countries such as Indonesia. Indeed, external pressures are mounting up and the proposed state budget is well-tuned to this scenario. Looking at the revenue side, non-tax revenue is expected to decline by 16.6% compared to the last budget as the government prepares for life when commodity prices return to normal. However, commodity windfall may not evaporate altogether, as the current drought in South China, phasing out of Russia's gas by European countries, and the looming winter may sustain demand for energy commodities such as coal.

Revenue: Taxes take centre stage

- What Indonesia lost in non-tax revenue, may gain in tax revenue. Indeed, domestic economic activities would be relied upon as a source of state revenue growth, supplanting the role of outsized exports and government spending which had been crucial during the COVID-riddled year (***Chart 1***). This leads to the government projecting a 4.8% increase in taxation revenue, driven by the recovering domestic consumption coupled with the reformed taxation system that would unearth more taxpayers. The increase in tax revenue is more than enough to offset the sizable decline in non-tax revenue, and there should be no significant issue for the government to hit the 0.3% projected increase in the state revenue.
- However, the government should not expect for a smooth sail either. For one, domestic consumption is still dominated by essential items, as higher food prices suppress spending on discretionary items that correlates more to the VAT revenue. More ominous is the prospect of adjustment to subsidised fuel prices (more on this later). While a slight upward deviation from inflation will (nominally) increase tax revenues, high inflation will hamstrung efforts to increase consumption in real terms; limit the extent to which domestic consumption can be relied upon to fill the government's coffers (as taxable consumption dried up) and also to support prospects of economic growth in the periods ahead.

Spending: Would it be enough?

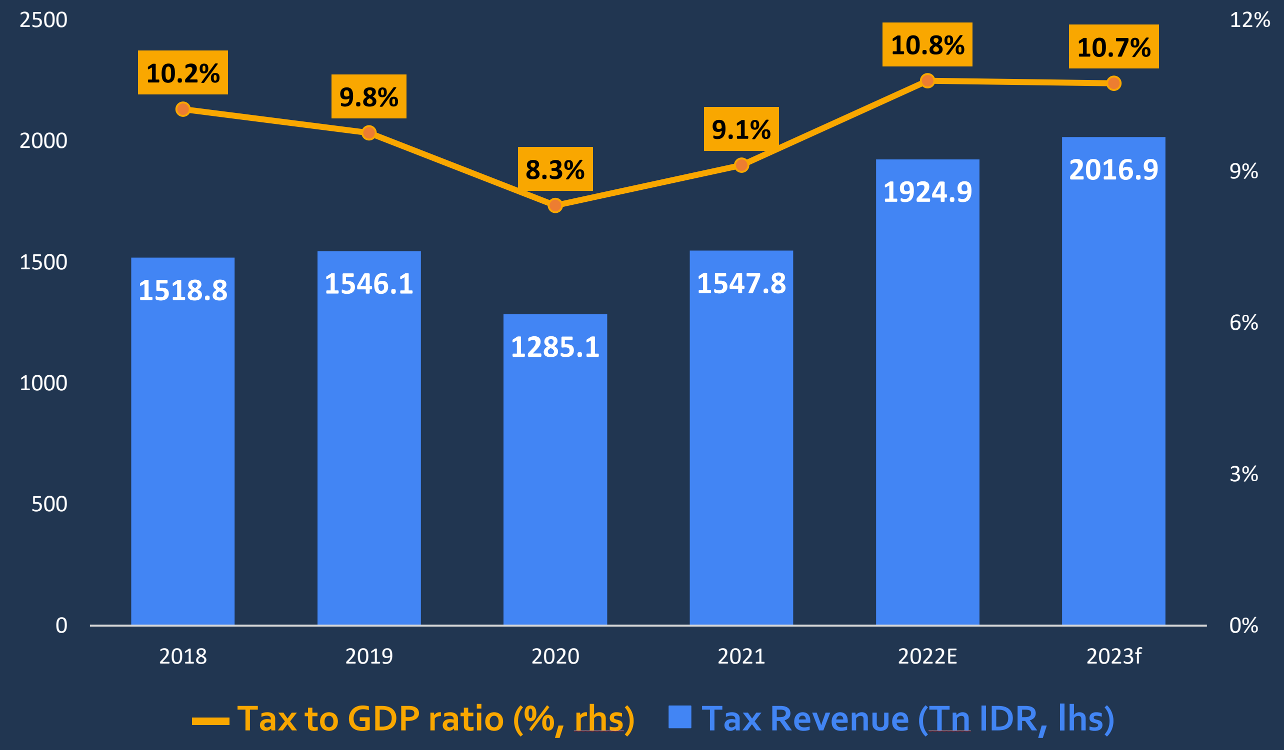
- On the other side of the proposed budget, state spending is set to decline from Rp 3169 Tn to Rp 3041.7 (-4.04%), resulting in a predicted fiscal deficit of just shy of 3% of GDP (2.85%). Much of the reduced spending comes from slashing of Covid-19 related funds and a significant reduction in subsidies. The reduction in subsidies (Rp 165 Tn) will entail a significant hike in retail domestic fuel price as hinted various government officials. The measure by fuel prices increase will subsequently determine the impact on inflation and on consumer confidence. To alleviate the drop in consumption the government boost social assistance (Rp 148.6 Tn,up by 3.4%) and employee expense (Rp 442 Tn, up by 6.24%) (***Chart 2***). While significant fuel hike will hit consumption, the budget will provide some protection especially of the lower and middle classes. This means domestic consumption is unlikely to reach the same growth momentum at of 2022.

- That leaves the rest of the assumed growth will come from business related spending. The government's own capital goods expenditures (Rp 199.1 Tn,-14.4%), outright infrastructure spending (Rp 392 Tn, 7.84%) and state injections into infrastructure related SOEs (Rp 65.8 Tn) will provide some push but it is not enough. Meanwhile gloomy global outlook and reduced domestic consumption is likely to deter investors. Continued slowdown in China will also likely reduce commodity prices, leading to worsening exports and thinner trade surpluses.

Macroeconomic assumptions: Sounds good, may not work

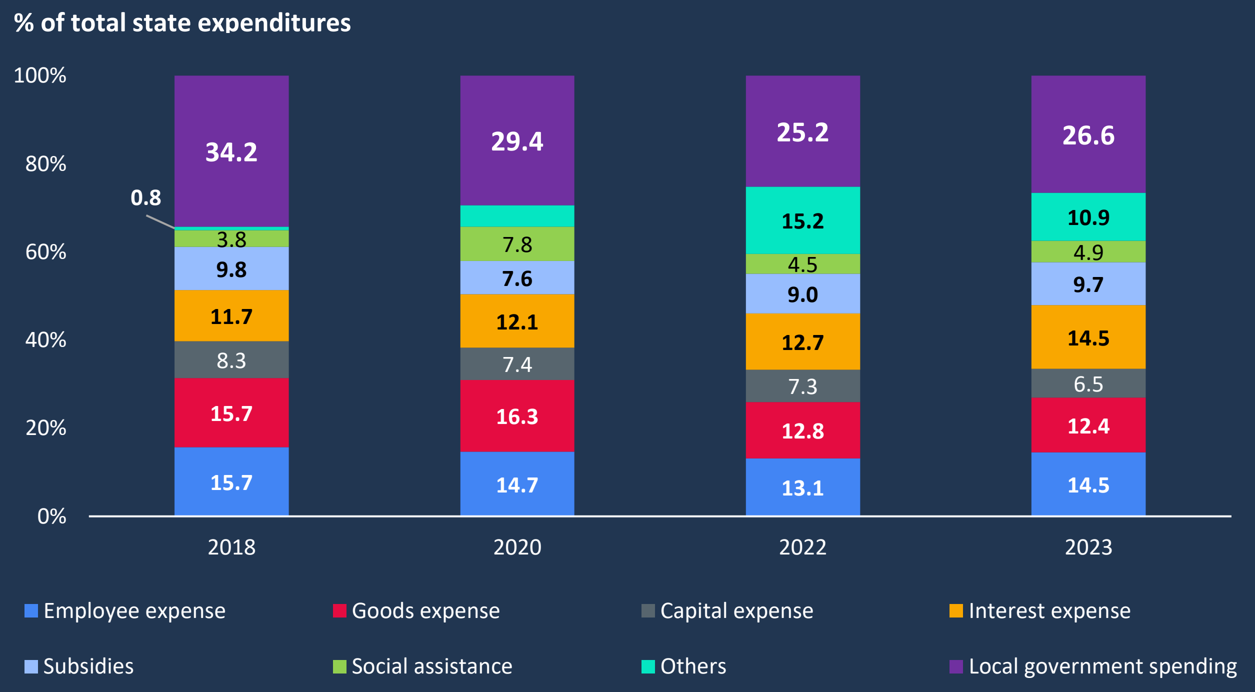
- Not only growth target likely to fall short, but inflation as well. Hike in retail fuel prices coupled with continued global supply chain problems likely to push inflation well above 3.3% assumption in the budget. BI's response of tightening interest rate will further depress economic growth, undermining the assumption which consumption will be instrumental to boost economic growth. Meanwhile the Fed's aggressive monetary stance is likely to defend a strong Dollar, depressing the Rupiah above the 14,750 assumption.
- Another thing to consider is the assumed 7.9% yield on Indonesian government bonds. Indeed, the recent inflow to the domestic bond market has suppressed yield to the lower 7% level despite BI's move to tighten liquidity by gradually starting to sell government bonds. However, the recent inflow is likely a function of the market expecting a premature Fed pivot despite the still-high US inflation may point to the opposite conclusion (continued tightening). Prospects for continued global monetary tightening, coupled with risk-on sentiments due to uncertain global prospects might not fit the government's model which saw yield hover around the 7.9% level. Hence, it is unlikely that all of the macroeconomic assumptions would hold amid the intensifying global pressures, forcing the government to pick 1 or 2 battles that it could win.

Chart 1. The government will rely on taxes to finance its spending as tax revenue have rebounded above pre-pandemic levels



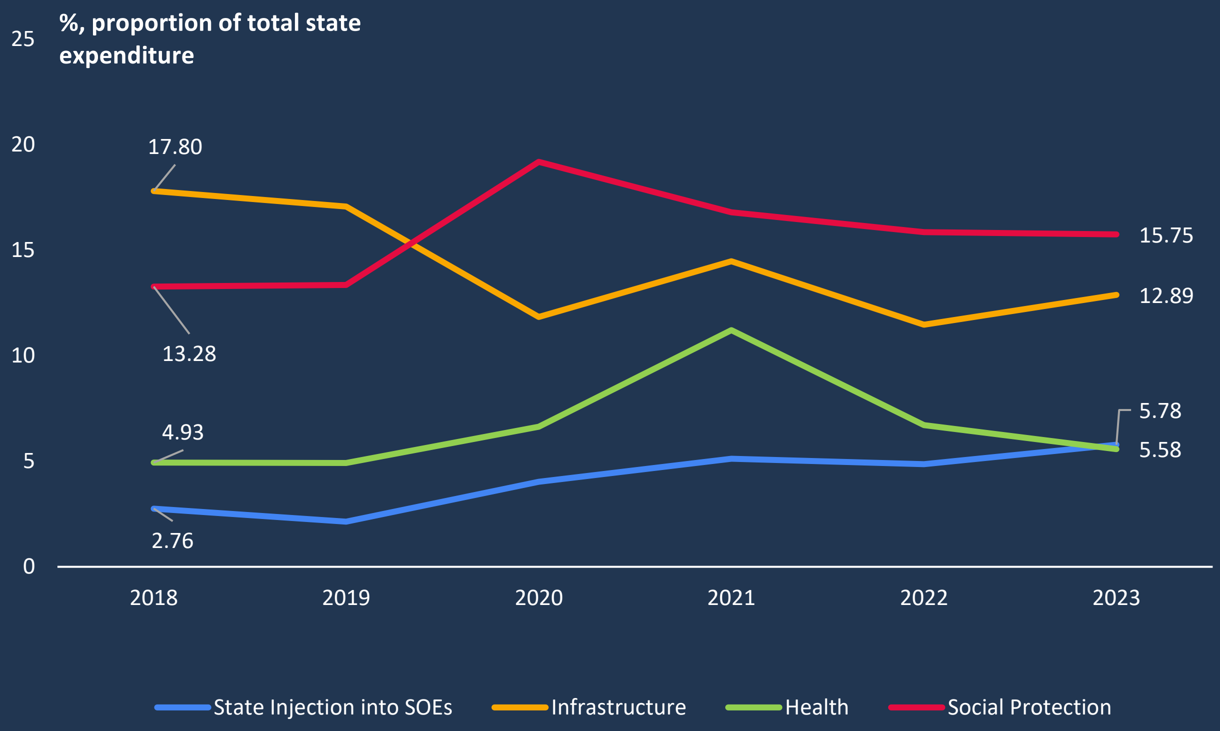
Source: MoF

Chart 2. Increased interest and demand-boosting expenditures may squeeze government's fiscal space



Source: MoF

Chart 3. Capital injections into SOEs would sustain infrastructure spending



Source: MoF

Indonesia – Economic Indicators Projection

	2017	2018	2019	2020	2021	2022E
Gross Domestic Product (% YoY)	5.1	5.2	5.0	-2.1	3.7	5.1
GDP per Capita (US$)	3877	3927	4175	3912	4350	4564
Consumer Price Index Inflation (% YoY)	3.6	3.1	2.7	1.7	1.9	5.2
BI 7-day Repo Rate (%)	4.25	6.00	5.00	3.75	3.50	4.50
USD/IDR Exchange Rate (end of year) **	13,433	14,390	13,866	14,050	14,262	15,070
Trade Balance (US$ billion)	11.8	-8.5	-3.2	21.7	35.3	36.9
Current Account Balance (% GDP)	-1.6	-3.0	-2.7	-0.4	0.3	0.5

** Estimation of Rupiah's fundamental exchange rate

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