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Topics Fuel subsidies resumed in Asian emerging countries in Asia

Fuel subsidy programs resumed in Indonesia and Malaysia against the backdrop of concerns over economic downturn due to the acceleration of inflation and political factors. While the revival of the programs will have a positive impact on the economy, there is a fear that this will cause momentum towards reforms to stagnate.

■ Fuel subsidies have been revived

Asian emerging countries abolished their fuel subsidy programs one after another during the period between 2014 and 2015. However, fuel subsidy programs have been revived in some Asian emerging countries since the spring of 2018. The Joko administration in Indonesia announced in March that it will not raise the prices of gasoline and diesel subject to subsidies until 2019. If the price of crude oil rises, the increase will not be passed onto consumers through higher retail fuel prices but will be absorbed by the subsidy. Meanwhile, the Mahathir administration in Malaysia also announced a plan to resume the fuel subsidy program in May to carry out his election manifesto.

■ Fuel subsidies have both merits and demerits

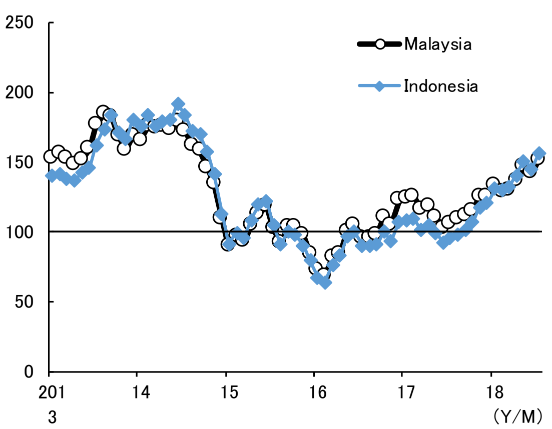
Fuel subsidy programs have both merits and demerits.

On the positive side, subsidies can help to mitigate the impact of a rapid rise in crude oil prices and prevent a decline in consumption due to the acceleration of inflation. Normally, a rise in crude oil prices will boost prices directly through an increase in fuel prices. Based on an estimate using the cases of Indonesia and Malaysia, when the price of crude oil rises by 10%, consumer prices will rise by 0.6% and 0.3%, respectively. Furthermore, an increase in crude oil prices will have ripple effects on many goods and services through the production and transportation processes of products, indirectly pushing forward prices on the whole. Therefore, mitigating a rise in retail fuel prices by means of fuel subsidies is beneficial in the sense of preventing economic downturn.

Meanwhile, the negative side is the burden on public finances. Indonesia and Malaysia used to cover fuel subsidies with their enormous tax revenues from the export of crude oil. However, due to an increase in domestic crude oil consumption in line with economic growth, they can no longer cover the subsidies with tax revenues from the export of crude oil. As a result, owning to the growing budget deficit, negative effects emerged including a shortage in budget in areas necessary for growth such as infrastructure and education.

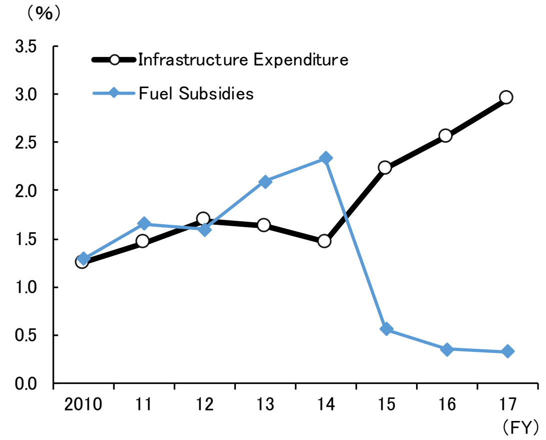
Indonesia and Malaysia decided to abolish their fuel subsidy programs in 2014 and 2015 due to concerns over the negative effects of the subsidies. Firstly, on the back of a decline in crude oil prices, domestic fuel prices in Indonesia and Malaysia significantly dropped, which resulted in less necessity for the subsidies. On the other hand, it became an imminent challenge to reduce the accumulated financial burdens. In Indonesia, since the lack of infrastructure and high logistics costs as a result have been significant barriers for inward direct investment, the government expenditure for these sectors had been anticipated. Also in Malaysia, the balance of public debt had grown closer to the legal limit due to the

＜Each Currency Dominated Crude Oil Price in Malaysia and Indonesia＞



Source : Bloomberg L.P.

＜Infrastructure Expenditure and Fule Subsidies in Indonesia (To Nominal GDP Ratio) ＞



Souece : Ministory of Finance, Directorate General of Treasury, Statistics Indonesia, CEIC persistent budget deficit.

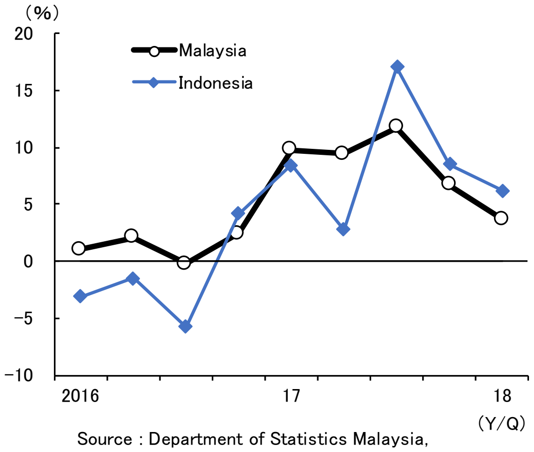
The abolition of the fuel subsidies brought many positive effects. For instance, in Indonesia, the budget that could be allocated to infrastructure development became a trigger to improve the investment climate.

■ What is behind the revival of the subsidies?

The revival of the fuel subsidy programs in Indonesia and Malaysia reflects changes in economic and political circumstances.

Firstly, there have been increasing downside economic risks for the future outlook. In both countries, domestic retail oil prices have been increasing since the middle of 2017 against the backdrop of the rise in global crude oil prices and the depreciation of their own currencies. As a result, there is growing fear over cost-push inflation. Moreover, the momentum of foreign demand that had driven the economy has peaked out. This is why the governments of the two countries started to focus on the control of inflation and the boosting of consumer spending.

＜Real Export in Malaysia and Indonesia (YoY)＞



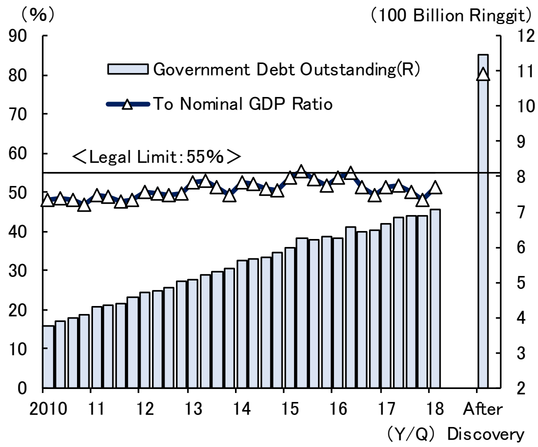
Source : Department of Statistics Malaysia, Statistics Indonesia

Secondly, there have been political aspects. In Indonesia, general elections for the lower house and the presidential election are scheduled in the spring of 2019. The Joko administration, therefore, has been trying to create a favorable situation for the upcoming elections by adopting policies that would appeal to the general public. The situation is similar in Malaysia. After the former opposition led by Mahathir gained political power in the general elections held on May 9, the administration poised the “10 promises in 100 days” and announced the revival of the fuel subsidy program. Both of these moves seem to have been driven by populist factors.

■ Prolongation of the fuel subsidy programs remains a concern

While the revival of the fuel subsidy programs in Indonesia and Malaysia will underpin their economies through the control of inflation, they will put a brake on their economic structural reforms and fiscal consolidation plans. According to an estimate on the impact on fiscal balance for 2019 based on certain conditions, deficits are likely to increase by 0.9 percentage points of nominal GDP in Indonesia and by 0.4 percentage points of nominal GDP in Malaysia. Especially in Indonesia where the impact on the fiscal balance will be significant, infrastructure investment may be reduced substantially. Meanwhile, in Malaysia, the statistical window dressing of public finances by the former Najib administration has been revealed, and it was found that the government debts outstanding had been significantly above the legal limit. An increase in expenditures due to the fuel subsidy program will further increase concerns about government debt among overseas investors.

＜Government Debts Outstanding in Malaysia＞



Source : Bank Negara Malaysia, Department of Statistics Malaysia

Another concern is the risk that the fuel subsidies will become established and prolonged in the future. In light of the reduction in crude oil production in oil-producing countries, increase in geopolitical risks and monetary policy normalization in the United States and Europe, there is a low possibility that crude oil prices will quickly drop as was the case in 2014 and 2015. Therefore, the pressure imposed by the fuel subsidies on public finances is likely to gradually increase. If the fuel subsidy programs become prolonged, the economic structural reforms and fiscal consolidation plans in the both countries will be significantly delayed.

(Yuta Tsukada)

Indonesia *Attention must be paid to downside risks for the future outlook*

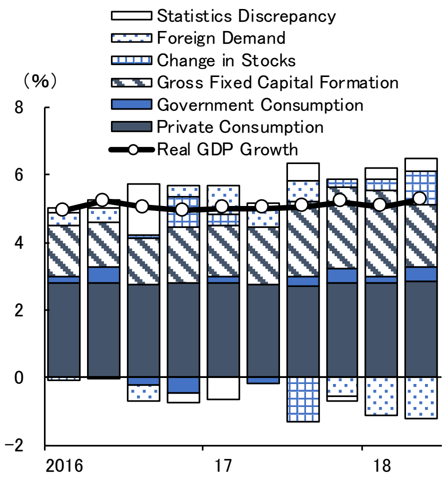
■ GDP grew by 5.3 percent during the April-June 2018 period

Indonesia's economy has picked up. The country's real GDP in the April to June quarter of 2018 grew 5.3 percent, compared to the same period in the previous year, achieving growth at a high level for the first time in four and a half years.

The economic recovery was driven by domestic demand. Positive contributing factors for the growth in private consumption included an increase in public works and a rise in bonuses for civil servents, which resulted in an improvement in consumer sentiment. Government consumption was boosted by an increase in personnel expenses due to the rise in bonuses for civil servants. However, gross capital formation declined over the same period of the previous year from 8.0 percent to 5.9 percent as the rapid increase in the past had run its course.

Meanwhile, the negative contribution of foreign demand to GDP has expanded. However, this is inextricably tied to the recovery driven by domestic demand. Real exports grew 7.7 percent compared with the same period of the previous year on the back of the rebound in the world economy, maintaining a high growth rate. However, the higher growth in real imports propelled by the expansion of domestic demand led to an increase in the trade deficit.

＜Real GDP Growth and Contribution by Expenditures(YoY)＞



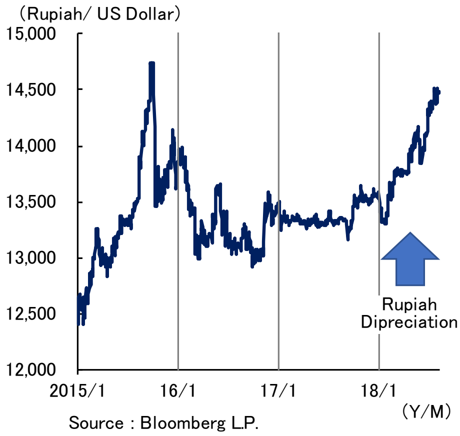
Source : Statistics Indonesia

■ Interest rate hikes and the cheaper rupiah remain concerns

Looking at the future outlook, the traction of domestic demand will likely increase. In addition to the continuing resilience of personal consumption, there are other factors that will likely boost the economy. Since the Asian Games will be held in Jakarta in August 2018, improvement in consumer sentiment and inbound consumption by the teams and tourists are anticipated. Furthermore, as the general elections and the presidential election are scheduled in the spring of 2019, government consumption and private consumption are expected to increase accordingly.

Nonetheless, downward pressure on the economy is also expected to emerge. Firstly, the rise in the inflation rate against the backdrop of the cheaper rupiah will become a factor suppressing private consumption. Indonesia, which depends for many of its consumer goods on imports, is subject to import price inflation. Looking at the exchange rate for the Indonesia rupiah to the U.S. dollar, the depreciation of the rupiah has accelerated since the beginning of 2018 due to the forecast on interest rate hikes in the United States. As the Indonesian government has been increasing expenditures towards the upcoming elections through the revival of the fuel subsidy and the rise in salaries for civil servants, the depreciation of the rupiah is anticipated to accelerate in the future due to concerns over the expansion of the fiscal deficit. Furthermore, such depreciation of the currency and monetary tightening against inflation will produce a headwind for the economy. Indonesia's central bank has already raised its policy rate by 1.0 percent in total through three rate hikes conducted in May and June 2018. The effects of these rate hikes are likely to push down investment and automobile sales gradually after the second half of 2018.

＜Indonesia Rupish Exchange Rate＞



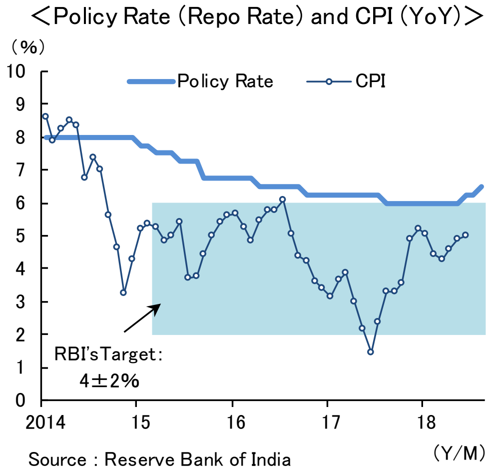
Source : Bloomberg L.P.

As a result, the Indonesian economy will likely face a conflict between upside pressure from domestic demand and downside pressure from the market for the foreseeable future. Indonesia's real GDP growth rate during the period between the second half of 2018 and the first half of 2019 is anticipated to remain flat, hovering around the lower half of 5 percent.

(Yuta Tsukada)

India The policy rate was hiked for the second time this year

■ The policy rate has been raised to 6.5 percent

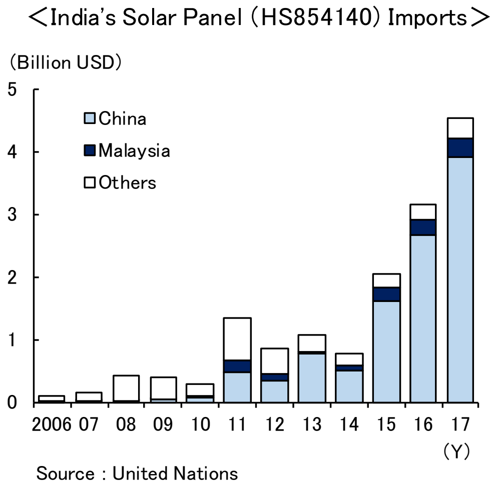


The Indian economy has maintained robust growth driven by consumption and investment. On the back of economic expansion and a subsequent improvement in investor sentiment, the country's representative stock index SENSEX continued to set new records day after day in July.

Meanwhile, as inflation pressure has been increasing against the backdrop of the depreciation of the rupee reflecting the gradual interest rate hikes in the United States and the rise in the price of crude oil, the Reserve Bank of India has been leaning towards the tightening of its monetary policy. The Consumer Price Index has currently been growing by around 5 percent on a year-on-year basis, which is within the inflation target range (4±2 percent) set by the Reserve Bank of India. However, since the margin to the upper limit had been getting smaller, the interest rate was raised by 0.25 percent in June. In addition, inflation risk was heightened after the government significantly lifted MSP (Minimum Support Prices), the purchase price of crops planted during the June-September period, mainly for millet and corn in early July. Subsequently, the interest rate was raised again by 0.25 percent at the monetary policy meeting held at the beginning of August.

As for the future outlook, given the fact that the situation with upward pressure on the inflation rate is likely to continue, the central bank of India is expected to maintain its monetary tightening policy for the time being. However, high inflation significantly exceeding the inflation target range is unlikely by taking into account the following forecasts: 1) the advance of rapid increases in crude oil prices will not likely continue as increased production of shale oil is anticipated in the United States; and 2) the hike in MSP for rice which accounts for a significant portion in production has been limited to around 10 percent. Therefore, it is expected that a similar situation seen in the latter half of 2013 is unlikely where a significant rate hike provoked declines in durable goods consumption and investment.

■ Safeguard duty on solar cells has been introduced



With the aim of responding to the expansion of power demand in line with economic growth without causing environmental burdens, the Indian government has been aggressively pursuing the introduction of renewable energy with a focus on solar power generation. As a result, the import of solar cells has been rapidly increasing since 2015. Amid such circumstances, the government decided to impose a safeguard duty on solar power generational equipment imported mainly from China and Malaysia at the end of July in order to protect local manufacturers and to promote the production of equipment in India by foreign enterprises. However, as the duty is a time-limited measure for two years and the tax rate is scheduled to be lowered gradually after the beginning of 2019, it is unpredictable whether the measure will bring the positive effects expected by the government. Rather, attention must be paid to a risk of significant negative impact such as a delay in the introduction of solar power generation equipment made in China, which is cheaper and higher in quality compared to that made by local manufacturers, and a subsequent rise in costs for electricity power generation and sales.

(Shotaro Kumagai)

China *The economic policy in the second half of 2018 was announced*

■ Priority has been placed on economic stability due to the intensified trade friction with the United States

China's policies for economic management in the second half of 2018 were announced. The major characteristics of the policy can be summarized into the following three points.

＜Policies for Economic Management for the Second Half of 2018＞

Item	Focus Points
Recognition of Current Conditions	It is mandatory to take measures due to significant changes in the external environment.
Target	Maintain the stability of employment through policy measures.
Fiscal Policy	By promoting the policy more aggressively, fulfill more significant roles in expanding domestic demand.
Monetary Policy	Aim to achieve economic stability by implementing adequate monetary easing measures.

Source: News of the Communist Party of China, Website of Chinese Government

The first point is the emphasis on concerns over economic slowdown due to falling exports. Retaliatory tariffs were initiated by the Trump administration in July, and the Chinese side also raised tariffs in response, which resulted in the intensification of trade disputes between the United State and China and an early resolution of which seems unlikely. Under such circumstances, it was recognized that "it is mandatory to take measures due to significant changes in the external environment." In light of the fact that employment stabilization was incorporated into the targets, we can assume that the Xi Jinping administration is most concerned over the plunge in consumption triggered by the deterioration in the employment situation in line with the intensification of trade friction, which will consequently depress the entire economy.

The second point is a further shift in priority of policies from a focus on the economy and structural reforms at the same level to a focus on economic stability. In terms of fiscal policy, it was proposed to aggressively promote the early implementation of infrastructure development through the issuance of special municipal bonds and tax reductions, thus leveraging them to fulfill more significant roles in expanding domestic demand. As for monetary policy, priority has been placed on the securing of liquidity and the achievement of economic stability through additional monetary easing. In fact, China's stance towards monetary policy has been changing as seen in the large-scale supply of funds by the People's Bank of China on July 23.

The third point is that the intention was shown to control side-effects of pump-priming measures as much as possible and to pursue structural reforms at the same time while focusing on the economy. For example, when specific measures for tax reduction were decided at the Standing Committee of the State Council held on July 23, it was made clear that the government will not take economic stimulus measures based on a "pork-barrel policy." It seems that there was a judgement to avoid the negative effects of large-scale economic stimulus packages which occurred at the time of the collapse of Lehman Brothers. At the meeting of the Political Bureau of the Communist Party of China (CPC) held on July 31, "structural reforms of the supply side" and the avoidance of financial risks were raised as key policies for the latter half of the year along with the pump-priming measures.

■ Additional measures will depend on exports

Looking at imports and exports as well as the manufacturing PMI (Purchasing Managers' Index), there have been no signs of economic slowdown yet. Exports in July grew by 12.2 percent from the same month of the previous year, showing greater growth compared to June. While the growth rate declined for exports to the United States, the momentum of exports has been maintained. The manufacturing PMI has stood at a level exceeding the 50-point mark that separates growth from contraction. Orders for exports have not been significantly affected yet.

The stance for future economic management will largely depend on the trend of exports. If exports fall below the previous year's level and downside pressure on industrial production, employment and consumption increases, it will become inevitable to implement additional measures. Growth at around 6.5 percent is mandatory to achieve China's medium-term target of doubling the real GDP in 2020 compared to that in 2010. Therefore, while the current stance is to examine carefully both the economy and structural reforms, should exports continue to decline, the government will likely implement more powerful measures towards the expansion of domestic demand by further reducing taxes for research and development, lowering policy rates and boosting infrastructure investment.

(Junya Sano)