



The **5** Most
Dilemmatic
Trade-offs
in
the **Indonesian**
Economy

Indonesia's Economy at Glance

Indonesia is an emerging market economy, an upper middle income and a G20 member. Its economic value is expected around \$1.3 trillion in 2022, making it the world's 16th largest economy in terms of nominal GDP, with a GDP per capita of around \$4,784.

Indonesia's economic strength stems from its reliance on domestic markets, substantial government budget allocations, and ownership of several state-owned firms. In a market-driven economy, the government also plays an important role in controlling the pricing of major commodities, like rice, fuels, and electricity. The Indonesian and foreign private companies play a larger role in the economy, driving competition in various sectors while navigating the complexities of government regulations.

In the wake of the 1997 Asian financial crisis, the Indonesian economy has shown resiliency since 1999, with growth rates rising to 4-6% in the early 2000s. The year 2020 brought unprecedented challenges as the COVID-19 pandemic led to a recession, causing the economy to drop by -2.07%, the sharpest contraction since the 1997 crisis. In 2022, the economy expanded by 5.31%, a turnaround attributed to the easing of COVID-19 restrictions and a surge in exports, supported by robust commodity prices.

Indonesia poised to become the world's fourth largest economy by 2045. President Joko Widodo's administration envisions a population of 309 million by that year and the economy is expected



to grow 5% to 6% and a GDP of \$9.1 trillion, with per capita income to reach \$29,000. These forecasts are revealing Indonesia's ambitions for significant economic development, underscoring the need for consistent policies to harness its full potential.

Indonesia's location in Southeast Asia provides strategic access to some of the world's fastest growing economies and consumer markets such as China, India, and ASEAN. Indonesia has a large domestic market of over 270 million people, offering significant opportunities for businesses and investors. Indonesia also has a young and growing population, providing opportunities for economic growth and development. With the right policies and investment in education and skills development, Indonesia's workforce could become a significant source of innovation, entrepreneurship and productivity.

Indonesia's path to economic growth and development involves navigating various trade-offs. These trade-offs require thoughtful and strategic decision-making to ensure that the country can harness its potential while addressing its challenges. By carefully managing these trade-offs, Indonesia can work towards a more prosperous and equitable future for its people. At least five of the most complex trade-offs in the Indonesian economy arise from the dilemmas of fuel subsidies vs. fiscal responsibility, global vs. domestic monetary policy, trade liberalisation vs. protectionism, labour market flexibility vs. worker protection, and economic growth vs. environmental protection.





#1 Fuel Subsidy vs. Fiscal Prudence

In Indonesia, a persistent trade-off between fuel subsidies and fiscal prudence has been a central concern for more than five decades, dating back to the 1970s. This trade-off stems from the government's aim to provide affordable fuel prices while at the same time maintaining a healthy government budget for fiscal sustainability. Subsidising fuel can also be politically appealing in terms of popular support, but it puts pressure on the budget, and a trade-off is made that prioritises short-term political gains at the expense of fiscal sustainability.

Fuel subsidies: Indonesia has introduced fuel subsidies to maintain artificially low prices for petrol and diesel, primarily to benefit ordinary citizens who rely on motorised transport for their daily needs. These subsidies are well-intentioned as they aim to reduce the cost of living for the population. However, fuel subsidies come at a significant fiscal cost, requiring substantial budgetary allocations, and putting pressure on public finances.

Fiscal prudence: Maintaining fiscal prudence entails responsible fiscal management to achieve a balanced budget, minimise budget deficits and avoid excessive public debt. Such prudent fiscal policies are essential for long-term economic stability and financial resilience. Reducing or eliminating fuel subsidies can contribute significantly to fiscal prudence by reducing the burden on the government budget and releasing resources for other critical public expenditures such as health, education, and defence.



The inherent trade-off is that fuel subsidies can be politically popular and provide immediate relief to consumers. On the other hand, they impose a significant fiscal burden, potentially leading to fiscal imbalances and higher public debt. The opportunity cost of fuel subsidies is the potential for more productive, effective, and sustainable use of government resources to address various socio-economic challenges and improve the well-being of the population.

This highlights the ongoing trade-off between the short-term benefits of lower fuel prices and the long-term benefits of alternative investments and policy priorities. Achieving this equilibrium requires thoughtful and rational planning as well as a commitment to transitioning towards cleaner and more sustainable energy sources in particularly non-fossil-based fuels, i.e., new and renewable energy like biofuel, solar and wind energy, and etc.

The fiscal impact of fuel subsidies goes beyond the immediate fiscal burden. Prolonged reliance on these subsidies can distort the economy by encouraging excessive energy consumption and discouraging energy efficiency measures. Fluctuations in global energy markets can force the government to allocate more resources to maintain subsidy levels, diverting resources from essential public services or requiring additional borrowing, which in turn can increase interest payments and lead to higher public debt. These complexities highlight the multifaceted challenges the Indonesian government faces in striking the right balance between short-term fuel price relief and long-term fiscal sustainability.





#2 Global vs. Domestic Monetary Policy

As an emerging market economy, Indonesia faces a difficult balancing act in formulating its monetary policy. The country has to consider both global economic conditions and domestic factors to ensure stability, economic growth, and financial resilience. The trade-off between global monetary conditions and domestic policies revolves around the challenge of formulating and implementing effective policies while taking into account external factors that may affect the country's economic stability and growth.

Global monetary policy: Indonesia is not immune to global monetary trends and policies, particularly the influence of global interest rates. When major central banks, such as the Federal Reserve in the United States, raise or lower their interest rates, this can affect capital flows and exchange rates in Indonesia. If global economic conditions, such as rising interest rates in major economies, lead to capital outflows from Indonesia, the central bank may need to adjust interest rates to stabilise the exchange rate and mitigate potential financial instability. But these interest rate adjustments may affect domestic borrowing costs and economic growth.

Domestic monetary policy: Bank Indonesia (BI) is responsible for designing and implementing Indonesia's domestic monetary policy. BI uses tools such as interest rates, reserve requirements and open market operations to control inflation, stabilise the rupiah and support economic growth. A key concern is controlling inflation, as rising prices can erode people's purchasing power.



As a central bank, BI aims to maintain price stability through a target inflation rate, currently set at 2-4%, and plays a role in promoting financial stability and ensuring a healthy banking sector.

Interplay between global and domestic factors: Indonesia's monetary policy is linked to global factors. Exchange rate stability is a case in point. The central bank can intervene in foreign exchange markets to prevent a rapid depreciation of the rupiah, which can result from global capital outflows or changes in investor sentiment. The central bank's ability to set interest rates is also affected by global conditions. For example, if global interest rates rise, BI may need to adjust its interest rates to attract or retain foreign investment while still meeting its domestic policy goals.

Indonesia's dual focus on global and domestic monetary policy must strike a balance between promoting economic growth and ensuring financial stability. BI must remain vigilant to external shocks, such as financial crises or shifts in global investor sentiment, which may affect the country's monetary policy decisions. Fiscal policies, budget decisions and public spending, can either complement or conflict with monetary policy objectives.

To manage the complexities of this dual challenge, Indonesia must remain adaptive and closely monitor global economic developments, while implementing policies that promote domestic stability and prosperity. Balancing these competing demands is essential for the country's continued economic success.





#3 Trade Liberalisation vs. Protectionism

This trade-off is exemplifying the ongoing debate over the right approach to international trade policy. As a player in the global economy, Indonesia is constantly wrestling with the choice between trade liberalisation and protectionism. These two contrasting trade policies have different implications for the country's economic growth, industries, and international relations.

Trade liberalisation: Trade liberalisation involves the reduction or elimination of barriers to international trade, such as tariffs, quotas, and trade restrictions. Indonesia has entered into various trade agreements and initiatives aimed at opening its markets to international competition. This approach can lead to benefits such as increased access to foreign markets for Indonesian exports, a wider variety of goods for consumers, and opportunities for economic growth through specialisation and increased efficiency. Indonesia's participation in regional trade blocs such as ASEAN, ASEAN+1 Free Trade Agreements, bilateral agreements with various countries - such as Japan, South Korea, Australia, and others - and multilateral trade agreements under the World Trade Organization demonstrates its commitment to trade liberalisation.

Protectionism: On the other hand, protectionism is characterised by policies that shield domestic industries from foreign competition. Such measures can include the imposition of tariffs, import quotas and subsidies to protect local industries. Indonesia has at times used protectionist policies to protect key sectors such



as agriculture and manufacturing. The rationale behind protectionism is to promote domestic industries, encourage self-sufficiency and reduce dependence on foreign imports. However, this approach can also lead to inefficiencies, higher prices for consumers and reduced competitiveness in the global market.

The challenge is to strike a balance between trade liberalisation and protectionism. The government must consider the needs and vulnerabilities of different industries. While protecting domestic industries can be essential for national security and job preservation, excessive protectionism can stifle innovation and hinder economic growth. Finding this balance is crucial for Indonesia's economic development and competitiveness in the global marketplace. Policymakers must therefore carefully assess the trade-offs and design policies that promote both domestic industrial health and international competitiveness.

Indonesia's trade policy choices between liberalisation and protectionism reflect a delicate balancing act that requires a distinct approach. The country must continually assess the interests of its domestic industries and consumers, as well as its role in the global economy. Finding the right balance between these two approaches will be crucial for Indonesia's continued economic development and its ability to adapt to the evolving dynamics of international trade. Furthermore, achieving this balance is essential for the country's prosperity and upgraded competitiveness in the global marketplace.





#4 Labour Market Flexibility vs. Protection

Indonesia's labour market operates in a complicated balance between labour market flexibility and worker protection. Striking the right balance between these two aspects is essential for achieving economic growth, social welfare, and employment stability. This briefing outlines the key considerations related to Indonesia's labour market flexibility and worker protection policies.

Labour market flexibility: Labour market flexibility refers to the ease with which employers can hire and fire workers, adjust working hours, and adapt to changing economic conditions. Indonesia has traditionally favoured a more flexible labour market, which can be attractive to companies seeking low-cost operations. It allows companies to respond quickly to market changes, potentially boosting job creation and economic growth. However, this approach can also lead to job insecurity, lower wages and limited access to social benefits for workers.

Worker protection: Labour protection policies aim to safeguard the rights and welfare of workers. Indonesia has enacted various labour laws and regulations to provide workers with job security, fair wages and benefits. These protections include minimum wage laws, limits on working hours, and provisions for collective bargaining. Protecting workers is crucial to promoting social justice and ensuring that workers are not subjected to exploitative practices. Yet, overly stringent regulations can deter companies from hiring and investing, potentially limiting employment.



Indonesia faces the challenge of keeping a balance between labour market flexibility and worker protection. Reaching this balance is key to promote economic growth while ensuring that workers are not subject to exploitation or job insecurity. Policymakers should consider the needs of both employers and workers and design policies that promote a fair and dynamic labour market.

The flexibility of Indonesia's labour market can influence its economic development and competitiveness in the global arena. Indonesia also faces the challenge of balancing labour market flexibility and worker protection to leverage its demographic bonus effectively, promoting economic growth while ensuring that workers are not subject to exploitation or job insecurity. Reaching this equilibrium is vital for harnessing the potential of a young and growing workforce. A more flexible labour market can attract foreign investment, stimulate entrepreneurship, and enhance competitiveness. Still, this should not be at the expense of workers' rights and social protection.

Indonesia's labour market flexibility and worker protection policies are essential components of its economic and social framework. In 2032 members of the productive age group – those aged between 15 to 60 – would comprise majority of the population. Striking the right balance means that new labour market entrants can find meaningful and secure employment. Indonesia's ability to harness the demographic dividend hinges on effectively managing its labour market flexibility and worker protection policies.





#5 Economic Activity vs. Environment

Indonesia faces trade-offs between promoting economic activity and protecting the environment. As a rapidly developing country with abundant natural resources, it must carefully manage these competing priorities to ensure sustainable growth, protect its ecosystems and address pressing environmental challenges.

Economic activity: Indonesia's economy has experienced robust growth over the years, driven by industries such as agriculture, mining, manufacturing and tourism. Economic activity creates employment opportunities, raises income levels, and reduces poverty. The country's vast natural resources, including palm oil, minerals, coal, and timber, have contributed significantly to its economic expansion. However, the pursuit of economic growth often involves resource exploitation and industrial activities that can have a negative impact on the environment.

Environmental impacts: Indonesia's rich biodiversity, including rainforests, coral reefs, and unique ecosystems, is under constant threat from deforestation, pollution, and climate change. Rampant logging, expansion of palm oil plantations and illegal fishing practices have led to habitat destruction and loss of biodiversity. Air and water pollution in big cities and industrial areas pose serious health risks to local communities. These environmental problems have the potential to cause long-term ecological damage and harm public health, making it imperative for Indonesia to adopt a holistic approach to sustainable development.

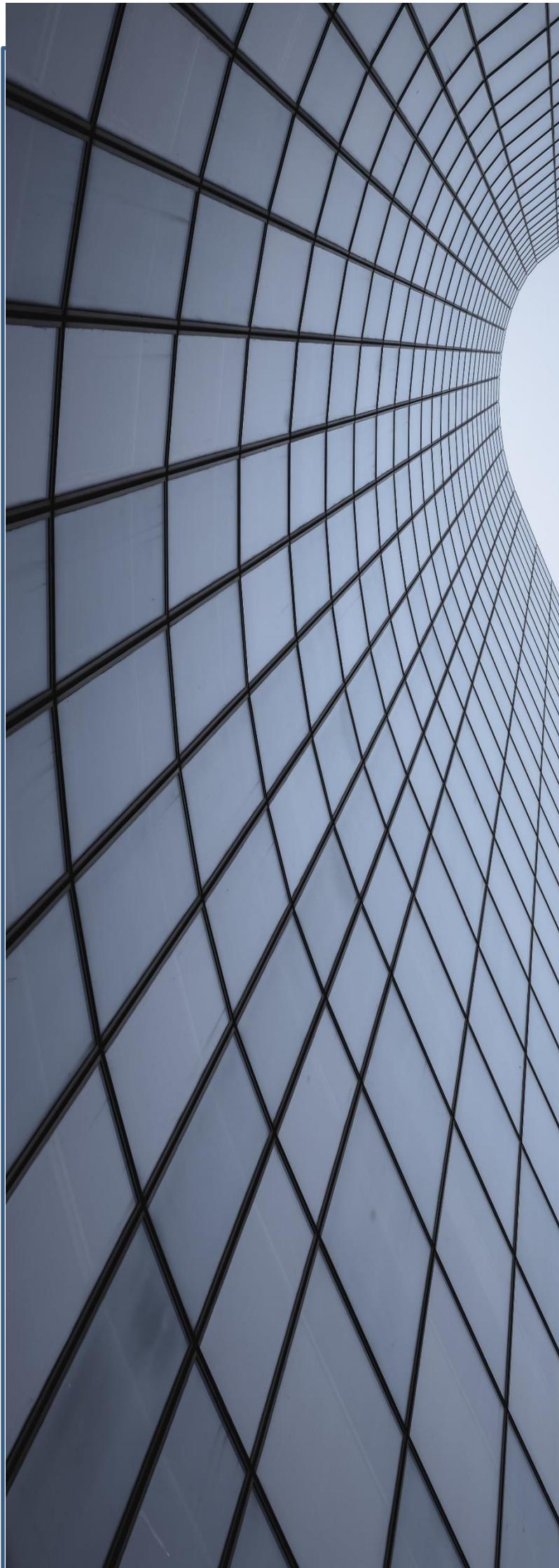


Policymakers must consider the long-term effects of resource exploitation and industrialisation as well as the short-term economic benefits. Achieving this balance requires effective regulation, conservation efforts and sustainable practices that minimise the environmental footprint of economic activities. Striking the balance will ensure a healthier environment and a more sustainable future for all Indonesians as well as contribute to the global efforts to combat climate changes.

Indonesia's environmental policies are also influenced by global concerns about climate change and biodiversity conservation. The country is a signatory to international agreements such as the Paris Agreement and the Convention on Biological Diversity, which commit it to reducing greenhouse gas emissions and protecting its natural heritage. Meeting these commitments while maintaining economic growth will require careful planning and innovation.

Indonesia's trade-offs between economic activity and environmental conservation are complex and multifaceted. Balancing these priorities is essential for the country's sustainable development and the well-being of its citizens. To achieve this balance, Indonesia must implement robust environmental regulations, promote sustainable practices, and invest in technologies that reduce the environmental impact of economic activities. In addition, international cooperation and engagement will play a critical role in addressing global environmental challenges while supporting the country's economic growth.





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