Fuel Price Increase and the Potential Impacts to Indonesian Agriculture

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Background

Fuel price in Indonesia has been subsidised for a long period of time and subject to policy discussion considering its impact to the economy. Relatively low price of fuel has motivated higher consumption of fuel. It creates more traffic, and provides negative impact to the environment. From a welfare distribution point of view, wealthier people enjoyed higher benefit of the subsidy because they consume higher quantity of fuel. Furthermore, this policy has created a heavy burden to the government budget. In 2014, the government spends more than US$59.9 billion to finance the subsidy.

During the course of Indonesian economic development history, fuel price has been repeatedly increased. On 18 November 2014, the new administration of President Joko Widodo, again increased fuel price by 32.1% for premium from US$0.53/litre to US$0.70/litre, and by 37.8% for diesel from US$0.45/litre to US$0.62/litre. The new price of fuel is now closer (only 2% lower) to its economic price. The policy has attracted public reaction which concerns on its impact to the welfare of poor households. This note will briefly outline on the immediate impacts of this policy and the corresponding "compensation policy", particularly those related to agriculture.

Potential impacts and policy responses

The policy is considered to have potential impacts to the macro economy at large, both immediate and longterm. The immediate impact is particularly to the rate of inflation directly by the increase of fuel price itself or indirectly through multiplier effect of the increase of other commodities' prices. Some estimate mentions on additional 2 percentage point of inflation rate in 2014, namely from 5.3% to 7.3%. In the subsequent years, its impact to inflation will decline as the economy finds its new equilibrium point. Another important implication of this policy concerns the development of bio-energy. With the increase of fossil fuel price, the bio-energy sector is becoming more competitive, and provides conducive environments for future bio-energy development.

The second most important impact concerns the welfare of the poorest segment of the population. Since their income is not immediately adjusted to the new equilibrium, their purchasing power is significantly reduced. This aspect has been a subject of political debate among politicians, particularly parliament members.

The corresponding impacts to the agricultural sector is considered not to serious. This is due to the fact that the intensity of mechanization (which uses fuel energy) in the sector is minor, which means that relatively low intensity of fuel energy is consumed in agriculture. Of course in the short term competitiveness of the sector declined due to the increase of production cost along the whole value chains.

Realizing all these potential impacts, the government has formulated a"compensation policy" to those who suffer from the impact and reallocate the saving of subsidy money to more productive spending. Direct cash payment in the amount of US$32.8/household/month is provided to 15.5 million of poor household during the month of November and December 2014. Related to agriculture, some of the subsidy money is used to strengthen national food security (food production), particularly rice, maize, and soybean. This policy innitiative includes: (a) rehabilitation of local irrigation canals covering the area of 1 million hectares paddy field; (b) construction of new irrigation canals covering 3 million hectares of new paddy field, and construction of 30 new water reservoir; (c) increase the availability and quality of subsidized fertilizers and seeds; (d) delivery of 2 million units of mechanical equipment to the priority regions.

Conclusion

At the early stage of the new administration, President Joko Widodo has made an appropriate decision (even though publicly unpopular) to phase out fossil fuel subsidy. The policy has placed Indonesian economy toward healthier fiscal status, and provides better signal on the price of fuel energy to the business community. Even though the negative impact to agricultural sector is relatively small, the sector gets benefit by receiving higher investment, particularly on rural infrastructures. The policy also provides a better incentive to produce bio-energy, including feed stock supplied by the sector such as oil palm, cassava, jatropha, etc.

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