Legally Blunt

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Proposed changes to Bank Indonesia's governing law come at a tricky time

- Reports suggest that Indonesia's parliament is considering sweeping changes to the law governing the central bank. While the bill is not final and not all proposed changes will come to fore, what markets have seen thus far is enough to pose uncomfortable questions about the impact on BI's precious independence and the country's even dearer macroeconomic stability.
- A Monetary Board, helmed by Finance Minister, is to play a leading and instructive role on monetary policy setting. The government could send multiple ministers to BI's MPC meetings, with the right to not only speak but to vote, as well. For good measure, the amendment proposes a dismissal of the current MPC, relegating it to an acting role to be replaced within a year, as and when the law comes to pass – putting BI's credibility on the line.
- The proposal would also entrench the debt monetization scheme that is now supposed to be temporary in nature. Rather than repeated stipulations that BI is not allowed to extend credit to the government as per current laws, BI would be "allowed to offer" temporary funding to the government whenever there is a revenue shortfall. If these are adopted, the benefit of the doubt that market has given to the authorities would be challenged.

Not worth it

There is a saying in Bahasa Indonesia: "*Karena nila setitik, rusak susu sebelanga*." Literally translated, it means, because of one drop of ink, a whole pail of milk turns bad. It is one of those proverbs that schoolkids across Indonesia learn, as a reminder to be careful and not to make even small mistakes, for they can carry huge consequences potentially.

It is probably market's best hope now then that Indonesia's parliamentarians remember that *peribahasa* from their school years, as they weigh a proposal to amend the laws governing Bank Indonesia's workings.

For one, the proposal – covering articles after articles of far-reaching amendments – is more than just a stray drop of ink. For another, a lot more than a pail of milk is at stake here. The credibility that Indonesia's policymakers have built up one painstaking day after another could come at risk and putting its macroeconomic stability on the line.

Articles of faith

As a background, two laws govern BI's workings currently. The fundamental one was passed in 1999 before a 2004 law presented some amendments to it. The timing of the first law means that the travails of the 1997-98 Asian Financial Crisis, as well as the lessons learned, loomed large within it.

For the first time in Indonesia's history, the idea of central bank independence was enshrined legally. Bank Indonesia was to be an independent state institution, Article 4 states, adding that it was free from interference by the government and other external parties. For the avoidance of doubt, Article 9 further stipulated that not only are external parties forbidden from interference of all kinds, BI was required by law to refuse (or plainly ignore) all such attempts of intrusion.

Regarding the setting of monetary policy, BI was given a clear institutional mandate in Article 43, as well. A Board of Governors ("BoG", "Dewan Gubernur" in Bahasa) was set up, acting as the Monetary Policy Committee ("MPC"), to meet and decide on policy at least once a month. While the government could send one or more ministers to air their views (*hak bicara* in Bahasa) in such MPC meetings, they have no votes (*hak suara*).

Even as the 2004 amendment started to set some tentative boundaries to BI's independence – adding a clause on how it is independent "in carrying out its duties and authorities" in Article 4 and inserted a whole segment of parliamentary oversight in a new Article 58A – for all intents and purposes, the notion of central bank independence continued to take root. This is especially because the setup of the MPC – and the lack of government voting rights within – were left untouched.

New board onboard

All these legal barriers preserving BI's independence are now coming unbound, however, potentially, starting from the fundamental article that governs BI's legal status. Article 4 could now be amended to BI having to "**coordinate** with the government in carrying out its duties and authorities," even if they remain "free from interference by **other** parties."

The entire Article 9 preventing interference risk is revamped wholesale, as well. Rather than the emphasis and re-emphasis on no-interference from external parties before in the 1999 Law (and left untouched in the 2004 amendment), a new "Monetary Board" is to be set up. This creation is to "lead, coordinate and instruct monetary policy in line with general government economic policies."

While the governor and senior deputy governor of BI have seats on the 5-person board, it is to be presided by the Finance Minister of the day. If the board cannot reach consensus on policy action, presumably because the central bank sees things differently from the government officials in it, the BI governor can "raise the opinion" to, of all places, back to the government – without stipulation on what happens thereafter. Such inherent bureaucratic circuitousness would have made Kafka snigger, perhaps.

The more the merrier?

In and of its own, the establishment of the Monetary Board could have diminished the existing structure of Bank Indonesia's Board of Governors in its authority to set the monetary policy course already, given that its stipulated leading role and its helming by the Finance Minister. For good measure, however, the workings of BI's Board of Governors could come to be challenged too.

Under the proposal, Article 43 will be amended to say that the BoG/MPC meeting is **to be** attended by (rather than **can be** attended by, with the drop of the word "*dapat*" in the current law) by government ministers. They will now have the right not just to speak but also to vote (possessing both *hak bicara* and *hak suara*). Given that the number of ministers attending the meetings can be sizable, since the amendment stipulates the presence of the Finance Minister as well as **one or more** economics-related ministers, their voting rights could counter the 5 BI officials sitting on it now.

On paper, the MPC decision is to be undertaken by consensus (*musyawarah* and *mufakat* in Bahasa). However, in practice, the granting of voting rights to potentially numerous government officials in the MPC would be extremely hard to square with the preservation of central bank independent policy decision making – even if we put aside the super-arching role to be played by the new Monetary Board to begin with.

All change?

To be sure, there does not appear to be any proposed amendment to Section 3 of the Article 43 of the 1999 Law, which states that if no consensus is reached in the MPC, the Governor makes the final decision. However, as we dug deeper into the weeds of the proposed amendment and contrasting them with the respective articles in the existing laws, something else struck us.

That is the proposed change to Article 75 on the make-up of the MPC itself during the transition period from one governing law to another. During the adoption of the 1999 Law, the MPC members were dismissed (because they were appointed under the then-newly defunct law no. 13 of 1968) but were immediately reappointed under the new stipulations, such as the 4-year term limits imposed by the incoming law.

Fast forward to now, domestic reports on the amendment proposal signal that the same article could be amended. As per the previous transition, the board members would be terminated, given that their appointments were made under the would-be-defunct law. However, instead of being reappointed immediately, they would merely be subordinated into an acting capacity, for at most one year, until the president nominates a new board with a 5-year term limit.

The set-up is such that it will be easy to imagine that the market will be less unreservedly accepting of the technocratic competence and independent-thinking quality of any newly appointed board members. If that occurs, it could challenge for the level of confidence that market players have on the well-regarded institution.

The notion of policy and institutional continuity could also come under scrutiny, potentially speaking. The text of the proposed Section 1 of the article almost suggests that, as it stands, the current suite of leadership in BI would have no place in the new BI. It says that "Considering that the change in monetary policy is very fundamental in nature, a change in the board of governors is needed."

More responsibility but less authority

All in all, if the changes to the legal standing, inner workings, and leadership structure are made wholesale as per the proposal, the authority that the central bank has in carrying out its duties could be considerably impacted.

Rather curiously – again, assuming all the reported changes are adopted – the diminished authority for BI also comes at a time of increased responsibilities.

For one, rather than the singular objective of achieving and maintaining Rupiah stability, BI is to "improve economic growth and employment creation", as well. Instead of the inflation-targeting framework that it has now, BI will have to pay attention as well to growth and labour market targets too.

Already, as it stands, there are times when it feels like BI has to pursue quite a few sometimes conflicting goals that arise from the fact that it has to maintain rupiah stability while keeping an eye on inflation, as well.

On paper, the two go hand-in-hand. After all, partly because of the relatively high import content of domestic consumption and business investment, a stronger rupiah would have resulted in lower inflation – and policy rates could be lowered without jeopardizing either currency or price stability.

In practice, however, there have been episodes including in this year whereby inflation can be low at a time when rupiah volatility is high due to global events outside of BI's control. In such cases, BI has had to tread gingerly in terms of cutting rates (to take advantage of the space offered by low inflation) but not doing so too quickly (to avoid exacerbating currency volatility).

Plugging the gaps

To add even more objectives and targets to BI's sometimes-tangled KPI list is not going to help matters. It will be akin to asking the little Dutch boy to plug more fingers in the multiple holes of a leaky dike – at a time when his hands are getting tied behind his back.

This is not to say that the new objectives of egging on growth and creating jobs are not important. They are especially front-and-centre at a time when the pandemic has caused the economy to shrink by the most since the Asian Financial Crisis.

However, BI has already cut interest rates considerably, and ramped up its purchases of government bonds – be it via primary and secondary markets and now directly – helping to anchor government bond yields. If the economic contraction and job losses are painful even with the relative stability in bond yields (and in currency and prices on top of that) that BI has helped to engender, how much worse would it be if BI has not been there to help?

When one-off becomes always-on?

Another unsung aspect is the fact that BI's repeated reassurances that the debt monetization move that it has undertaken with the government thus far is a one-off – a point that has thankfully been echoed by Finance Minister Sri Mulyani – is also a key plank in preserving market confidence through a period when more and more untraditional ideas take root.

Thus far, the market has given them the benefit of the doubt, and appears to have bought the idea that the temporary measures needed to tide Indonesia through extraordinary times that we are in now would not become entrenched.

That notion, however, may come under challenge under the proposed amendment. For one, the new Article 55's Section 5 could be changed to prolong debt monetization. Without specifying the trigger criteria, it says that "Under specific economic conditions, BI can purchase coupon-less government bonds at a discounted price that is agreed with the government."

Moreover, compared to the outright prohibition for BI to extend credit to the government under the existing Article 56, the proposal would amend it to "BI is allowed to offer temporary funding to the government due to a shortfall in government revenue." If passed, the two amendments could therefore entrench the deficit-financing mechanism in a long-lasting law, rather than the temporary government regulation in-lieu of law umbrella that it operates under now. In other words, it might just throw the one-off assurances to the wind.

Already, we have cautioned about how a clear exit strategy from the ongoing debt monetization move is crucial. Indeed, we noted in our July 7th report that "Having such restriction ex ante would also limit the domestic pressure for the government to continue using such financing scheme to deal with other forms of expenditure in the future."

Rather than steadfastly exiting from debt monetization at some point, the amendment means that there is potentially a scenario in which the authorities could be adding to it. This could have considerable implications on inflationary pressure down the road, right when BI's traditional power to fight it via an independent decision to raise interest rates and such could become extremely encumbered. That is not encouraging.

Saving grace?

As the news about such amendments circulated, market has reacted with some understandable caution. Even set against a backdrop of weaker US dollar overall yesterday, for instance, BI reportedly had to step in to intervene to prevent rupiah from weakening against the greenback. There is some hope that the potential adverse market reaction would compel the parliamentarians to judge the merits of the amendments more carefully.

Already, a member of the parliament's Commission XI that oversees finance and central bank matters was quoted as saying that "In times of recession and pandemic crisis, the market needs more cues of stability than shock therapy."

The process of turning a bill into a law can take some time as well, allowing for more consultations with various parties. According to a member of the Legislation Committee – which submitted the proposal – the process may need a year or two. He is further quoted as saying that even though the president can enact specific changes more quickly by issuing decrees, he is in favour of letting the parliament decide for now.

Overall, the scale and extent of the pandemic damage have obviously been extraordinary and have required equally extraordinary remedial policies. Indonesia has navigated through such uncharted waters like other countries the best way it could. Ultimately, one key lesson learned from its experience in handling previous crises, including from the 1997-98 upheavals, is that the strength of institutions matters, including in the setting of the monetary policy.

The laws of 1999 and 2004 governing Bank Indonesia now may not be perfectly in tune with the evolving needs of the country, but by instituting various levels of challenges to its independence, the proposed amendments could uproot the very bedrock of macroeconomic stability that the country has achieved thus far – one that it crucially needs to ensure a solid footing for the recovery path ahead.

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