Indonesia

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Not-so-Free Money

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A look at Indonesia's new deficit-financing scheme

- Virus cases are still going up and economic momentum is still going down. Indonesia is facing such a challenging period that its president has openly and passionately berated his cabinet for failing to grasp the sense of crisis that the country is in and for operating as if it is still business as usual.
- The last point is not as fair, however, if we consider how much out-of-the-box thinking has gone in the fiscal space. As if suspending the 3% deficit-to-GDP limit and getting Bank Indonesia to purchase bonds in the primary market were not offbeat enough, there was some serious discussion to fully monetize part of the deficit, with BI buying government bonds at 0% rate.
- As it turned out, good sense prevailed in the end. Although BI will cough up almost USD40bn, the interest rates will be tied to BI reference rate rather than floored all the way at 0% for some portion. Crucially, reassurances that the scheme is one-off should limit the perception risk of an ever-generous central bank financing an ever-profligate government spending, as well.

Sharing is caring

Indonesia's parliament had been weighing a burden-sharing agreement between the government and the central bank. This was ostensibly to minimize interest cost burden at a time when fiscal deficit has been repeatedly adjusted upward, to now 6.34% of GDP.

During the course of the discussion, Bank Indonesia was slated to finance as much as IDR574.4tn (~USD40bn) of government's stimulus measures. Indeed, a chunky portion of that, IDR 397.6tn (~USD27.5bn) that is meant to fund health care, social protection and financial aid to regional governments, may be pegged at an interest rate of zero percent. The others will be floating alongside BI reference rate at 0-1ppt discount.

Money from?	Money to?	Amount		Interest Rate Scheme	
		in IDR tn	in USD bn equivalent	As Initially Proposed	As Finally Agreed
To be financed directly by Bank Indonesia	Health care, social protection, support for regional governments	397.6	27.5	0%	4.25% (Floating, at BI rate)
	SMEs	123.5	8.5	3.25% (Floating, at BI rate minus 1%)	BI to cover 1% + the gap between BI rate and market rate. Government to cover the rest, i.e. 1% less than BI rate.
	Non-SME corps	53.4	3.7	4.25% (Floating, at BI rate)	
To be financed by the Ministry of Finance	Others	329.0	22.8	Market Rate	Market Rate

Source: OCBC, Bloomberg.

As it turned out, the interest rate framework of the financing scheme was amended in the final version to something a lot less radical – limiting the concerns that market might have about outright "cost-free" debt monetization.

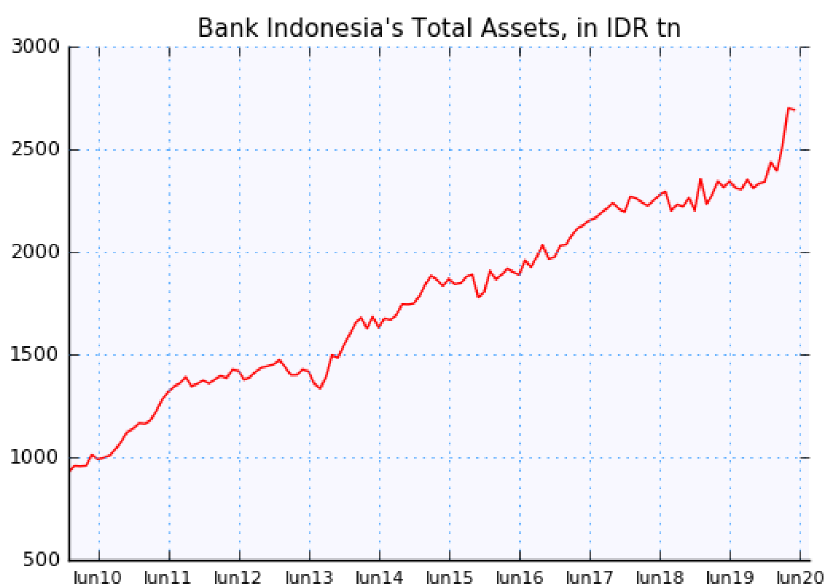
For instance, for the biggest portion of the burden sharing mechanism on social spending, the interest rate is no longer floored at 0% as previously feared. Instead, it will be tied to the BI 7-day reverse repo policy rate which is currently at 4.25%.

For the remaining portions involving BI financing amounting to IDR176.8tn (USD12.2bn) that are meant to help businesses, BI will be liable to cover some part of the costs. Assuming a market rate equivalent to the 10-year yield of 7.25%, for instance, BI will be covering 4 percentage points of the interest rate, while the government's portion is fixed at 3.25 percentage points. (See table above for details).

Tradable = Flexibility

Importantly, under the agreed-upon mechanism, the instruments at hand will be tradable. Given that were talks about how such instruments should not be made tradable, the final outturn is a plus in terms of operational flexibility for the central bank.

Such flexibility is important in terms of limiting the potential impact that such financing mechanism might have on inflation, as well. The new agreement would allow BI to use these bonds in its monetary operations, including selling them onward to banks to withdraw liquidity from the system in sterilization operations as needed.

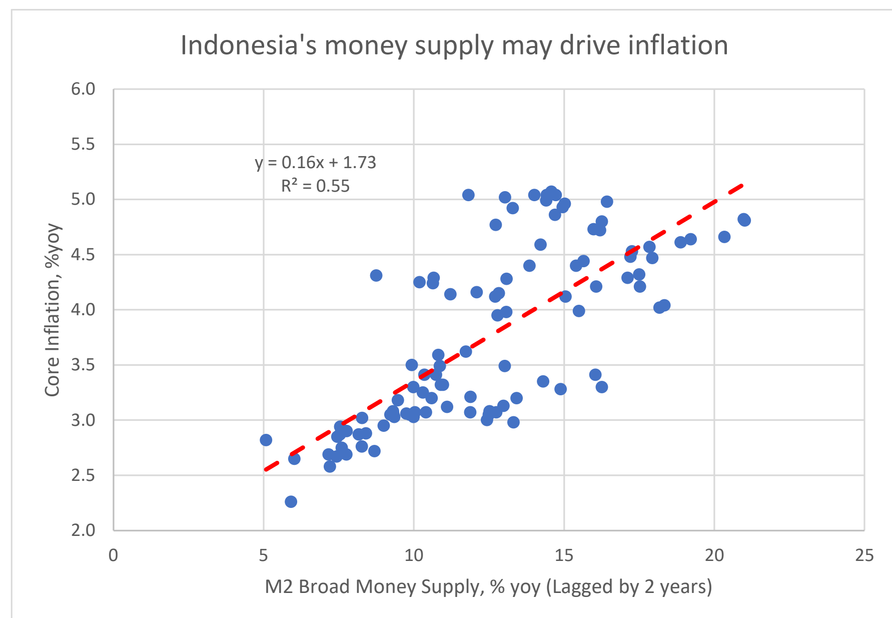


Source: OCBC, Bloomberg.

Inflation Prospect

At a time when demand is low and prices are on the decline, talking about the prospects of inflation risk may seem misplaced. Still, given the considerable amount involved in the monetization scheme – which would increase the balance sheet size of BI by over 20% – we cannot be too complacent about the risk of inflation risk down the road.

Indeed, as much as a big part of fiscal stimulus in general is indeed to encourage economic growth by pumping money through the system, judging from history, any marked increase in broad money supply (M2) has a tendency to lead to inflation uptick in Indonesia, albeit at a considerable lag. Looking at the data since 2012, for instance, one strong predictor of core inflation trend in Indonesia is the growth in M2 two years before.



Source: OCBC calculations, Bloomberg data.

Hence, as much as inflation may seem like a distant thing from where we are now, a prudent BI would want to watch for any stronger-than-expected transmission from its balance sheet expansion towards the broad money supply to ensure that the inflation anchor that it has established over the years is not at risk. To that end, the utilization of sterilization measures – that the tradable nature of the bonds allows – to withdraw liquidity when necessary will be crucial.

Legacy Issue

The feature will also prevent such bonds being ‘stuck’ on the books for a long time, akin to the series of bonds that the government issues to BI in the aftermath of the Asian Financial Crisis as part of bank deposit guarantee and recapitalization initiatives at that time. Going by BI’s annual financial report,

as of end-2019, more than IDR140tn of the so-called SUP bonds – that were made non-tradeable and non-transferable – remain on BI's balance sheets, after more than 2 decades.

Indeed, the presence of such bonds may have inadvertently given rise to the misplaced notion that BI has "gained" from buying government bonds at "high" (i.e. market) interest rates in general.

Like other central banks, BI is mandated to transfer some operational surplus back to the government on an ongoing basis, apart from tax payments. In Indonesia's case, in the event that BI's capital ratio reaches 10%, it is bound by its founding act to transfer the remainder to the government. Essentially, after accounting for prudential reserves, the government would have received back any interest payment it has made to the central bank anyway.

However, because the legacy bonds are still on BI's books, any surplus that would have been transferred back to the government goes into paying down these bonds instead. The absence of an active reminder that any 'profit' from BI would have circled back to the government anyway on annual basis may have unwittingly contributed to the political compulsion for BI to buy the latest government bonds at sub-market price or even 0%.

Hence, viewed from the medium-term lens of not having even more government bonds that it cannot unwind, allowing BI to eventually be able to transfer operating surplus back to the government once more to avoid future misunderstanding, the tradable feature of the new bonds is another undoubted plus. To be sure, it does not appear that BI will have the immediate need to unwind these bonds in the near term, but having the flexibility to do so is a good thing.

No slippery slope

Going into the announcement, there had been some market concerns that the debt monetization move might only be the tip of the iceberg, with potentially further occurrence of such burden sharing mechanism once the initial one goes through.

Hence, the commitment by the government, with Finance Minister Sri Mulyani saying that the mechanism is a one-off should go a long way in minimizing the potential for market misunderstanding that this may just be the beginning of a slippery slope towards ever-looser fiscal stance for ever-broader spending needs.

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. While the extraordinary times that we live in compel the government to step in for justifiable humanitarian purposes, there might be concerns that, once such a tap is open, it could have theoretically also led to calls for BI direct financing for other areas.

Cost without benefit

Overall, with talks about the debt monetization scheme floating around int he market for the past few weeks, now that the terms and financing mechanism are ironed out and agreed upon by the relevant authorities is in itself a good thing, as it removes an overhang on market sentiment.

The fact that the more radical elements of the proposal, such as 0% interest rate on a good chunk of the bonds, did not make it to the final round is a bonus, and should lead to a net improvement in sentiment towards Indonesian assets in general. Indeed, the sovereign bond has rallied at the time of writing, with 10-year yield dropping below 7.2% partly because of the easing of supply concerns as well.

To be sure, with covid-19 cases yet to plateau and economic momentum yet to pick up forcefully, the roster of challenges facing Indonesian policymakers remain hefty. Indeed, now that the funding mechanism for the various stimulus measures is settled, the authorities should turn their full attention to implementing them. Given that the disbursement rate of some the measures remains abysmally low – just 1.5% of the health budget has been disbursed thus far, reportedly – there remains plenty to do.

Without a more forceful disbursement pipeline to pass on the actual benefit of stimulus measures, Indonesia would have been incurring the cost – both tangible in terms of interest payments and intangible in terms of market uncertainty surrounding the funding mechanism – for nothing.

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