Fiscal issues and central banks: Indonesia's experience

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1. Indonesia's recent fiscal experience

Prior to the economic crisis, Indonesia had a good track record of fiscal prudence. For three decades, the government had avoided financing its deficits through money creation or government debt, relying instead on external concessionary financing. This ensured domestic financing was available to the private sector and inflation was kept in check.

The severe economic crisis in 1997 left the Indonesian government with a huge amount of debt, primarily due to the recapitalisation of the banking system, which cost about half of annual GDP. In addition, the burden of servicing the external debt rose sharply due to the rupiah's depreciation, and to a lesser extent some increase in foreign borrowing. Total government debt, both domestic and external, rose from 25% of GDP at end-1996 to 102% by end-2000. This large debt burden has threatened Indonesia's economic recovery and put fiscal sustainability at risk.

In response, the government has set two strategic objectives for the budget: reducing the ratios of the deficit and total debt to GDP. It intends to optimise domestic tax and non-tax revenues, improve the efficiency of public expenditure, decrease subsidies and reduce reliance on external financing.

Some encouraging progress has been made. Notwithstanding some revised assumptions, most importantly about GDP growth, inflation and interest rates, and the economic fallout from the Bali bombing, fiscal policy is back on track, with the fiscal deficit for 2002 estimated at 1.7% of GDP, well below the 2.8% in 2001.

Total revenue in 2002 of around IDR 300 trillion was about the same as in 2001. However, compared to GDP, revenue in 2002 (18% of GDP) was lower than that of 2001 (20% of GDP). The government continues to intensify tax collection and expand the tax base in terms of both the number of taxpayers and the types of taxable income. The government lowered its spending relative to GDP, mostly by cutting central government routine expenditure. The major component of current expenditure remains interest on public debt, which consumes 5.6% of GDP. This is less than the 6.0% of GDP in 2001, as interest rates eased and the rupiah strengthened.

2. Fiscal positions in the medium term

The effort to safeguard fiscal sustainability continues. Parliament has agreed to a budget deficit of 1.8% of GDP for 2003 and a balanced budget in 2004. Budgetary subsidies should be phased out by 2004. Over the longer term, the government is committed to lowering debt to below 60% of GDP.

Almost all domestic debt takes the form of bonds issued for the bank recapitalisation programme and promissory notes issued to the central bank (Bank Indonesia, BI) to cover BI's liquidity support to ailing banks and financing bank liabilities under the guarantee programme. Most government bonds will mature during 2004-09. The main concern of domestic debt management is to smooth out the maturity profile of bonds coming due in 2004-09 to a new series of bonds maturing in 2010-20. This has been facilitated by parliament passing a law in September 2002 regulating the rescheduling of the bank recapitalisation bonds. The law also allows the government to issue domestic debt instruments in order to finance the state budget. The government is also reducing outstanding debt through a

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buyback programme financed by proceeds from asset disposals by the bank restructuring agency, proceeds from privatisation and divestments and direct swaps for the restructuring agency's loan assets. The government has also worked hard to develop a liquid and active secondary bond market so that optimal debt portfolio management can be achieved in the future.

The government has strengthened cooperation with the central bank to help achieve monetary stability (low inflation rate and stable exchange rate). Given its interest-sensitive debt, the government seeks lower interest rates. Under a burden-sharing agreement between the government and BI, in line with the recommendations of the independent team headed by Mr Volcker, a large proportion of government promissory notes were finally converted into perpetual notes with zero interest. So far the government has issued IDR 228 trillion of promissory notes to BI, of which IDR 159 originated from liquidity support given to banks during the crisis to prevent the collapse of the payment system. IDR 25 trillion of the cost will be borne by BI.

Measuring the fiscal position and assessing sustainability

The current central bank law gives BI the sole objective of achieving and maintaining the stability of rupiah value. Given the strong implications of the budget for monetary policy, the central bank should coordinate with the fiscal authority.

The most relevant measure of the fiscal position for the central bank is the impact of fiscal conditions on base money, as this serves as the operational target. Under the current monetary targeting framework, the impact of fiscal policy is divided into three main channels: (i) maximisation of revenues, mainly from tax; (ii) reduction of expenditure by cutting either routine expenditure such as subsidies or development expenditure; and (iii) financing of the deficit.

Assessing fiscal sustainability is also important for the central bank. Steps taken by the government to achieve fiscal sustainability will affect the central bank's monetary policy objectives. For example, the government may insist that the central bank maintain low interest rates or may ask the central bank to fund the budget deficit.

Fiscal sustainability means that the government can repay its debts in an orderly way without resorting to extraordinary measures. Simple measures of assessing sustainability include whether GDP is growing faster than debt, GDP growth exceeds the domestic real interest rate, export growth exceeds the external real interest rate and depreciation, and the money base is growing faster than GDP. As long as these conditions are met, the debt/GDP ratio will eventually decline. The central bank can assist fiscal sustainability by maintaining relatively low interest rates to encourage economic recovery and lighten the government's interest burden without sacrificing monetary objectives.

Constraints on the provincial fiscal position

The legal basis for decentralisation in Indonesia is provided by laws 22/1999 and 25/1999, which emphasise the devolution of authority from the central government to districts and municipalities. Previously the provincial government was the second most powerful level. Now provincial governments serve only as the representatives of central government in the region and will handle inter-district affairs while the bulk of spending authority is devolved to the local governments.

The law allows local governments to borrow from external sources: central government, financial institutions, other local sources and foreign institutions (bilateral or multilateral). Local governments can borrow either long- or short-term, but long-term debt (maturity over one year) can only be used for development projects, not to meet cash flow problems. However, due to the current national debt problem, a presidential decree has been issued to halt the borrowing by local government.

Government regulation 107/2000 sets out a three-part rule on local government borrowing:

- total amount of principal local debt repayment in any fiscal year should not exceed 75% of the local general revenue in the previous year;
- debt service coverage ratio (net revenue less non-discretionary expenditure divided by total amortisation and interest payments) is projected to exceed 2.5 during the borrowing period;
- short-term borrowing is less than one sixth of the local budget and has to be fully paid back by the end of the year.

The borrowing proposal must be approved by the Ministry of Finance and the local parliament.

Improving fiscal discipline and fiscal rules

The central bank law prohibits BI from buying government bonds in the primary market. In any case, no government bonds have been issued to fund budget deficits. The government bonds were issued to recapitalise banks and replace liquidity support by the central bank. To enhance market confidence, the government explicitly allocates about one fifth of the budget to paying interest on domestic debt. On the financing side, the government will issue some new bonds to replace maturing debt as indicated in the National Development Programme. In addition, as mentioned above, the government is extending the maturity of some bonds.

As in most countries, the government is required to submit an annual budget bill to parliament. Since 1997, the government has not been able to leave any revenues or expenditure off the balance sheet. As well as the amounts of money involved, the bill must also indicate the fiscal strategy and the underlying macroeconomic assumptions. If the assumptions are revised, an amended budget bill must be submitted. As a long-term guideline, the budget deficit and spending are controlled through the National Development Programme Act 2000-04.

Fiscal sustainability can be accomplished through either raising taxes or cutting spending. Cutting spending will help ease demand pressures while reducing subsidies for petrol will affect the supply side and eventually create inflation. Other examples of major government policies that influence inflation are electricity tariffs, transport rates and fuel prices.

3. Countercyclical policy: monetary policy, fiscal policy or both?

The increasing popularity of independent central banks has made monetary and fiscal policy more independent. But this does not mean that central bankers are indifferent to fiscal policy. As mentioned above, achieving rupiah stability requires BI to maintain close coordination with the government. For example, the government should be fully aware of the impact of reducing subsidies on inflation, and the impact of large government transactions on base money. On the other hand, BI must be aware that excessive tightening of monetary policy would be harmful to economic growth. Furthermore, each percentage increase in domestic interest rates adds IDR 2-2.5 trillion to the budget for interest payments.

Based on Indonesia’s experience, countercyclical monetary and fiscal policies are not employed. Fiscal policy is directed towards a balanced budget and monetary policy towards monetary stability. The central bank does not adjust monetary policy to boost the economy. It aims at creating monetary stability that in turn will induce economic growth.

While the government budget does not have an annual cyclical pattern, there is a seasonal pattern. Revenue and expenditure peak in the last quarter of each year. On the monetary front, the central bank always tends to apply tight monetary policy or at least neutral monetary policy in order to bring base money to its indicative target. These two illustrations show that there is no automatic stabiliser between fiscal and monetary policy.

4. Central bank balance sheets and fiscal policy-type operations

As mentioned above, BI has provided liquidity support to prevent bank runs and payment system failure. As a consequence, it issued BI certificates to absorb the huge amount of excess liquidity. The increasing burden of paying interest on these certificates raised the problem of the financial soundness of the central bank itself. The problem was exacerbated when the government disputed how much of the losses related to the provision of liquidity support should be borne by BI. After long discussions, the burden-sharing agreement is nearing fruition. The government has sent its final proposal for review by the Supreme Audit Board ahead of further consideration by parliament. However, as noted above, this involves BI paying interest on its own certificates but earning no interest on the government’s perpetual notes. This presents a tough challenge in BI’s balance sheet. If the dispute is not settled soon, it may eventually erode the central bank's financial sustainability. A possible solution is to convert the government notes into a marketable instrument, but this would require parliamentary approval as it affects the budget.