Fiscal policy, public debt management and government bond markets in Indonesia

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Abstract

Over the past several years, the Indonesian government has pursued a prudent fiscal policy while still promoting economic growth. Since 2005, the government has shifted the source of deficit financing from external to domestic debt via the issuance of government securities. In doing so, it has sought to lengthen the maturity of local currency government bonds and to construct a yield curve. Meanwhile, the global excess of liquidity has driven foreign investors to seek for higher yields. With its strong fundamentals and attractive yields, Indonesia has therefore been the recipient of massive capital inflows, most of which have been invested in stock and government bonds. As the central bank, Bank Indonesia has adopted a mixture of monetary and macroprudential policy measures to manage these capital inflows and excess liquidity. From early 2008, the Bank has conducted daily operations with government securities to manage liquidity in the market.

Keywords: Central Banks, Monetary Policy, Fiscal Policy, Indonesia

JEL classification: E58, E63

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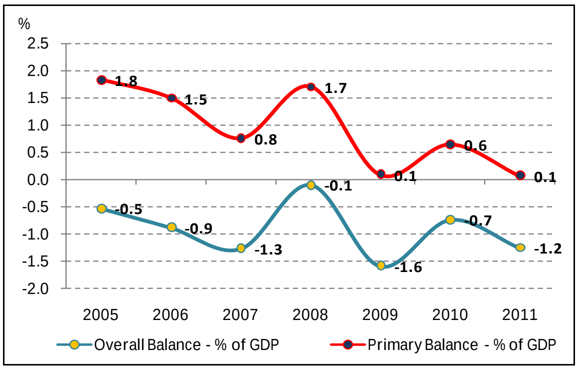
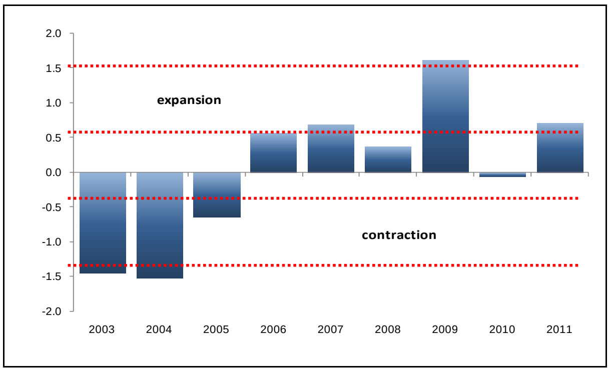
Fiscal policy overview

Fiscal policy indicators show that the Indonesian government has managed to pursue a prudent fiscal policy while still promoting economic growth. The fiscal policy stance is measured by estimating the overall balance, the primary balance, and fiscal impulse. Over the past several years, a relatively low deficit has been reflected in the ratio of the overall balance, which indicates the difference between revenues and grants, and expenditures. The exception was in 2009, when the overall fiscal deficit reached 1.6% of GDP as the government sought to cushion the impact of the global crisis on the Indonesian economy. At the same time, the fiscal impulse – which indicates the role of government in increasing (or dampening) aggregate demand – also showed an expansion, in line with the government's prioritisation of economic growth.

Indonesia overall and primary balance

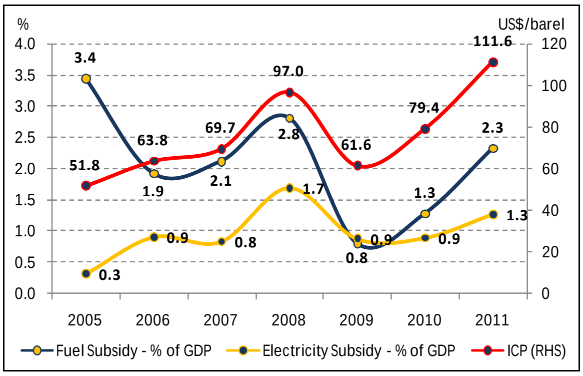


Fiscal impulse

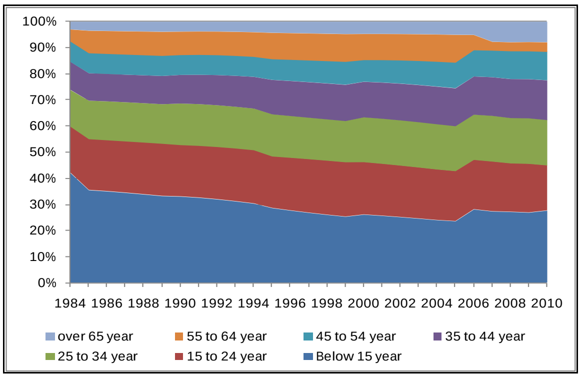


Medium-term pressures could potentially arise from official subsidies, especially those for fuel and electricity. Rising as it does in line with the oil price, the cost of fuel subsidies has the potential to undermine the state budget. In 2012, the government has sought to place limits on the fuel subsidy, with a view to reallocating the subsidy budget to more productive expenditure such as infrastructure and capital development. However, the medium-term demographic threat to the government budget from pensions or health care spending is limited, we believe, given that around 65% of Indonesia's population lies within the economically active 15–64 age bracket.

Energy subsidies as a share of GDP

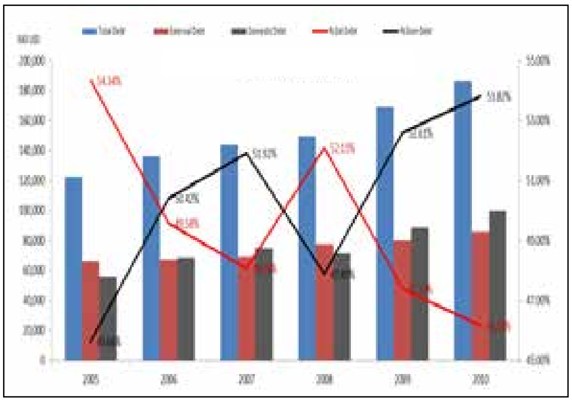


Population demography

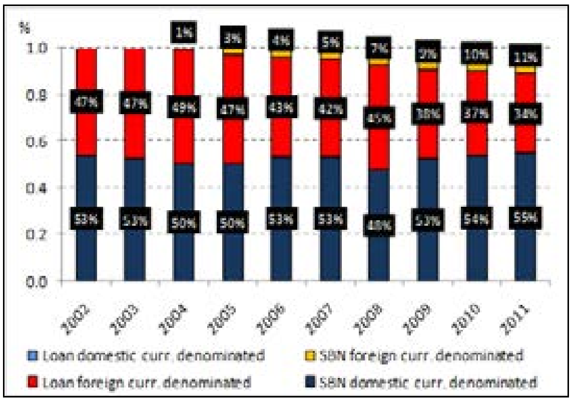


The government has shifted the financing of the government deficit from external to domestic financing. Since 2005, government securities have become the primary financing instruments for the government deficit. The ratio of domestic debt relative to total debt increased from 45% in 2005 to 54% in 2010. However, this trend was interrupted in 2005 and 2008, when new public debt was issued in US dollars. The government's aim is to refinance maturing foreign debt by issuing securities in the domestic market, to achieve a sound balance of foreign and domestic debt, and to strengthen the domestic financial market. Thus, financing from external borrowing has trended downwards since 2004. From that point, planned loan repayments have been set to exceed disbursements.

Central government debt



Composition of central government debt

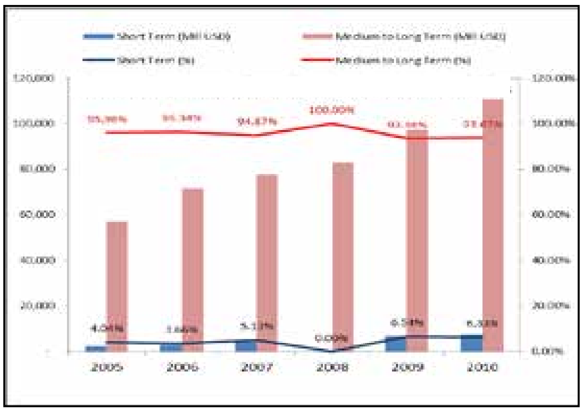


Source: Debt Management Office, Ministry of Finance.

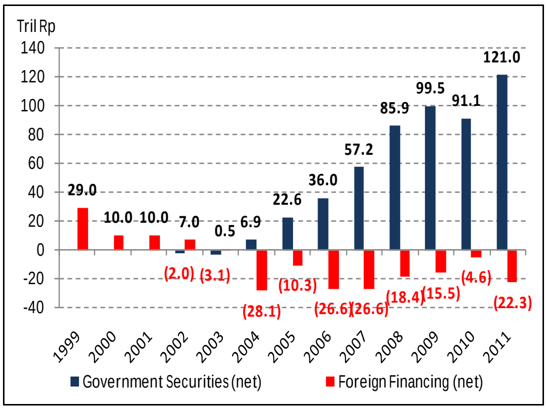
Bonds market, money market and monetary policy implementation

The government is seeking to lengthen the maturity of its domestic bonds and to construct a yield curve. More than 90% of the outstanding central government debt is in medium- to long-term maturities. Since 2002, the government has conducted a reprofiling strategy to improve the maturity profile of government debt securities, hence reducing refinancing risk. Capital flows from abroad, combined with a relatively flat yield curve, have pushed down government bond yields. With its strong fundamentals and attractive yields, Indonesia has received massive capital inflows from yield-seeking foreign investors. Most of these inflows are invested in stocks and government bonds. Coupled with the limited supply of paper, this strong demand has further reduced the yield on government bonds.

Maturity profile of government debt

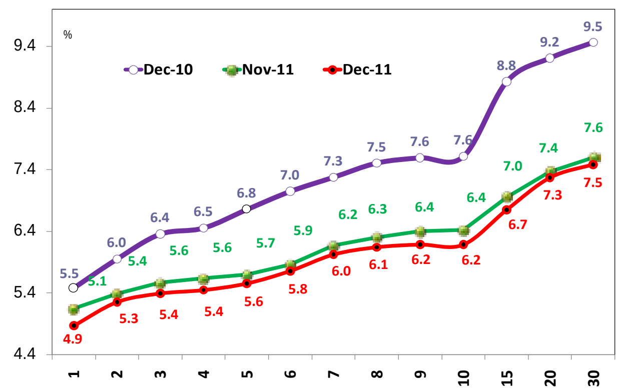


Reprofiling strategy for government debt



Source: Debt Management Office, Ministry of Finance.

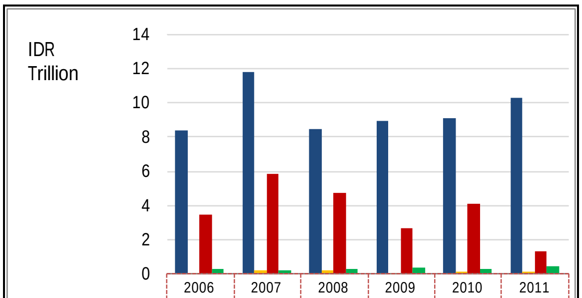
Yield curve for government debt



The Indonesian money market is dominated by interbank call money. In terms of the underlying transaction assets, the Indonesian money market can be categorised into collateralised and uncollateralised segments. Based on transaction volume, more than 70% of money market transactions, in daily volume terms, are conducted in interbank call money. Owing to the excess liquidity in the economy, the money market rate tends to hover around the lower border of the central bank's corridor, ie the deposit facility rate. As the repo market is undeveloped on account of this excess liquidity, demand for short-term liquidity is largely met by interbank call money. Repo rates are also higher than those for interbank call money, despite the lower credit risk.

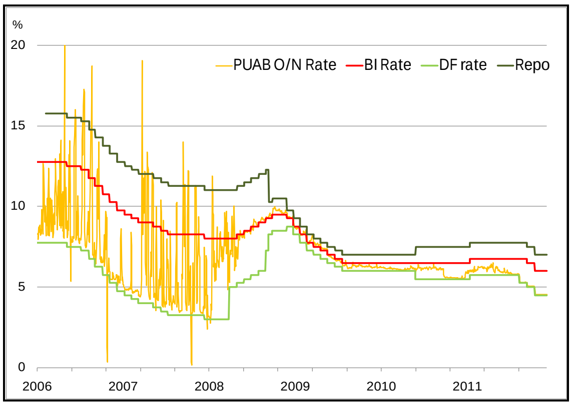
Bank Indonesia has taken various monetary and macroprudential policy measures to manage capital inflows and curb excess liquidity. To maintain financial stability amid massive portfolio capital inflows, Bank Indonesia has imposed a six-month holding period for Bank Indonesia bills (formally known as Certificates of Bank Indonesia or SBI). At the same time, this policy measure supports the central bank's aim of managing excess liquidity by lengthening the maturity profile of monetary instruments. In this regard, the Bank is currently issuing only nine-month SBIs (in monthly auctions) with a view to absorbing liquidity over a more sustained period.

Daily average volume



	2006	2007	2008	2009	2010	2011
Interbank MM	8,392	11,79	8,488	8,946	9,095	10,272
SUN Repo	0,04	0,19	0,19	0,07	0,13	0,09
Secondary SBI	3,49	5,83	4,76	2,71	4,13	1,36
Secondary Govt Bond	0,28	0,2	0,28	0,4	0,35	0,51

Interbank money market rate



Since early 2008, Bank Indonesia has conducted daily operations to manage liquidity in the market. Among others, one aim of this policy enhancement is to reduce fluctuations in the overnight interbank call money rate, which is the operational monetary policy target rate. Daily liquidity management operations have relied mainly on term deposits, reverse repo transactions (with government bonds as underlying securities) and deposit facilities (standing facilities). As the market believes that Bank Indonesia will act to maintain the stability of the overnight interbank call money rate, it is expected that the effect of these measures will be transmitted to the longer-term interest rates too.

The coordination of monetary policy and fiscal policy

The monetary authority coordinates with the fiscal authority in conducting macro policy. According to the Central Bank Act, Bank Indonesia has operational independence in determining monetary policy. However, to improve the effectiveness of monetary policy and fiscal policy, there is close cooperation between the central bank and the fiscal authority. Moreover, Bank Indonesia is prohibited from buying government securities in the primary market for its own account, except when purchasing short-term government securities solely for the purpose of monetary operations. In the primary market for short-term government securities, Bank Indonesia acts as a non-competitive bidder. At the same time, according to the Government Securities Act, Bank Indonesia is the auction and administration agent for government securities. In this connection, the government is required to consult with Bank Indonesia before issuing government securities.

Since 2002, Indonesia's public debt management has been conducted by the Debt Management Office within the Ministry of Finance. For its part, Bank Indonesia is responsible for managing the country's foreign exchange reserves, conducting various foreign exchange transactions, and receiving the proceeds of foreign borrowing. The central bank and the Ministry of Finance coordinate closely with the aim of improving the quality of macroeconomic policy. In addition, the Central Bank Act requires the Ministry of Finance to consult with Bank Indonesia before any issuance of debt. The Act further states that Bank Indonesia must evaluate the monetary implications of such issuance and advise the Ministry of Finance on its terms. As the auction agent for domestic government securities, Bank Indonesia announces the auction plan for government securities, conducts the auctions, and announces the auction results. The Bank also has a role in administering government securities, including their registration, clearing and settlement, and repayment in both primary and secondary markets. For global issuance, the Ministry of Finance appoints external agents to conduct the auctions as well as clearing and settlement.

Since 2011, Bank Indonesia has increased its use of government bonds in its reverse repo operations with the aim of absorbing excess liquidity. As part of its enhanced monetary policy implementation, Bank Indonesia has gradually shifted from the issuance of central bank bills (SBI) to reverse repo transactions as a means of absorbing excess liquidity. This strategy has a twofold benefit, in that it stimulates the development of the government bond market and reduces price discrepancies between different government securities.