Monetary and fiscal policy interactions in the wake of the pandemic

Bank Indonesia
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Abstract

The Covid-19 crisis was what the BIS's *Annual Economic Report 2020* called a policy-induced recession generated by repressing economic activity. Extraordinary policy responses were required in terms of health, fiscal and monetary stimulus, and also in terms of the financial sector's response. The speed and effectiveness of policymakers in meeting the challenges of the Covid-19 pandemic will determine the process of economic recovery.

Throughout 2020 and to date in February 2021, Bank Indonesia has maintained a diverse policy mix to mitigate the economic risks associated with Covid-19 and support the national economic recovery programme. To this end, Bank Indonesia has strengthened its policy mix to maintain exchange stability, keep inflation in check, and safeguard financial system stability. It is also taking the necessary follow-up policy measures in coordination with the government and the Financial System Stability Committee in order to maintain macroeconomic and financial system stability, and to expedite the economic recovery.

JEL classification: E52, E58, E61.

Keywords: monetary and fiscal policy interactions, integrated policy framework, policy coordination.

1. Recent economic development

After the contraction in the second quarter of 2020, world economic activity has started to increase, although it is still overshadowed by the risk of a second or third pandemic wave in some regions. In the third quarter of 2020, economic activity gradually improved, although the degree of improvement varied from country to country. Meanwhile, vaccinations are likely be carried out more widely in 2021, including in Indonesia.

On global financial markets, uncertainty has eased, although caution is warranted. The rapid spread of the Covid-19 pandemic worldwide caused a global financial market panic in March 2020, leading to turbulence in the financial markets of emerging market economies (EMEs). Portfolio investment withdrawals from EMEs occurred on a large scale, resulting in a scarcity of US dollars that subjected EME currency exchange rates to major depreciation pressures. However, as global financial market uncertainty subsided, the flow of portfolio investment started to return to EMEs. From early November 2020, this was expected to stimulate foreign capital inflows and further appreciation of the exchange rates in EMEs, including Indonesia. Meanwhile, weak domestic demand implies muted inflationary pressures. At the same time, the financial system, which was in good shape when the pandemic started, has provided a cushion for financial system resilience, although credit growth has contracted due to weak domestic demand.

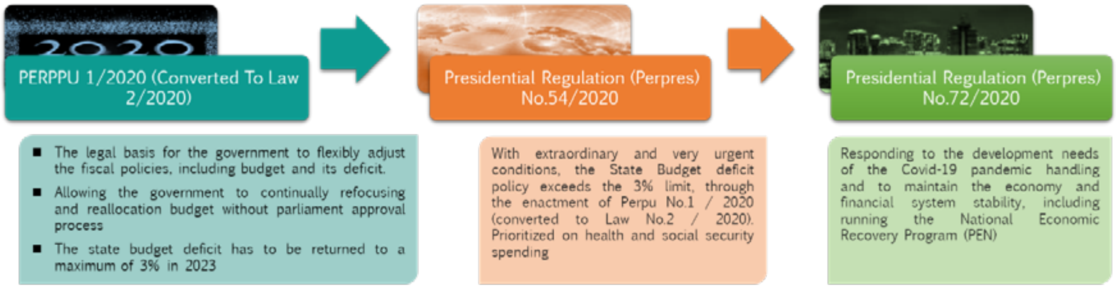
Many countries provided a sizeable fiscal stimulus for economic recovery from the impact of the Covid-19 pandemic. Fiscal stimulus was generally allocated for health budgets, social assistance programmes, incentives for the business world, especially for micro, small and medium-sized enterprises (MSMEs), and tax relief for corporations. The amount of additional spending amid falling tax revenues has led to a widening of the fiscal deficit in many countries, with a large increase in deficits exceeding 8% of GDP in some developed countries, as compared with generally smaller deficits in EMEs. The fiscal stimulus has had a positive impact on the economic recovery since the third quarter of 2020.

The process of economic recovery from the Covid-19 pandemic was also supported by monetary stimulus from central banks in many countries. With monetary policy interest rates approaching zero in developed countries, central banks have created monetary stimulus by injecting liquidity (via quantitative easing or QE) into the financial sector, particularly banking. In EMEs, monetary stimulus is implemented through a combination of lower policy interest rates and injecting liquidity into banking and financial markets. Liquidity injection (QE) is generally carried out through monetary operations, given the limited depth of secondary market financial assets in EMEs. In this vein, Indonesia has carried out the largest amount of QE, amounting to 4.4% of GDP, followed by Mexico (3.3%), Chile (2.8%), and the Philippines (1.6%).

2. National economic performance and process: recovery under way

The Covid-19 pandemic also had a tremendous impact on Indonesia's health, economy, and finances, especially in the second quarter of 2020. Indonesia is still experiencing a spike of Covid-19 cases, although the recovery rate continues to improve. The social restriction policies needed to prevent the spread of Covid-19 placed constraints on labour mobility in almost all major cities from April to June, and also undercut economic activity in the second quarter of 2020. Labour mobility has gradually improved since July 2020, in line with the easing of social restrictions in various regions. This has also stimulated economic activity from the third quarter of 2020. Meanwhile, the global financial market turbulence at the end of March and April 2020 resulted in a large outflow of foreign portfolio investment, putting heavy depreciation pressure on the rupiah. With a strong commitment to stability policies from Bank Indonesia, the rupiah exchange rate has strengthened significantly since the end of March 2020, thus supporting the economic recovery. Stability has been maintained, and the process of economic recovery is ongoing.

Amendment of state budget posture in 2020 in response to the pandemic



	[Initial Budget] Law No. 20/2019	Perpres No. 54/2020	Perpres No. 72/2020
Budget Deficit to GDP	1.76%	5.07%	6.34%
Budget Deficit	IDR307.2 tn (~USD 21.0)	IDR852.9 tn (~USD 58.2 bn)	IDR1,039.2 tn (~USD 70.9 bn)
2020 Financing Need	IDR 741.8 tn (~USD 50.6 bn)	IDR 1,439.8 (~USD98.3 bn)	IDR 1,645.3 (~USD112.3 bn)

PERPPU 1/2020 is emergency law issued by government to respond the COVID-19 outbreak

The Indonesian authorities responded immediately to the multidimensional effects of Covid-19. The coordinated policy measures of the government, Bank Indonesia and other authorities were given legal backing by the enactment of Law No 2 of 2020. This ensured that the authorities could quickly and accountably take extraordinary steps in overcoming the pandemic and encouraging economic recovery.

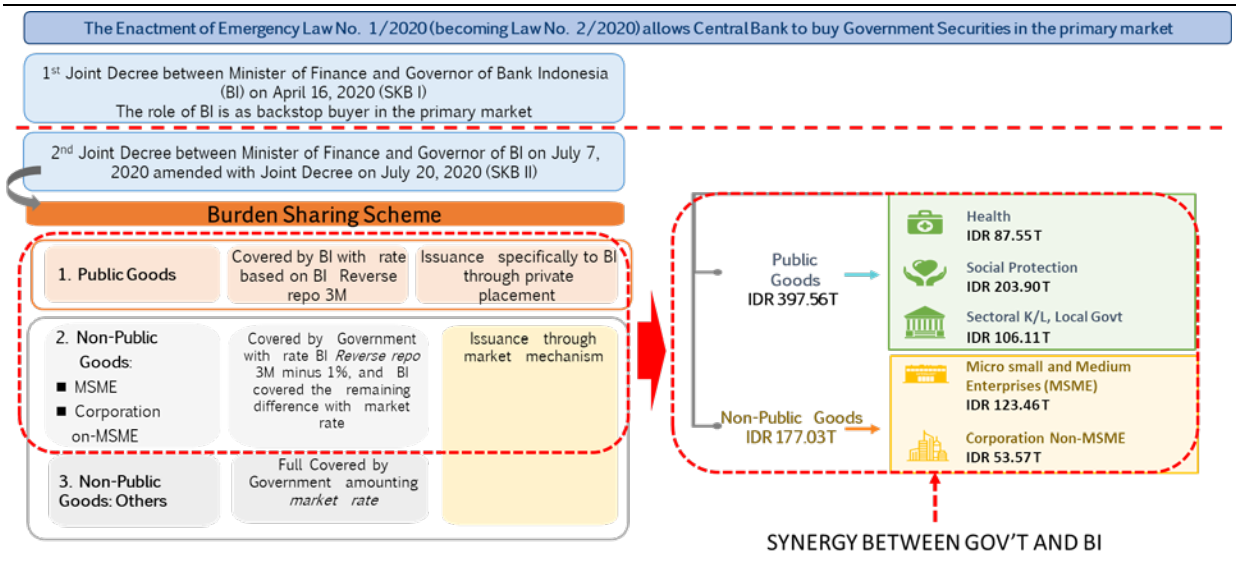
The government pursued an expansive fiscal policy, expanding the deficit and increasing budget financing in 2020. Bank Indonesia conducted an accommodative policy mix amid low inflationary pressures, including monetary stimulus through interest rates and monetary easing on a large scale. These policies were supported by the stabilisation of the rupiah exchange rate, the easing of macroprudential policies, and the digitisation of payment systems.

3. Bank Indonesia's policy response: coordinate to build optimism for economic recovery

During the pandemic, the fiscal and monetary authorities coordinated their policies in order to maintain stability. Under Law No 2 of 2020, Bank Indonesia was authorised to assist the financing of APBN 2020 (the state budget) through the purchase of long-term government bonds (SBNs) in the primary market and to share the burden of fiscal financing through market mechanisms and private placements.

Coordination between the central bank and the government in accelerating the economic recovery

Graph 1



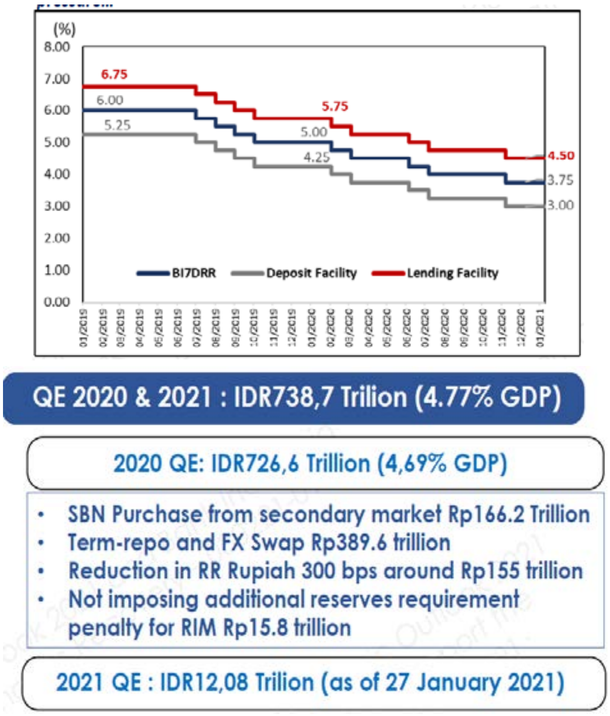
Policy coordination was also strengthened by the Financial System Stability Committee (KKSK), with the aim of mitigating any effects of Covid-19 on financial stability. In addition to the fiscal and monetary measures, the Financial Services Authority (OJK) focused on maintaining the stability of the financial system through restructuring programmes for SMEs and corporations, as well as other initiatives to maintain the function of financing intermediaries. Likewise, the Indonesia Deposit Insurance Corporation (LPS) also continued to ensure that public savings in the banking sector were guaranteed to support financial system stability.

On the policy mix to maintain stability and support the recovery

Low inflation and external stability were the key factors that led Bank Indonesia to conduct easing monetary policy through quantitative easing, as well as funding the 2020 state budget, by purchasing SBN in the primary market and sharing the burden of fiscal financing. An expansion of liquidity was carried out to maintain financial system stability and promote the functioning of financial intermediaries with a view to supporting the economic recovery.

Bank Indonesia carried out this accommodative monetary policy by lowering the BI 7-Day Reverse Repo Rate (BI7DRR) policy rate by 125 bp in 2020. Bank Indonesia also implemented a monetary stimulus in the form of a QE policy. As of 30 December 2020, Bank Indonesia had injected rupiah liquidity of around IDR 726.57 trillion or about 4.7% of GDP, mainly from reducing the reserve requirement of around IDR 155 trillion and monetary expansion around IDR 555.77 trillion. Bank Indonesia also lowered its reserve requirement ratio by 300 bp in relation to reserve requirements, including the easing of reserve requirement incentives of 50 bp.

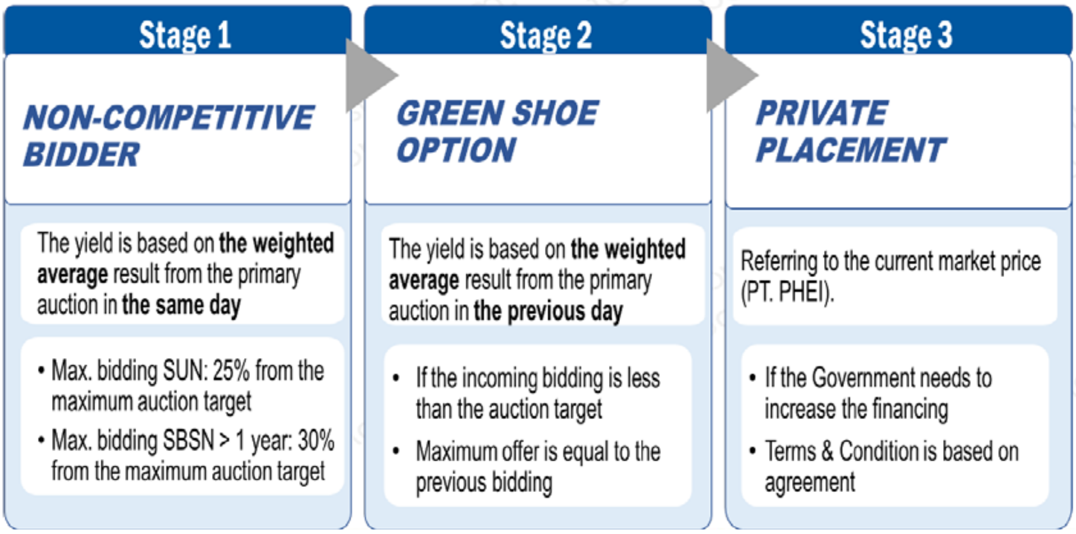
Reduced policy rate and injection of liquidity Graph 2



Under Act No 2 of 2020, Bank Indonesia is committed to funding the 2020 state budget by purchasing SBNs in the primary market. The commitment was carried out by adhering to prudent principles to maintain economic stability, also taking into account the effect on inflation. Overall, in 2020, Bank Indonesia has purchased SBNs in the amount of IDR 473.42 trillion for funding and burden-sharing in the 2020 state budget for the national economic recovery programme. The first purchase consisted of IDR 75.86 trillion worth of SBNs in the primary market. The second purchase consisted of IDR 397.56 trillion through a private placement under the Joint Decree of the Minister of Finance and Governor of Bank Indonesia issued on 7 July 2020. Furthermore, Bank Indonesia has also undertaken burden-sharing with the government to fund non-public sector SMEs in the amount of IDR 114.81 trillion and non-public sector corporates in the amount of IDR 62.22 trillion according to the Joint Decree of the Minister of Finance and the Governor of Bank Indonesia issued on 7 July 2020. Coordination between fiscal and monetary policy through the purchase of SBNs by Bank Indonesia to fund the State Budget 2020 has provided sufficient room for fiscal manoeuvre. This cooperation has allowed the government to focus on driving the momentum of national economic recovery.

Indonesia's economic growth started to improve in the second half of 2020, along with the loosening of social restrictions, the realisation of increasing fiscal stimulus, and the global economic recovery. Economic growth in the third and fourth quarters of 2020 fell by 3.49% year on year and 2.19%, respectively, resulting in an overall contraction of 2.07% in 2020. Macroeconomic stability remained under control. Indonesia's balance of payments was solid, thereby reinforcing external sector resilience. Supported by Bank Indonesia's stabilisation measures and steady foreign capital inflows to domestic financial markets, the rupiah appreciated. Inflation remained low due to compressed domestic demand and adequate supply. In line with Bank Indonesia's accommodative monetary and macroprudential policy stance, liquidity conditions stayed loose, prompting lower interest rates and stimulating economic financing.

Mechanism of government bond purchases from the primary market Graph 3



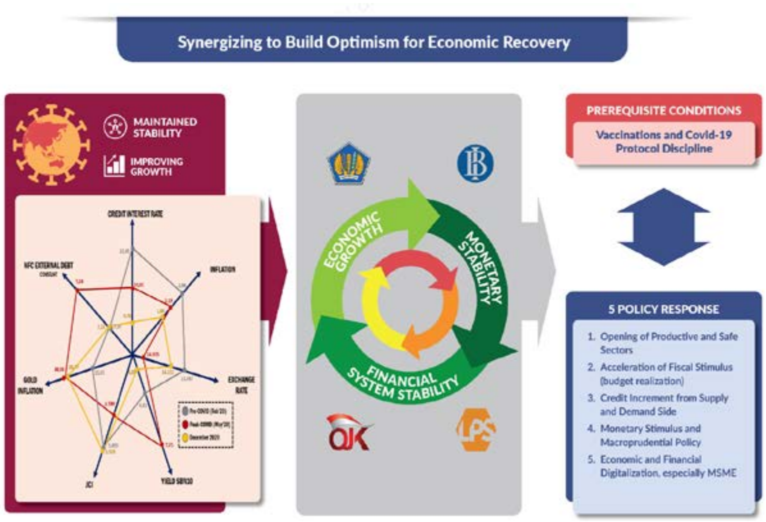
4. Bank Indonesia's policy response: synergise to build optimism for economic recovery

On macroeconomic and financial stability risk management

Act No 2 of 2020 allows the government to raise the fiscal deficit above 3% until 2022 as a part of its extraordinary measures to mitigate the impact of the pandemic on the economy. In 2020, the fiscal deficit increased from the initial target of 1.76% of GDP to 6.34% of GDP. Meanwhile, the public debt as of November 2020 rose to US$ 203.7 billion, up from US$ 198.6 billion in November 2019 (2.57% year on year). Nevertheless, the fiscal deficit and public debt remained manageable and also relatively low compared with peer countries. The expansionary fiscal policy is ongoing, as reflected in the 2021 State Budget deficit of IDR 1,006.4 (5.7% of GDP), after a deficit of IDR 1.039.2 trillion (6.3% of GDP) in 2020, but despite this increase in debt the government has remained within the provisions of the law. Hence, we do not view the increase in fiscal deficits and public debt as raising macroeconomic and financial stability risks.

Going forward, the coordination of fiscal and monetary policy continues to be strengthened under the Financial System Stability Committee (KKSK), with the aim of maintaining macroeconomic and financial system stability, as well as accelerating the economic recovery. The focus of policy coordination is oriented towards overcoming supply and demand-side constraints, in terms of bank lending to priority sectors, to support economic growth and the economic recovery.

Synergy for building optimism: one prerequisite, five strategies Graph 4



On exchange rate vulnerabilities and inflation

BI's policy mix has been carried out in a prudent and measured manner by taking into account its impact on stability, including the exchange rate and inflation. Pursuing accommodative monetary policy through a combination of lower policy interest rates and purchasing bonds is appropriate under the current exceptional circumstances. This combination is more likely to achieve accommodative financial conditions along the rupiah yield curve than if policymakers were to depend only on interest rate measures. Bank Indonesia is fully aware that bond purchases, notably those in primary markets, pose risks to monetary policy credibility and, when large, might be difficult to absorb by the Bank while meeting its inflation mandate.

Current developments indicate that the rupiah exchange rate remains stable, with the potential to strengthen. This is in line with its fundamentally undervalued level, supported by the low current account deficit, the high attractiveness of domestic financial assets and a declining risk premium for Indonesia. Low and controlled inflation has also supported the exchange rate movement as evidence that the impact on inflation is manageable in line with weak demand and adequate supply.

Bank Indonesia will continue to strengthen its exchange rate stabilisation policy in line with the currency's fundamental value and market mechanisms through monetary operations and by providing market liquidity. Inflation in 2021 is projected to remain within the 3.0% ±1% target corridor. Bank Indonesia remains firmly committed to maintaining price stability and strengthening policy coordination with the government through national and regional inflation control teams (TPI and TPID), with the aim of keeping inflation within the predetermined target range.