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Indonesia's Mounting Fiscal-Monetary Risks

In a Nutshell: The abrupt r**emoval of Finance Minister Sri Mulyani Indrawati risks dangerously eroding fiscal-monetary policy credibility**. Especially given the *optics of political expedience* to side-step binding fiscal constraints. And **Bank Indonesia's "burden sharing" amplifies risks** as the *threat of monetary policy subordination to fiscal dominance* further compromise macro-stability. **Wider credit spreads** e*xacerbated by rising global term premium* suggest **higher cost of capital**. **Rupiah debasement risks** also mount as investor assess debt monetization. And in any case, *Bank Indonesia's easing may impose sharper IDR stability trade-offs.*

- **Risks to Indonesian assets are mounting as fiscal** and **monetary policy threats conspire to undermine credibility**.
- The *latest assault on confidence* stems from abrupt **removal of internationally respected Finance Minister (FinMin) Sri Mulyani Indrawati**.
- To be sure, her replacement **Purbaya Yudhi Sadewa is accomplished** in both finance and public service.
- So, this is not about suitability or qualifications. He is amply qualified and **would ordinarily feature very favourably as a successor**.
- ***But these are not ordinary times***. In fact, the **timing and abruptness** of the move is **extraordinary** and **very inconvenient**.
- An abrupt and presumably unplanned removal **creates optics of political expedience** *at the expense of fiscal/macro stability.*
- Especially given FinMin Indrawati's pushback to overly-aggressive/unrealistic fiscal plans/projections put forward by the President.
- Upshot being, given *President Prabowo's aggressive populist policies that sometimes bend fiscal feasibility it is* **critical to project fiscal credibility** to temper risks and assure investors.
- And (ex-)**FinMin Indrawati did precisely that**. As an independent figure with **a track record of objectivity,** *and when required,* **objections**.
- Whereas the onus may be on in-coming FinMin Prubaya to reassure investors that fiscal integrity will not be compromised.
- *Making matters worse,* that this **follows hot on the heels of Bank Indonesia's "burden sharing" arrangement,** which we warned* was problematic of policy/macro stability even with FinMin Indrawati's backing.
- Specifically, "burden sharing" **undermines monetary policy** by *potentially subordinating it to fiscal objectives.*

- Consequently, the worse-case iterations **threaten to subject rupiah to debasement** from *debt monetization risks* (perceived or real).
- This **feeds off, and into, mounting risks of wider credit spreads** *exacerbated by rising global term premium* to d**rive up Indonesia's yields** (pressuring bond prices).
- That will inevitably present itself as a **higher effective cost of capital** burdening growth. And more so as "crowding out" pressures also rise.
- For now, Bank Indonesia will have to watch macro/FX-stability closely and lean against capital outflows risks.
- As a corollary, this may **compromise scope to ease** as ***trade-off with rupiah stability sharpens***.

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*Bank Indonesia: "Burden-Sharing" Risks [published 3rd September]

- **Bank Indonesia's** announced **"burden-sharing" arrangement with the government**, **entailing debt servicing subsidy***, **risks being problematic for monetary policy** and the **rupiah** *unless it is managed very tightly.*
- Admittedly, **compellingly conservative limits to Bank Indonesia's debt servicing liabilities** could effectively mitigate adverse impacts on monetary policy/rupiah.
- But *unless* Bank Indonesia's *interest burden-sharing commitments are tightly defined and conservatively limited,* there are **three clear of risks**, with **inadvertent**, and **potentially adverse risks** to **policy**, **rupiah** and **rates**.

Risk 1 – Interest Rate Subsidy:

- First off, at the very least, **"burden sharing" will be recognized as interest rate subsidy**.
- To be sure. *within tight and pre-defined limits,* this could be **passed off as an operational^ revenue/profit transfers** (from BI to the government).
- But **beyond** the **usual dividend payment thresholds**, a more significant subsidy may be recognized as a **targeted, effective rate cut for the government**.
- Albeit one that comes **at the expense of the private sector**, potentially entailing *"crowding out" risks that is typically not growth positive.*

Risk 2 – Fiscal Dominance:

- **At a certain scale**, such a **"burden sharing"** arrangement **risks subordinating monetary policy**.
- In other words, **Indonesia may be confronted with** the **threat of "fiscal dominance"**, which **inadvertently undermines monetary policy**.
- To be fair, the MoF has stressed on Bank Indonesia's policy independence. And this is the case.
- But the **degree of policy flexibility** that Bank Indonesia could be *unintentionally* **constrained *if interest subsidy obligations turn significantly more burdensome.***

Risk 3 – QE & Debt Monetization:

- Without check, and ***in extreme iterations***, **"burden-sharing" could** be **construed as backdoor** (even if only partial) **debt monetization**.
- To be clear, overt debt monetization accusations are effectively deflected given Bank Indonesia not buying from primary markets (and only acquiring bonds via secondary markets).
- But insofar that bonds (on which interest subsidy is extended) are bought, **Bank Indonesia's expanding balance sheet** may **justifiably be conflated with defacto QE** (quantitative easing).
- Moreover, in **buying bonds outside of an economic crisis** (which may warrant QE/aggressive easing) *to subsidize debt servicing burden,* **Bank Indonesia is exposed to allegations of "debt monetization lite"** (justified or not).

Policy Impact: All else equal, "burden-sharing" will **sharpen rupiah stability-rate cut trades offs**. *Sharper rupiah falls from rate cuts is the risk.* So, for now, it **may constrain** (certainly impose greater caution around) **scope for further rate cuts**.

Rupiah Impact: **Rupiah pressures will also be increased** amid perceptions of QE/"debt monetization lite" hedging rupiah debasement risks as well as effectively lower real returns perceived.

Rates/Yield Impact: Yields may be nudged higher on perceptions of **wider risk premiums**. This ought to be more pronounced via **term premium impositions** at the longer-end *entailing uncertainty and debasement risks.* But **near-term bond buying by Bank Indonesia could still forcibly suppress yields albeit at the expense of the rupiah**.

* While a detailed plan has not been made available, the guidance suggests that Bank Indonesia at least partly subsidizes interest on bonds that it buys on the secondary market.

^ Central banks are known to pay dividends to respective Ministries of Finance

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