

Indonesia's Mounting Fiscal-Monetary Risks

In a Nutshell: The abrupt **removal 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 exacerbated 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 drive 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*.

*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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