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Indonesia Economic Flare

Reading the Tides of Capital

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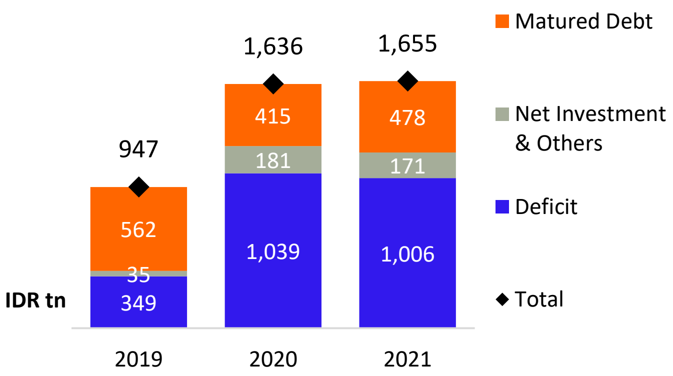
- **Indonesia's 2021 budget was concluded with a deficit target at 5.7% of GDP.** Under the assumption of 5.0% economic growth, the government had set a total spending of IDR2,750tn (+0.4% yoy) with IDR1,744tn target in state revenue. Consequently, the fiscal deficit is expected to be IDR1,006tn or lower than 2020's deficit target of IDR1,039tn (6.3% GDP). Marking the start of consolidation, the government attempts to push fiscal deficit back down to its 3.0% of GDP threshold by 2023.

- **Spending for National Economic Recovery Program was elevated.** Having IDR695tn for the economic recovery program in 2020, the government had reallocated and set ID699tn for this year. Stimulus for health program and social security remained as top priorities, with respective budgets worth IDR176tn and IDR157tn. The intention is two-fold: 1) provide support for most vulnerable income classes, while simultaneously 2) ensure that vaccine roll-out is well-executed.

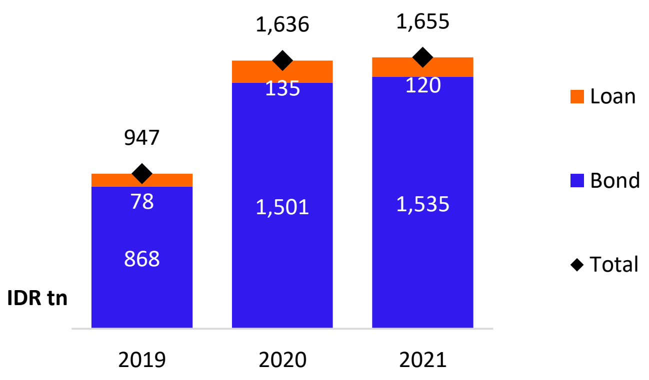
- **Tides of Capital.** Financing needs will still be high at IDR1,655tn (vs IDR1,636tn in 2020) as the government penciled-in IDR171tn of *below-the-line* net investment and deals with IDR478tn of maturing debt (*please see Chart 1*). According to the Ministry of Finance (MoF), domestic and foreign loan withdrawal would be around IDR120tn, which means that the remaining IDR1,535tn is financed through bond issuances (*please see Chart 2*). The MoF planned to issue around 80%-85% in rupiah denominated bond, or amounting to IDR1,305tn, on medium-long tenor in order to mitigate both currency and refinancing risks. Share of retail bond would also be lifted from 5.0% to 6.0% of total issuance, this year.

Chart 1. State Budget Financing Needs



Source: MoF, Audit Board

Chart 2. Source of Financing



Source: MoF, Audit Board

Excess financing from 2020 offered some relief. Earlier this year, the MoF had announced that FY20 deficit realization stood at 6.1% of GDP and that excess of net financing had quadrupled to IDR235tn. Aside from lower than targeted expenditure, this excess was also a product of favorable commodity prices, namely oil and coal. Officials then stated that IDR60tn, of which, will be used to relief some of the issuance whilst IDR66tn had also been placed within the banking system for loan restructuring. The rest will be posted in the government's cumulative cash balance at Bank Indonesia (BI) as a second line of defense, and in-case of liquidity shortage.

Table 1. Tradable Domestic Government Securities by Ownership

(In IDR tn)	Dec-19	%	Dec-20	%	Mar-21	%	Δ20	Δ21
Banks*	581	21.1	1,376	35.5	1,583	38.4	795	207
Bank Indonesia**	263	9.5	454	11.7	422	10.2	191	(32)
Mutual Funds	131	4.8	161	4.2	164	4.0	30	3
Insurance Company & Pension Fund	472	17.1	542	14.0	582	14.1	70	40
Foreign	1,062	38.6	974	25.2	953	23.1	(88)	(21)
Individual	81	2.9	131	3.4	170	4.1	50	39
Others	163	5.9	232	6.0	251	6.1	69	19
Total	**2,753**		**3,871**		**4,127**			

Source: Ministry of Finance as of 30-Mar-2021

*including Government Securities used in monetary operation with BI

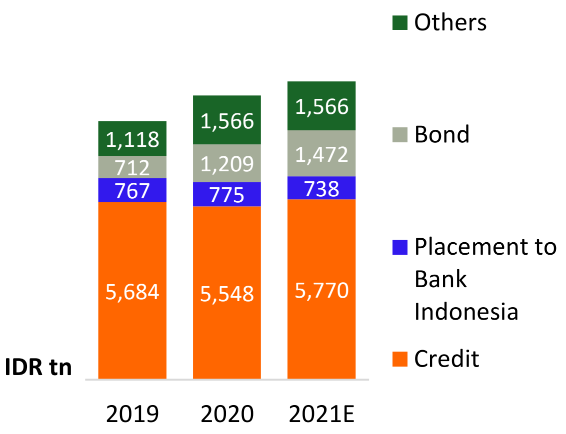
**net, excluding Government Securities used in monetary operation with Banks

Foreign investors are no longer the largest LCY bond holder. Banks now owned 38% of IDR government bond or equivalent to IDR1,583tn (*please see Table 1*), increasing by IDR1,002tn since 2019 and replacing foreign as the major holder. Fund distribution has shifted from loan to bond amid sliding demand, escalating risk in asset quality, and sporadic repayments.

How much could banks add in 2021? Under the backdrop of loan contraction, banks have placed a large portion of funds in both government and central bank securities last year. We are in the view that its sustainability would depend on the pace of economic recovery. As an intermediary, banks would shift back to loan when demand starts to recover (*please see Chart 3*). An economic expansion would also generate Third Party Fund (TPF), providing further room on their balance sheets. While in retrospect, BI could twiddle around with reserve requirement ratios as they did last year, we think it is un-called-for at the moment. Hence, we expect banks would participate around IDR263tn, assuming 5.0% loan growth and 4.6% deposit growth throughout 2021.

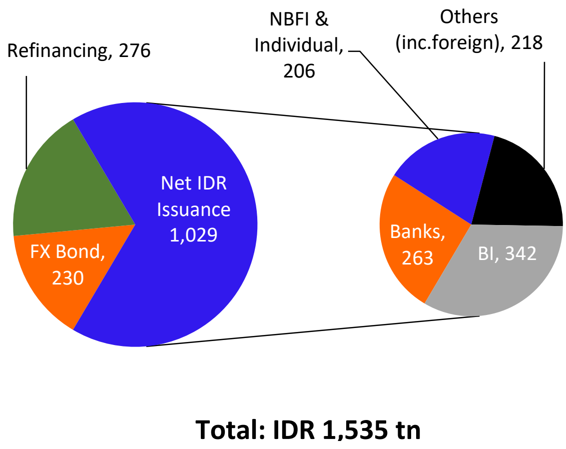
What do we have on the table? Per Mar-21, banks had already added IDR207tn worth of government bond to its balance sheet (including from BI's monetary operation), leaving a limited space for the rest of the year. This condition has also been reflected in the primary market, as incoming bids of conventional bond have faded. Meanwhile, we do not see any factor that can trigger a substantial increase in absorption capacity for Non-Bank Financial Institution (NBFI) and retail investors. Assuming a stable asset growth, we estimated a potential of IDR206tn with current utilization rate at 39.8%. This leaves us with 2 remaining sources.

Chart 3. Banks' Distribution of Funds



Source: Indonesian Banking Statistics, E=Danamon Estimates

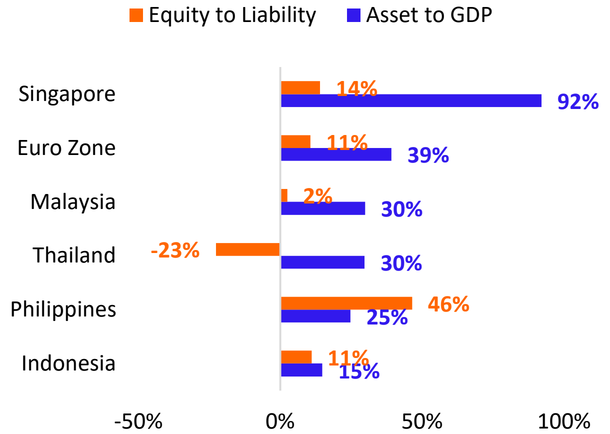
Chart 4. Potential Financing Source in 2021



Source: Danamon Indonesia

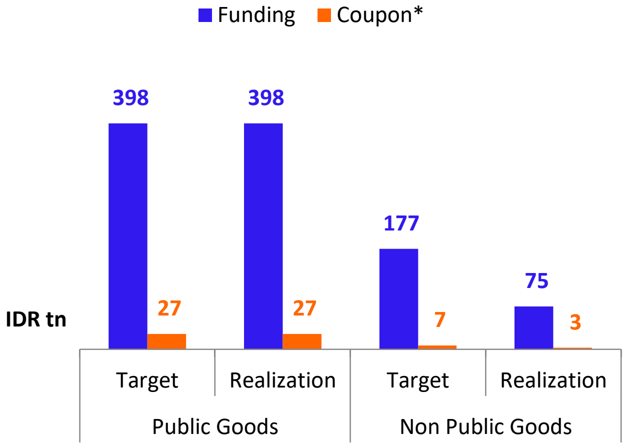
Under a joint agreement between BI and MoF back in April 2020, the central bank has committed to act as a standby buyer in the primary market and could purchase government bond through non-competitive bidding, should market demand fell short. The agreement itself will last for a maximum of 3 years until 2022. However, the amount purchased by BI would be capped at 25% of conventional debt securities and 30% of sharia securities. Based on our calculation, it translates to a maximum contribution of IDR342tn in 2021. Moreover, another joint agreement between fiscal and monetary authorities in July 2020 regulates a direct purchase of government bond through private placement and cost sharing on bonds issuances, which officials have repeatedly stated that it is a one-off policy and have lapsed in 2020. As such, other sources are expected to fill-in the remaining IDR218tn gap, including from foreign investors.

Chart 5. Central Bank's Balance Sheet



Source: MAS, ECB, BNM, BOT, BNP, BI

Chart 6. BI Coverage on Burden Sharing 2020



Source: BI, MoF *Danamon Estimates, Public Goods Coupon at 6.9%, Non-Public Goods Coupon at 4%

Does a healthy balance sheet justify the act of a standby buyer? In 2019, BI reported an asset to GDP ratio of 15%, or half than that of peers, but well below major central banks (*please see chart 5*). A simple calculation would suggest that BI can ramp-up its asset by purchasing IDR1,600tn worth of bond (10% of GDP), just to be next in-line. The monetary authority also saw some deterioration in its equity to liability ratio from 11.1% to 8.5% by 2020 (*please see table 2*). On the aftermath of purchasing bond, at the amount of IDR473tn through both private placement and standby buyer schemes (*please see chart 6*), financial asset had soared and rippled through some increase in liabilities. We estimated that IDR30tn of interest had already been covered by BI for these transactions, and our same model indicates further decrease in equity to liability ratio to 5.2% should BI quell over the IDR342tn bond in 2021. This just goes to show that despite having the capacity to dig once again, it is not without consequences.

Table 2. Bank Indonesia's Balance Sheet (IDR tn)

	Assets			Liabilities	
	2019 (Audited)	**2020 (Unaudited)**		**2019 (Audited)**	**2020 (Unaudited)**
Gold	53.5	67.1	Money in Circulation	793.7	898.9
Financial Asset	2,086.1	2,795.5	Financial Liabilities	996.1	1,330.4
Special Drawing Rights	36.6	38.7	Special Drawing Rights Allocation	38.1	40.2
Claims	140.8	109.5	Liabilities to Government	162.9	315.5
Non-Policy Asset	34.4	29.3	Non-Policy Liabilities	19.6	15.5
			Revaluation Difference	106.9	200.9
			Equity	3.7	3.7
			Surplus/Deficit Accumulation	230.1	234.9
Total Asset	**2,351.3**	**3,040.1**	**Total Liabilities**	**2,351.3**	**3,040.1**
Asset to GDP (%)	**14.8%**	**19.2%**	**Equity to Liabilities (%)**	**11.1%**	**8.5%**

Source: Bank Indonesia, Danamon

What are the options? Should foreign investors remain on the sideline, then the alternatives are as follow: 1) adjust expenditure to reduce bond issuances. Average historical spending hovered around 94%-95% of total budget, thus emphasizing on prioritized discretionary spending is a viable yet politically challenging option; 2) increase the share of global bond temporarily, 3) shift to loan program from development partners (i.e. World Bank, ADB, KfW, JICA, EDFC, and AIIB) at a potentially higher cost, and; 4) lift the cap of BI's buying scheme from currently 25% for conventional and 30% for sharia securities.

Indonesia's Selected Economic Indicators

	2018	2019	2020	2021E	2022E
National Accounts					
Real GDP (% y-o-y)	5.2	5.0	-2.1	3.4	5.0
Domestic demand ex. inventory (% y-o-y)	6.3	3.6	-3.1	3.2	6.3
Real Consumption: Private (% y-o-y)	5.0	5.0	-2.7	3.0	6.5
Real Gross Fixed Capital Formation (% y-o-y)	6.7	4.4	-4.9	3.3	7.3
GDP (USD bn) — nominal	1,042	1,119	1,059	1,125	1,212
GDP per capita (USD) — nominal	3,932	4,193	3,917	4,132	4,422
Open Unemployment Rate (%)	5.3	5.3	7.1	8.2	9.1
External Sector					
Exports (% y-o-y, BoP Basis)	7.0	-6.8	-3.0	3.2	5.9
Imports (% y-o-y, BoP Basis)	20.7	-8.9	-18.1	16.2	19.2
Trade balance (USD bn, BoP Basis)	-0.4	3.5	28.2	11.5	-8.0
Current account (% of GDP)	-2.9	-2.7	-0.4	-1.0	-1.9
Central government debt (% of GDP)	30.2	30.5	38.1	41.4	42.3
International Reserves –IRFCL (USD bn)	120.7	129.2	135.9	137.3	130.3
Reserve Cover (Months of imports & ext. debt)	6.5	7.3	9.8	7.8	7.0
Currency/USD (Year-end)	14,481	13,901	14,050	14,350	14,766
Currency/USD (Average)	14,250	14,146	14,529	14,340	14,689
Other					
BI 7-Day Reverse Repo rate (% year end)	6.00	5.00	3.75	3.50	4.25
Consumer prices (% year end)	3.13	2.72	1.68	3.58	4.00
Fiscal balance (% of GDP; FY)	-1.75	-2.20	-6.09	-5.07	-3.82
S&P's Rating – FCY	BBB-	BBB	BBB	BBB	BBB

Source: CEIC, E = Danamon Estimates

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