Indonesia Economic Flare

4 July 2022

The Liquidity Conundrum

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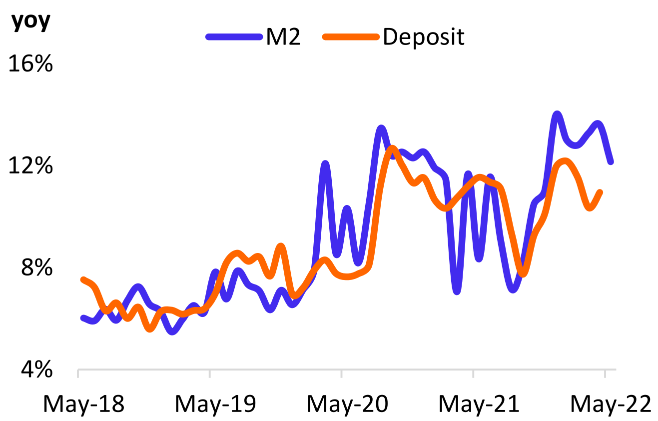
- **Excess liquidity on the aftermath of the pandemic**. During the pandemic era, authorities had flooded the domestic financial system with stimulus. Liquidity growth almost doubled compared to normal condition. In 2020, when COVID first emerged, deposit grew by 11.5% yoy or up from the previous year at 6.9% yoy. On a much larger picture, money supply (M2) also grew by double digit at 12.5% yoy (*Chart 1*). The strong liquidity growth was a result of IDR 576 tn stimulus under the national economic recovery program, where Bank Indonesia (BI) contributed around IDR 474 tn on its financing. In 1H21, liquidity in the banking system began to normalize, along with the improvement of economic activities. Unfortunately, it did not last long due to the delta outbreak in 3Q21. The government decided to add more stimulus in order to cushion the impact of the outbreak, while BI committed in helping to finance this additional stimulus. Thus, BI injected another IDR 358 tn to the system by purchasing government bond through the primary market, which led into a higher growth of M2 and deposit in 2021 (13.9% yoy and 11.9% yoy, respectively).

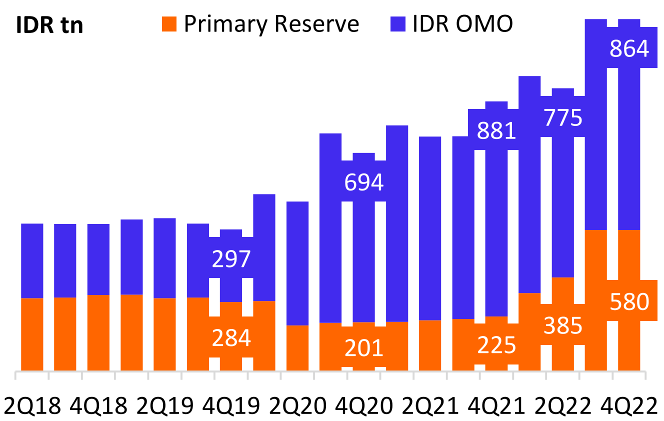
- **2022: The year of normalization.** Heading to 2022, COVID situation has receded and followed by improving domestic economy. In Jan-22's monetary policy meeting, BI signaled that they will begin their policy normalization this year. The central bank announced their plan of increasing reserve requirement ratio gradually throughout the year to 6.5%, starting in March. Thus, the primary reserve increased to IDR 324 tn in Apr-22, absorbing liquidity from the system. Excess liquidity in the money market dropped to IDR 688 tn within the same period, from IDR 890 tn previously (*Chart 2*). As mentioned in our previous report (*A Road to Normalization)*, BI will focus on liquidity approach first, prior to rate adjustment. This leaves us with a question regarding the impact of BI's policy normalization to domestic liquidity, something that the financial market is closely watching.

Chart 1. Money Supply (M2) and Banks' Deposit



Source: Bank Indonesia

Chart 2. Primary Reserve and Excess Liquidity in IDR

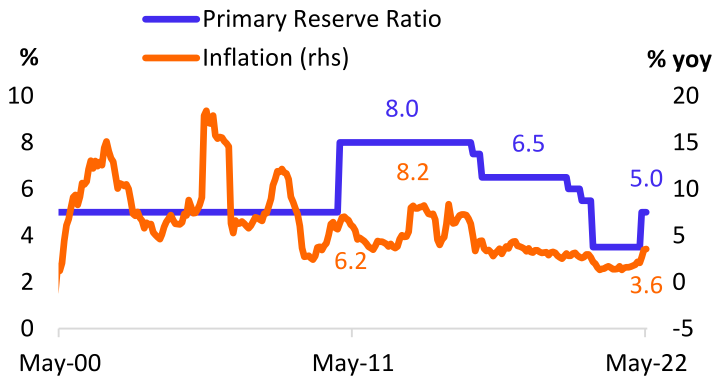


Source: Bank Indonesia, Danamon

Liquidity approach to curb inflation. Post Asian Financial Crisis (AFC), the highest primary Reserve Requirement Ratio set by BI was at 8.0% between November 2010 and October 2015, increased from 5.0% in previous years (*Chart 3*). The central bank, then, decided to absorb liquidity from the system in order to address overheating inflation. Headline inflation in 2011 was above 5.0%, with core inflation posted above headline inflation. A similar step was taken by BI back then, where liquidity approach was prioritized as a measure to curb inflation, prior to policy rate adjustment. During the abovementioned period, deposit bookings were around IDR 3,000 tn on average. Nowadays, deposit level doubled to around IDR 6,500 tn, which poses risk of stronger inflation pressure when demand returns. Since liquidity is currently at a record high, BI took a pre-emptive action in terms of liquidity absorption to prevent inflation from overshooting.

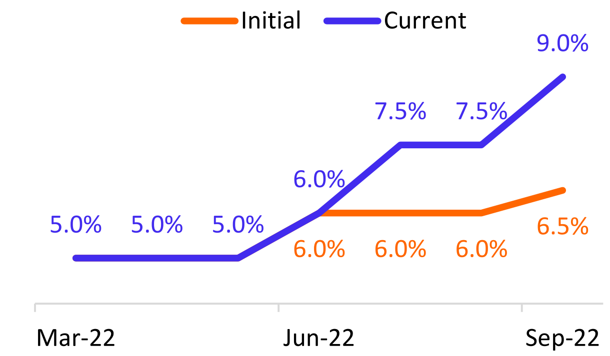
An assertive liquidity absorption. Recent leading indicators signaled that the domestic economy would recover at a faster pace. Therefore, BI revised its initial plan from increasing RRR to 6.5% gradually towards year-end, to a higher level of 9.0% (*Chart 4*). The first hike of RRR has materialized in Mar-22, where BI increased RRR by 150 bps from 3.5% to 5.0%. As a result of this increase, BI absorbed IDR 119 tn of liquidity from the system. This leaves us with another 4.0% increase throughout the year. Based on our calculation, it will shift around IDR 259 tn of liquidity from the market to BI's balance sheet.

Chart 3. Primary Reserve Requirement Ratio (RRR)



Source: Bank Indonesia

Chart 4. Primary RRR Plan in 2022



Source: Bank Indonesia

Additional budget allocation for energy subsidy and compensation. In May-22, the Parliament approved a proposal from the government to increase energy subsidy and compensation, without having to adjust its retail prices. This was a result of rising global oil price, which exceeded the initial 2022 budget assumption of USD 63/b. Brent oil price reached USD 120/b due to the Russia-Ukraine tension, pushing year-to-date average of oil price up to USD 104/b. The subsidy for energy was increased by IDR 75 tn, comprises of IDR 72 tn for fuel and LPG and another IDR 3 tn for electricity. On top of that, the government added compensations for Pertamina and PLN by IDR 195 tn and IDR 21 tn, respectively (*Chart 5*). Hence, the total compensation for this year should be around IDR 324 tn, considering the carried-over liabilities from last year at IDR 108 tn. Of which, IDR 275 tn would be settled this year and carry over the rest to next year.

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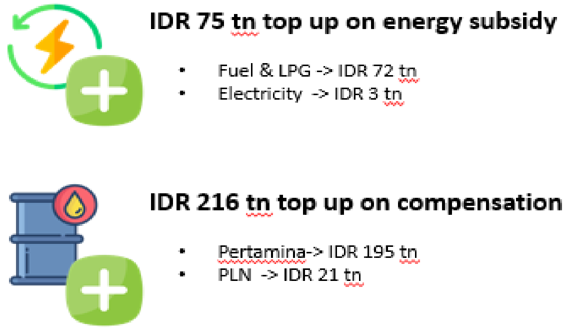
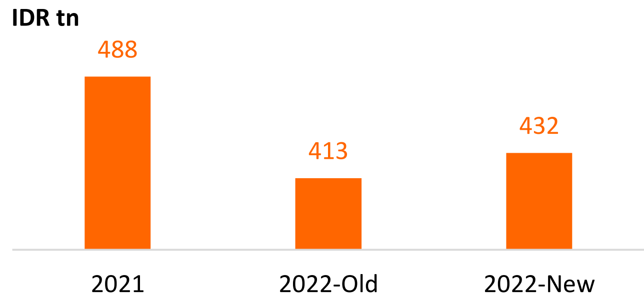
Chart 5. Subsidy and Compensation for Energy



Source: Ministry of Finance

Chart 6. Budget for Social Security

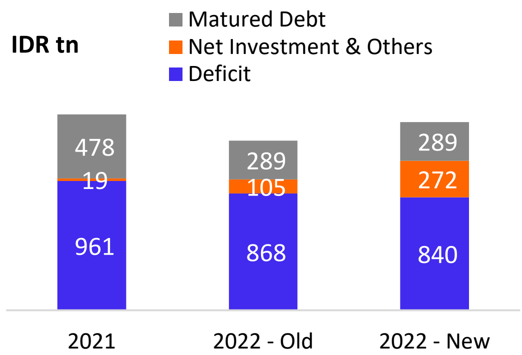


Source: Ministry of Finance

Strengthening social security to protect purchasing power. The government decided to increase its budget for social security by IDR 19 tn, which will be disbursed through cash transfers for 20.6 million households and finance micro businesses. The aim of such move is to protect middle-lower purchasing power amid increasing inflation pressure. All in all, the budget for social security was revised up to IDR 432 tn (*Chart 6*).

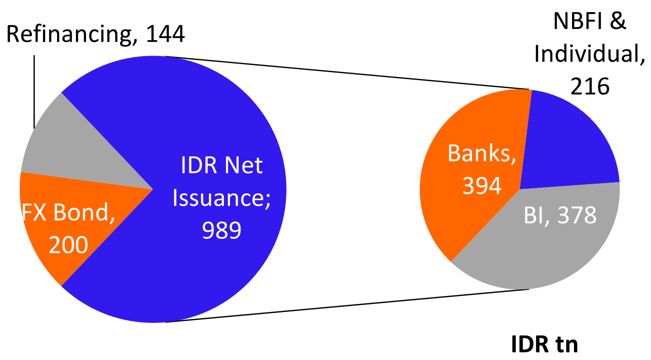
Expanded budget requires expanded financing. Since the government plans to pay IDR 275 tn of compensation this year, of which IDR 108 tn is carried over from last year (incorporated within the initial budget), we expect that there will be an additional financing need of IDR 167 tn. This additional financing is posted in the "below the line" section. Hence, the total gross financing need was revised to around IDR 1,400 tn, up from IDR 1,261 tn previously (*Chart 7*). According to the debt management office, 95% would be financed through bond issuance, whereby 85% of total bond issuance would be denominated in IDR.

Chart 7. Government Financing



Source: Ministry of Finance, Danamon

Chart 8. Bond Supply and Demand



Source: Danamon

BI is committed to help fiscal financing through Private Placement (PP) and Green Shoe Option (GSO). Carrying on its commitment to purchase government bond through the primary market, the Ministry of Finance (MoF) could potentially utilize IDR 224 tn of PP from BI. Learning from experience, MoF will likely optimize this channel, although as a last resort. On top of that, BI also has the commitment as a standby buyer through GSO, should demand from market falls short. As of May-22, BI has purchased IDR 30 tn of government bond in the primary market through this scheme. From a domestic buyer perspective, we expect banks would be able to absorb around IDR 394 tn this year, as deposit growth will remain higher than credit growth. While from the NBFIs and individuals, absorption could reach IDR 216 tn as economic recovery continues, which could help amplify money multiplier. Foreign flows will remain on the sideline, along with global monetary policy tightening. Hence, there is a good chance that BI would purchase around IDR 378 tn this year through both PP and GSO, considering the abovementioned capacity of demand from domestic buyers (*Chart 8*).

Heading towards year-end 2022, the combination of monetary and fiscal operations will have net expansionary impact to IDR liquidity. In summary, the RRR increase for the rest of 2022 would likely absorb around IDR 259 tn from the system. On the other hand, BI's purchase of government bond will provide net additional IDR 345 tn of IDR liquidity to the banking system. This would result in net liquidity injection of around IDR 89 tn for the rest of the year. The position of excess IDR liquidity in BI's open market operation remained high at IDR 775 tn per 27-Jun. Thus, we do not see that liquidity will substantially shrink this year. However, such condition may reverse next year since BI will no longer purchase government bond in the primary market, while the fiscal deficit will return to below 3.0% of GDP. From the perspective of banking business, we expect loan growth to be higher next year, both against this year as well as against deposit growth. Hence, the increase in deposit would not be able to cover the increase in loan. Excess liquidity will then begin to shrink to fulfill loan demand.

Table 1. Liquidity Impact[1]

IDR tn		Liquidity Impact (May-22)	
Deposit	**a**		**6,474**
RRR (4%*a)	b	(259)	
FY22 Total BI Purchase (Estimated)	**c**		**378**
Private Placement BI	d	224	
Financing via Standby Buyer (c-d)	e	154	
Standby Buyer Realization (May-22)	f	(30)	
Net Liquidity Impact	**b+c+f**	**89**	

Source: Danamon

[1] *Notes: we assume that the MoF will fully utilize BI's commitment in purchasing government bond through PP and GSO. Should the MoF decided to reallocate their existing budget to finance this revision, then there is a possibility that net liquidity impact will reverse to contraction.*

Indonesia's Selected Economic Indicators

	2018	2019	2020	2021	2022E
National Accounts					
Real GDP (% y-o-y)	5.2	5.0	-2.1	3.7	5.1
Domestic demand ex. inventory (% y-o-y)	6.3	3.6	-3.1	2.8	5.4
Real Consumption: Private (% y-o-y)	5.0	5.0	-2.7	2.0	4.9
Real Gross Fixed Capital Formation (% y-o-y)	6.7	4.4	-4.9	3.8	7.3
GDP (USD bn) — nominal	1,042	1,119	1,059	1,186	1,212
GDP per capita (USD) — nominal	3,932	4,193	3,917	4,450	4,422
Open Unemployment Rate (%)	5.3	5.3	7.1	6.0	5.7
External Sector					
Exports (% y-o-y, BoP Basis)	7.0	-6.8	-3.0	42.5	30.9
Imports (% y-o-y, BoP Basis)	20.7	-8.9	-18.1	39.9	41.1
Trade balance (USD bn, BoP Basis)	-0.4	3.5	28.2	43.8	26.0
Current account (% of GDP)	-2.9	-2.7	-0.4	0.3	-0.5
Central government debt (% of GDP)	30.2	30.5	38.1	41.0	42.3
International Reserves –IRFCL (USD bn)	120.7	129.2	135.9	144.9	140.8
Reserve Cover (Months of imports & ext. debt)	6.5	7.3	9.8	7.8	7.2
Currency/USD (Year-end)	14,481	13,901	14,050	14,253	14,628
Currency/USD (Average)	14,250	14,146	14,529	14,296	14,511
Other					
BI 7-Day Reverse Repo rate (% year end)	6.00	5.00	3.75	3.50	4.50
Consumer prices (% year end)	3.13	2.72	1.68	1.87	4.15
Fiscal balance (% of GDP; FY)	-1.75	-2.20	-6.09	-4.65	-5.00
S&P's Rating – FCY	BBB-	BBB	BBB	BBB	BBB

Source: CEIC, E = Danamon Estimates

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