AMRO Country Report
ACR/22-04

AMRO Annual Consultation Report

Indonesia - 2021

ASEAN+3 Macroeconomic Research Office (AMRO)

April 2022

Acknowledgements

1. This Annual Consultation Report on Indonesia has been prepared in accordance with the functions of AMRO to monitor and assess the macroeconomic status and financial soundness of its members; identify relevant risks and vulnerabilities; report these to member authorities; and if requested, assist them in mitigating these risks through the timely formulation of policy recommendations. This is being done in accordance with Article 3 (a) and (b) of the AMRO Agreement.
2. This Report is drafted on the basis of the Annual Consultation Visit (ACV) of AMRO to Indonesia, which was conducted virtually from October 25 to November 19, 2021 (Article 5 (b) of the AMRO Agreement). The AMRO ACV team was headed by Dr Sumio Ishikawa, Group Head and Lead Economist. The ACV members were Dr Nguyen Thi Kim Cuc, Country Economist for Indonesia; Dr Andriansyah, Fiscal Specialist and Back-up Economist for Indonesia; Dr Jade Vichyanond, Economist and Back-up Economist for Indonesia; Ms Yang Chunyu, Associate Economist; and Mr Sota Nejime, Associate Researcher. AMRO Director Mr Toshinori Doi and Chief Economist Dr Hoe Ee Khor participated in key policy meetings with the authorities. The AMRO Annual Consultation Report on Indonesia for 2021 was peer reviewed by Dr Lee Jae Young, Group Head and Lead Economist, and Ms Laura Grace Gabriella, Associate Economist; format-reviewed by Ms Madeleine Vinuya, Research Data Analyst; and approved by Dr Hoe Ee Khor, AMRO Chief Economist.
3. The analysis in this Report is based on data and information available up to January 3, 2022, with several key sectors updated with data and information available up to February 15, 2022.
4. By making any designation of or reference to a particular territory or geographical area, or by using the term “member” or “country” in this Report, AMRO does not intend to make any judgments as to the legal or other status of any territory or area.
5. No part of this material may be disclosed unless so approved under the AMRO Agreement.
6. On behalf of AMRO, the ACV team wishes to thank the Indonesian authorities for their comments on this Report, as well as their excellent meeting arrangements during our visit.

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Executive Summary

The Indonesian economy has regained traction and is on track to a firm recovery as a result of the government's effective containment of the Delta variant outbreak and ongoing policy support. In light of continued pandemic uncertainties, the pace of vaccination should be further ramped up and policy measures should be geared toward supporting a sustainable recovery. Accelerating structural reforms is crucial to strengthen the country's resilience and growth potential in the post-pandemic new normal.

1. Economic activity has regained growth momentum following the effective containment of the Delta variant outbreak and relaxation of mobility restrictions. After contracting moderately by 2.1 percent in 2020, real GDP rebounded by 3.7 percent in 2021, led by robust exports and stronger domestic demand, and is expected to grow further by 5.2 percent in 2022. Demand normalization along with economic recovery, is expected to lift inflation from the subdued level of 1.6 percent (annual average) in 2021 to 2.8 percent in 2022.

2. Stellar export performance and an increase in foreign investment inflows have supported Indonesia's external position in 2021. Merchandise exports posted a 43 percent year-on-year (yoy) growth in 2021, underpinned by global demand recovery and higher prices of Indonesia's key commodities. Foreign direct investment realization in 2021 increased by 8.5 percent from a year earlier, with sustained inflows into metal processing, automotive, and mining activities. Likewise, portfolio investment rose relative to 2020, driven by net inflows into the stock market and higher issuance of global bonds by the government and corporate sector. These developments have supported the rupiah and led to an increase in the gross international reserves to USD144.9 billion, equivalent to 8 months of imports, as at December 2021.

3. Financial markets remain resilient to external headwinds. Outflows were observed in the government bond market in 2021, as investor sentiment toward emerging markets (EMs) was adversely affected by uncertainties over the timing of the U.S. Federal Reserve's policy normalization and the resurgence of the virus in the region. Nevertheless, Indonesian government bond yields picked up only moderately relative to its EM peers. A better-than-expected fiscal outturn coupled with strengthened fiscal-monetary policy synergy, led to lower bond issuances amid sustained demand by domestic investors. Improved corporate sector performance, underpinned by higher commodity prices and a recovery in domestic demand, has combined with e-commerce expansion, to attract inflows to the stock market.

4. Improved economic conditions are underpinning a recovery in loan growth and a moderation in loan restructuring due to COVID-19. Stronger economic activity saw bank loans rebound by 5.2 percent (yoy) at end-2021, the highest since mid-2020. With more borrowers making repayments, the overall size of pandemic-related restructured loans declined to about IDR663.5 trillion in December 2021, equivalent to 11.5 percent of total loans outstanding. Banks have reportedly downgraded or even written off non-viable loans voluntarily, aiming to avoid a potential spike in non-performing loans (NPLs) post-restructuring. High capital adequacy ratios of above 20 percent, alongside elevated loan-loss provisions which cover close to 200 percent of NPLs, should provide adequate support to the banking sector's resilience moving forward.

5. Bank Indonesia's policy mix continues to support economic recovery. BI has kept its policy rate at a record low of 3.5 percent following six rate cuts since the pandemic outbreak in early 2020. A low interest environment, coupled with BI's quantitative easing measures and fiscal-monetary policy synergy to support economic recovery from the pandemic, have underpinned loose liquidity conditions. As the banking sector remains sound, macroprudential regulations on automotive and property loans have been further relaxed, in sync with the government's tax incentives on car and home purchases, to boost domestic demand under an integrated

policy package coordinated by the Financial System Stability Committee. Efforts have also been stepped up to digitalize the payment system and enhance financial inclusion.

6. Fiscal policy remains supportive. The government increased the fiscal support package to about 4.4 percent of GDP in 2021 to combat the impact of the Delta variant outbreak, of which 88.4 percent, or 3.9 percent of GDP, was disbursed. Following a burden-sharing scheme introduced for 2020, BI and the government have entered into another agreement, in which the central bank would contribute to the cost of financing pandemic-related healthcare spending and humanitarian aid by buying government bonds through private placement at variable rates in 2021-2022. Debt management measures have also been adopted, including increased usage of cash reserves. The 2022 Budget is designed to sustain the recovery momentum in view of the continuing uncertainty surrounding the pandemic. To support medium-term fiscal consolidation and restore fiscal discipline post-pandemic, the government has succeeded in pushing through parliament a comprehensive tax reform package, including a higher value-added tax rate and a new carbon tax, the latter being a signal of its commitment to the climate change agenda.

7. Risks to the near-term outlook continue to stem from possible COVID-19 resurgences and Fed policy uncertainties. The likelihood of having repeated waves of infections, especially with the emergence of new variants, followed by tighter containment measures, would weigh on Indonesia's recovery prospects and deepen the disparity across sectors. A spike in risk aversion among global investors, triggered by a sharper-than-expected Fed tightening, could heighten volatility in the domestic financial markets. However, reduced foreign holdings of government bonds, a strengthened external position, and low inflation, should help mitigate possible spillovers.

8. Indonesia is also facing challenges of executing a smooth exit from its expansionary pandemic policies in the medium term. The country's elevated debt-service burden, as a result of higher government debt due to the pandemic, could increase further should Fed tightening lead to significantly higher domestic interest rates, reducing the room for much-needed capital spending. This will be particularly critical when Indonesia restores the fiscal rule of a maximum budget deficit of 3 percent of GDP in 2023. Fiscal-monetary synergy has been strengthened in response to the ongoing pandemic, with BI's contribution to the cost of financing healthcare spending and humanitarian aid until 2022. A smooth exit from this arrangement underpinned by the implementation of the tax reform package and continued fiscal-monetary policy synergy is crucial to maintain market confidence and support economic recovery post-pandemic.

9. The pace of vaccination should be further ramped up, along with policy measures geared toward supporting a sustainable recovery. Faster vaccination, especially in rural and remote areas, and enhanced healthcare capacity are essential to mitigate the risk of a resurgence of infections. To provide continued support to affected businesses, it is important to set a sufficient size of loan guarantee programs for micro, small and medium enterprises (MSMEs), and corporates moving forward. Policy measures to promote financial inclusion should be complemented with concerted efforts to build a sound business framework for banks to lend to MSMEs, including the adoption of proper bookkeeping and strengthened risk management practices among these enterprises. Looking ahead, in light of increased external headwinds, AMRO supports BI's continuous recalibration of its policy mix by adopting a prudent and measured normalization of the monetary policy to safeguard financial stability, while maintaining an accommodative macroprudential policy and accelerating the digitalization of payment systems, as well as financial deepening, to support sustainable economic recovery. External resilience will be further strengthened by BI's continuous engagement in bilateral, regional, and multilateral financial cooperation.

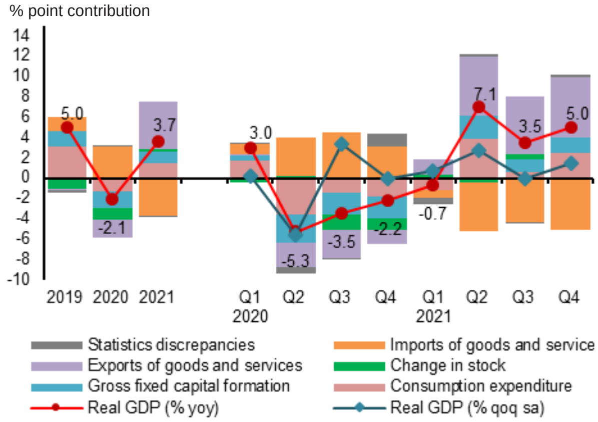
10. Accelerating structural reforms is crucial to facilitate a smooth exit from expansionary pandemic policies and strengthen Indonesia's growth potential in the new normal. AMRO staff welcomes the tax reform package passed in October, as the additional revenue will support infrastructure spending amid fiscal consolidation post-pandemic. Ongoing reforms in financial deepening and inclusion, enhancement of the investment climate, and digitalization of the economy, will boost growth and productivity. Last, but not least, efforts to mitigate the country's impact on climate change will contribute to the achievement of Indonesia's sustainable development goals.

A. Recent Developments and Outlook

A.1 Economic recovery underway

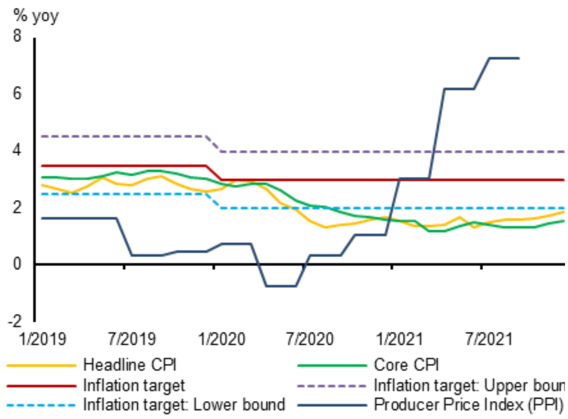
1. The Indonesian economy demonstrated resilience during the COVID-19 pandemic. Despite the severe outbreak and lockdown, the economy contracted by a relatively mild 2.1 percent last year compared with other emerging market economies. Led by robust exports and domestic consumption, the economy posted a solid expansion of 7.1 percent in Q2 2021. Nevertheless, growth slowed to 3.5 percent in Q3 as domestic demand weakened amid a major resurgence brought by the Delta variant and a retightening of containment measures Following a sharp decline in the infection rate and a ramp-up in vaccination, the relaxation of mobility restrictions among a broader number of economic sectors and ongoing policy supports led to a recovery in domestic consumption and investment in Q4, amid continued strong exports (Figure 1). Consequently, real GDP in 2021 rebounded by 3.7 percent and is expected to accelerate to around 5.2 percent in 2022.

Figure 1. Contribution to Real GDP Growth: from the Demand Side



Source: Statistics Indonesia; CEIC; AMRO staff calculations
Note: The sequential growth (%qoq sa) is from AMRO staff estimates.

Figure 2. Consumer and Producer Price Index



Source: Statistics Indonesia; CEIC; AMRO staff calculations
Note: Data is on a monthly basis and up to December 2021, except for PPI which is quarterly and up to Q3 2021.

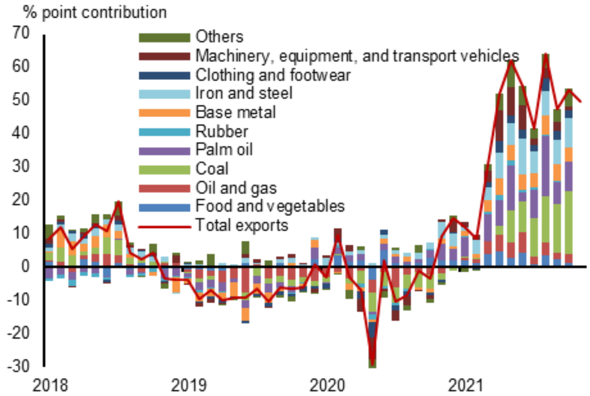
2. Inflation is expected to increase from the currently subdued level, but to remain contained within Bank Indonesia's target inflation band. The lingering weak domestic demand and limited pass-through of rising prices of fuel and other inputs have kept headline and core inflation low and stable at 1.6 percent and 1.4 percent (annual average), respectively, in 2021 (Figure 2).[1] Notably, stable domestic fuel prices and electricity subsidies to households and businesses during the pandemic kept energy prices subdued despite rising global oil prices. The impact of global supply disruptions elsewhere on Indonesia's inflation has been also limited given its moderate integration into global/regional value chains.[2] Looking forward, demand normalization in line with economic recovery, combined with likely increases in the prices of high-grade fuel, a higher value-added-tax (VAT) rate, and an expected removal of pandemic-related electricity subsidies, is expected to lift headline inflation to about 2.8 percent in 2022 (Box A).

3. A strong export performance and increased foreign investment have supported Indonesia's external position. Merchandise exports posted a 43-percent (yoy) growth in 2021, underpinned by global demand recovery and higher prices of Indonesia's key

[1] Headline and core CPI stood at 1.9 percent (yoy) and 1.6 percent (yoy) as at December 2021, compared with 1.7 percent and 1.6 percent, respectively, as at December 2020.
[2] For a discussion on this topic, one could refer to "Why Isn't There More Inflation in Indonesia Right Now?", The Diplomat, December 15, 2021, available at https://thediplomat.com/2021/12/why-isnt-there-more-inflation-in-indonesia-right-now/.

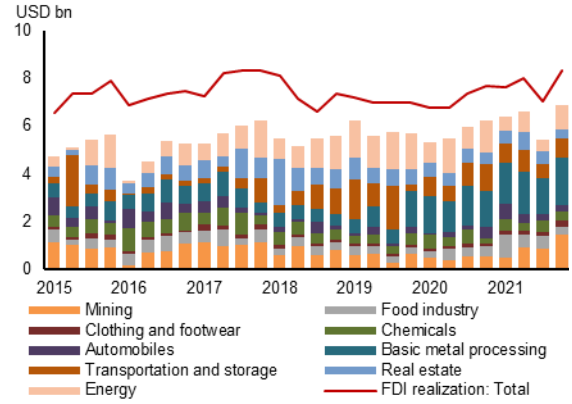
commodities (Figure 3). Indonesia has also benefited from notable exports of stainless steel as the result of a wave of FDI into the industry during 2016-2017, leveraging the country's rich nickel reserves and the government's policy to promote investment in higher value-added metal processing and other downstream activities.[3] Robust exports sustained an improvement in the current account balance, which reversed to a surplus in H2 2021 after registering a modest deficit in H1 2021. Foreign direct investment realization in 2021 grew by 8.5 percent from a year earlier, with continued inflows into activities in metal processing, automobiles including electric vehicles and battery manufacturing, and mining (Figure 4). Likewise, portfolio investment rose in 2021, driven by net inflows into the stock market and higher issuance of global bonds by the government and corporate sector. The strong export performance and higher foreign investment inflows have supported Indonesia's balance of payments and a relatively stable rupiah throughout the year, resulting in an increase in gross international reserves to USD144.9 billion as at end-2021,[4] up from USD135.9 billion at end-2020 (Figures 5, 6).

Figure 3. Contribution to Export Growth



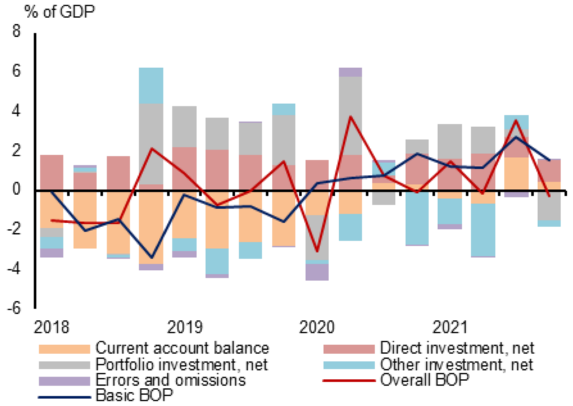
Source: Statistics Indonesia; CEIC; AMRO staff calculations
Note: Monthly data are up to December 2021.

Figure 4. FDI Realization



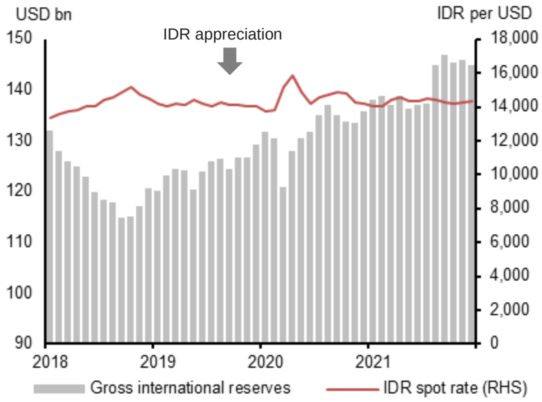
Source: Investment Ministry; CEIC; AMRO staff calculations
Note: Quarterly data are up to Q4 2021.

Figure 5. Basic and Overall Balance of Payments



Source: Bank Indonesia; CEIC; AMRO staff calculations
Note: Quarterly data are up to Q4 2021.

Figure 6. Gross International Reserves and IDR Spot Rate

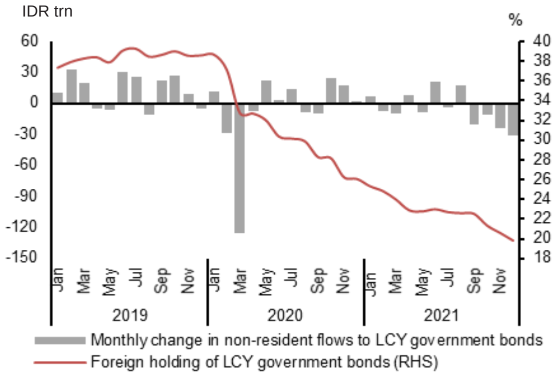


Source: Bank Indonesia; CEIC; AMRO staff calculations
Note: Monthly data are up to December 2021.

[3] Indonesia's nickel ore production accounts for about 60 percent of global output. The country has banned exports of unprocessed ores since 2014 to preserve its nickel ore resources for metal processing industries, notably nickel pig iron and stainless steel melting. A wave of FDI from Chinese firms flowed into Indonesia around 2016-2017 with the establishment of a stainless steel complex in Morowali, Central Sulawesi, which has boosted the industry's output and exports significantly over the past few years. Indonesia's stainless steel production volumes increased from less than one million tons (MT) in 2017 to about 2.8MT in 2020, and is projected to rise further to 4.2MT in 2021, compared to the maximum capacity of 5.5MT. Data from Statistics Indonesia also indicates a steady increase in exports of iron and steel from USD2.2 billion in 2017 to USD11.2 billion in 2020.
[4] This includes the IMF's SDR allocation in 2021 to Indonesia, which amounted to IDR4.5 billion, equivalent to USD6.3 billion.

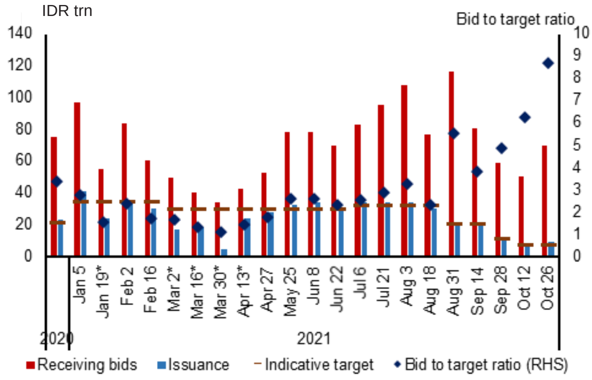
4. The financial markets remain resilient to external headwinds. Intermittent outflows were observed in the government bond market in 2021, as investor sentiment toward EMs was adversely affected by uncertainties over the timing of the U.S. Federal Reserve's policy normalization, resurgences of Covid-19 in the region, and to some extent, developments in China's credit market. Foreign holdings of government bonds moderated to about 20 percent of total bonds outstanding by end-2021, down from 26 percent at end-2020 and the pre-pandemic level of close to 40 percent (Figure 7). Underpinned by strengthened fiscal-monetary policy synergy and better-than-budgeted fiscal outturn, the government reduced bond issuances at regular auctions, notably in February-April and September-October 2021 (Figure 8), and canceled the planned auctions in November-December 2021. A significant share of the financing needs were absorbed by BI through additional auctions known as greenshoe options earlier in the year, and through private placements at variable rates in the final months of 2021 under a new agreement between the government and BI in August.[5] BI also stepped up its triple interventions, notably in the domestic non-deliverable forward (DNDF) market in times of stress, to maintain the rupiah exchange rate stability in line with the currency's fundamentals and market mechanism.[6] While Indonesian government bond yields have risen from end-2020, the increase is modest relative to its EM peers and U.S. Treasuries (Figure 9). Meanwhile, strengthened recovery prospects, underpinned by the successful containment of the Delta variant outbreak and boosted by a commodity price boom and e-commerce expansion, have attracted capital inflows and sustained a rally in the Jakarta Stock Exchange in 2021 (Figure 10).

Figure 7. Foreign Holdings and Net Inflows of Government Bond Market



Source: Ministry of Finance; CEIC; AMRO staff calculations
Note: Monthly data are up to December 2021.

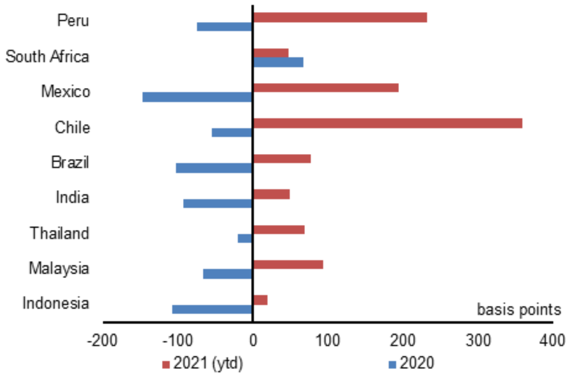
Figure 8. Conventional Regular Bond Auctions: 2020-2021



Source: Ministry of Finance; CEIC; AMRO staff calculations
Note: Data refers to regular conventional bond auctions only. Data for 2020 is on the average amount per auction. Auctions in 2021 with asterisks were followed by a GSO the following day.

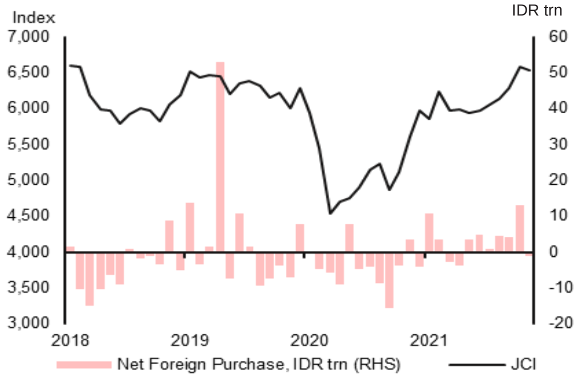
[5] For details of BI's different budget financing arrangements during the pandemic, see paragraph 12 and Selected Issue 1.
[6] The DNDF was launched in late 2018 to provide an alternative hedging instrument to foreign investors who were hedging their rupiah exposure in offshore NDFs, and to deepen the onshore foreign exchange market. It has been mainly provided by BI at a cheaper cost than offshore NDFs, and has hence attracted some flows from Singapore-based investors who have used the offshore NDF.

Figure 9. Annual Change in Government Bond Yields: Selected EMs



Source: Various national authorities; CEIC; AMRO staff calculations
Note: Annual changes for 2021 were between October 2021 and December 2020.

Figure 10. Jakarta Composite Index and Net Inflows to the Stock Market



Source: Jakarta Stock Exchange; CEIC; AMRO staff calculations
Note: Monthly data are up to November 2021.

5. External debt moderated in 2021. Indonesia's gross external debt increased from USD403.6 billion in 2019 to USD416.9 billion in 2020, as both the government and non-financial corporates stepped up foreign currency (FCY) bond issuances and foreign borrowing amid a sell-off by foreign investors of their local currency (LCY) bonds. In 2021, gross external debt moderated to USD415.1 billion as of December (Table 1). While FCY bonds and notes issued by non-financial corporates continued to edge up, foreign loan repayments and a further decline in the foreign holding of LCY government bonds underpinned a moderation in government external debt. As such, the external debt-to-GDP ratio has abated, easing to 35 percent compared to the peak of 39.4 percent in 2020. Indonesia's prudent debt structure has been maintained, with short-term debt by remaining maturities accounting for about 14 percent of total external debt and 41 percent of gross international reserves as of end-2021.

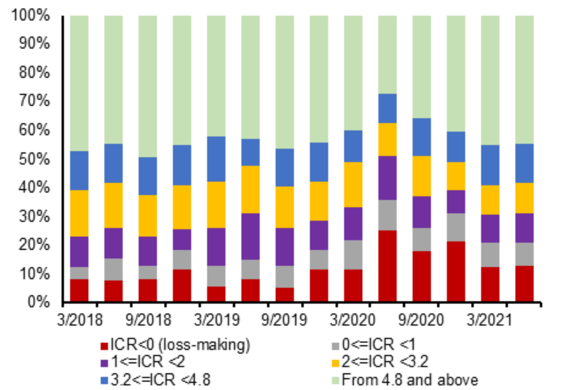
Table 1. Gross External Debt: 2017-2021

USD bn	2017	2018	2019	2020	2021			
	Dec	Dec	Dec	Dec	Mar	Jun	Sep	Dec
External Debt: Total	352.5	375.4	403.6	416.9	415.5	416.3	424.0	415.1
in percent of GDP	*34.7*	*36.0*	*36.1*	*39.3*	*39.0*	*37.5*	*37.0*	*35.0*
External Debt: Government	177.3	183.2	199.9	206.4	203.2	205.0	205.5	200.2
o/w LCY bonds and notes held by non-residents	61.7	61.7	76.4	69.0	65.3	67.2	67.2	62.4
o/w FCY bonds and notes	61.1	66.3	69.1	77.7	79.8	80.7	81.7	81.3
o/w FCY loans	54.5	55.2	54.4	59.6	58.1	57.1	56.7	56.5
External Debt: Bank Indonesia	3.3	3.1	3.0	2.9	2.8	2.8	9.1	9.0
External Debt: Banks	30.3	34.4	35.2	33.6	34.0	33.2	34.0	33.0
External Debt: Non-bank financial corporates	10.3	10.6	11.4	9.6	9.5	9.1	8.8	8.5
External Debt: Non-financial corporates	131.3	144.2	154.1	164.5	166.0	166.1	166.5	164.4
o/w LCY bonds and notes held by non-residents	2.7	1.4	0.6	0.3	0.3	0.3	0.1	0.1
o/w FCY bonds and notes	25.8	34.0	38.5	46.6	48.5	50.2	50.0	49.7
o/w FCY loans	91.5	95.5	100.0	104.9	103.7	100.5	99.9	99.7
o/w trade credit	10.1	12.0	13.7	11.0	12.2	13.8	14.4	13.8
o/w other borrowings	1.3	1.2	1.2	1.6	1.3	1.3	2.1	1.1
External debt: short-term by remaining maturities	54.8	60.2	63.3	65.1	68.3	65.3	64.8	59.4
in percent of total external debt	*15.6*	*16.0*	*15.7*	*15.6*	*16.4*	*15.7*	*15.3*	*14.3*
in percent of gross international reserves	*42.1*	*49.9*	*49.0*	*47.9*	*49.8*	*47.6*	*44.1*	*41.0*

Source: Bank Indonesia; CEIC; AMRO staff calculations
Note: BI's increased external debt from September 2021 is due to the additional SDR allocation in 2021.

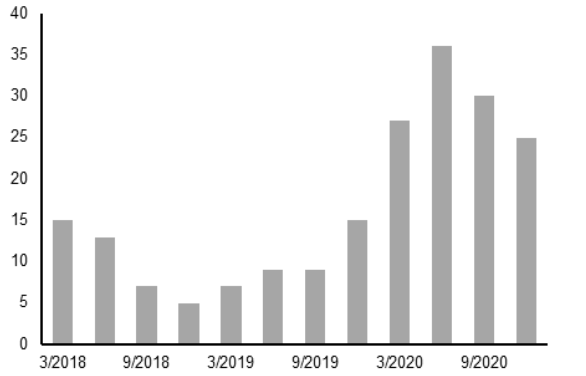
6. The corporate sector's performance has been boosted by a recovery in global demand, higher commodity prices, and greater domestic mobility. The proportion of listed firms that reported an interest coverage ratio (ICR)[7] of below 2, peaked at almost 50 percent of total listed firms in mid-2020, but moderated to the pre-pandemic level of about 30 percent in early 2021 (Figure 11). Likewise, the number of firms that reported at least three consecutive quarters of negative earnings has also decreased from the 2020 peak (Figure 12). Increased earnings are notable among energy and primary material producers which have benefited from a recovery in global demand and higher commodity prices. Greater mobility and a rebound in domestic consumption have also supported a recovery in earnings among firms providing consumer goods and services (Figure 13).

Figure 11. Listed Firms Composition by ICR



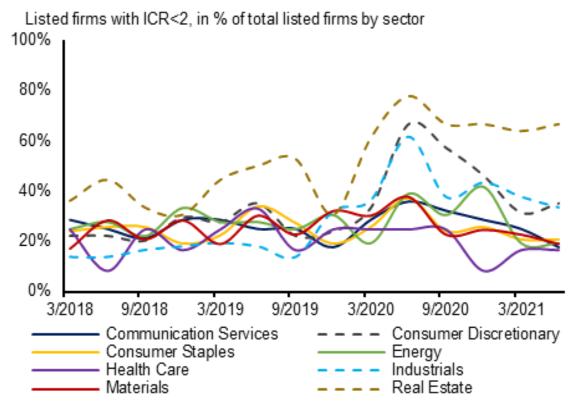
Source: Bloomberg; AMRO staff calculations
Note: Internal Coverage Ratio (ICR) is calculated as the ratio of earnings before tax, depreciation and amortization (EBITDA) to total interest expenses. Quarterly data are up to Q2 2021.

Figure 12. Number of Listed Firms with Three Consecutive Negative Earnings



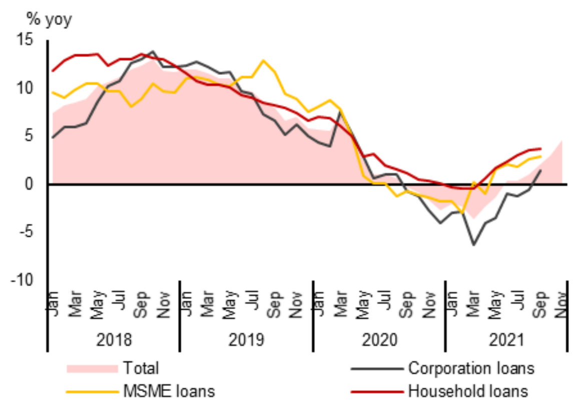
Source: Bloomberg; AMRO staff calculations
Note: Listed firms' earnings are before tax, depreciation and amortization (EBITDA). Quarterly data are up to Q4 2020.

Figure 13. Listed Firms at Risk, by Sector



Source: Bloomberg; AMRO staff calculations
Note: ICR is calculated as the ratio of EBITDA to total interest expenses. Quarterly data are up to Q2 2021.

Figure 14. Bank Loan Growth, by Type of Loans



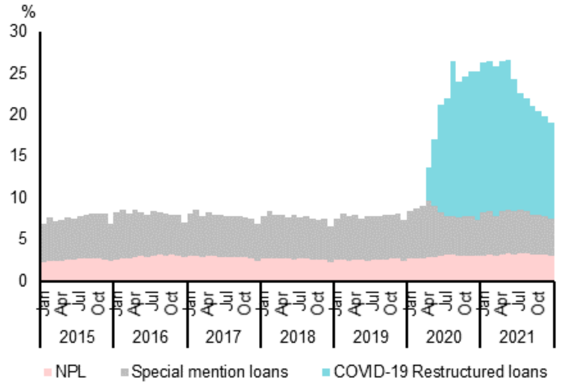
Source: Bank Indonesia; OJK; CEIC; AMRO staff calculations
Note: Monthly data are up to November for total loans, and September for loan growth by different type of loans.

7. Improved economic conditions are underpinning a recovery in loan growth and moderation in COVID-19 restructured loans,[8] while strong capital buffers and elevated provisions continue to support the banking sector's resilience. Bank loans rebounded to grow by 5.2 percent (yoy) in December 2021, driven by a pickup in household and MSME loans, and more recently, corporate loans (Figure 14; see Selected Issue 3 for an analysis on recent developments in bank loans and policy responses during the pandemic). With more

[7] The ICR is calculated as the ratio of earnings before tax, depreciation and amortization (EBITDA) to total interest expenses.
[8] To support pandemic-hit businesses, the Financial Services Authority (OJK) allows banks to restructure loans affected by the pandemic and classify them using relaxed criteria. In particular, banks could assess loan quality based on the borrower's ability to serve their debt obligations in a timely manner and regardless of the macroeconomic conditions and business prospects. The loan restructuring program was launched in April 2020 and has been extended to March 2023.

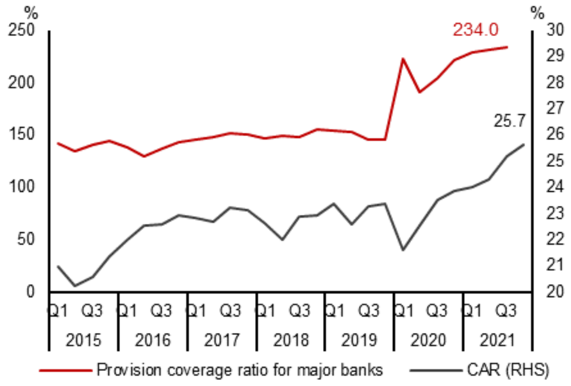
borrowers repaying their restructured loans, the size of pandemic-related restructured loans declined to about IDR663.5 trillion as of December 2021, making up 11.5 percent of total loans outstanding (Figure 15). Banks' profitability has also improved on the back of stronger loan growth and lower cost of funding. The loan restructuring program, under which loan classification criteria have been relaxed, along with improved macroeconomic conditions, have helped contain banks' non-performing loan (NPL) ratio at 3.0 percent of total loans outstanding by end-2021. To avoid a potential spike in NPLs after the restructuring program ends, some banks have started voluntarily downgrading or even writing off non-viable loans from their books. Meanwhile, high capital adequacy ratios of above 20 percent, coupled with elevated loan-loss provisions which cover close to 200 percent of NPLs, should provide adequate support to the banking sector's resilience moving forward (Figure 16).

Figure 15. Banks' NPLs, Special Mentions, and Restructured Loans



Source: OJK; CEIC; banks' financial reports; AMRO staff calculations
Note: Monthly data are up to December 2021.

Figure 16. Capital Adequacy Ratio and Provision Coverage of NPLs

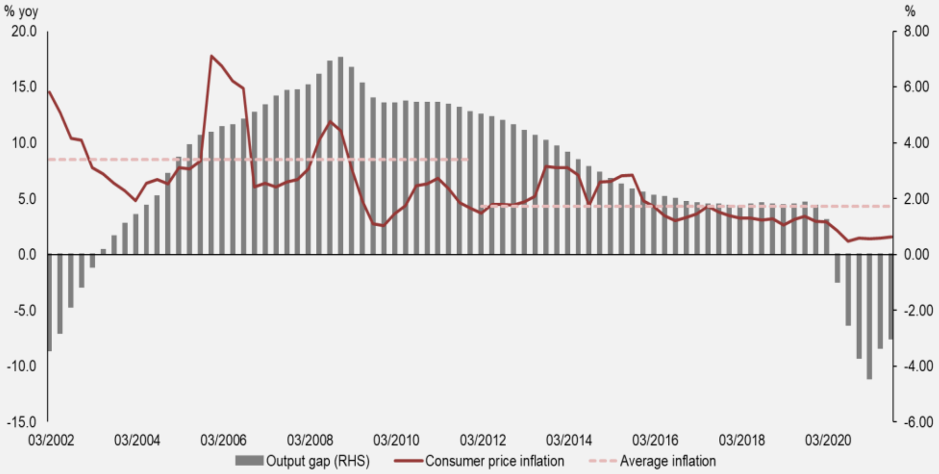


Source: OJK; CEIC; Moody's; AMRO staff calculations
Note: The provision coverage of NPLs is calculated by AMRO staff using data of Bank Rakyat Indonesia (BRI), Bank Mandiri, Bank Central Asia (BCA), Bank Negara Indonesia (BNI), Bank CIMB and Bank Danamon. Data are up to Q4 2021 for the capital adequacy ratio, and Q3 2021 for the provision coverage ratio.

Box A. Inflation Drivers in 2022[9]

Indonesian inflation was subdued at 1.6 percent in 2021, well below BI's inflation target, but it is expected to rise in 2022 in tandem with the economic recovery. Historically, inflation had been relatively high in Indonesia before 2010 and it gradually trended down during the 2010s (Figure A1). Average headline inflation declined from around 8.5 percent between 2000 and 2009 to around 4.3 percent between 2010 and 2021. Accordingly, BI reduced its inflation target to 3 percent plus or minus 1 percentage point at the beginning of 2020, and inflation has been below this target since June 2020. The consistently lower headline inflation figures since 2010 suggest that inflation dynamics may have undergone structural changes in the past decade.

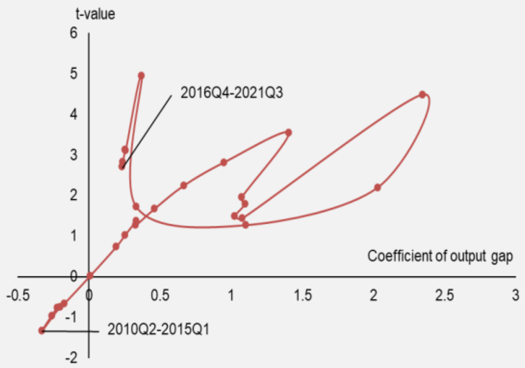
Figure A1. Headline Consumer Price Inflation and Output Gap[10]



Source: Statistics Indonesia; Haver Analytics; AMRO staff calculations

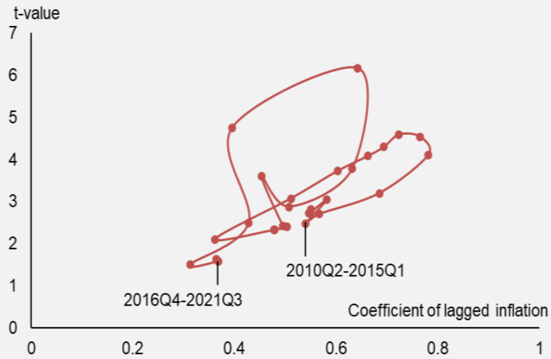
That said, the relationship between inflation and the output gap is changing constantly even after 2010, according to the result of a simple rolling window regression. We ran a simple rolling window regression to examine the impact of the output gap on inflation, with five-year rolling windows, between Q1 2010 and Q3 2021. In addition to the output gap, a lagged inflation was included as an explanatory variable to better capture inflation transition. The results suggest that inflation may be positively correlated with the output gap with the size of the correlation varying over time (Figure A2).[11] It is also shown that the lagged inflation has a pivotal role in estimating current inflation. Using the regression result for the most recent periods from Q4 2016 to Q3 2021, economic recovery is expected to raise inflation to 2.3 percent in Q4 2022 as a demand factor (Table A1).

Figure A2. Transition of the Coefficient of the Output Gap



Source: Statistics Indonesia; Haver Analytics; AMRO staff calculations

Figure A3. Transition of the Coefficient of the Lagged Inflation



Source: Statistics Indonesia; Haver Analytics; AMRO staff calculations

[9] Prepared by Sota Nejime, Associate Researcher
[10] The output gap is measured as the difference between real GDP and the trend estimated by the HP filter (one-sided, λ=40,000). The 4Q moving-sum real GDP, which is seasonally adjusted, is used as a sample for calculating the trend.
[11] Most of t-values with the five-year rolling windows from Q4 2012 to Q3 2021 are above 1.73, which indicates the correlation between output gap and inflation is statistically significant at a 90-percent confidence level for a sample size of 20.

Other factors including supply conditions could also affect inflation on top of demand.

High-grade fuel prices

- **Higher oil prices also contribute to an increase in inflation, via hikes in high-grade fuel prices.** In Indonesia, only diesel and LPG 3kg, which is mainly used as household cooking energy, are subsidized, while non-subsidized fuel products are floating, subject to maximum retail prices set by the government since 2018. This is meant to mitigate the impact of higher global oil prices on domestic fuel prices, supporting consumers while squeezing the profitability of fuel producers. Amid the recent rise in global oil prices, Pertamina Dex, the highest grade of fuel, became more expensive in Q3 2021 and may see further increases in 2022, considering current international oil prices. Another high-grade fuel, Pertamax, likewise may see an increase in price, given that its price was raised together with Pertamina Dex in 2018. The potential price hikes of these high-grade fuels are expected to push up inflation by 0.21 percentage point from Q1 2022 to Q4 2022 (Table A1).

Electricity tariff normalization

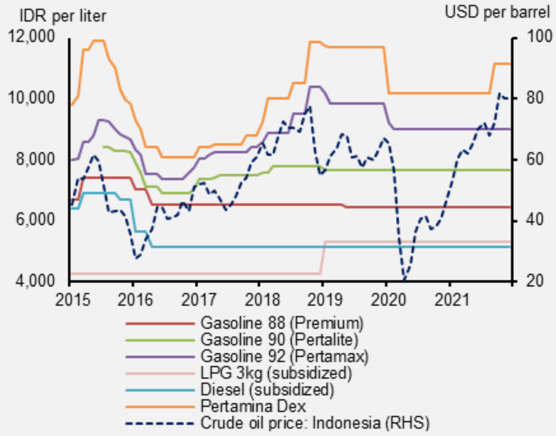
- **On the back of the economic recovery, the electricity tariff discount introduced at the onset of the pandemic could be removed in 2022, which may lead to higher inflation.** The government introduced a program in April 2020 that discounted the standard electricity tariff chargeable to low-income households in the two lowest power consumption tiers, i.e. within the 450 volt ampere (VA) and 900 VA categories, to help them withstand shocks due to the pandemic. In Q2 2021, the discount rate was reduced from 100 percent to 50 percent for those within the 450 VA category and from 50 percent to 25 percent for the 900 VA category. Looking ahead, if the economic recovery stays on track and the impact of COVID-19 on households eases, this program may come to an end in early 2022, which could lead to an increase inflation by 0.23 percentage point going forward (Table A1).

VAT rate hike

- **The VAT rate hike, to take place in April 2022, will push up inflation thereafter.** With the comprehensive tax reform package passed in October 2021, the standard VAT rate will go from the current 10 percent to 11 percent, effective April 1, 2022. Although VAT exemptions and retailers' absorption of the VAT increase could alleviate the impact on inflation, the higher rate is expected to drive up inflation by 0.38 percentage point from Q2 to Q4 2022 (Table A1).

Demand recovery, supply factors and the VAT rate hike are expected to increase inflation in 2022 from 2.4 percent in Q1 to 3.2 percent in Q4, which will translate into 2.8 percent for the whole year.

Figure A4. Fuel Price Developments



Source: Statistics Indonesia; CEIC

Table A1. Projection of Consumer Price Inflation

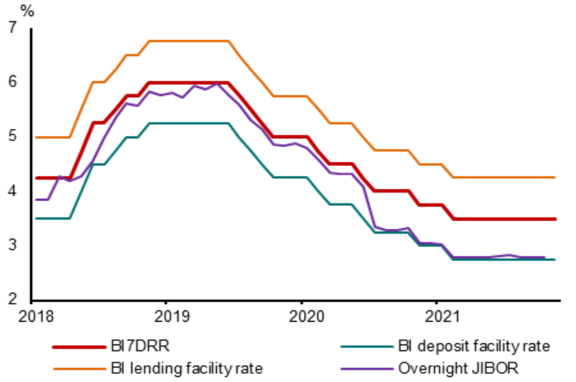
Projection periods	2022			
	Q1	Q2	Q3	Q4
Final headline inflation, % yoy	**2.4**	**2.8**	**3.0**	**3.2**
contributed by:				
Demand factor, %	**1.9**	**2.0**	**2.2**	**2.3**
Other factors, %	**0.4**	**0.8**	**0.8**	**0.8**
1. Increase in the price of fuels	**0.21**	**0.21**	**0.21**	**0.21**
Pertamina Dex	0.11	0.11	0.11	0.11
Pertamax	0.10	0.10	0.10	0.10
2. Electricity tariff normalization*	**0.23**	**0.23**	**0.23**	**0.23**
3. VAT rate hike	**-**	**0.38**	**0.38**	**0.38**

Source: Statistics Indonesia; CEIC; AMRO staff calculations
Note: */ For households with power consumption within the 900 VA categories.

A.2 Strengthened monetary-fiscal policy synergy

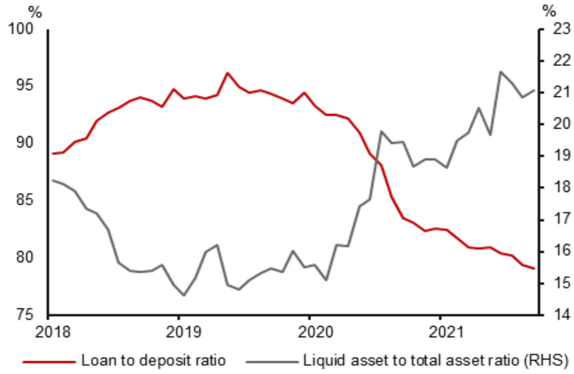
8. The central bank's policy mix continues to support economic recovery. In light of subdued inflationary pressure, BI has kept its benchmark seven-day reverse repo rate at a record low of 3.5 percent since March 2021, following five rate cuts in 2020 and one in February (Figure 17). Ample liquidity in the banking system has been sustained by BI's continuing quantitative easing measures (Figure 18).[12] As the banking sector remains sound, macroprudential regulations on automotive and property loans have been further relaxed, in sync with the government's tax incentives on car and home purchases to boost domestic demand and as part of an integrated policy package coordinated by the Financial System Stability Committee (KSSK).[13] To promote inclusive financing, BI has amended MSME lending requirements for banks by expanding the coverage and raising the MSME lending ratio, known as macroprudential inclusive financing ratio, from 20 percent to 25 percent of total bank loans outstanding by 2023, and to 30 percent by 2024.

Figure 17. BI's Policy Rates and Interbank Overnight Rate



Source: Bank Indonesia; CEIC; AMRO staff calculations
Note: Monthly data are up to December 2021 for policy rates and November 2021 for overnight JIBOR.

Figure 18. Liquidity Conditions in Banking System



Source: OJK; CEIC; AMRO staff calculations
Note: Monthly data are up to October 2021.

9. Payment systems and financial deepening policies have facilitated financial inclusion and enhanced resilience. On the payment system, BI's Quick Response Code Indonesian Standard (QRIS) program has reached 14 million merchants by end-2021, exceeding the initial target of 12 million, of which 96 percent are MSMEs. By standardizing QR payments for offline commerce and e-commerce using either mobile banking or mobile payment apps, the expanded reach of the QRIS has raised economic efficiency and financial inclusion amid the pandemic. Other notable efforts to implement Indonesia Payment System Blueprint 2025 include regulatory reforms to accelerate the digitalization of payment systems without compromising financial system stability and payment system integrity, the launch of the National Payment Open API Standard (SNAP) and the establishment of a real-time and 24/7 payment infrastructure, known as BI-FAST, by end-2021. In a bid to build up external resilience, BI has extended the window for calculating the daily reference USD/IDR exchange rate, the Jakarta Interbank Spot Dollar Rate (JISDOR), and expanded the local currency settlement (LCS) arrangement with more regional currencies[14]. It has also developed DNDFs

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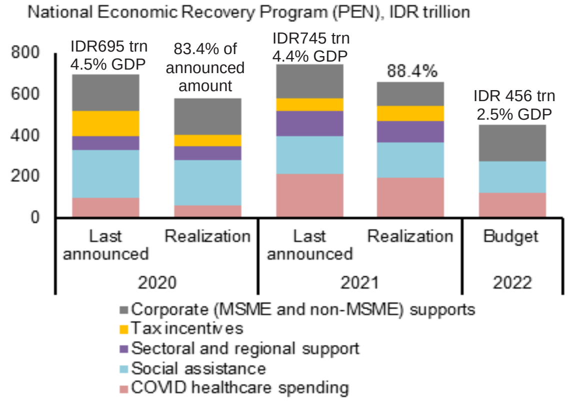
[12] In 2021, BI reportedly injected about IDR147.8 trillion into the banking system through quantitative easing measures such as term repos, FX swaps, and the purchase of government bonds in the secondary market. In addition, BI had bought IDR358.3 trillion of government bonds in the primary market as of mid-December. Of these bonds, 143.3 trillion was purchased via bond auctions, and IDR215 trillion through private placement at variable rates (BI's press release dated January 20, 2022).
[13] KSSK consists of the Ministry of Finance, Bank Indonesia, Financial Services Authority and Deposit Insurance Agency.
[14] Indonesia signed an LCS agreement with China in 2021. Prior to this, Indonesia had entered into LCS agreements with Japan, Malaysia and Thailand. Similar agreements with the Philippines and Singapore are being planned.

denominated in these regional currencies, in addition to efforts to boost the liquidity of USD-denominated DNDF.[15]

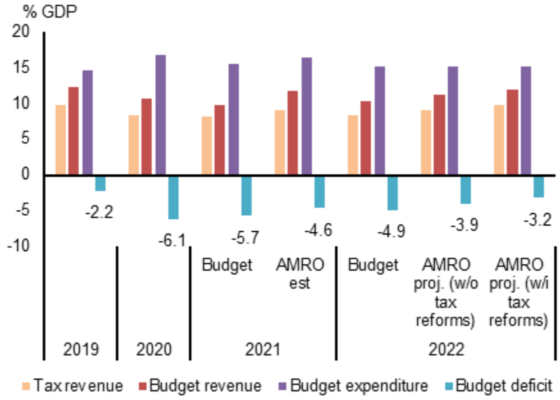
10. The fiscal policy stance has prudently shifted toward a trajectory of gradual consolidation while providing continued pandemic relief and targeted support. In light of the Delta variant outbreak, the fiscal support package was raised to IDR745 trillion in 2021, equivalent to about 4.4 percent of GDP, and about 88.4 percent of this amount has been disbursed (Figure 19). To finance a larger fiscal support package, the government had revised the 2021 Budget allocation without increasing total expenditure. This, coupled with a boost from commodity-related revenue, is estimated to have contributed to a smaller budget deficit of 4.6 percent of GDP in 2021 compared to a Budget target of 5.7 percent, and a 6.1 percent deficit in 2020. The 2022 Budget has been designed to provide continued fiscal support in view of ongoing pandemic uncertainties, with a budgeted deficit of 4.9 percent of GDP, which could be lowered with the implementation of the new tax reform package (Figure 20).

Figure 19. Fiscal Support Packages: 2020-2022



Source: Ministry of Finance; CEIC; AMRO staff calculations

Figure 20. Budget Performance: 2019-2022



Source: Ministry of Finance; CEIC; AMRO staff calculations
Note: AMRO proj. stands for AMRO projections. For 2022, AMRO projections consist of two scenarios, with tax reforms and without tax reforms.

11. To support medium-term fiscal consolidation and return to the fiscal rule of a 3-percent budget deficit ceiling in 2023, the government has succeeded in pushing through parliament a comprehensive tax reform package.[16] Key revenue-enhancing measures include:

a. increasing the standard VAT rate from 10 percent to 11 percent in 2022 and further to 12 percent in 2025, and removing VAT exemptions;

b. introducing a new top personal income bracket of IDR5 billion and above, on which a higher personal income tax rate of 35 percent is payable, and canceling a planned reduction of the corporate income tax rate from 22 percent to 20 percent in 2022;

c. expanding the coverage of excise tax from alcoholic beverages and tobacco products to include more products, such as plastics;

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[15] Since the launch of the DNDF in 2018, BI has implemented different policy measures to boost DNDF liquidity and to make the tool more investor-friendly. Examples of such measures are (i) the inclusion of DNDFs in calculating banks' net open position, (ii) the removal of documentation evidence of underlying for DNDFs selling up to USD5 million, and (iii) an expansion of the coverage of underlying assets and transactions to include FCY deposits. In addition, early termination and rollover of DNDF contracts have been allowed since 2019.

[16] The tax reform package was included in the Law on the Harmonization of Tax Regulations, or Undang-Undang Harmonisasi Peraturan Perpajakan (UU-HPP), which was passed by parliament on October 7, 2021.

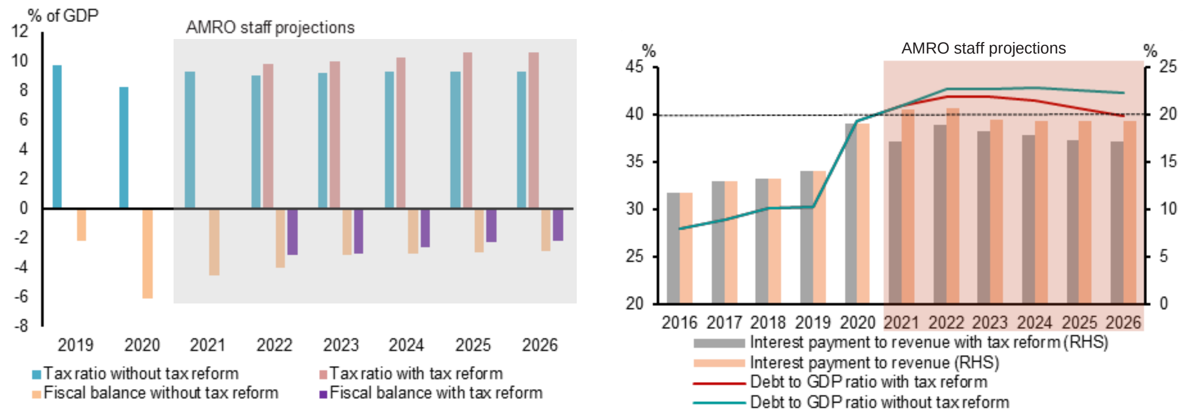
d. introducing a minimum carbon tax rate of IDR30 per kilogram of carbon dioxide equivalent (CO_2e), which is equivalent to about USD2.10 per ton of CO_2e using the current exchange rate; and

e. enhancing taxpayer compliance via a voluntary disclosure program (VDP), effective between January and June 2022, to allow taxpayers to disclose their undeclared assets by paying at a final income tax rate ranging from 6 to 18 percent.

Additional revenues arising from the tax reform measures are expected to rebuild fiscal space and preserve fiscal sustainability over the medium term (Selected Issue 2). In particular, the tax reform package could increase the tax ratio from 9.1 percent of GDP in 2021 to above 10 percent in 2024 (Figure 21a), and bring down the debt level to below 40 percent of GDP by 2026 (Figure 21b).

Figure 21. Impacts of Tax Reforms on Medium-term Fiscal Performance

a. Tax Ratios and Budget Deficits | **b. Government Debt and Interest Burden**



Source: Ministry of Finance; CEIC; AMRO staff calculations | Source: Ministry of Finance; CEIC; AMRO staff calculations

12. Fiscal-monetary policy synergy has been strengthened in response to the ongoing pandemic, with a new agreement to finance health-care spending and humanitarian aid until 2022. To support fiscal spending related to the COVID-19 pandemic, BI and the Ministry of Finance signed two joint decrees in 2020, known as SKB I and SKB II, under which BI would directly buy government bonds by (i) participating in bond auctions as the standby buyer (SBK I) and (ii) private placement at variable rates equivalent to the three-month reverse repurchase rate in 2020 and then sharing the interest income with the government (SKB II). In light of the Delta variant outbreak, BI and the government have entered into another agreement known as SKB III, where BI would contribute to the cost of financing the health-care spending and humanitarian aid by buying government bonds through private placements in 2021-2022. AMRO estimates that SKB III could save the government's expenses in bond interest payments by 0.2-0.3 percent of budget revenue from 2022 onwards, in addition to a 1.9 percent of budget revenue savings due to SKB II in 2020.[17] While SKB II and III are expected to increase BI's cost of absorbing excess liquidity as needed, these decrees are not likely to worsen the central bank's financial position against the backdrop of its lower tax obligations and dividend contributions to the Budget (see Selected Issue 1 for more details about the fiscal-monetary policy synergy that aims to fund the fiscal support packages and its impact on the government budget, as well as BI's financial position).

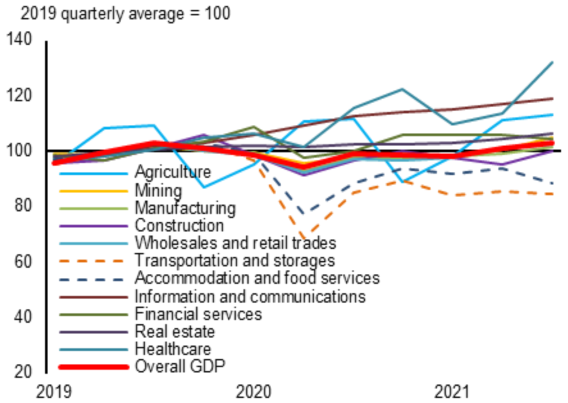
[17] Our estimate takes into consideration only the direct interest savings due to bonds issued to BI at below market rates and the forgone interest incomes by BI. Besides the direct interest savings, the burden-sharing schemes have helped the government to reduce its bond supply to the market and to thereby issue bonds at lower yields than under normal conditions. The interest savings could be partially canceled out by BI's lower contribution to the budget revenue in terms of tax and dividend payments.

B. Risks, Vulnerabilities and Challenges

B.1 Near-term risks of pandemic and policy uncertainties

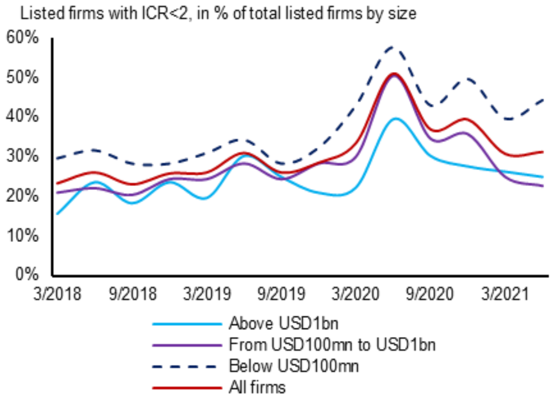
13. Risks to the near-term outlook continue to stem from possible COVID-19 resurgences and subsequent containment measures that could weigh on Indonesia's recovery prospects and deepen the disparity across sectors. Despite an increase in economic activity earlier this year, the recovery has been uneven as sectors relying on close contact services remain lackluster (Figure 22). This is consistent with micro data that shows financial distress is still affecting smaller listed firms (Figure 23) and those that provide discretionary consumer goods and services, such as fashion products, transportation, hotels and restaurants, and real estate. The likelihood of repeated waves of infection, especially with the emergence of new variants such as the highly infectious Omicron, and the resultant tightening of mobility restrictions, may disrupt the recovery momentum and deepen the scarring effects in sectors disproportionately affected by the pandemic.

Figure 22. Real GDP and Components by Sector



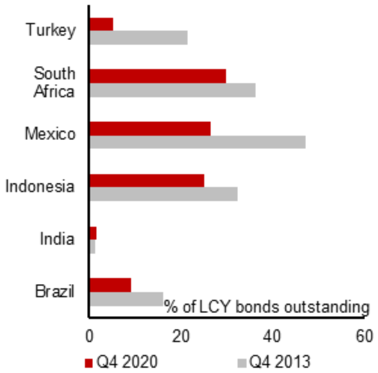
Source: Statistics Indonesia; CEIC; AMRO staff calculations
Note: Quarterly data are up to Q3 2021.

Figure 23. Listed Firms at Risk by Size



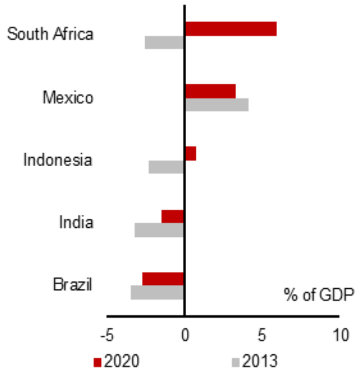
Source: Bloomberg; AMRO staff calculations
Note: Quarterly data are up to Q2 2021.

Figure 24. Foreign Holdings of LCY Government Bonds



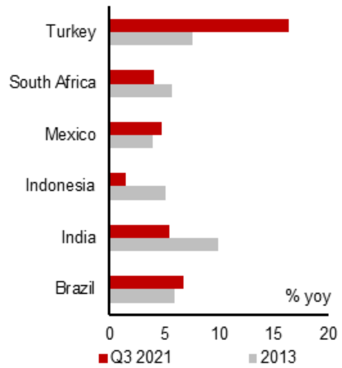
Source: IMF; AMRO staff calculations

Figure 25. Current Account Balance



Source: AMRO Artemis Database

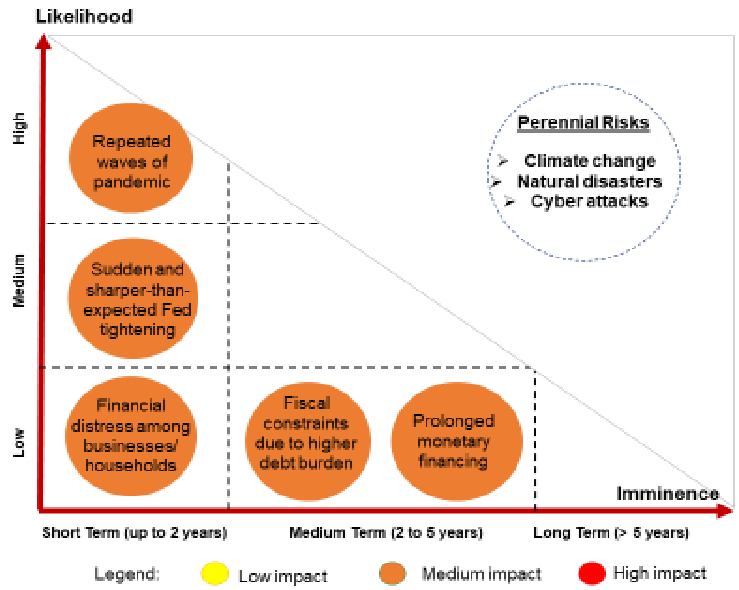
Figure 26. Headline CPI



Source: AMRO Artemis Database

14. Global investor sentiment is constantly shifting against the uncertainties of monetary policy actions by the central banks in advanced economies, and remains a key risk for Indonesian financial markets. Notably, the markets continue to be concerned over possible changes in the U.S. monetary policies, including the potential for a sudden and sharper-than-expected Fed tightening. This could lead to increased volatility in financial markets and capital outflows from EMs, including Indonesia. That said, a lower share of foreign holdings of government bonds, stronger external position supported by robust exports and sustained FDI inflows, and low inflation, have put Indonesia in a better position to cope with possible spillovers from U.S. monetary policy changes relative to the Taper Tantrum (Figures 24-26). Lastly, as interest rates are expected to rise globally when the central banks in advanced economies tighten their monetary policies, this could put upward pressures on domestic interest rates and increase the debt-servicing burden of the Indonesian government and corporate sector.

Figure 27. Indonesia's Country Risk Map



Source: AMRO

B.2 Challenges of executing a smooth exit from pandemic measures

15. The elevated interest burden amid rising debt may reduce the government's discretionary spending for public consumption and investment. The rollout of fiscal support packages to combat the pandemic has triggered a significant increase in government debt and a steep rise in the interest burden. The government debt-to-GDP ratio climbed by 9 percentage points to 39.4 percent in 2020, and is estimated to increase further to 40.7 percent and 41.9 percent in 2021 and 2022, respectively. Likewise, the interest burden rose from 14.1 percent of budget revenue in 2019 to 19.1 percent in 2020, and is expected to remain elevated at 17.8 percent on average in 2021-2026. Higher mandatory spending as a result of elevated interest payments will limit the room for the government to finance its much-needed capital spending when the fiscal rule of a maximum budget deficit of 3 percent of GDP is restored in 2023.

16. A smooth exit from extraordinary pandemic policies is crucial to maintain market confidence post-pandemic. In response to the unprecedented health crisis, Indonesian authorities, as with some other EMs, have ventured into the unchartered territory of asset purchase programs without causing significant concerns and unsettling the financial markets. Thus far, the markets have accepted very well BI's direct purchase of government bonds, and this could be attributed to a number of factors. Notably, improved central bank credibility and fiscal prudence over the years have helped anchor inflation and contained exchange rate pass-through, creating greater room for monetary easing during the pandemic, including the use of QE measures such as the asset purchase programs, to provide liquidity to the markets. In addition, transparent and time-bound monetary financing mechanisms in line with prudential principles, including specified amounts of government bonds purchased by BI in SKB II and III, have been effectively communicated to the market. A smooth exit from this extraordinary policy underpinned by the implementation of the tax reform package and continued fiscal-monetary policy synergy is crucial to maintain market confidence and support economic recovery post-pandemic.

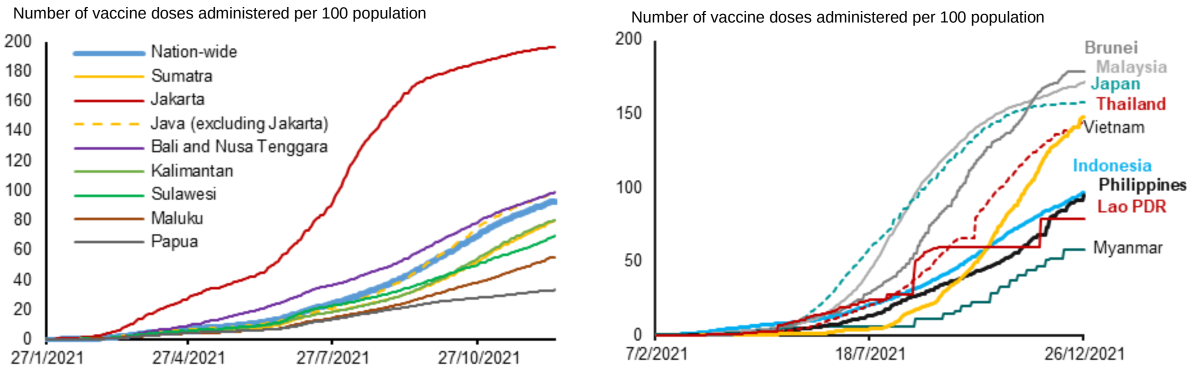
C. Policy Discussions and Recommendations

C.1 Accelerated vaccination and targeted support crucial for recovery

17. A continued ramp-up of vaccinations and an enhanced healthcare capacity are crucial for a sustainable reopening of the economy. Vaccination has been sped up significantly with more than 40 percent of the entire Indonesian population being fully vaccinated and a higher coverage in the Java-Bali islands by end-2021 (Figure 28a). The number of daily administered vaccine doses increased steadily from less than 100,000 doses on average in early 2021 to peak at about 2 million doses in October, before moderating somewhat towards the year-end. That said, Indonesia's vaccination coverage remains modest in comparison to neighboring countries (Figure 28b). Underlying factors are: constraints in vaccine supply and distribution, limited healthcare capacity, and vaccine hesitancy. Strengthening the healthcare system, together with efforts to push up the vaccination rate in remote and rural areas, will boost the protection of and immunity in the community in anticipation of renewed waves of infections due to new variants.

Figure 28. Vaccination Rate

a. Indonesia | **b. Selected ASEAN+3 Economies**



Source: Ministry of Health; CEIC; AMRO staff calculations
Note: Daily data are up to end-2021.

Source: Haver Analytics; AMRO staff calculations
Note: Daily data are up to end-2021.

18. Accelerated disbursement of fiscal stimulus measures and enhanced support will help relieve the financial difficulties facing hard hit firms. Targeted support has been promptly provided in various forms to businesses during the pandemic. For instance, the government has raised the quota for existing MSME loan guarantee programs (KUR) and introduced new guarantee facilities, known as the working capital loan guarantee scheme, to help larger firms operating in sectors which are disproportionately affected by the pandemic, such as hospitality businesses. As the disbursement rate of the new working capital loan guarantee program was particularly low, in part due to the complicated and costly compliance requirements, the program design has been adjusted, including by relaxing some eligibility criteria.[18] Continued fine-tuning of the programs will further accelerate the disbursement of the targeted support moving forward. It is also crucial to set a sufficient KUR size moving forward. To ensure efficient credit allocation, the implementation of the macroprudential inclusive financing ratio should be complemented with concerted efforts to build a sound business

[18] For example, firms with at least 100 employees are now eligible after the requirement was lowered from a minimum of 300 employees, in line with Regulation 32/08/2021 issued by the Ministry of Finance in April 2021.

framework for banks to lend to MSMEs, including the adoption of proper bookkeeping and strengthened risk management practices among MSMEs.

C.2 A smooth exit from pandemic relief is contingent on continued policy synergy

19. AMRO welcomes BI's continuous recalibration of its policy mix to support economic recovery and safeguard financial stability. BI's current accommodative policy stance has appropriately supported the economy affected by the pandemic. Looking ahead, in light of increased external headwinds, AMRO supports BI's continuous recalibration of its policy mix by adopting a prudent and measured normalization of the monetary policy to maintain financial stability, while maintaining an accommodative macroprudential policy and accelerating the digitalization of payment systems, as well as financial deepening, to support sustainable economic recovery. On a positive note, a record high international reserve buffer and the availability of more intervention tools, including the DNDF, have boosted BI's capacity in maintaining rupiah stability, relative to past episodes of financial stress.

20. A credible exit strategy from the extraordinary monetary financing arrangements should be designed and clearly communicated to the market. The experience of advanced economies suggests that clear communication and a gradual exit from central banks' asset purchase programs would facilitate a smooth normalization of their ultra easy monetary policy.[19] Indonesian authorities have informed the market that BI's purchase of government bonds via private placements under SKB III will end by 2022. BI has also shared a monetary normalization strategy that would start with the central bank absorbing excess liquidity through open market operations and/or increasing the statutory reserve requirement, followed by raising the interest rate upon signs of rising inflation. At the same time, the fiscal policy stance has shifted toward a trajectory of gradual consolidation to bring the budget deficit under 3 percent of GDP in 2023, supported by the recently approved tax reform package. The coordination of monetary and fiscal policies should continue, to ensure a smooth exit from the pandemic stimulus policy package.

21. Effective implementation of the tax reform measures will facilitate a smooth exit from the expansionary pandemic policies. AMRO commends the tax reform package which parliament approved in October 2021. The necessary regulations to implement these reform measures should be issued in a timely manner and effectively publicized to the public, in particular on the removal of VAT exemptions. A clear road map and implementation guidelines are also needed to roll out new taxes such as the carbon tax. The staff would also recommend that the VAT base be further broadened by lowering the VAT registration threshold at an appropriate time.[20] In addition, global tax reform initiatives should be incorporated into domestic regulations.[21] Ongoing efforts to strengthen tax administration capacity, focused on modernizing the core tax system, should also include enhancing tax processing and identifying new tax bases in the context of an increasingly digitalized economy.

22. Expenditure reforms are also necessary. The staff welcomes the recent approval of the HKPD Law, which governs the fiscal relationship between the central and regional governments and aims to strengthen local taxation systems, improve the quality of regional

[19] For literature on U.S. monetary policy and spillovers to EMs, see Chen et al. (2104), and on the Fed experience in exiting unconventional monetary policy between 2014-2019, see Congressional Research Service (2020). The latter shows the Fed ended unconventional monetary policy that was conducted between 2009 and 2013 in a gradual manner by (i) maintaining the size of its balance sheet between 2014-2017 by rolling over maturing securities, and (ii) gradually reducing its balance sheet by ceasing to roll over maturing securities at a pre-announced rate from late 2017 onwards.
[20] AMRO Annual Consultation Report on Indonesia (2020)
[21] In July 2021, along with other member countries and jurisdictions, Indonesia joined the Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalization of the Economy, which established a new framework for international tax reform.

spending, and increase synergy between central and local government expenditure.[22] The staff also recommends continuing efforts to re-prioritize budget expenditure in favor of capital spending and other growth-supporting expenses.

23. Policy initiatives to improve debt management should continue. AMRO staff supports the government's efforts to minimize refinancing and currency risks by changing the maturity structure of its debt and diversifying the borrowing-denominated currencies. To optimize the usage of cash buffers (SAL), a new regulation has been issued to let the government utilize SAL to stabilize the government bond market, in addition to meeting temporary liquidity needs and budget financing.[23] The disbursement of fiscal packages and other expenditure could be expedited, along with better SAL management, to minimize excess financing. In parallel with a credible exit plan from the central bank's budget financing, the government may consider issuing special bonds, in particular sharia-compliant bonds (sukuks), at below-market coupon rates to domestic investors, and channeling these proceeds into spending related to the pandemic or other socially inclusive purposes.

C.3 Structural reforms to strengthen resilience and boost growth potential

24. Efforts on financial deepening and inclusion will bolster Indonesia's resilience to external headwinds and lower borrowing costs. Concerted efforts have been made over the past years to strengthen the resilience of domestic financial markets and broaden the domestic investor base. Examples of these efforts include ongoing enhancements to the DNDF market and other initiatives to develop the onshore FX market and reduce dependence on the U.S. dollar as the main currency of trade and financial settlement. To deepen the domestic bond market, the government has issued new instruments, such as retail bonds, and tapped on financial technology to distribute bonds so as to reach out to the unbanked and underbanked (Selected Issue 4).[24] To realize the potential of fintech in improving financial inclusion and literacy, it is crucial to strengthen collaboration with financial institutions and enhance self-regulation and self-supervision among fintech players. AMRO staff supports the recent lowering of the final income tax rate on government bond interests to 10 percent, from 20 percent for foreign investors and 15 percent for domestic investors.[25] We recommend that the authorities expand the coverage and raise the contribution rates of mandatory pension funds, which are expected to be addressed in an upcoming Omnibus Bill on the Financial Sector.

25. Further improvement of the investment climate could boost Indonesia's growth potential. After the Omnibus Law on Job Creation was passed last year, an upgraded Online Single Submission platform has been launched, adopting a risk-based licensing approach (Table 2). This is expected to streamline business licensing procedures and improve the ease of doing business. More economic sectors have opened up for FDI with the issuance of a Priority Investment List in early 2021. Regulations to address bottlenecks in the labor market have also been issued in line with the Omnibus Law. Furthermore, the Indonesia Investment Authority (INA) has actively engaged with potential global investors since its establishment last year, to bring in equity investment to finance domestic infrastructure development.

[22] Parliament approved the Law on Fiscal Relations between the Central Government and Local Governments, known as Hubungan Keuangan antara Pemerintah Pusat and Daerah in Bahasa Indonesian, in December 2021. The HKPD Law amended the Central-Regional Fiscal Balance Law Number 33 dated 2004, the Regional Taxes and Levies Law Number 28 dated 2009, and Article 114 in the Job Creation Law passed in 2020.
[23] According to the Ministry of Finance's Regulation 147/PMK.05/2021 dated November 2021, SAL can be used to buy or reverse repo short-term instruments, including government debt securities, to stabilize the government bond market if needed.
[24] The value of retail bonds distributed via fintech companies remains modest compared to other distributors, namely commercial banks and securities firms; however, the distribution channels of fintech companies are used by up to 20 percent of retail investors, most of them millennials.
[25] Domestic commercial banks and pension funds are not included.

Continued efforts to enhance Indonesia's competitiveness and attract long-term, stable direct investment flows are highly recommended.

Table 2. Omnibus Law on Job Creation

Areas of Reform	Implementation Progress*
• Simplifying business licensing and enhancing the ease of doing business • Launch an upgraded Online Single Submission platform that adopts the risk-based licensing approach • Build a single database for SMEs • Remove minimum capital requirement for Limited Liability Companies (LLCs)	 √ √ √
• Further opening the economy • Shorten the Negative Investment List to six highly-restricted sectors only and issue a Priority Investment List	√
• Addressing labor market rigidities to balance with labor rights protection • Link minimum wage hike to regional GDP growth or inflation • Exempt SMEs from minimum wage hike formula • Lower severance pay to maximum 25 months' salary (from 32 months), of which employers will cover 19 months	 √ √ √
• Supporting national development • Establish a strategic development sovereign wealth fund (Indonesia Investment Authority-INA) to support infrastructure financing • Accelerate land acquisition and release land for infrastructure projects • Establish a single, uniform land map at the national level	 √ √ √

Source: Investor Relations Unit (Indonesia Presentation Book November 2021); AMRO staff compilation

26. AMRO staff welcomes the government's efforts to mitigate the country's adverse impact on climate change. Indonesia generates a significant amount of greenhouse gas emissions and its carbon footprint is also high relative to regional peers, reflecting the commodity-intensive nature of the economy. Under the Paris Agreement, Indonesia has pledged a Nationally Determined Contribution (NDC) in the form of a 29 percent reduction in greenhouse gas emissions from the business-as-usual (BAU) baseline by 2030.[26] The country has also committed to achieving net zero carbon emissions by 2060. To achieve this reduction, the government's efforts are focused on three key areas: forestry, energy and waste management. In addition, a carbon tax has been recently approved, which will be integrated with an emissions trading system under a cap-and-tax scheme (Box B). The carbon tax introduction highlights Indonesia's commendable commitment towards the global climate change agenda. The development of the cap-and-tax system should be complemented with policy measures to encourage and facilitate the greening of the industrial sector and mitigate adverse impacts on economic growth and the government budget going forward.

Authorities' Views

27. The authorities generally agreed with AMRO's outlook for the economic recovery and assessment of risk facing the Indonesia economy, particularly risks to the recovery from spillovers from the tightening of US monetary policy and more severe pandemic-induced disruptions. They also emphasized Indonesia's readiness to respond to future headwinds by strengthening the synergy of national policies between BI, the government and KSSK, to overcome the Covid-19 pandemic, maintain macroeconomic stability, and encourage the process of national economic recovery. In this case, policy synergy is required to accelerate the vaccination rollout and Covid-19 response by reopening priority economic sectors as a prerequisite to maintain national economic recovery momentum. The authorities have identified five key policy measures to accelerate the national economic recovery, namely: (i) faster real sector transformation and reform, (ii) synergy between monetary stimuli, macroprudential policy and fiscal policy, (iii) faster financial sector transformation, (iv) economic and financial digitalization, and (v) green economy and finance. In particular, the central bank's policy mix for 2022 will continue to be synergized as part of the national

[26] In addition, with international support (financing, technology transfer, etc.) taken into account, Indonesia has also pledged a 41-percent reduction in greenhouse gas emissions from the business-as-usual (BAU) baseline over the same timeframe.

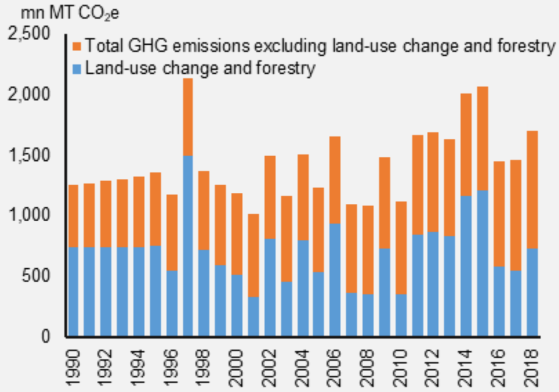
economic policy mix to accelerate economic recovery while maintaining stability. Given the risk of increasing global financial market instability stemming from monetary policy normalization by the Fed and several advanced economies, the monetary policy in 2022 will be directed at maintaining inflation and rupiah stability, as well as macroeconomic and financial system stability. Monetary policy normalization will be prudent and measured to avoid disrupting the national economic recovery. Meanwhile, macroprudential policies, digitalization of the payment system, deepening of money markets, and development of inclusive and green financial economy will continue to be directed as an integrated part of joint efforts with the government to accelerate national economic recovery. Last, but not least, the authorities will continue to strengthen fiscal-monetary synergy by maintaining policy credibility to boost market confidence and support national economic recovery via a well-calibrated, well-planned, and well-communicated exit strategy.

Box B. Climate Change: Regional Comparison and Indonesia's Policy for Climate Change Mitigation[27]

Regional Comparison

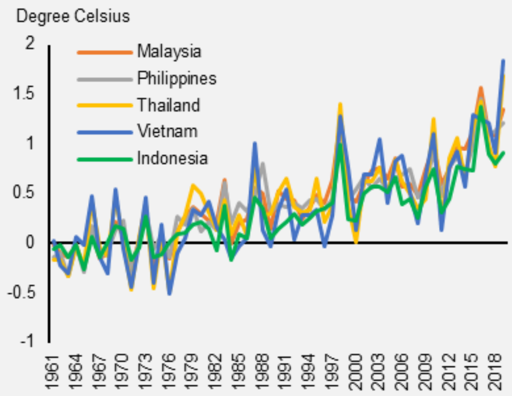
Among ASEAN-5 economies, Indonesia generates the most greenhouse gas emissions, a significant proportion of which is due to deforestation.[28] Indonesia contributed about 40 percent to ASEAN-5's GDP and yet accounted for around 55 percent of the region's greenhouse gas emissions as of 2018. Around 43 percent of the country's emissions was due to land-use changes and deforestation, larger than the regional average of 26 percent (Figure B1). Meanwhile, surface temperatures in the region have been rising steadily and with increasing volatility since around the late 1970s, and Indonesia is no exception (Figure B2).

Figure B1. Total Greenhouse Gas Emissions in Indonesia



Source: IMF; AMRO calculations

Figure B2. Change in Surface Temperature

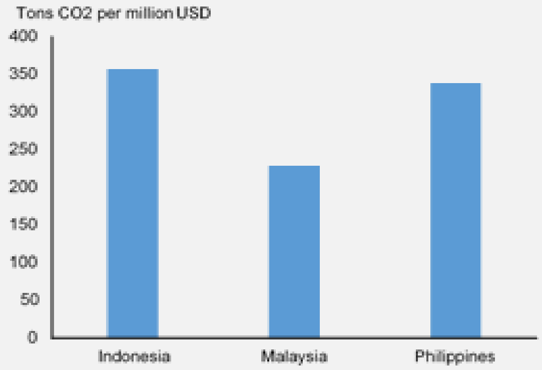


Source: IMF; AMRO calculations

Indonesia's carbon footprint of loans is relatively high, while the country's government expenditure on environment protection exceeds those of regional economies. Reflecting the commodity-intensive nature of the economy, the average carbon footprint of loans in Indonesia is higher than those of its regional peers (Figure B3). However, Indonesia's government spends more than other countries in the region on environment protection as a share of GDP, at around 0.23 percent of GDP in 2019 (Figure B4).

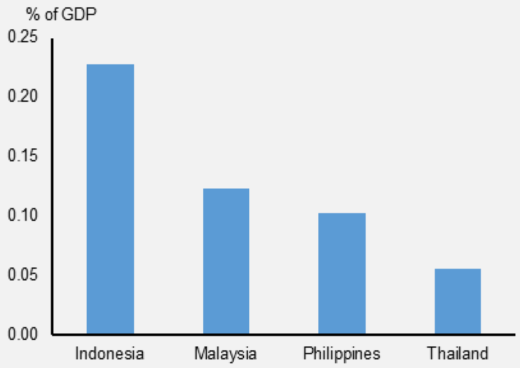
[27] This box is prepared by Jade Vichyanond, Economist.
[28] The ASEAN-5 countries refer to Indonesia, Malaysia, the Philippines, Thailand and Vietnam.

Figure B3. Average Carbon Footprint of Loans (2015)



Source: IMF; AMRO Staff Calculations

Figure B4. Government Expenditure on Environment Protection (2019)



Source: IMF; AMRO Staff Calculations

Indonesia's Policy for Climate Change Mitigation

The government has identified three key areas in which to mitigate the country's impact on climate change. Under the Paris Agreement, Indonesia has pledged a 29 percent reduction in greenhouse gas emissions from the business-as-usual (BAU) baseline by 2030, as Nationally Determined Contributions.[29] To achieve this reduction, the government's efforts focus on three key areas: forestry, energy and waste management.[30] In the forestry sector, the target is to complete 2 million hectares of peatland restoration and 12 million hectares of rehabilitation of degraded land by 2030. In the energy sector, the government aims to adjust the country's energy mix in such a way that new and renewable energy will account for at least 23 percent by 2025. And in terms of waste management, emphasis will be placed on raising the capacity to manage urban wastewater, reducing landfill waste and using waste for energy production. Over the longer horizon, Indonesia has set a goal of achieving carbon neutrality by 2060.

Table B1. Taxes on Vehicles and Fuel

Law	Object	Key points
Motor vehicle tax *(Pajak Kendaraan Bermotor)*	Motor vehicle ownership	• Depends on rate, value, and weight (which reflects road damage and pollution) • Rate: 1%-2% for 1st car, 2%-10% for 2nd car and so on • Annual
Registration/Transfer-of-title tax *(Bea Balik Nama Kendaraan Bermotor)*	Registration/transfer of title	• Depends on rate and value • Rate: max. 20% for 1st time (registration), max. 1% afterwards (transfer of title) • Electric vehicles: 90% tariff reduction nationwide (except Jakarta and Bali – zero tariff) • Upon registration/transfer of title
Fuel tax *(Pajak Bahan Bakar)*	Fuel	• Depends on rate, fuel price • Rate: max. 10%
Luxury goods sales tax	Motor vehicle	• Depends on emissions • Rate: 0%-95% • Once, at factory or when imported
Import duty	Motor vehicle imported in incompletely knocked down (IKD) form	• Depends on whether the motor vehicle is battery-based electric • Rate: 0% • Once, when imported

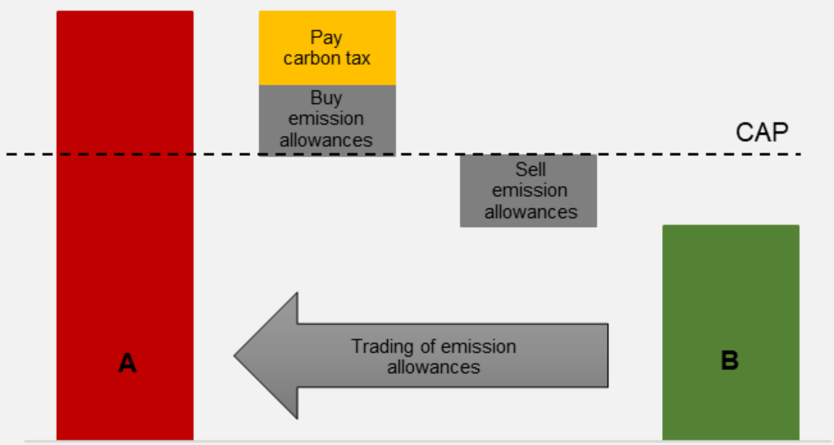
Source: AMRO compilation
Note: With the recently passed HKPD Law, which has a phase-in period of five years, the registration/transfer-of-title tax specifies the following rates: maximum 12 percent for registration and 0 percent for transfer of title, with the exception of special provinces such as Jakarta and Yogyakarta (maximum 20 percent).

[29] In addition, Indonesia has pledged a 41 percent cut in greenhouse gas emissions from the BAU baseline over the same timeframe if international support such as funding and technological transfer can be obtained.
[30] The forestry and energy sectors have been assigned 17 percentage points and 11 percentage points, respectively, to realize the 29 percent reduction commitment.

As far as the Ministry of Finance is concerned, three main fiscal avenues can be used to achieve the mitigation goals: revenue, expenditure and financing. On the revenue side, the government provides tax allowance for investment in renewable energy, as well as a number of VAT exemptions for certain goods and services that contribute toward climate change mitigation. In addition, motor vehicle tax, registration/transfer-of-title tax and luxury goods sales tax are targeted at vehicle ownership, while fuel tax is levied on fuel consumption (Table B1). As for expenditure, part of the budget is set aside for climate change mitigation activities, although this allocation constitutes only around 23 percent of the amount estimated to achieve the goal of a 29 percent reduction in emissions. And to finance its mitigation efforts, the ministry regularly issues green sukuks (shariah-compliant bonds) in both the domestic and global markets and debuted Sustainable Development Goal (SDG) bonds in the global market in 2021.

More recently, a carbon tax scheme was approved in October 2021. The government in October passed the Harmonized Tax Law (UU-HPP),[31] which, inter alia, introduces a carbon tax. This tax will be levied on both goods and activities which generate carbon footprints. Such goods contain carbon, primarily fossil fuel, while activities under the scope of the carbon tax are those that generate carbon emissions. It will levy the tax on carbon-containing goods and/or carbon-emitting activities at or above the market price, but not lower than IDR30 (around USD0.0021) per kilogram of CO2 equivalent.[32] Effective starting April 1, 2022, the tax will first be imposed on coal-fired power generation at the floor rate of IDR30 for carbon emission exceeding a stipulated cap under an emissions trading mechanism, making it a cap-and-tax scheme (Figure B5). While the mechanism for the carbon market is being developed, the carbon tax will then be gradually expanded to cover other sectors according to the carbon tax roadmap.

Figure B5. Cap-and-Tax Scheme



Source: IMOF

Revenue from the carbon tax can be used to fund climate change mitigation and adaptation activities through the central government budget. In particular, the revenue can be partly allocated for expenditure on climate change mitigation and adaption activities in the central government budget, and partly transferred to the Environmental Fund Management Agency, an independent institution formed by the government to channel various sources of funds into activities aimed at environmental protection.

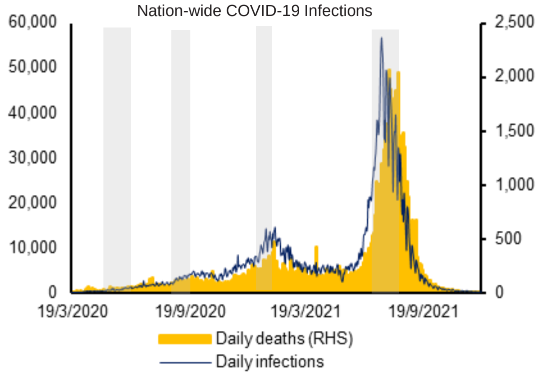
[31] Undang-Undang Harmonisasi Peraturan Perpajakan
[32] This floor rate of USD2.10 per ton of CO_2 equivalent is lower than the current global average of USD3 per ton of CO_2 equivalent and far less than USD75 per ton of CO_2 equivalent, the price level required by 2030 to reduce global emissions to keep global warming below 2°C relative to preindustrial levels (IMF 2021).

Appendices

Appendix 1. Selected Figures for Major Economic Indicators

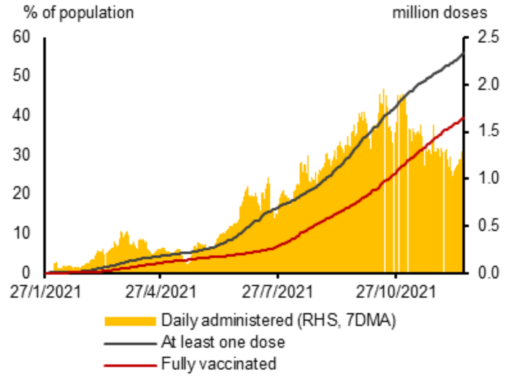
Figure 1.1. COVID-19 Pandemic Developments and Vaccination Drive

The daily infection rate has declined following tighter mobility restrictions to curb the Delta variant outbreak…



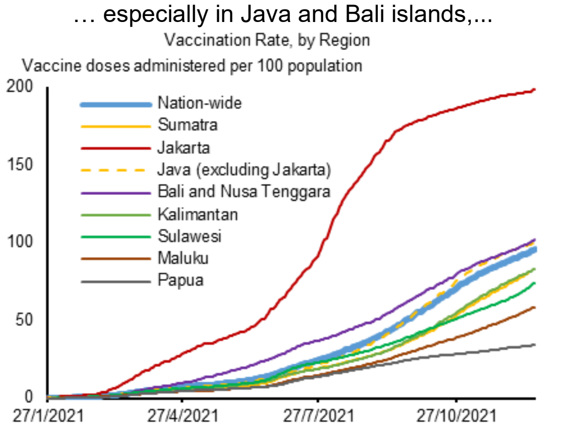
Source: Ministry of Health; AMRO staff calculations
Note: Daily data is up to December 18, 2021. Shaded areas refer to the implementation of large-scale social restrictions (PSBBs) in April-May 2020, PSBB retightening from mid-September to mid-October 2020, PSBB retightening from mid-January to mid-February 2021, and Level 4 Public Activity Restrictions (PPKM Level 4) from July to early September 2021.

… and a ramp-up in vaccination, …



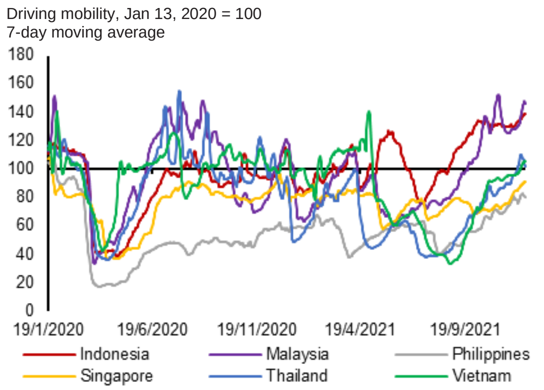
Source: Ministry of Health; AMRO staff calculations
Note: Daily data is up to December 18, 2021.

… especially in Java and Bali islands,...



Source: Ministry of Health; AMRO staff calculations
Note: Daily data is up to December 18, 2021.

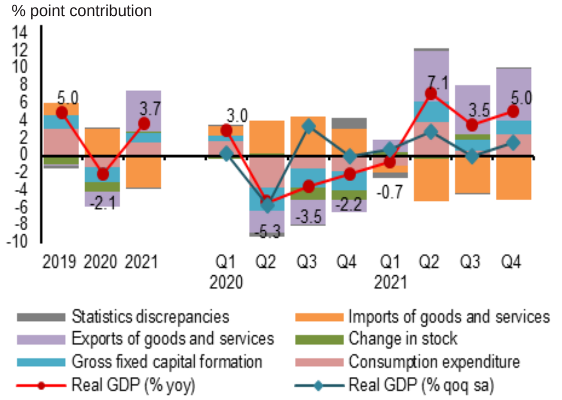
… enabling an early resumption of mobility.



Source: Apple Mobility Database; AMRO staff calculations
Note: Daily data is up to December 17, 2021.

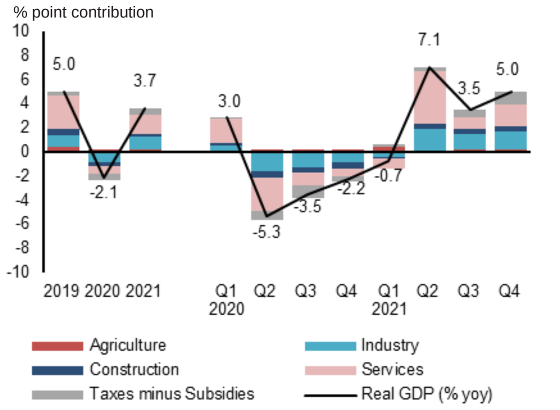
Figure 1.2. Real Sector

GDP rebounded to grow by 3.7 percent in 2021, supported by global demand recovery, and…



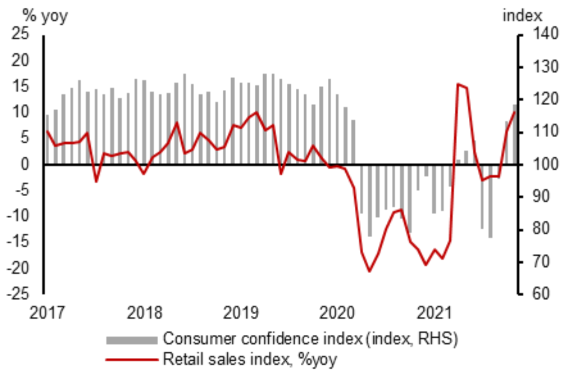
Source: Statistics Indonesia (BPS); CEIC; AMRO staff calculations
Note: Real GDP growth on qoq basis, seasonally adjusted (% qoq sa), is estimated by AMRO staff.

…stronger domestic economic activity.



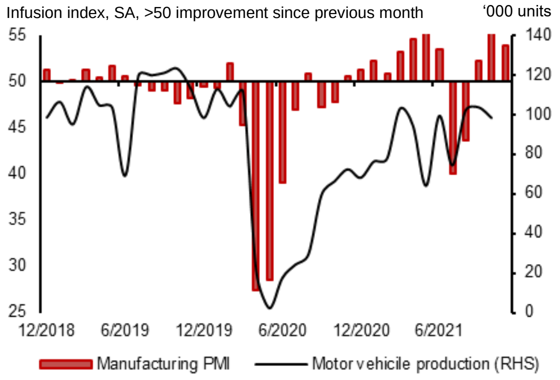
Source: BPS; CEIC; AMRO staff calculations

Consumer confidence and retail sales continued to strengthen in recent months, …



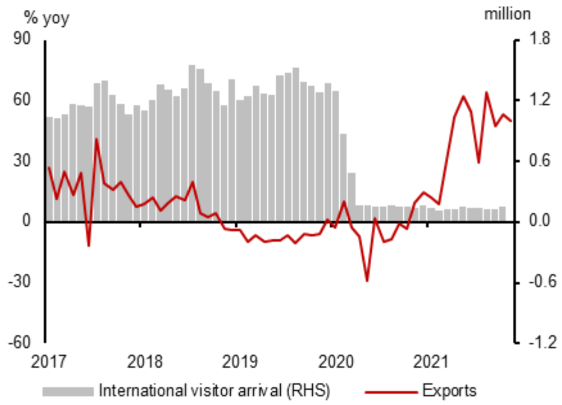
Source: BI
Note: Monthly data is up to November 2021. The November retail sales number is preliminary only.

… which is in line with manufacturing production.



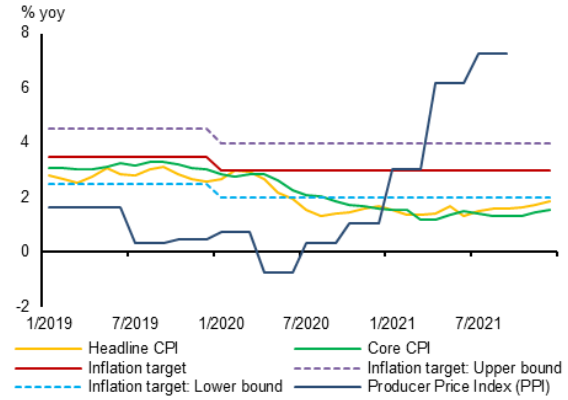
Source: ISH Markit; BPS; CEIC
Note: Monthly data is up to November 2021 for PMI, and up to October 2021 for motor vehicle production.

International visitor arrivals remained muted on a cautiously gradual border reopening; exports maintained robust growth, benefiting from strong global demand.



Source: BPS; CEIC; AMRO staff calculations
Note: Monthly data is up to November 2021 for export growth and, up to October 2021 for international visitor arrivals.

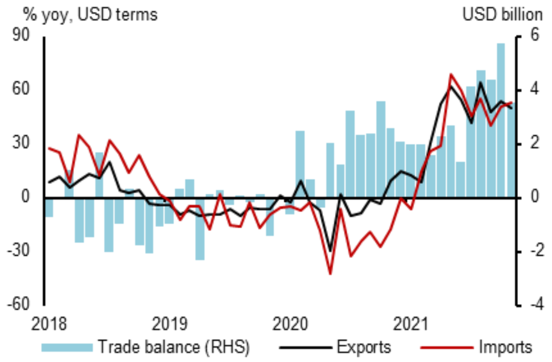
CPI inflation was still low, as firms have not passed higher input costs to consumers in light of lingering subdued demand.



Source: BPS
Note: Data is up to December 2021 for CPI, and up to September 2021 for PPI.

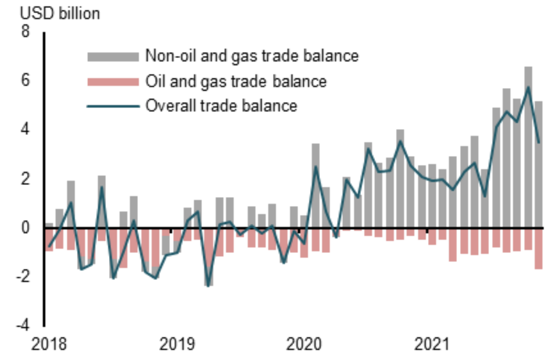
Figure 1.3. External Trade

Merchandise trade maintained robust growth and trade surplus…



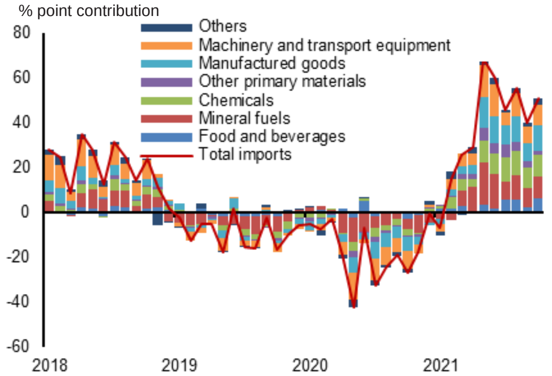
Source: BPS; AMRO staff calculations
Note: Monthly data is up to August 2021.

… driven by non-oil and gas sectors.



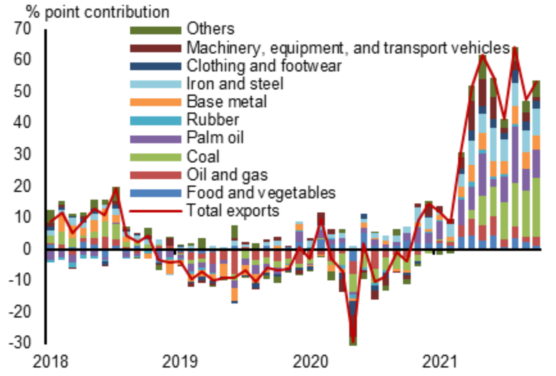
Source: BPS; AMRO staff calculations
Note: Monthly data is up to August 2021.

A rebound in imports was led by intermediate and capital goods, and to a lesser extent by consumer goods.



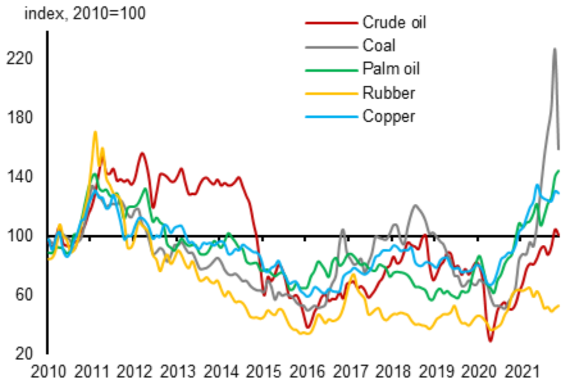
Source: BPS; AMRO staff calculations
Note: Monthly data is up to October 2021.

The recovery in exports was broad-based, led by both manufacturing and commodities…



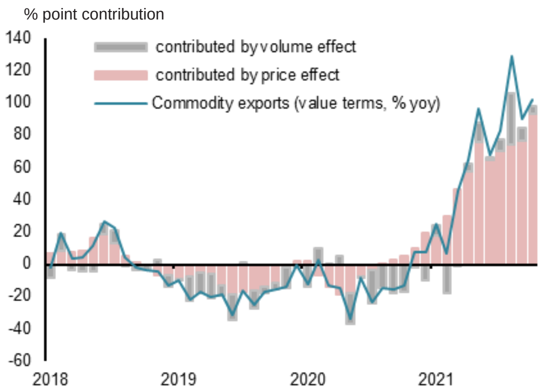
Source: BPS; AMRO staff calculations
Note: Monthly data is up to October 2021.

… benefiting from rising commodity prices



Source: CEIC; AMRO staff calculations
Note: Monthly data is up to November 2021.

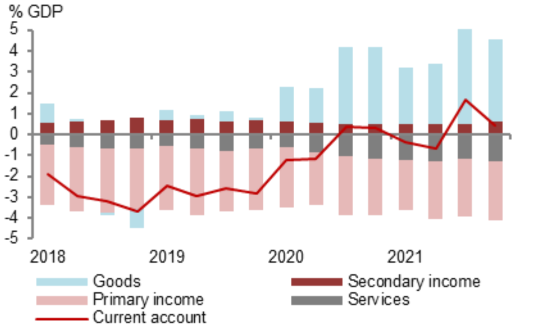
… and demand recovery.



Source: BPS; AMRO staff calculations
Note: Monthly data is up to October 2021.

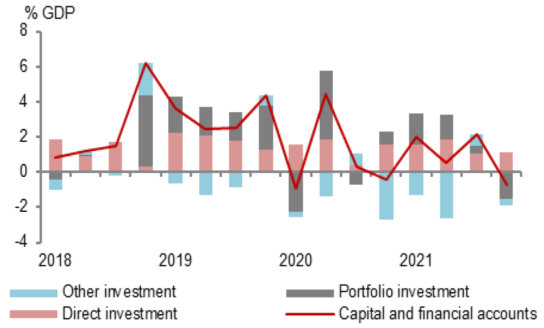
Figure 1.4. External Sector

Strong exports underpinned an improvement in the current account balance in H2 2021...



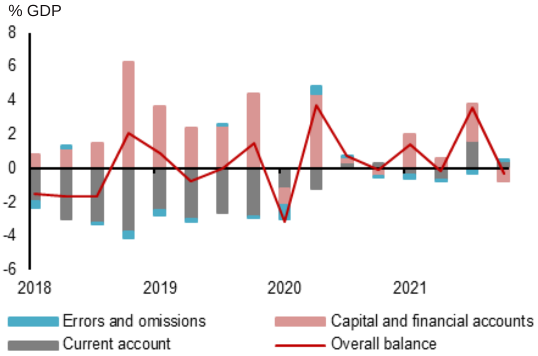
Source: BI; CEIC; AMRO staff calculations
Note: Quarterly data is up to Q4 2021.

… which combined with sustained foreign investment inflows,…



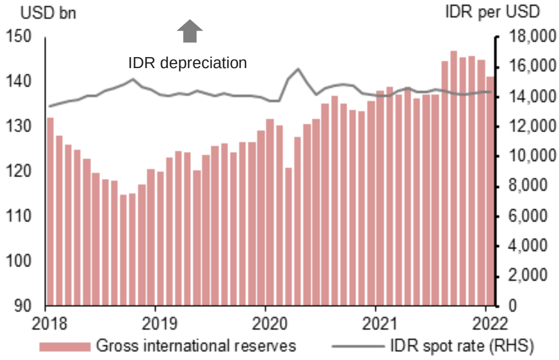
Source: BI; CEIC; AMRO staff calculations
Note: Quarterly data is up to Q4 2021.

…supported the overall balance of payments…



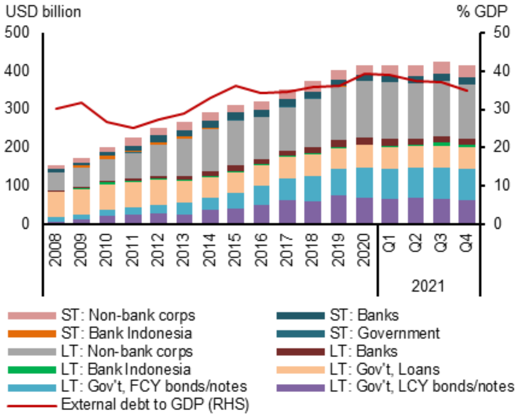
ource: BI; CEIC; AMRO staff calculations
Note: Quarterly data is up to Q4 2021.

… and reserves accumulation.



Source: BI; CEIC; AMRO staff calculations
Note: Monthly data is up to January 2022.

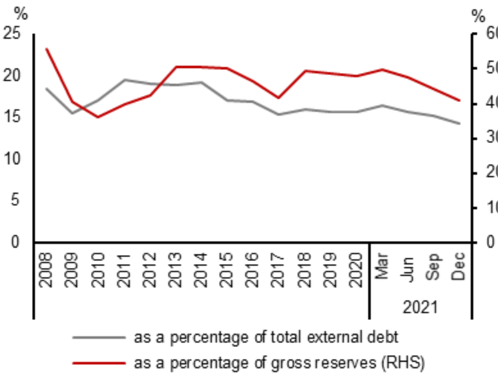
Gross external debt moderated in 2021 due to reduced foreign holding of LCY bonds and loan repayment by the government and corporates.



Source: BI; CEIC; AMRO staff calculations

Short-term external debt remained manageable, accounting for about 15 percent of total external debt and less than 50 percent of reserves.

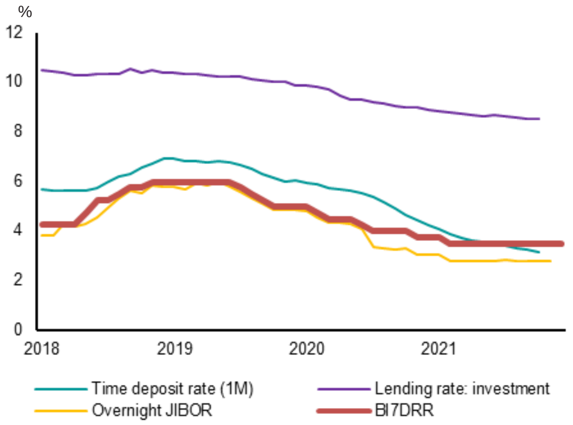
Short-term External Debt by Remaining Maturities



Source: BI; CEIC; AMRO staff calculations

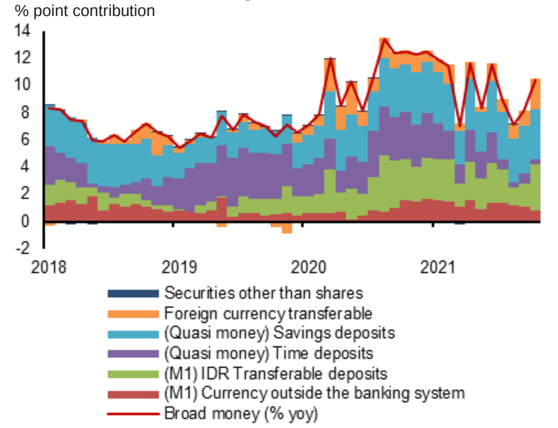
Figure 1.5. Monetary and Banking Sector

Interest rates moderated, although the lending rate lagged the deposit rate and BI's policy rate.



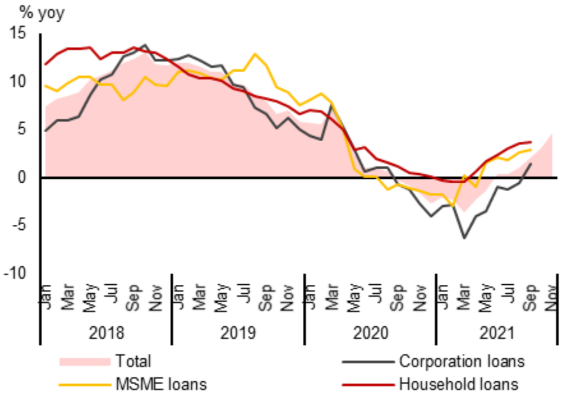
Source: BI; CEIC
Note: Monthly data is up to November 2021 for the policy rate, up to October 2021 for the overnight JIBOR rate, and up to September 2021 for the deposit and lending rates.

Liquidity has been ample, supported by solid deposit growth.



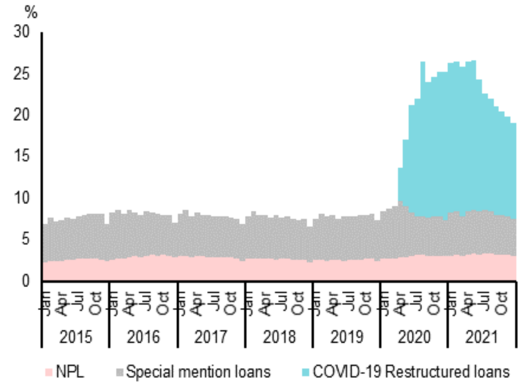
Source: BI; CEIC; AMRO staff calculations
Note: Monthly data is up to October 2021.

Bank loans have rebounded along with economic recovery, lifted by MSME and household loans, and more recently, corporate loans.



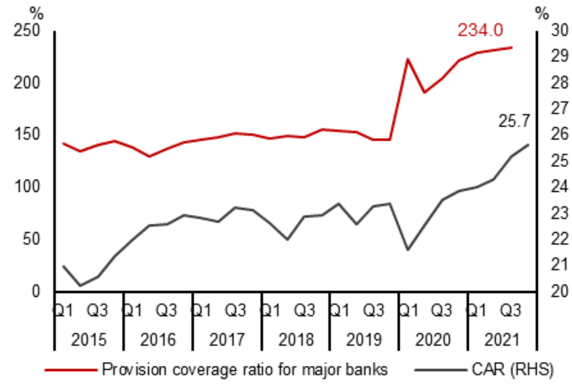
Source: BI; OJK; CEIC; AMRO staff calculations
Note: Monthly data is up to November 2021 for total loans, and up to September 2021 for component loans by type of borrower.

At the same time, loans restructured due to the pandemic have moderated.



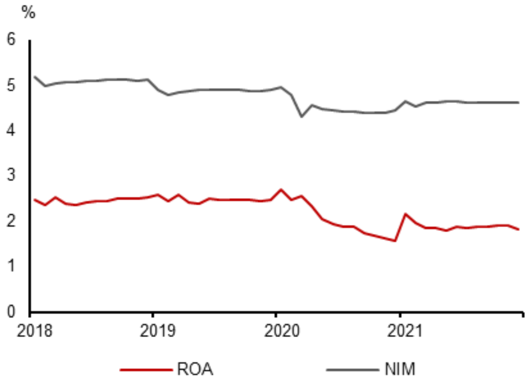
Source: Banks' financial reports; OJK; CEIC; AMRO staff calculations
Note: Monthly data is up to December 2021.

Strong capital buffers and elevated provisioning will likely support banks to withstand a potential deterioration in asset quality when loan restructuring expires.



Source: Banks' financial reports; OJK; CEIC; AMRO staff calculations
Note: Quarterly data are up to Q4 2021 for CAR, and Q3 2021 for the provision coverage ratio.

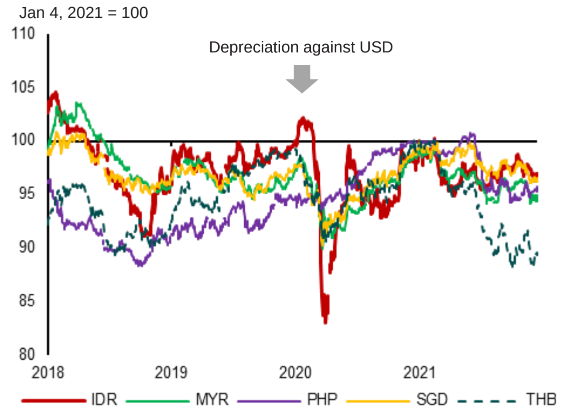
Lower funding costs and positive loan growth lifted banks' profits, as reflected in the improved net interest margin and return on assets, relative to 2020.



Source: OJK; CEIC; AMRO staff calculations
Note: Monthly data is up to December 2021.

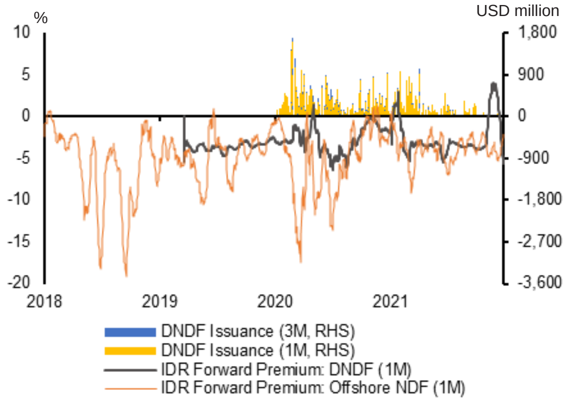
Figure 1.6. Forex and Financial Markets

The rupiah depreciated moderately against the U.S. dollar, relative to some other regional currencies.



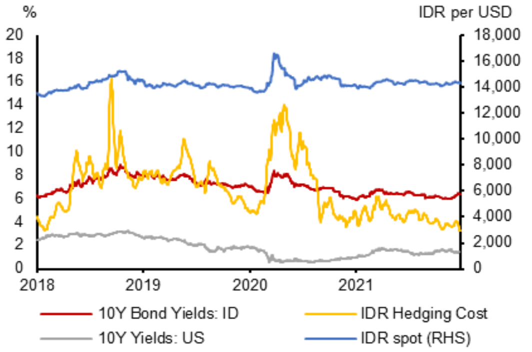
Source: CEIC; AMRO staff calculations
Note: Daily data is up to December 17, 2021.

The domestic NDF market facilitated price discovery and interactions between onshore and offshore markets, influencing rupiah hedging costs...



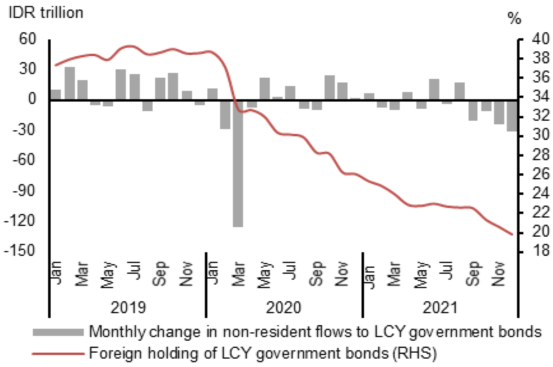
Source: Bloomberg; BI; CEIC; AMRO staff calculations
Note: Daily data is up to end-2021. The forward premium is calculated as the annualized difference between the forward and spot rates of a currency. A negative value indicates an expected depreciation in the currency in the future.

… and maintaining the attractiveness of rupiah-denominated government bonds...



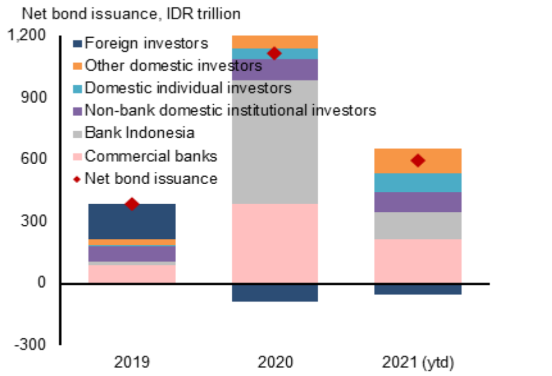
Source: Bloomberg; BI; Ministry of Finance; CEIC; AMRO staff calculations
Note: Daily data is up to end-2021. IDR hedging cost is calculated as the three-month offshore NDF-implied deposit rate.

… as foreign investors were sensitive to developments in the monetary policy stance of central banks in advanced economies, notably the Fed.



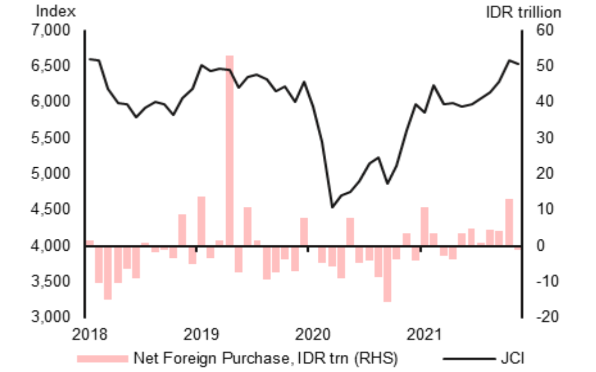
Source: Ministry of Finance; CEIC; AMRO staff calculations
Note: A positive value indicates a net inflow and a negative value indicates a net outflow. Monthly data is up to December 2021.

BI's direct budget financing and strong demand by domestic investors continued to support for the government bond market.



Sources: Ministry of Finance; AMRO staff calculations
Note: Data for 2021 is up to November 2021.

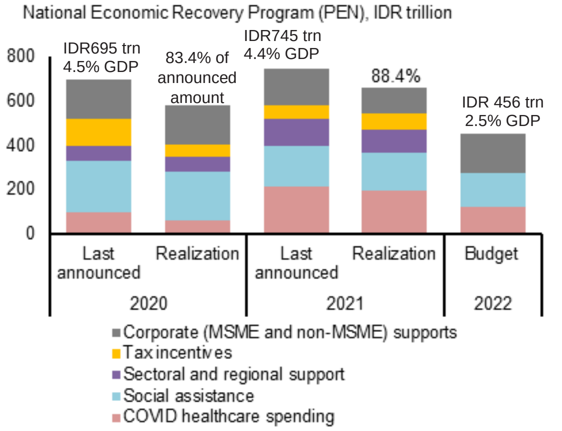
The stock market rebounded with resumed inflows in recent months.



Source: Jakarta Stock Exchange; CEIC; AMRO staff calculations
Note: Monthly data is up to November 2021.

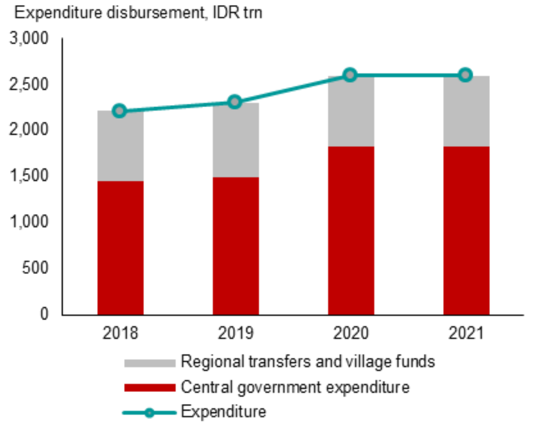
Figure 1.7. Fiscal Sector

Increased spending needs for healthcare and social assistance due to the Delta variant outbreak...



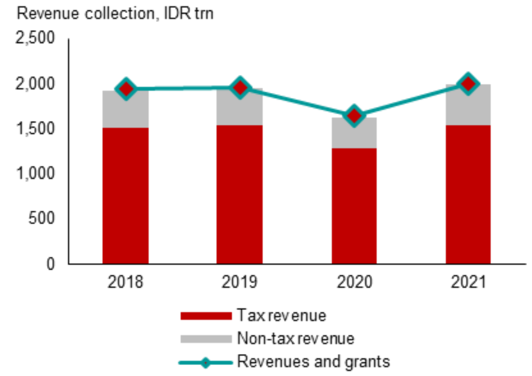
Source: Ministry of Finance; AMRO staff calculations

… have been financed by budget reallocation, minimizing impacts on budget expenses in 2021...



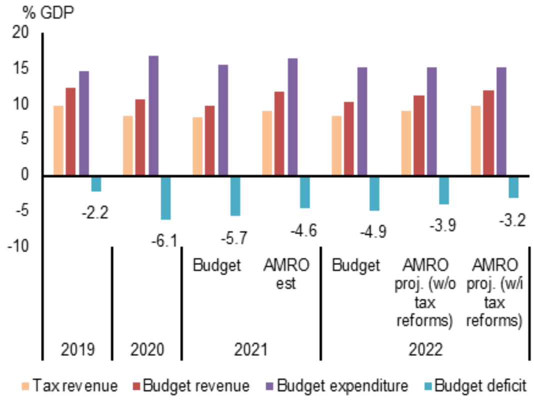
Source: Ministry of Finance; CEIC

… and coupled with a revenue windfall due to higher commodity prices…



Source: Ministry of Finance; CEIC

… will likely lower the fiscal deficit below the Budget target.



Source: Ministry of Finance; CEIC; AMRO staff estimates

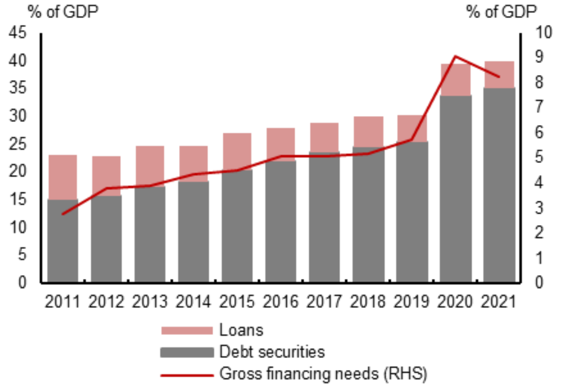
The government has pushed through a comprehensive tax reform package to raise tax revenue, rebuild fiscal space and preserve fiscal sustainability post-pandemic**.**

Tax type	Reform proposals
Value-added Tax (VAT)	• Raise the standard VAT rate from 10% to 11% in 2022, and to 12% in 2025 • The standard VAT rate could be adjusted between 5% and 15% by government regulations • Remove a number of VAT exemptions (but keep necessity goods and services, including staple goods and medical, social and education services)
Income tax	• [Personal Income Tax] Add one more annual personal income bracket, of IDR5 billion and above, with a 35% tax rate (to the existing four income brackets and tax rates ranging from 5-30%) • Raise the upper threshold of the lowest taxable income bracket from IDR50 million to IDR60 million • [Corporate Income Tax] Cancel the planned reduction of the CIT rate from 22% to 20% in 2022
Excise	• Expand the coverage (from alcoholic beverage and tobacco) to include plastic products
Carbon tax	• Impose carbon tax on goods containing carbon and/or on activities that cause carbon emissions, at the rate of IDR30 per kg of CO_2e, which is equivalent to USD2.1 per ton of CO_2e using the current exchange rate. For the initial stage starting April 1, 2022, the carbon tax will be applied to the coal-fired power plant sector under a cap-and-tax scheme.
Voluntary Disclosure Program (VDP)	• Impose a final tax rate on undisclosed assets, depending on when the assets were acquired either by December 31, 2015, or between 2016-2020, and whether they would be invested in government securities instruments between January-June 2022.

Source: Ministry of Finance; AMRO staff compilation

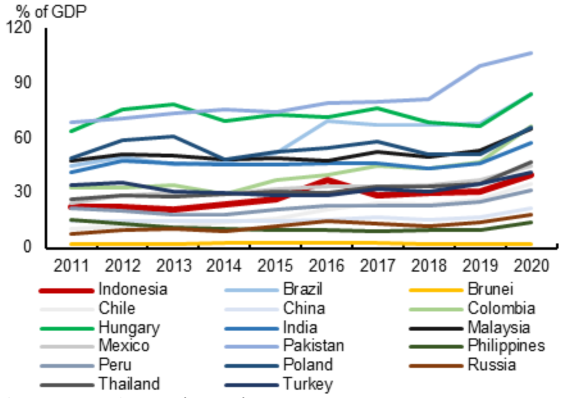
Figure 1.8. Debt Sustainability Analysis

Indonesia's government debt and financing needs rose on the back of fiscal support packages in response to the pandemic...



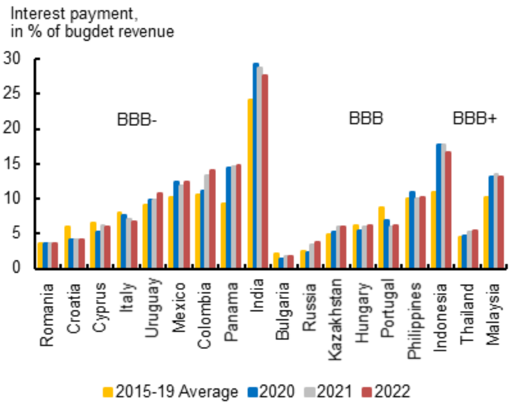
Source: CEIC; IMOF; AMRO staff projections
Note: Debt data is from debt realized as of October 2021. Gross financing needs and nominal GDP for 2021 come from AMRO's projections.

… … which has been in line with its EM peers.



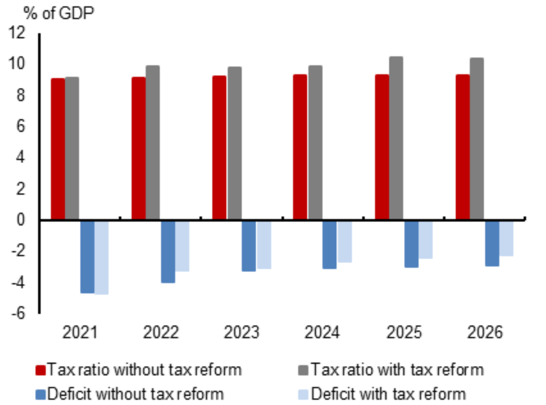
Source: AMRO Artemis Database

Rising debt has pushed up the interest burden, which was already elevated pre-pandemic, in part reflecting a modest tax revenue.



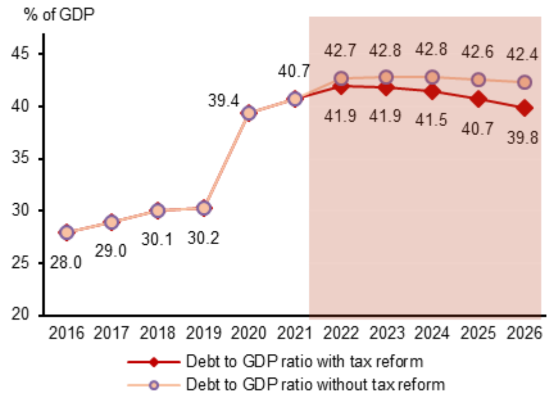
Source:: Fitch Ratings; Mandiri Sekuritas

The tax reform package passed in October is expected to lift the tax ratio and lower the budget deficit...



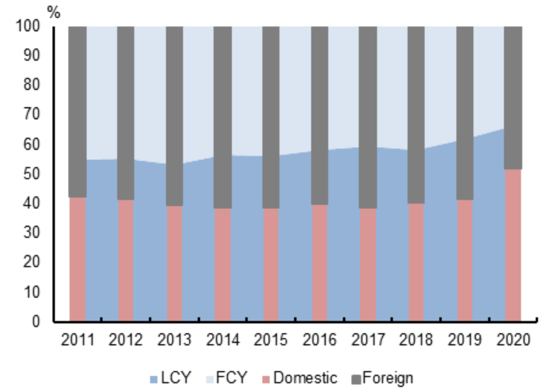
Source: AMRO staff projections

… supporting debt consolidation and lowering the interest payment burden over the medium term.



Source: Ministry of Finance; CEIC; AMRO staff projections

Indonesia's reliance on external financing, reflected in the still-elevated debt held by foreigners, underscores the need to develop the domestic debt market.



Source: Ministry of Finance; CEIC; AMRO staff projections

Appendix 2. Selected Economic Indicators for Indonesia

Selected indicators	2017	2018	2019	2020	2021	2022*
Real GDP (percent change yoy)	5.1	5.2	5.0	-2.1	3.7	5.2
Household consumption	4.9	5.1	5.0	-2.6	2.0	5.7
Government consumption	2.1	4.8	3.3	2.0	4.2	4.4
Gross fixed capital formation	6.2	6.7	4.5	-5.0	3.8	5.5
Exports of goods and services	8.9	6.5	-0.5	-8.1	24.0	4.3
Imports of goods and services	8.1	12.1	-7.1	-16.7	23.3	11.4
Balance of payments (percent of GDP)						
Current account balance	-1.6	-2.9	-2.7	-0.4	0.3	-1.2
Trade balance	1.9	0.0	0.3	2.7	3.7	2.1
Oil and gas	-0.7	-1.1	-0.8	-0.5	-1.0	-1.1
Non-oil and gas	2.6	1.1	1.1	3.2	4.7	3.2
Financial account balance	2.8	2.4	3.3	0.7	1.0	1.4
Foreign direct investment (net)	1.8	1.2	1.8	1.3	1.4	1.6
Portfolio investment (net)	2.1	0.9	2.0	0.3	0.4	0.6
Other investment (net)	-1.1	0.3	-0.5	-0.9	-0.9	-0.8
Overall balance	1.1	-0.7	0.4	0.2	1.1	0.0
Gross foreign reserves (USD bn)	130.2	120.7	129.2	135.9	144.9	145.4
External debt	34.7	36.0	36.1	39.3	35.0	34.6
Central government (percent of GDP)						
Revenue and grant	12.3	13.1	12.4	10.7	11.8	11.9
Expenditure	14.8	14.9	14.6	16.8	16.4	15.1
Budget balance	-2.5	-1.8	-2.2	-6.1	-4.6	-3.2
Central government debt	29.4	30.4	30.2	39.5	40.7	41.9
Money and credit (yoy, end of period)						
Broad money	8.3	6.3	6.5	12.5	13.9	8.6
Private sector credit	8.0	12.5	5.5	-1.7	5.4	9.6
Memorandum Items:						
Headline inflation (yoy, end of period)	3.6	3.1	2.7	1.7	1.9	3.2
Headline inflation (yoy, period avg)	3.8	3.2	3.0	2.0	1.6	2.8
BI policy rate	4.25	6.00	5.00	3.75	3.50	-
Exchange rate (rupiah/USD, period avg)	13,385	14,246	14,237	14,582	14,308	14,596
Nominal GDP (USD bn)	1,015	1,041	1,119	1,060	1,186	1,257
Nominal GDP (IDR trn)	13,590	14,839	15,833	15,438	16,971	18,353

Source: BPS; BI; Ministry of Finance; AMRO staff calculations
Note: */ Data for 2022 are AMRO staff projections. Fiscal projections for 2022 has incorporated the impact of the tax reform package.

Appendix 3. Balance of Payments

in % of GDP, unless otherwise indicated	2017	2018	2019	2020	2021
Current Account	-1.6	-2.9	-2.7	-0.4	0.3
Goods	1.9	0.0	0.3	2.7	3.7
Exports	16.6	17.4	15.1	15.4	19.6
Oil	0.7	0.8	0.4	0.3	0.5
Gas	0.8	0.9	0.7	0.5	0.6
Non-Oil & Gas	15.1	15.7	14.0	14.6	18.4
Imports	14.8	17.4	14.7	12.7	15.7
Oil	2.0	2.5	1.7	1.1	1.8
Gas	0.3	0.3	0.2	0.3	0.4
Non-Oil & Gas	12.5	14.6	12.7	11.4	13.5
Services	-0.7	-0.6	-0.7	-0.9	-1.2
Primary Income	-3.2	-3.0	-3.0	-2.7	-2.7
Secondary Income	0.4	0.7	0.7	0.6	0.5
Capital Account	0.0	0.0	0.0	0.0	0.0
Financial Account	2.8	2.4	3.3	0.7	1.0
Direct Investment, net	1.8	1.2	1.8	1.3	1.4
Portfolio Investment, net	2.1	0.9	2.0	0.3	0.4
Other Investment, net	-1.1	0.3	-0.5	-0.9	-0.9
Net Error & Omissions	-0.1	-0.2	-0.1	-0.1	-0.1
Overall Balance	1.1	-0.7	0.4	0.2	1.1
Memorandum items:					
International reserves (USD bn)	130.2	120.7	129.2	135.9	144.9
External debt	34.7	36.0	36.1	39.4	35.0
Exchange rate (rupiah/USD)	13,385	14,246	14,237	14,582	14,308
Nominal GDP (USD bn)	1,015	1,041	1,119	1,060	1,186

Source: Bank Indonesia; BPS; CEIC; AMRO staff calculations

Appendix 4. Central Government Budget

In trillions of IDR, unless otherwise indicated	2018	2019	2020	2021	Annual change (% yoy)				2021 Act*		
					2018	2019	2020	2021B	IDR trillion	% yoy	% of Budget
	Act	Act	Act	Budget	f/r 2017	f/r 2018	f/r 2019	f/r 2020			
A. Total Revenue and Grants	1,944	1,961	1,648	1,744	16.6	0.9	-13.4	5.8	2,003	21.6	114.9
1. Taxes Revenue	1,519	1,546	1,285	1,445	13.0	1.8	-9.2	12.4	1,547	20.3	107.1
a. Income Taxes	750	772	594	684	16.0	3.0	-13.2	15.1	697	17.3	101.9
- Oil and Gas	38	59	33	46	-24.3	55.3	-46.1	38.6	53	60.1	115.5
- Non-Oil and Gas	817	713	561	638	37.0	-12.7	-10.5	13.7	644	14.7	100.9
b. VAT	537	532	450	519	11.8	-1.1	-15.3	15.1	551	22.3	106.3
c. Excise	160	172	176	180	4.1	8.0	2.3	2.1	196	10.9	108.6
d. International Taxes	46	41	37	35	17.1	-10.6	-10.6	-4.8	73	100.0	210.1
2. Non tax Revenue	409	409	344	298	31.5	-0.1	-15.9	-13.3	452	31.5	151.6
a. Natural resources	181	155	97	104	62.6	-14.2	-37.2	7.1	151	55.1	144.9
b. Others	229	254	247	194	14.3	11.1	-3.0	-21.3	301	22.1	155.2
3. Grants	16	6	19	1	34.5	-58.5	190.6	-95.2	5	-75.7	506.2
B. Government Expenditures	2,213	2,309	2,595	2,750	10.2	4.3	12.4	6.0	2,787	7.4	101.3
1. Central Government	1,455	1,496	1,833	1,955	15.0	2.8	22.5	6.6	2,001	9.2	102.4
a. Personnel	347	376	381	421	10.9	8.4	1.2	10.7	388	1.9	92.0
b. Materials	348	334	422	362	19.2	-3.8	26.3	-14.2	527	24.7	145.3
c. Capital	184	178	191	247	-11.8	-3.4	7.4	29.3	242	26.5	97.9
d. Interest Payment	258	276	314	373	19.1	6.8	14.0	18.8	344	9.4	92.0
- Domestic	238	254	297	355	19.2	6.6	17.0	19.5	333	12.0	93.7
- Foreign	20	21	17	18	18.5	9.1	-21.0	7.2	11	-37.2	58.5
e.Subsidies	217	202	196	175	30.3	-7.0	-2.8	-10.6	243	23.9	138.6
- Energy	154	137	97	111	57.3	-10.8	-28.8	13.5	140	44.2	127.0
- Non Energy	63	65	99	65	-7.7	2.4	52.2	-34.4	103	3.9	158.4
f. Grants spending	2	5	6	7	-72.2	233.2	25.6	8.1	4	-31.2	63.7
g. Social	84	112	203	161	52.4	33.4	80.1	-20.3	174	-14.3	107.5
h. Other Spendings	16	12	120	207	13.8	-27.6	925.9	72.7	81	-32.7	39.0
2. Transfer to Region & Village Funds	758	813	763	795	2.1	7.3	-6.2	4.3	786	3.0	98.8
C. Primary Balance	-11	-73	-634	-633	-	-	-	-	-440	-	69.5
D. Overal Balance	-269	-349	-948	-1,006	-	-	-	-	-784	-	77.9
% of GDP	*-1.8*	*-2.2*	*-6.1*	*-5.7*	-	-	-	-	*-4.6*	-	-

Source: Ministry of Finance; CEIC; AMRO staff calculations
Note: */ 2021 budget realization data (2021 Act) are preliminary (unaudited) and provided by Ministry of Finance.

Annexes: Selected Issues

1. Monetary - Fiscal Policy Synergy during the Pandemic[33]

*As with some other emerging markets (EMs)**,** Indonesia has entered unchartered territory where the central bank buys government bonds to support the government budget in response to the unprecedented health crisis. This selected issue aims to provide a detailed account of how the country has implemented its synchronised and complementary monetary and fiscal policies, their impacts on macroeconomic variables, as well as the central bank's financial position. A discussion on policy implications post-pandemic will end this selected issue.*

Introduction

1. The unprecedented COVID-19 pandemic has posed mounting challenges to Indonesian policymakers. The coronavirus, especially its Delta variant, has spread exponentially and caused more than four million infections and close to 150,000 deaths in Indonesia by end-2021. Mobility restrictions imposed to contain the spread have also affected businesses and households. As a result, the pandemic has created multidimensional challenges on the health, economic, financial, and social fronts. Policy responses have required large amounts of budget financing and flexible implementation of fiscal rules. The rollout of much-needed fiscal support packages to address the health crisis and provide relief to affected businesses and households has pushed the budget deficit beyond the fiscal rule of 3 percent of GDP. Challenges have also arisen from the financing side, in light of Indonesia's small domestic capital market and investors' risk-off sentiment.

2. Authorities have temporarily allowed a suspension of fiscal rules and monetary financing by issuing a special legislation in 2020, Law No 02/2020. In particular, the special law has suspended the application of fiscal rule that caps the fiscal deficit at 3 percent of GDP from 2020 to2022. It also authorizes BI to buy government bonds in the primary market as part of deficit financing in connection with the COVID-19 pandemic.[34]

Monetary-Fiscal Policy Synergy

3. Three joint decrees issued by the government and BI regulate the monetary financing mechanisms that govern BI purchases of government bonds in the primary market. The first joint decree, known as SKB I, was signed on April 16, 2020, stipulates the general schemes and coordination mechanism between the government and BI. SKB I states that the purchase must follow an order of priority, that is, by regular auction, additional auction known as the greenshoe option (GSO), and private placement.[35] The purchase must be conducted under prudent principles and in line with market mechanism. For example, the central bank must act as a standby buyer; the bonds must be tradable and marketable; and the purchase must consider any inflationary impact. SKB I was initially effective until December 2020 and was later extended to December 2022.

4. The second joint decree, known as SKB II, was signed on July 7, 2020, in anticipation of a wider fiscal deficit, from 5.1 percent of GDP to 6.3 percent.[36] SKB II, which was effective only in 2020, regulated BI's purchase of government bonds that financed government spending on public goods, namely health-care spending, social protection, and sectoral and local government pandemic support. The bonds are issued through private placement and

[33] This selected issue is prepared by Andriansyah, Fiscal Specialist and Nguyen Thi Kim Cuc, Country Economist for Indonesia.
[34] Previously, BI could buy long-term government bonds only in the secondary market.
[35] BI will carry out private placement if the regular auction and GSO cannot fulfill the issuance target. The amount the central bank can buy is set by an agreement it has with the government, and takes reference from the latest market price published by the Indonesia Bond Pricing Agency.
[36] See Box A for a more detailed explanation of SKB I and SKB II.

carry a variable coupon equivalent to the three-month reverse repurchase (3MRR) rate, which BI will *fully* relinquish. BI will also share with the government *part* of the interest expense of bonds issued to fund the non-public goods package, which provides MSME and corporate support (Table A1.1).

5 . BI and Ministry of Finance signed the third joint decree, known as SKB III, in August 2021, as a response to the Delta variant outbreak which raised the fiscal support package to about 4.5 percent of GDP in 2021. Under SKB III, the central bank will buy government bonds issued to fund health-care spending and humanitarian aid through a private placement mechanism and relinquish the interest income on the portion used to finance health-care spending. SKB III will be effective until December 31, 2022 (see Table A1.1 for a comparison of SKB I, II, and III).

Table A1.1. Joint Decrees on BI's Purchase of Government Bonds

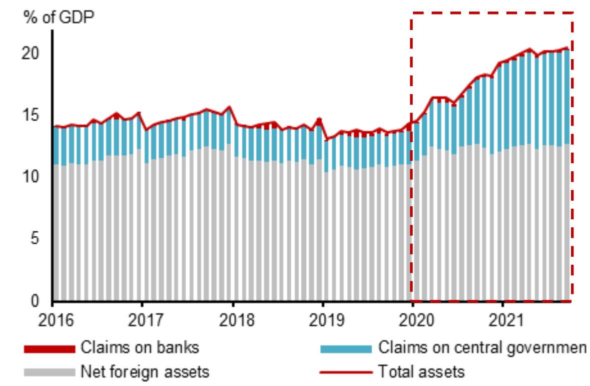
Joint Decree	SKB I	SKB II	SKB III
Term	April 2020 to December 2020, and extended to December 2021	July 2020 to December 2020	August 2021 to December 2022
Number of schemes	3	3	2
Scheme #1	**Regular auction** (first priority)	**Public goods** (*health-care spending, social protection, sectoral and local government support*)	**Cluster A** (*vaccination programs and health-care spending*)
Method of purchase	Investors: competitive bidding BI: non-competitive bidding[1/]	Private placement	Private placement
Burden-sharing mechanism	Not applicable; government pays BI interest at the market rate [2/]	Government pays BI based on floating interest rates equivalent to 3MRR rates, and BI fully returns/relinquishes this interest income to the government	Government pays BI based on floating interest rates equivalent to 3MRR rates, and BI fully returns/relinquishes this interest income to the government
BI's amount of purchase	Maximum 25 percent and 30 percent of targeted amount for conventional bonds and sharia bonds, respectively	2020: maximum IDR398 trillion	2021: maximum IDR58 trillion 2022: maximum IDR40 trillion
Tenor (years)	>1	5, 6, 7, 8	5, 6, 7, 8
Scheme #2	**Greenshoe option (**second priority)	**Non-public goods** (MSME and corporate support)	**Cluster B** (Healthcare spending other than Cluster A and humanitarian aid)
Method of purchase	Investors and BI: Non-competitive bidding	Follow the priority order (SKB I): Bonds are issued at market rates	Private placement
Burden-sharing mechanism	Not applicable: government pays BI interest at the market rate[3/]	BI shares the interest burden with the government on this package. The government will pay the interest equivalent to the 3MRR rate minus 1 percent. BI will share the remaining cost (equivalent to the market rate minus the government's interest payment).	Government pays BI based on floating interest rates equivalent to 3MRR rates.
BI's amount of purchase	Maximum 25 percent and 30 percent of targeted amount/issuance(?) for conventional bonds and sharia bonds, respectively	2020: maximum IDR177 trillion	2021: maximum IDR157 trillion 2022: maximum IDR184 trillion
Tenor (years)	>1	7	5, 6, 7, 8
Scheme #3	**Private placement** (last priority)	**Other incentive support**	**Not available**
Method of purchase	Direct sales to BI	Follow the priority order (SKB I)	-
Burden-sharing mechanism	Not applicable; government pays BI interest at the market rate[4/]	Government pays BI interest at the market rate	-
BI's amount of purchase	In accordance with the agreement between the government and BI	Not regulated	-
Tenor (years)	>1	5	-

Note: [1/] In a regular bond auction, a competitive bidder submits purchase offers by stating the volume and yield (for fixed-rate bonds or zero-coupon bonds) or price (for variable-rate bonds). A non-competitive bidder states only the volume. [2/] As a non-competitive bidder, BI will pay the weighted average of yields awarded to competitive bidders. Competitive bidders will pay with their asking yields or prices. [3/] In the GSO, a bidder can submit only the volume they wish to buy at the weighted average yield of the regular auction. [4/] Under SKB I's private placement scheme, the interest rate paid to BI takes reference from the latest market price published by the Indonesia Bond Pricing Agency.
Source: Ministry of Finance; Bank Indonesia; AMRO staff compilations

A preliminary impact assessment

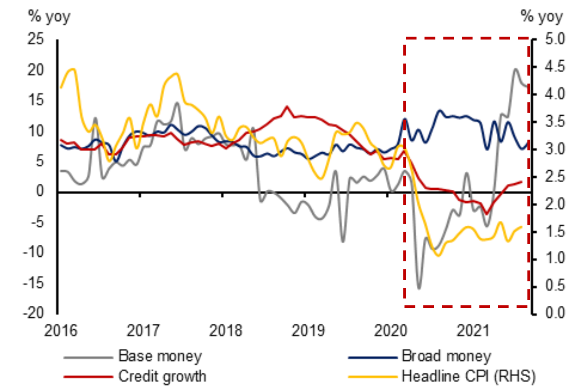
6. BI's balance sheet has expanded in tandem with its purchase of government bonds, but this has yet to translate into inflationary pressures. The central bank bought government bonds worth about IDR75.9 trillion and IDR143.3 trillion in 2020 and 2021, respectively, under SKB I, while a total of IDR397.6 trillion of bonds was privately placed with BI in 2020 in line with SKB II. These purchases have raised BI's claims on the government from 2.7 percent of GDP in 2019 to 6.8 percent in 2020, and further to 7.5 percent as at August 2021.[37] BI's gross assets have increased from 14.5 percent of GDP at end-2019 to 19.3 percent at end-2020, and stayed elevated at about 20 percent of GDP in 2021 (Figure A1.1). Its enlarged assets have been associated with a higher growth in broad money and, more recently, base money. Meanwhile, inflation have remained muted reflecting compressed domestic demand as a result of containment measures and credit growth has rebounded gradually (Figure A1.2).

Figure A1.1. BI's Balance Sheet: Assets



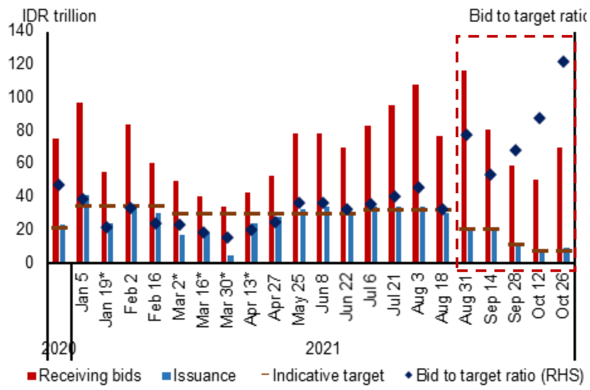
Source: BI; Statistics Indonesia; CEIC; AMRO staff calculations

Figure A1.2. Aggregate Monetary Indicators and CPI



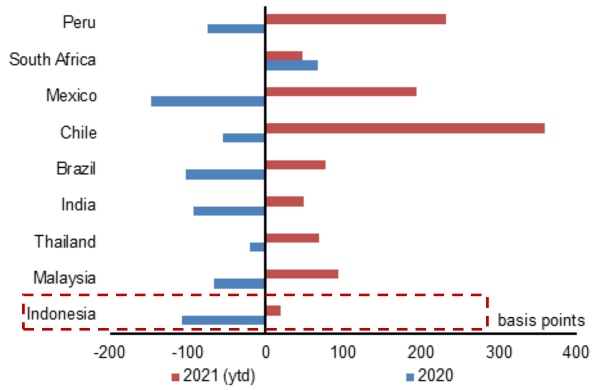
Source: BI; Statistics Indonesia; CEIC; AMRO staff calculations

Figure A1.3. Regular Conventional Bond Auctions: 2020-2021



Note: The data refers to regular conventional bond auctions only. The 2020 data is on the average amount per auction. Auctions in 2021 with asterisks were followed by a GSO the following day.
Source: Ministry of Finance; AMRO staff calculations

Figure A1.4. Changes in 10-Year Government Bond Yields in Selected EMs



Note: The changes in bond yields in 2020 are calculated as the changes in bond yields from December 2019 to December 2020, while those for 2021 are between October 2021 and December 2020.
Source: Various national authorities; CEIC; AMRO staff calculations

7. The joint decrees on BI's purchases of government bonds have helped alleviate pressures on bond yields. The SKB I mechanism was used extensively in January-April 2021 when market expectations of an early Fed tapering led to capital outflows and rising bond yields in EMs, including Indonesia. In response, the Indonesian government decreased its bond issuances in regular auctions and conducted GSOs, under which BI absorbed most of the remaining financing needs. With the announcement of SKB III in August 2021, the

[37] BI's claims on the central government could increase further in tandem with the realization of SKB III, under which BI bought IDR215 trillion of government bonds via private placement in November-December 2021.

government reduced its issuance target in September-October (Figure A1.3) and canceled the planned auctions in November-December. These moves, coupled with sustained demand from banks and other domestic investors, have helped contain an increase in government bond yields in 2021 relative to other EMs (Figure A1.4).

8. SKB II and III have directly lightened the government's interest payment burden. Explicit savings to the government budget consist of BI's forgoing part of the interest payment by the government on the private placement amounts under SKB II and III, as well as its share of interest costs on the non-public goods package under SKB II. The government has also been able to save on interest payments by privately placing bonds with BI at below market rates.[38] According to AMRO staff estimates, SKB II could save the government's interest expenses by about 1.9 percent of annual budget revenue on average starting in 2021, while SKB III could result in additional savings of 0.2-0.3 percent from 2022 onwards. These savings to the government's interest burden will be partially offset by BI's lower tax payments and dividend contributions to the budget revenue; nonetheless, the net impact of SKB II and III on the government budget is projected to be positive (Table A1.2).

Table A1.2. Simulation on Impacts of SKB II and III on BI's Financial Position and Government Budget

in trillions of rupiah, unless otherwise indicated	2018	2019	2020	AMRO Projections		
				2021	2022	2023
BI's financial position						
Total revenue	106	92	86	99	106	113
o/w interest income arisen from SKB II			3	13	13	13
o/w interest income arisen from SKB III					7	14
Total expenditure	41	47	53	87	96	104
o/w interest income/burden forgone/shared with the government under SKB II			4	21	21	21
o/w interest income forgone from the government under SKB III					2	3
o/w additional cost of absorbing excess liquidity due to SKB II and III[2/]				13	20	28
Current year surplus (deficit) before tax	65	45	33	12	10	9
Tax payment	17	12	8	3	3	2
Current year surplus (deficit) after tax	48	33	25	9	8	7
Transfer of current year surplus (deficit) after tax to government budget[3/]	30	21	0	0	0	0
Retained current year surplus (deficit) after tax	18	12	25	9	8	7
Net impact on BI's financial position						
Change in retained surplus (deficit) from 2019 level			13	-3	-4	-5
Capital ratio (%)[4/]	11.6	11.1	8.6	8.2	7.9	8.3
Net impact on the government budget (change from 2019 level)			**-9**	**12**	**18**	**25**
Revenue			-25	-30	-31	-31
Tax receipts from BI			-4	-9	-9	-10
Current year surplus after tax transfer			-21	-21	-21	-21
Expenditure			16	42	49	56
Interest cost shared by BI			4	21	23	24
Explicit interest cost savings due to private placement at below market rates			2	13	20	26
Implicit interest cost savings from lower bond yields compared with savings achieved without SKB II or III[5/]			10	9	6	6

Sources: Bank Indonesia (financial reports), AMRO Staff Projections
Note: [1/] Data for 2021-23 are AMRO Staff Projections.[2/] By purchasing government bonds at below market rates and remunerating partly or fully the interest income to the government, BI has injected liquidity into the system at relatively low or even zero interest rates. In case BI is required to mop up excess liquidity in the future, through conducting repurchase agreements with banks, BI needs to pay the market rates to banks. The cost of doing so using the government bonds issued to BI via private placements under SKB II and III, is higher than the interest income BI receives from holding these bonds, and result in a net expenditure in BI's income statement. The actual cost would depend on the size of liquidity that BI needs to absorb if at all, and hence could be lower than the amount estimated by AMRO staff. [3/] The transfer of BI's surplus after tax should appear in the Budget of the following year. As the capital ratio has fallen below 10 percent since 2020, no transfer is assumed afterwards. [4/] Capital ratio is calculated as the ratio of (General reserves+revaluation of fixed assets+90% of current year surplus (deficit) after tax+ BI's own equity/capital) to total monetary liabilities. [5/] The implicit interest cost savings from lower government bond yields than without SKB II and III is calculated by assuming that government bond yields should have increased 70 basis points more than the current level in case there was no SKB II and III. This is derived from comparing Indonesia's 10-year government bond yields movement year-to-date with some ASEAN peers (Malaysia, Thailand, and Singapore).

[38] Unlike the private placement arrangement under SKB I, bonds privately placed with BI under SKB II and III carry a variable coupon rate equivalent to the 3MRR rate, which stood at about 3 percent as of November 2021, compared to 10-year government bond yields of 6.4-6.5 percent.

9. At the same time, impacts of the joint decrees on BI's financial position will likely be contained. Net expenses incurred include BI's share of interest costs for the non-public goods package under SKB II, and the additional cost of absorbing excess liquidity, if needed, as a result of SKB II and III. While this could lower BI's current year surplus before tax, the central bank's financial position may not necessarily worsen against the backdrop of an expected lowering of its tax obligations and dividend contribution to the Budget (Table A1.2).

Policy Discussions

10. A combination of factors has led to market acceptance of BI's direct purchases of government bonds thus far. In response to the unprecedented health crisis, Indonesia, as with some other EMs, have ventured into the unchartered territory of asset purchase programs without causing significant disruptions in the financial markets. Aguliar and Cantú (2020) suggest two underlying factors, which were certainly at play for Indonesia. First, EMs' cyclical position and structural changes, especially their improved central bank credibility and fiscal prudence that anchored inflationary pressures and contained exchange rate pass-through, gave these countries greater room for monetary easing during the pandemic, including expanding their policy toolkits to include asset purchase programs. Second, monetary easing conducted by the central banks of advanced economies, notably the Fed, dampened the appreciation pressure on the U.S. dollar, which could have been a major risk to EMs' central banks. In addition, the Indonesian authorities' clear communication of their monetary-fiscal policy synergy contributed to sustained market confidence. In particular, BI and the Ministry of Finance maintained regular conference calls with investors on a virtual basis, during which BI's transparent and time-bound purchases of government bonds in line with prudential principles were clearly explained to the market.

11. Moving forward, a credible exit strategy from the extraordinary monetary financing arrangements should be designed and effectively communicated to the market. The experience of advanced economies suggests that clear communications and a gradual exit would facilitate a smooth normalization from central banks' asset purchase programs.[39] Indonesian authorities have told the market that BI's purchase of government bonds via private placements under SKB III will end by 2022. BI has also shared a normalization strategy that would start with the absorption of excess liquidity through open market operations and/or increasing the statutory reserve requirement, followed by raising the policy rate upon signs of rising inflation. At the same time, the fiscal policy stance has shifted toward a trajectory of gradual consolidation to bring the budget deficit below 3 percent of GDP in 2023, supported by the tax reform package approved in October. The coordination of monetary and fiscal policies should be continued to ensure a smooth exit from the pandemic policy package, while securing the independence of the central bank.

[39] For the literature on U.S. monetary policy and spillovers on EMs, please see Chen et al. (2014), and on the Fed experience in exiting from unconventional monetary policy between 2014-2019, please see Congressional Research Service (2020). The latter shows the Fed exited from unconventional monetary policy conducted between 2009 and 2013 in a gradual manner by (i) maintaining the size of its balance sheet between 2014-2017 by rolling over maturing securities, and (ii) gradually reducing its balance sheet by ceasing to roll over maturing securities at a pre-announced rate from late 2017 onwards.

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2. Indonesia's Across-the-Board Tax Reform and Medium-Term Fiscal Consolidation[40]

Indonesian authorities are a step ahead of many emerging markets in fiscal consolidation efforts, by conducting across-the-board tax reform. This selected issue provides detailed tax reform measures and estimates their revenue impacts. It also discusses how additional revenue from the measures will benefit the rebuilding of fiscal space and medium-term fiscal sustainability.

Introduction

1. A bold and comprehensive tax reform package was passed in October 2021 in the form of Law Number 7 Year 2021 on Harmonization of Tax Regulation, at a time when Indonesia was experiencing a declining trend in tax revenue to GDP and a nascent economic recovery from the COVID-19 pandemic.[41] This new tax law is the largest reform package carried out by the government since 1983 and includes both tax policy and administration reforms.[42] It also demonstrates the government's commitment to the fiscal consolidation plan to reduce fiscal deficit by increasing revenue. The tax reform package includes tax administration reform, direct tax measures, indirect tax measures, a new carbon tax and a voluntary disclosure program.

Tax Measures

2. The tax administration reform aims to increase fairness, efficiency and effectiveness in tax administration. OECD (2021) showed that tax administration in Indonesia was weak compared with other countries (Table A2.1).[43] Under the reform, the most notable measure is to use the citizen identification number as a tax identification number to generate more registered taxpayers for personal income. Although not all registered taxpayers will have taxable incomes above the threshold of IDR54 million, the measure is expected to expand the tax base. The reform also prioritizes measures to recover revenue losses rather than impose criminal sanctions for tax offenses, by reducing the interest penalty on unpaid taxes to encourage compliance.[44]

Table A2.1. Tax Administration Performance

	Indonesia	OECD	Non-OECD
Registered personal income taxpayers (% population)	10.3	58.3	26.5
On-time filing (%)			
Corporate income tax	77.5	82.2	73.3
Personal income tax	77.4	88.3	80.8
On time payment (min, % estimated payment)	78.8	82.4	81.5
Tax arrears collected (% total year-end arrears)	39.6	55.5	52.0
Percentage of revenue collected through large taxpayer offices	30.0	41.6	49.2
Change in the "cost of collection" ratio 2016-2017	0.19	-2.5	-3.0

Source: OCED (2021)

Table A2.2. PIT Bracket and Tariff

Previous Brackets		Current Brackets	
Taxable Income	**Tariff**	**Taxable Income**	**Tariff**
≤ IDR50 million	5%	≤ IDR60 million	5%
IDR50 million to IDR250 million	15%	IDR60 million to IDR250 million	15%
IDR250 million to IDR500 million	25%	IDR250 million to IDR500 million	25%
> IDR500 million	30%	IDR500 million to IDR5 billion	30%
		> IDR5 billion	35%

Source: IMOF
Note The maximum non-taxable income is IDR54 million per annum for a single person.

[40] This selected issue is prepared by Andriansyah, Fiscal Specialist.
[41] This tax law is an omnibus legislation as it amended four tax laws and two other laws that contained taxation regulations.
[42] Indonesia's first tax reform introduced a self-assessment tax system in 1983. Since 2002, the country has been conducting a series of systematic tax reforms in three main phases, and this new tax law is part of the third phase, which began in 2017. The ongoing third phase also comprises a tax administration reform covering organization, human resources, business processes, information technology and databases, and tax regulations. This phase will last until 2024.
[43] One of the areas that Indonesia needs to improve on is the role of large taxpayer offices. Basri et. al. (2021) showed that transforming small tax offices into medium and large tax offices could have a larger impact on revenue collection than an increase in the tax rate.
[44] The compliance rate as of 2013 was about 53 percent (Sugana and Hidayat 2014).

3. Income tax reform consists of increasing the personal income tax (PIT) brackets and canceling a plan to reduce corporate income tax (CIT) to 20 percent. A new bracket for the highest earners, with taxable income above IDR5 billion, will be introduced at a 35 percent tax rate to make the new tax system more progressive. In addition, the upper threshold of the lowest taxable income bracket is also increased from IDR50 million to IDR60 million without changing the tax rate (Table A2.2). Meanwhile, a previous plan to reduce the CIT rate from 22 percent to 20 percent in 2022 has been scrapped.[45]

4. Reform to value-added tax (VAT) consists of a rate hike and the removal of exemptions. The standard VAT rate will be increased from 10 percent to 11 percent on April 1, 2022, and further to 12 percent by January 1, 2025, at the latest. Some exemptions have also been removed.[46] However, lower and middle-income groups are still granted exemptions for necessity goods and services, such as staple goods as well as medical, social and educational services, to ensure fairness in the tax system.[47]

5. A carbon tax is being introduced on goods containing carbon and activities that cause carbon emissions. The carbon tax will be initially implemented from April 1, 2022, limited to coal power plants under a cap-and-tax scheme. The implementation will be expanded to other sectors in 2025 in line with an upcoming carbon tax roadmap.[48] The new tax law states that the carbon tax rate must be no less than the carbon price in the domestic carbon market. The initial rate will be at least IDR30,000, or about USD2.10, per ton of CO_2 emissions.[49]

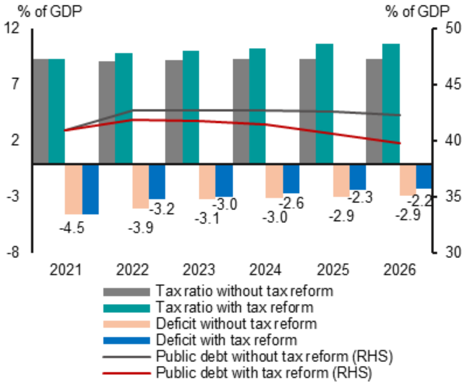
6. A voluntary disclosure program (VDP) will be launched in 2022 to raise taxpayer compliance and increase tax revenue. Following a tax amnesty program in 2016-2017, the new tax law provides another opportunity for taxpayers to disclose their undeclared assets through a VDP by paying a final income tax rate of 6 to 18 percent. The rate varies depending on when the assets were acquired and whether the overseas assets would be repatriated and invested domestically in government securities instruments, downstream natural resources, or renewable energy sectors (Table A2.3). This program will be implemented from January 1 to June 30, 2022.

Table A2.3. The Voluntary Disclosure Program

	Measure 1	Measure 2
Subject	Individuals and corporations that participated in the 1st tax amnesty	Individuals
Asset base	Assets as of December 31, 2005, that have not been declared in the 1st tax amnesty program	Assets that have been acquired in 2016-2020 and have not been declared in 2020 tax return
Final income tax tariff	• 11% for overseas declaration • 8% for repatriated overseas assets and domestic assets • 6% for repatriated overseas and domestic assets invested in government securities, downstream natural resources, or renewable energy sectors.	• 18% for overseas declaration • 14% for repatriated overseas assets and domestic assets • 12% for repatriated overseas and domestic assets invested in government securities, downstream natural resources, or renewable energy sectors.

Source: IMOF, AMRO Staff Compilation

Figure A2.1. Revenue Impact



Source: AMRO Staff Projections

[45] The original plan to reduce the CIT rate was stated in Law Number 2 Year 2020 on Job Creation.
[46] Exemptions from the VAT previously covered four main types of goods, and this is now down to only two types, namely food and beverages served in hotels and restaurants, as well as money, gold bullion and securities. In terms of services, 11 out of 17 types have been removed from the exemption list. The six types that are still exempted are religious, art and entertainment, hospitality, government, parking, as well as catering services.
[47] The continued exemptions can be stipulated through government regulation.
[48] The carbon tax road map reportedly will take into consideration the prospective sectoral readiness and overall economic conditions.
[49] This rate is far below the ideal rate of USD75 needed to meet Paris Agreement goals of limiting global warming to well below 2°C (Parry 2021).

7. The new tax law allows the government to expand the coverage of excise duty beyond alcoholic beverages and tobacco products. Any move to subject more products to excise duties must be carried out under an annual state budget consultation process with parliament. So far, the government and parliament have agreed to including single-use plastic products and prepackaged sugared beverages in the 2022 Budget.

Medium-Term Fiscal Consolidation

8. The above tax measures may increase tax revenue collection by 0.80 percent of GDP in 2022, and by above one percentage point from 2024 onward. Considering that the effects of removing exemptions will take some time to become observable, the additional revenue from the VAT reform is estimated at 0.23 percent of GDP in 2022, mainly from the one percent VAT rate hike. The revenue impact from PIT reform is neutral, while the revenue savings from the cancellation of the CIT reduction plan is about 0.26 percent of GDP.[50] According to AMRO staff's estimates, the additional revenue from carbon tax is expected to be 0.03 percent of GDP. Meanwhile, the additional revenue from the VDP will be a one-off for 2022 and is estimated at 0.30 percent of GDP.

9. These additional revenues from the tax reform are needed to rebuild fiscal space and preserve fiscal sustainability over the medium term. The reform package would potentially increase the tax ratio from 8.6 percent of GDP in 2021 to above 10 percent in 2024 (Figure A2.1). The implementation of an information technology system in 2023 to carry out core tax administration functions, together with another one percent hike in VAT in 2025, will also help Indonesia reach a 13 percent tax ratio in the medium term to support economic growth. These fiscal consolidation measures, supported by the tax reform and the efforts to refocus and reallocate budgets, will help the government's to fulfill its pledge to return to the 3 percent deficit ceiling by 2023. Effective implementation of the tax reform measures, especially the removal of VAT exemptions,[51] is a potential game-changer in the Indonesian tax system, medium-term revenue mobilization, and fiscal consolidation**.**

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[50] The additional revenue to be gained from introducing the new highest tax bracket will be offset by the reduction in tax revenue from raising the threshold of the lowest bracket.
[51] The revenue foregone under the VAT exemptions in 2019 was equivalent to 1.05 percent of GDP (FPA 2020).

3. Recent Developments in Bank Loans and Policy Responses during the Pandemic[52]

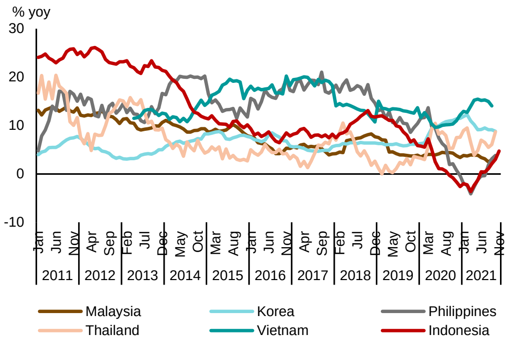
The COVID-19 pandemic has adversely affected the economy of Indonesia, which in turn has created challenges for the banking sector. Bank lending had already slowed before the COVID-19 broke out, and contracted in the second half of 2020, before picking up in June 2021. This selected issue aims to introduce the country's loan structure, provide a detailed analysis of key drivers behind loan growth development and put forward some policy issues.

1. Indonesia saw a contraction in bank lending with the onset of the pandemic, before it picked up in June 2021. Around the globe, the unexpected shock and uncertainties arising from the public health scare led to a slowdown in bank lending at the start of the pandemic (Çolak Gönül and Özde Öztekin, 2021). In Indonesia, bank lending had already slowed before COVID-19 broke out, and it entered a contraction phase when the economy was hit by the pandemic (Figure A3.1). After a slowdown from 11.7 percent in 2018 to 6.1 percent in 2019, loan growth turned negative in Q4 2020, and contracted 2.4 percent in 2020. Nevertheless, bank loans registered positive growth again in June 2021 and expanded by 5.2 percent by end-2021. [53]

Structure of bank loans in Indonesia

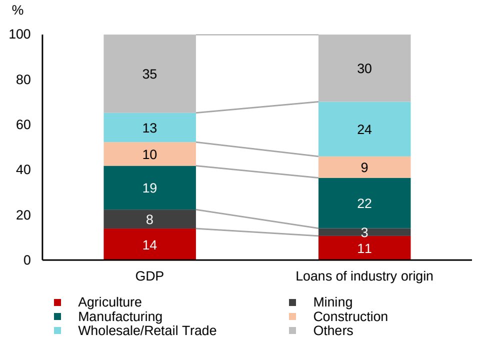
2. By industry, the borrowers are concentrated in wholesale/retail trade, manufacturing, agriculture and construction, which collectively account for 67 percent of total loans of industry origin (Figure A3.2). [54] The wholesale/retail trade sector takes up 24 percent of total loans of industry origin, followed by the manufacturing sector accounting for 22 percent of total loans of industry origin. The agriculture and construction sectors represent 11 and 9 percent of total loans of industry origin, respectively. This loan distribution is almost in line with the sectors' contributions to GDP. Put together, these four sectors contribute to about 57 percent of Indonesia's GDP.

Figure A3.1. Loan Growth in Selected Countries



Source: National authorities; CEIC

Figure A3.2. GDP and credit distribution by sector



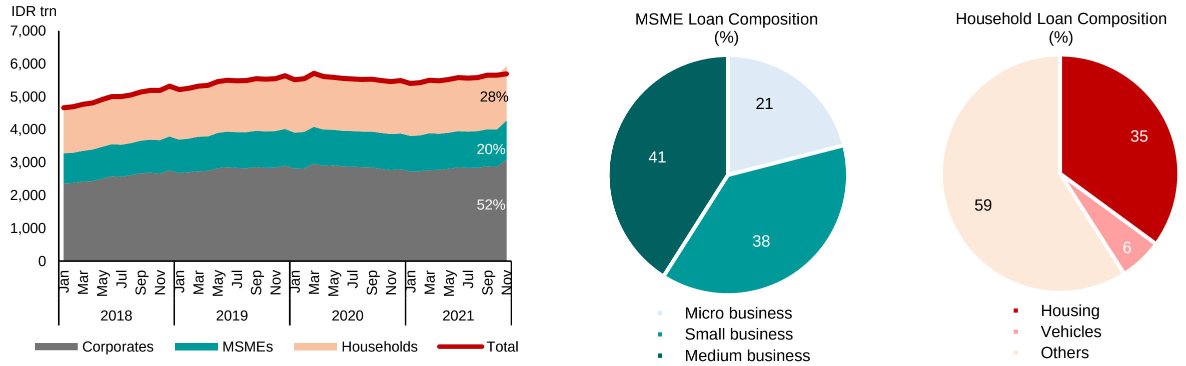
Source: Statistics Indonesia; AMRO staff calculations
Note: The data used is valid as of 2020.

3. By borrower type, corporates constitute the major share of bank lending while MSMEs and households make up relatively small proportions. Loans to corporates represent 52 percent of total loans, followed by households at 28 percent and MSMEs at 20

[52] This selected issue is prepared by Yang Chunyu, Associate Economist.
[53] The loan data referred here is by commercial banks only.
[54] Alternatively, these four sector collectively account for 51 percent of total commercial bank loans. In detail, the wholesale/retail trade sector takes up 19 percent of total commercial bank loans, followed by the manufacturing sector accounting for 17 percent of total commercial bank loans. The agriculture and construction sectors represent 8 and 7 percent of total commercial bank loans, respectively.

percent (Figure A3.3).[55] The share of loans granted to MSMEs is relatively small despite MSMEs constituting 99 percent of all enterprises and about 60 percent of GDP (Dinutistomo, I.A. and Lubis, A.W., 2021). Specifically, micro businesses, small businesses and medium businesses comprise 21 percent, 38 percent and 41 percent of loans to MSMEs, respectively.[56] The small share of loans to MSMEs, compared with their share in GDP, indicates that a great number of MSMEs do not have access to bank financing and many of them borrow from microfinance institutions (Batunanggar Sukarela, 2019). On the other hand, household loans consist of housing loans with a 35 percent share, followed by vehicle loans with 6 percent.

Figure A3.3. Bank Loans by Type of Borrowers



Source: Bank Indonesia; AMRO staff calculations

Key drivers behind loan growth development

4. The outbreak of the pandemic and subsequent containment measures affected economic activities and led to a further loan slowdown in 2020. Major sectors, including manufacturing, construction, and wholesale/retail trade, were adversely affected by the COVID-19 outbreak and the ensuing mobility restrictions, and registered four consecutive quarters of negative real GDP growth (Table A3.1). This dampened loan demand across sectors (Table A3.2, Panel A). The manufacturing sector saw loan contraction for five consecutive quarters from Q3 2020 to Q3 2021, and wholesale/retail trade also experienced contraction for four quarters in a row before picking up in Q2 2021. Loan growth in construction has remained positive despite stagnating in October 2021, largely underpinned by continuing demand for working capital.

Table A3.1. Contribution to GDP Growth

%	'18	'19	'20-Q1	'20-Q2	'20-Q3	'20-Q4	'21-Q1	'21-Q2	'21-Q3
GDP growth (yoy)	5.2	5.0	3.0	-5.3	-3.5	-2.2	-0.7	7.1	3.5
Contribution to growth by industry									
Agriculture	0.5	0.5	0.0	0.3	0.3	0.3	0.4	0.1	0.2
Mining	0.2	0.1	0.0	-0.2	-0.3	-0.1	-0.2	0.4	0.6
Manufacturing	0.9	0.8	0.4	-1.3	-0.9	-0.6	-0.3	1.3	0.8
Construction	0.6	0.6	0.3	-0.5	-0.5	-0.6	-0.1	0.4	0.4
Wholesale/Retail Trade	0.7	0.6	0.2	-1.0	-0.7	-0.5	-0.2	1.2	0.7
Other Industries	2.4	2.5	2.0	-2.6	-1.4	-0.7	-0.4	3.6	1.0

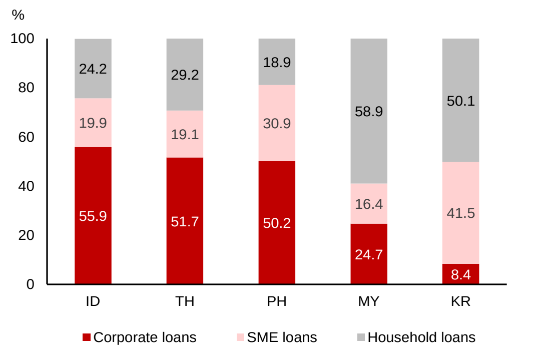
Source: Statistics Indonesia; AMRO staff calculations

[55] Data cover loans extended by commercial and rural banks, sourced from Bank Indonesia. For loans extended by commercial bank only, as at December 2021, the share is 55 percent, 24 percent, and 21 percent, for corporate, household, and MSME loans, respectively (Source: OJK).
[56] MSMEs are defined based on Article 6 of the National Law 20/2008 according to the following criteria: Micro-enterprises shall have maximum net assets of IDR50 million, or maximum annual revenues of IDR300 million. Small enterprises shall have net assets of more than IDR50 million but less than IDR500 million, or annual revenues of more than IDR300 million but less than IDR2.5 billion. Medium-sized enterprises shall have net assets of more than IDR500 million but less than IDR10 billion, or annual revenues of more than IDR2.5 billion but less than IDR50 billion.

5. Indonesia's slow recovery in bank loans can be partly attributed to its corporate-dominated loan structure (Figure A3.4)**.** Compared with regional peers, Indonesia's loan structure is skewed toward corporate loans and the share taken up by household loans is much smaller than its peers, like Malaysia and Thailand. However, corporate loans in Indonesia underperformed relative to loans to MSMEs and households during the pandemic (Table 2, Panel B). Corporate loans shrank for four consecutive quarters, reflecting corporates' hesitation to invest in light of the uncertain economic outlook, before gradually recovered and gained momentum by the end of 2021, growing by 8.0% (yoy) as of November 2021. MSME loans also contracted, especially those taken out by micro businesses, but rebounded faster than corporate loans, as MSMEs are more flexible in adapting to the new environment. Loans by the household sector contracted as well but only for two quarters, on account of the relatively strong performance of housing loans.

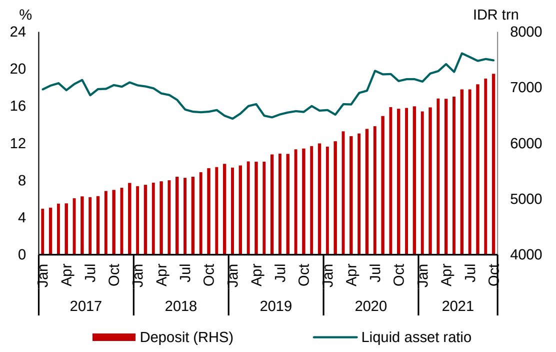
6. Despite ample liquidity, banks became more risk-averse during the pandemic, mainly due to the uncertain economic outlook. Liquidity has been ample given BI's policy support and solid deposit growth, hence it could not have been a constraint to bank lending (Figure A3.5). However, the prolonged pandemic and the uncertain economic outlook made banks more cautious in their lending operations and hence they were setting aside higher provisions and increasing allocations to less risky assets (Figure A3.6). Banks increased their loan loss provisions, normally covering about 150 percent of NPLs pre-pandemic, to 234 percent in Q3 2021.[57] On the other hand, the share of government bonds in total bank assets doubled to 13.6 percent in August 2021 from 6.5 percent in December 2019. Moreover, the ratio of risk-weighted assets to total assets declined to 63.5 percent in August 2021 from 71.7 percent in December 2019. All these changes imply that banks are adopting risk-averse strategies.[58] Indeed, on corporate loans, some banks were focusing on borrowers who are more resilient, prioritizing asset quality rather than loan growth. On household loans, some banks appraised the applications by conducting a granular profiling of customers based on factual information such as their employment status.

Figure A3.4. Loan Structure in Selected Countries



Source: National authorities; AMRO staff calculations

Figure A3.5. Liquidity and Deposit in Banking System

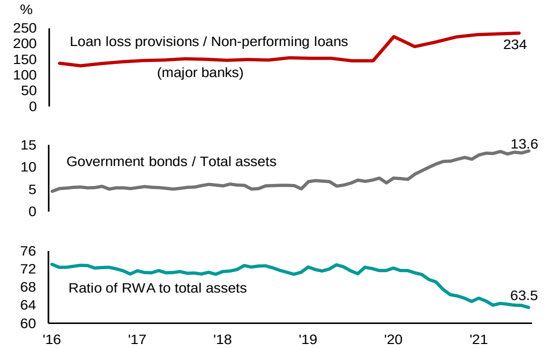


Source: Bank Indonesia; OJK

[57] The increase in loan loss provisions is also in part due to new international financial reporting standards (IFRS9) that took effect in January 2020. This approach requires banks to recognize expected credit losses in a forward-looking manner, including by considering the macroeconomic outlook. Previously, banks used an incurred loss model which recognized credit losses or impairment when the default occurred.

[58] Risk-weighted assets (RWA) = weight for risky assets * value of risky assets + weight for risk-free assets * value of risk-free assets. Less risky assets get a lower weight, with risk-free assets being zero-weighted, so the RWA will decline if banks increase their allocations to less risky assets. Therefore, the declining share of RWA to total assets represents a risk-averse strategy of banks.

Figure A3.6. Banks' Risk Appetite



Source: Bank Indonesia; Moody's; AMRO staff calculations
Note: Banks used in calculating loan loss provisions comprise BRI, Bank Mandiri, BCA, BNI, PT Bank CIMB and Bank Danamon.

Table A3.3. KUR Program

Program name	KUR Super Micro	KUR Micro	KUR Small
Target borrower	Micro business that was set up less than 6 months ago	Micro business	Small business
Experience requirement	No	Min. 6 months	Min. 6 months
Max. loan size	IDR10 million	IDR50 million	IDR500 million
Interest rate	19.0%	16.5%	11.5%
-- paid by borrower	6%	6%	6%
-- paid by government's subsidy	13%	10.5%	5.5%
Guarantee coverage	70%	70%	70%
Premium paid by bank	~2%	~1.75%	~1.5%
Collateral requirement	No	No	Yes, for loans > IDR100

Source: KUR, as cited in BRI presentations

7. Loan growth has been recovering since June 2021 in tandem with the economic recovery. Underpinned by improved economic conditions, loan growth turned positive in June 2021 and registered 4.7 percent in November 2021, the highest since mid-2020 (Table A3.2). In particular, housing loans made up 0.9 percent of total loan growth in October 2021. Meanwhile, loans to small businesses comprised 1.3 percent, the highest since 2017. In addition, working capital loans have shown signs of recovery, contributing 2 percent to total loan growth in October 2021. Vehicle loans, nevertheless, contracted from mid-2020 and has yet to recover.

Table A3.2. Contribution to the Loan Growth

%	'18	'19	'20-Q1	'20-Q2	'20-Q3	'20-Q4	'21-Q1	'21-Q2	'21-Q3	'21-Oct	21-Nov	21-Dec
Loan growth (yoy)	11.7	5.9	7.3	1.1	-0.3	-2.6	-3.7	0.4	2.1	3.0	4.4	5.2
Panel A: Contribution to growth by industry												
Industry Origin	**8.7**	**4.2**	**5.7**	**0.4**	**-0.5**	**-2.4**	**-3.4**	**-0.1**	**1.2**	**1.9**	-	-
Agriculture	0.8	0.3	0.6	0.3	0.3	0.3	0.1	0.5	0.4	0.5	-	-
Mining	0.4	0.0	0.2	0.1	0.3	-0.2	-0.4	-0.2	0.0	0.1	-	-
Manufacturing	1.6	0.6	1.6	0.1	-0.1	-0.8	-1.3	-0.4	-0.2	0.2	-	-
Elec/Gas Supply	0.4	0.5	0.5	0.1	-0.1	-0.5	-0.8	-0.8	-0.4	0.0	-	-
Constructions	1.2	0.8	0.5	0.3	0.1	0.3	0.4	0.4	0.3	0.0	-	-
Whol/Retail Trd: Veh Rep	1.9	0.4	0.3	-1.0	-1.2	-1.0	-0.9	0.1	0.4	0.3	-	-
Fin/Insurance	0.6	0.1	0.6	-0.2	-0.4	-0.6	-0.9	-0.5	-0.1	0.0	-	-
Other Industries	1.7	1.4	1.3	0.7	0.6	0.1	0.3	0.7	0.9	0.8	-	-
Non Industry Origin (Household loans)	**3.0**	**1.7**	**1.6**	**0.7**	**0.2**	**-0.2**	**-0.3**	**0.6**	**0.9**	**1.1**	-	-
Panel B: Contribution to growth by borrower type												
Corporates	**6.8**	**2.8**	**4.2**	**0.4**	**-0.3**	**-2.1**	**-2.8**	**-0.6**	**0.6**	**1.3**	-	-
MSMEs	**1.9**	**1.5**	**1.5**	**0.0**	**-0.1**	**-0.4**	**-0.6**	**0.4**	**0.6**	**0.6**	-	-
Micro Business	0.6	0.6	0.9	0.2	-0.3	-0.6	-1.3	-1.1	-0.7	-0.6	-	-
Small Business	0.6	0.6	0.5	0.2	0.2	0.2	0.5	0.9	1.2	1.3	-	-
Medium Business	0.7	0.3	0.1	-0.3	-0.1	0.1	0.9	0.6	0.1	-0.2	-	-
Households	**3.0**	**1.7**	**1.6**	**0.7**	**0.2**	**-0.2**	**-0.3**	**0.6**	**0.9**	**1.1**	-	-
Housing	1.2	0.7	0.6	0.3	0.1	0.3	0.3	0.6	0.8	0.9	-	-
Vehicles	0.3	0.0	0.0	-0.3	-0.5	-0.6	-0.7	-0.5	-0.3	-0.3	-	-
Others	1.5	1.0	1.0	0.7	0.5	0.2	0.1	0.5	0.4	0.5	-	-
Panel C: Contribution to growth by purpose												
Working capital loans	**6.1**	**1.1**	**2.4**	**-0.9**	**-1.4**	**-2.2**	**-2.2**	**0.1**	**1.2**	**2.0**	-	-
Investment loans	**2.7**	**3.1**	**3.3**	**1.3**	**0.9**	**-0.3**	**-1.2**	**-0.2**	**0.0**	**-0.1**	-	-
Consumption loans (Household loans)	**3.0**	**1.7**	**1.6**	**0.7**	**0.2**	**-0.2**	**-0.3**	**0.6**	**0.9**	**1.1**	-	-

Source: Bank Indonesia; AMRO Staff Calculations

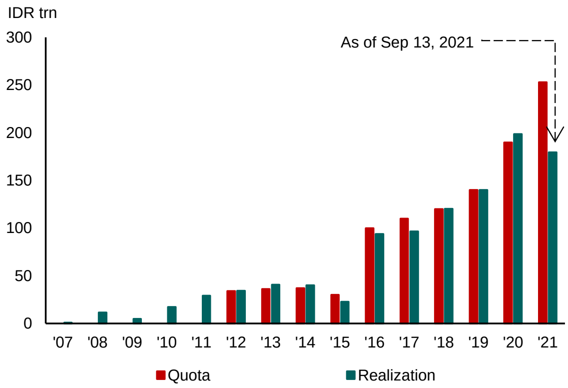
Policy discussions

8. The government's COVID-19 loan restructuring program has been extended until March 2023, providing businesses and banks with sufficient time to adjust to pandemic-related disruptions. To ensure that affected households and businesses have continued access to bank financing, OJK issued a regulation known as POJK11/2020 in April 2020 to let banks restructure loans under relaxed loan classification criteria. The end date of this program has been extended twice and is now set at March 2023.[59] It allows banks to classify restructured loans as performing, thus enabling banks to support pandemic-hit borrowers without worrying about an immediate spike in NPLs. The regulation also requires banks to keep monitoring the quality of their restructured loans and to set aside sufficient provisions for non-viable borrowers. Some banks have even started to voluntarily downgrade and/or write off the restructured loans of non-viable borrowers. This is a prudent move to avoid a major deterioration in asset quality once the loan restructuring program expires, and banks should continue doing so.

9. A coordinated policy package has been introduced to support the property and automotive sector, bolstering demand for household loans. The property and automotive sectors are among priority businesses identified by the authorities and are receiving integrated policy support. BI has lifted the loan-to-value (LTV) ratio for housing loans to 100 percent from the previous 85 to 95 percent, and lowered the down payment for vehicle loans to 0 percent. The government has reduced value-added taxes (VAT) on new home sales based on the transaction price, and also provided a temporary tax break for sales of sedans and two-wheel-drive cars.

10. Various measures, such as guarantee programs, interest subsidies and macroprudential measures, as well as digitalization of fund distribution, have been implemented to shore up MSME financing.[60] For micro and small businesses, the People's Business Credit (KUR) program was introduced in 2007, providing guarantees and interest subsidies when they borrow from banks (Table A3.3).[61] In response to the pandemic, the government greatly increased the KUR quotas for 2020 and 2021 (Figure A3.7), and allowed borrowers to defer principal payment by six months starting from April 2020.[62] Meanwhile, BI amended MSME lending requirements for banks in September 2021 by expanding the coverage and raising the MSME lending ratio, known as macroprudential inclusive financing ratio, to promote inclusive financing.[63]

Figure A3.7. Quota and Realization for KUR



Source: KUR

[59] Regulation POJK11/2020 was initially amended by the issuance of POJK48/2020 which extended the loan restructuring program until March 2022, and more recently by the issuance of POJK17/2021 which extended the loan restructuring program until March 2023.
[60] These measures are provided in regulations such as Permenko 8/2020, PMK No. 65/2020 and PMK No. 71/2020.
[61] Additional interest subsidies had been provided since mid-2020 ranging from 2 percent to 6 percent, although this support gradually faded in 2021.
[62] A working capital loan guarantee program was also introduced for MSMEs in July 2020, with the guarantee premiums borne by the government.
[63] The ratio will be raised to 20 percent in 2022, 25 percent in 2023 and 30 percent in 2024.

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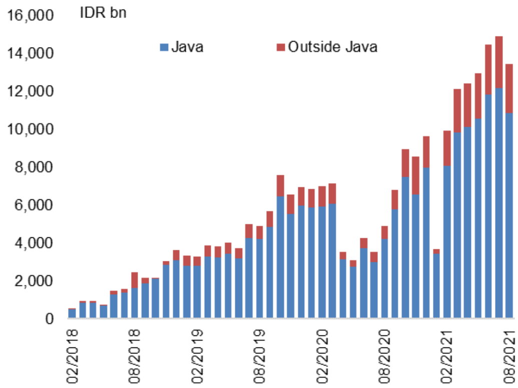
4. Recent Developments in Financial Deepening: Peer-to-Peer Lending and Retail Government Bonds[64]

Peer-to-Peer Lending

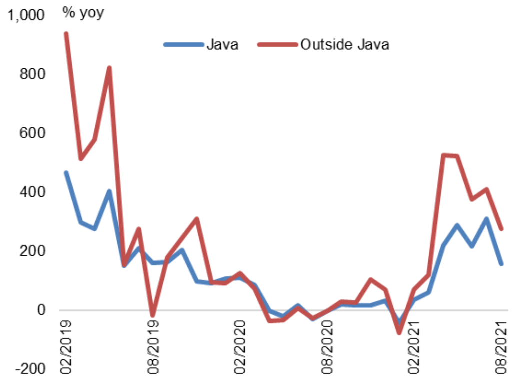
1. Peer-to-peer (P2P) lending in Indonesia has grown significantly over the past few years. Thanks to the authorities' efforts on financial deepening and a relatively low rate of bank penetration, the volume of P2P lending grew from almost zero at the beginning of 2018 to more than IDR12 trillion per month as of August 2021 (Figure A4.1). While most of the loan disbursements have taken place in Java, regions outside Java are not lagging, with monthly disbursements growing by about 370 percent over 24 months as of August 2021, compared to around 260 percent for disbursements in Java (Figure A4.2). Despite several months of contraction in the early period of the pandemic, P2P lending has bounced back strongly and is expected to remain robust given the increasing digitalization of the economy as a result of the pandemic.

Figure A4.1. Total Monthly Value of P2P Lending



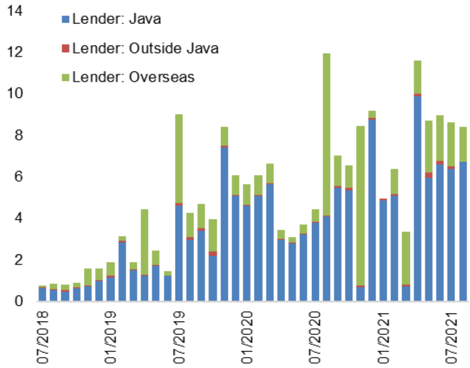
Source: OJK; CEIC; AMRO calculations

Figure A4.2. Growth in Monthly Value of P2P Lending



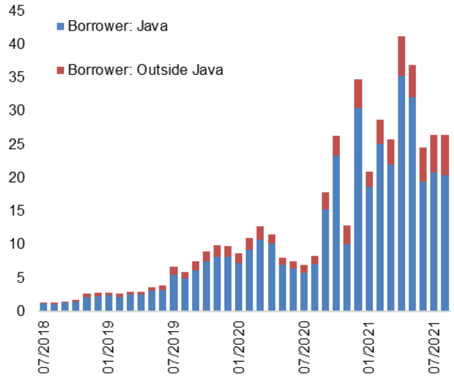
Source: OJK; CEIC; AMRO calculations

Figure A4.3. Number of Monthly Transactions by Lender's Location



Source: OJK; CEIC; AMRO calculations

Figure A4.4. Number of Monthly Transactions by Borrower's Location



Source: OJK; CEIC; AMRO calculations

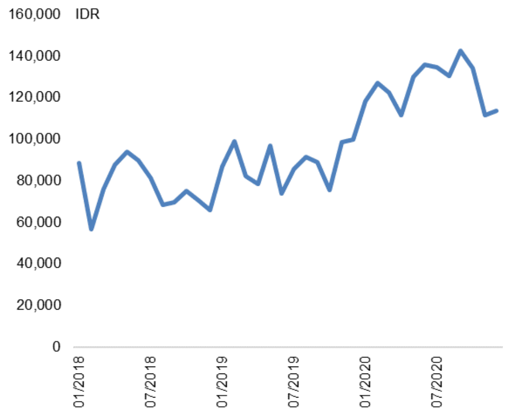
2. In terms of transaction volume, the bulk of the financing originates from Java and overseas banks, while borrowers are largely concentrated in Java. On the lending side, as of August 2021, residents in Java accounted for around 72 percent of the cumulative transactions (ytd), while overseas individuals constituted about 26 percent (Figure A4.3). On

[64] This selected issue is prepared by Jade Vichyanond.

the borrowing side, Java was home to around 84 percent of the borrowers, with areas outside Java making up the remaining 16 percent (Figure A4.4).[65]

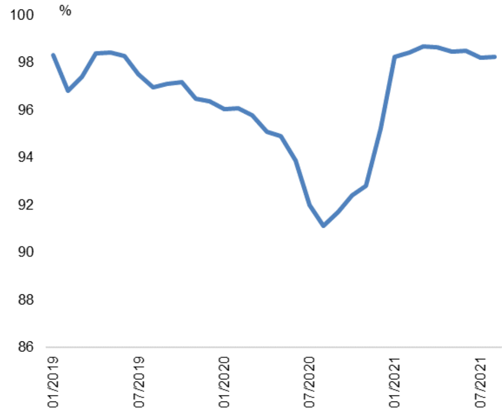
3. The average value of P2P loans is relatively small and the industry's loan repayment rate has been consistently high. Since most of the P2P loans are short-term disbursements and for small-ticket consumption, their average value is under IDR150,000 (about USD10) and the loan repayment rate is quite high, hovering in the range of 90-98 percent (Figures A4.5, A4.6). Lower income as a result of the pandemic seems to have increased the average value of P2P loans and suppressed, at least temporarily, the loan repayment rate.

Figure A4.5. Average Value of P2P Loans



Source: OJK; CEIC; AMRO calculations

Figure A4.6. Loan Repayment Rate



Source: OJK; CEIC; AMRO calculations

4. Because of greater familiarity with technology, most P2P lenders and borrowers are young adults. As of end-2020, 67.9 percent of P2P lenders and 68.2 percent of P2P borrowers were below 35 years of age. Men made up around 63 percent of lenders and 53 percent of borrowers. In terms of P2P lending operators, there were 149 P2P lending companies, of which 37 were licensed and 112 were registered.

Retail Government Bonds

5. Distribution of retail government bonds through fintech companies has been another key initiative taken by the authorities to deepen the financial market. In Indonesia, retail government bonds have traditionally been distributed via commercial banks, shariah banks, and securities companies. While the amount remains relatively small—retail investors accounted for only 5 percent of tradable domestic government securities as of end-September 2021—they represent an important investor base in the context of the authorities' efforts on financial market development as well as on improving financial literacy. As such, with the Indonesian population's growing use of fintech services, the government has added fintech companies as retail government bond distributors alongside the aforementioned traditional players. These fintech companies fall into two categories: fintech mutual-fund-selling companies and fintech P2P companies.

6. Four out of five types of retail government bonds can be purchased through a number of fintech companies.[66] These bonds are SBR (Savings Bond Ritel), ORI (Obligasi Negara Ritel), ST (Sukuk Tabungan) and SR (Sukuk Ritel), the latter two being shariah-compliant.

[65] The numbers in Figures A1.3 and A1.4 do not match as each lender's transaction amount can be distributed to one or more borrowers.
[66] CWLS Ritel (Cash Waqf Linked Sukuk Ritel) is the only type of retail government bond that is not distributed by fintech companies.

These four types of retail government bonds vary in terms of maturity, coupon payments, tradability, and shariah-compliance (Table A4.1).

Table A4.1. Characteristics of Retail Government Bonds

	SBR	ORI	ST	SR
Maturity	2 years	3 years	2 years	3 years
Coupon	Floating with floor, paid every month	Fixed, paid every month	Floating with floor, paid every month	Fixed, paid every month
Secondary market trading	Not allowed, but can be redeemed early after 1 year	Allowed, after 1 coupon payment	Not allowed, but can be redeemed early after 1 year	Allowed, after 3 coupon payments

Source: AMRO compilation

7. Bonds with fixed rate coupons and greater flexibility in trading (ORI and SR) account for a major share of retail government bonds. As of end-December 2021, the outstanding values of ORI and SR stood at IDR81 trillion and IDR103 trillion, respectively. Meanwhile, the outstanding values of SBR and ST, which have floating-rate coupons and cannot be traded in the secondary market, totaled only IDR10 trillion and IDR10 trillion, respectively.

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