AMRO Country Report
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AMRO Annual Consultation Report

Indonesia - 2020

ASEAN+3 Macroeconomic Research Office (AMRO)

February 2021

Acknowledgments

1. This Annual Consultation Report on Indonesia has been prepared in accordance with the functions of AMRO to monitor, assess and report its members' macroeconomic status and financial soundness, to identify relevant risks and vulnerabilities, and to assist them in the timely formulation of policy to mitigate such risks (Article 3 (a) and (b) of the AMRO Agreement).
2. This Report is drafted on the basis of the Annual Consultation of AMRO on Indonesia from September 21 to October 7, 2020 (Article 5 (b) of AMRO Agreement). The AMRO Mission team was headed by Dr Sumio Ishikawa, Group Head and Lead Economist. Members include Dr Nguyen Thi Kim Cuc, Senior Economist, Mr Muhammad Firdauz Muttaqin, Economist; Dr Jade Vichyanond, Economist, Dr Andriansyah, Fiscal Specialist, and Ms Yang Chunyu, Researcher. AMRO Director Mr Toshinori Doi and Chief Economist Dr Hoe Ee Khor also participated in key policy meetings with the authorities. This AMRO Annual Consultation Report on Indonesia for 2020 was peer reviewed by Dr Lee Jae Young, Group Head and Lead Economist, and Ms Laura Grace Gabriella, Researcher; and approved by Dr Hoe Ee Khor, AMRO Chief Economist.
3. The analysis in this Report is based on information available up to end-2020.
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. On behalf of AMRO, the Mission team wishes to thank the Indonesian authorities for their comments on this Report, as well as their excellent meeting arrangements and hospitality during our visit.

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Executive Summary

The economy of Indonesia remains resilient despite the COVID-19 pandemic. A prompt recalibration of the policy mix and the enactment of large stimulus measures have provided timely and much needed support to the affected households, businesses, and financial sector, as well as safeguarded macroeconomic and financial stability. Supportive policy synergy, together with the widespread availability of COVID-19 vaccines, are expected to underpin a rebound in growth in 2021. Furthermore, a smooth exit from the extraordinary policy measures is necessary to avoid cliff effects and facilitate a full economic recovery post-pandemic.

1. The economy of Indonesia has been resilient despite the COVID-19 pandemic. Economic activity has gradually turned around from a sharp contraction triggered by the imposition of large-scale social restrictions (PSBBs) in the second quarter of 2020. While real GDP contracted by 3.5 percent (year-on-year) in the third quarter, the pace of contraction has eased substantially from a 5.3 percent contraction in the second quarter. The recovery momentum is expected to be sustained in the final quarter of 2020, supported by further resumption of mobility and pro-active monetary and fiscal stimulus measures. For the whole of 2020, the Indonesian economy is expected to contract by 2.1 percent, which is relatively modest compared to regional peers. Continued supportive policy synergy, together with the widespread availability of COVID-19 vaccines, are expected to underpin a rebound in growth to 4.9 percent in 2021.

2. An improvement in the current account balance and resumption in capital inflows have supported the external position and a broadly stable rupiah. As muted domestic demand led to a decline in imports, the current account deficit narrowed to 0.7 percent of GDP in the first nine months of 2020. While imports remained weak, exports have gained traction on global rebound and a recovery in commodity prices. Inflows to the financial markets have meanwhile resumed after a large sell-off in March, particularly in the final quarter of 2020, underpinned by improved investor sentiment and increased global liquidity. This, coupled with continued FDI inflows and global bond issuances, have reversed a deficit seen in the capital and financial account in the first quarter of this year. Against these backdrops, the rupiah rebounded from a sharp depreciation in March and strengthened towards the year-end. Likewise, gross international reserves have fully recovered from the loss in March, reaching USD135.9 billion as of end-2020, equivalent to 10.2 months of imports and about 200 percent of short-term external debt.

3. Strong capital buffers supported by regulatory forbearance have underpinned overall banking resilience, as the economic downturn has affected banks' asset quality. Weakened household and corporate sector balance sheets have spilled over to banks' asset quality, as reflected in an increase in the non-performing loans (NPL). Meanwhile, banks have stepped up loan-loss provisioning, in part due to the implementation of the new financial reporting standards (IFRS9) and provision for restructured loans. To provide cushions for those businesses adversely affected by the pandemic, in particular micro, small and medium-sized enterprises (MSMEs), banks have been allowed to relax the quality assessment for loans of up to IDR10 billion and restructured loans, which helps to contain rising NPLs. Notwithstanding a recent dip, Indonesian banks' capital buffers remain among the highest in the region.

4. Bank Indonesia has actively recalibrated its policy mix to support economic recovery while safeguarding financial stability. The measures include providing substantial liquidity support through quantitative easing and conducting triple interventions in the spot FX, domestic non-deliverable forward, and secondary government bond markets, to provide cushions against

volatility shocks while maintaining rupiah flexibility. In light of subdued inflation, BI has lowered its benchmark rate, the 7-day reverse repo rate, by 125 basis points, to 3.75 percent as of November. Macroprudential measures have been also eased to stimulate financing to priority sectors while maintaining financial system resilience to support national economic recovery. The total amount of liquidity injected into the money market and banking system, notably through lowering the statutory reserve requirements, term repos, FX swaps, as well as purchase of government bonds in the secondary market, is estimated at IDR727 trillion, or about 4.7 percent of GDP, as of end-2020. Last, but not least, BI has also accelerated the implementation of the 2025 Payment System Blueprint initiatives to facilitate economic and financial digitalization.

5. Sizeable fiscal packages have provided assistance to affected households and businesses. The 2020 Budget introduced fiscal packages of about 4.4 percent of GDP to cover COVID-19 healthcare spending, social assistance to affected households, and sectoral and regional supports (known as the public goods package), and supports to businesses, including both MSMEs and non-MSME corporates (non-public goods package). Efforts to accelerate the disbursement of stimulus measures have been stepped up, with about 84.3 percent disbursed by the year-end. Fiscal stimulus packages have been also approved for 2021 Budget to ensure continued supports to the healthcare sector, affected households and communities, and strengthen structural reforms for a sustainable recovery.

6. Extraordinary policy measures have been well coordinated and communicated to the markets. A forward-looking regulation, Perppu 1/2020 (converted into Law 2/2020), was issued to suspend the fiscal deficit ceiling of 3 percent of GDP between 2020 and 2022. It also allows BI to purchase government bonds in the primary market, guided by prudent principles. In particular, the bonds held by BI should be tradable and marketable, purchased at market rates, with the amount not preset and guided by well-defined last resort criteria, taking into consideration the impact on inflation. BI has purchased government bonds through market-based mechanisms in line with a joint decree between the Finance Minister and BI Governor dated April 2020. Under a one-off burden sharing agreement in July 2020, BI has also agreed to finance the public goods package through private placements and absorb the entire interest cost of this package, as well as share part of the interest cost of the non-public goods package related to MSME and non-MSME corporate support.

7. With speedy vaccine developments lifting the outlook in 2021, downside risks may stem from ongoing uncertainties over the pandemic trajectory in the short-term. While the economic recovery is expected to gain further momentum under continued supportive monetary and fiscal policies, the pace of rebound may be weighed down by elevated infections domestically and tightened social restrictions. Against the backdrop of recent progress of vaccine developments, possible delays in inoculation or weaker-than-expected vaccine efficacy could trigger renewed lockdowns elsewhere and cast a shadow on global prospects, which in turn may affect Indonesia's commodity exports. On the upside, a swift and effective vaccination program on a large scale will enable a stronger recovery for Indonesia. In addition, the recent passage of an Omnibus Law on Job Creation is a breakthrough in improving the investment climate and facilitating job creation, hence supporting economic recovery.

8. Rising financing needs may put pressure on capital markets. The government's gross financing needs have risen sharply in 2020, and may remain elevated in 2021, due to sizeable fiscal packages. While an increase in precautionary savings, weaker demand for credit, and BI financing under the burden sharing scheme, funded the higher budget financing needs

without pushing up bond yields in 2020, pressures may arise when bond appetite normalizes in tandem with the economic recovery going forward.

9. The pandemic underscores the task of rebuilding policy space. The implementation of a consistently sound monetary and fiscal policy framework has helped Indonesia build up policy space over the years and gain credibility in the markets. However, with the implementation of sizeable fiscal packages, the policy space is estimated to have shrunk against the backdrop of rising debt levels as well as debt service burden. This could be further aggravated by a decline in tax revenue due to a planned reduction in the corporate income tax rate.

10. Policy synergy is aimed at achieving a smooth exit from pandemic measures. The current stimulus policy mix is expected to support the economy amid an ongoing pandemic situation. A smooth exit from the extraordinary policy measures is necessary to avoid cliff effects and to facilitate the transition to a full economic recovery post-pandemic. In this regard, the termination of BI's exceptional budget financing should be done in close coordination with the implementation of a credible fiscal consolidation plan. The pace and timing of Indonesia's exit from extraordinary stimulus measures should be also calibrated within the broader context of exit policies by advanced economies, in particular the U.S.

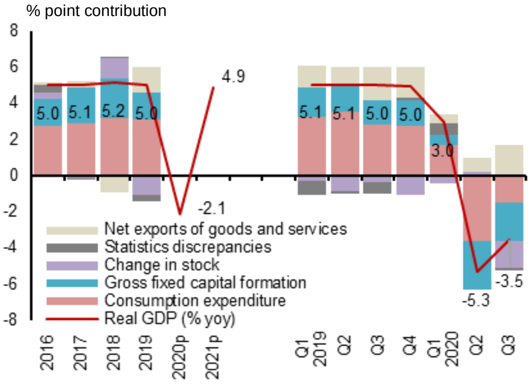
11. Structural reforms will help rebuild policy space and strengthen resilience. To rebuild fiscal space, the authorities could consider consolidating the fiscal position through raising tax revenue and enhancing spending efficiency. Efforts on financial deepening, in particular, broadening the domestic investor base, will strengthen the bond market against capital flow volatility shocks. In addition, recent initiatives such as the Blueprint for Money Market Development 2025 that aim to build a conducive ecosystem for foreign exchange and money markets, are expected to accelerate financial market development going forward. An effective implementation of the overarching Omnibus Law on Job Creation is expected to generate employment via increased investment by both domestic and foreign investors. In particular, the establishment of a sovereign wealth fund – the Lembaga Pengelola Investasi or Indonesia Investment Authority, as mandated under the Omnibus Law, is aimed at boosting infrastructure investment going forward. Continued reforms in the areas of economic diversification, investment climate, infrastructure and human capital development, and digital economy, would further enhance resilience against future shocks.

A. Recent Developments and Outlook

A.1 The economy is resilient against the Covid-19 pandemic

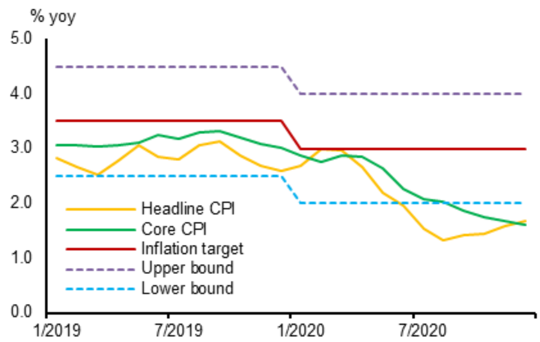
1. Economic activity is recovering gradually from the impact of COVID-19 pandemic. Since the first COVID-19 cases were reported in early March, Indonesia's total caseload exceeded 700,000 while the death toll rose to above 22,000, as of end-2020. In the real sector, the contraction in economic output narrowed to 3.5 percent (yoy) in the third quarter, improving from a sharp decline of 5.3 percent in the second quarter (Figure 1). In particular, domestic consumption has turned around in tandem with a partial relaxation of the large-scale social restrictions (PSBBs) which were imposed between April and May to contain the pandemic. The rebound in consumption has been also aided by increased disbursement of social assistance under the fiscal packages, and the release of a thirteenth month salary bonus among civil servants. Exports have also gained traction, driven by exports of agricultural and metal products, particularly to China. The recovery momentum is likely to continue, supported by a resumption of mobility and pro-active monetary and fiscal stimulus measures. According to AMRO staff's projection, real GDP is forecast to contract moderately by 2.1 percent for the whole of 2020, before rebounding by 4.9 percent in 2021.

Figure 1. Contribution to Real GDP Growth



Source: Statistics Indonesia, AMRO Staff Calculations
Note: Data for 2020-21 are AMRO staff projections.

Figure 2. Headline and Core CPI



Source: Statistics Indonesia
Note: The base year for this data series is 2018.

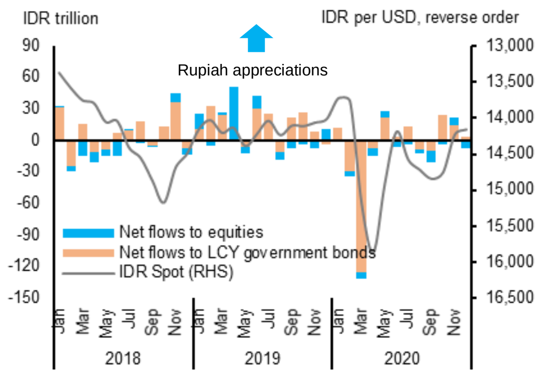
2. Inflation is likely to remain subdued, reflecting weak domestic demand. Headline consumer price index (CPI) increased by 1.7 percent in December 2020, down from 2.6 percent as of end-2019 (Figure 2). Weakened domestic demand triggered by the pandemic and mobility restrictions has led to disinflationary pressures with core CPI moderating from 3.0 to 1.6 percent during the same period.[1] Sustained supply amid weaker demand has also contributed to a low inflation, despite volatile food prices. Likewise, still-low global oil prices and discounted airfares have kept the administered prices under control. While inflationary pressures may rise to some extent in tandem with a gradual recovery in domestic demand, the inflation outlook is expected to remain benign in the near-term**.**

3. The external position has been resilient. Similar with other emerging markets, risk aversion triggered by pandemic fears earlier this year led to a large sell-off of Indonesian bonds and equities, amounting to IDR156 trillion (USD10.4 billion) in February-March, and a sharp depreciation of the rupiah (Figure 3). Bank Indonesia (BI) promptly stepped up its triple interventions in the FX spot, domestic non-deliverable forward, and secondary government bond markets, to avoid excessive rupiah movements while still allowing the currency to adjust in line with market mechanisms (Figure 4). Efforts have also stepped up to expand local

[1] Volatile food prices and administered prices, such as energy and airfares, are excluded from core CPI.

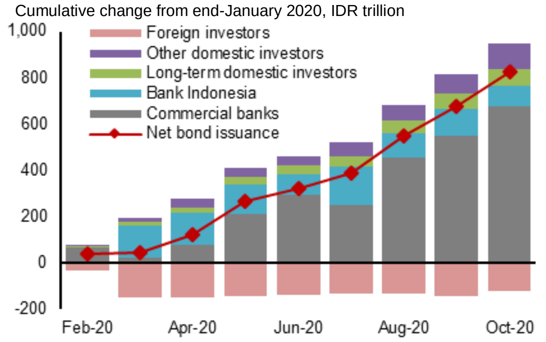
currency settlements (LCS) between Indonesia and regional trading partners, and hence reduce the reliance on the U.S. dollar in trade settlement.[2] BI also lowered the statutory reserve requirement (SRR) for USD-denominated deposits by 400 basis points to provide USD liquidity to the market. In addition, the announcement of a repo facility with the Federal Reserve helped maintain investor confidence.[3] Inflows to the financial markets have since resumed, which, coupled with continued FDI inflows and global bond issuances, have reversed the capital and financial account to a surplus (Figure 5). The current account deficit, meanwhile, narrowed from 2.7 percent of GDP in 2019 to 0.7 percent in the first nine months of 2020[4], in tandem with a sharp fall in imports which outweighed a decline in exports. While imports remained weak, exports have gained traction on global rebound and a recovery in commodity prices. Improved investor sentiment and increased global liquidity have also sustained inflows into the government bond market in recent months. Against those backdrops, the rupiah has rebounded from the March depreciation and strengthened towards the year-end. Likewise, gross international reserves have fully recovered from the loss in March, reaching USD135.9 billion in December, equivalent to 10.2 months of imports (well above the conventional threshold of 3 months of imports), and about 200 percent of short-term external debt (Figure 6).

Figure 3. Net Capital Flows and IDR Spot Rate



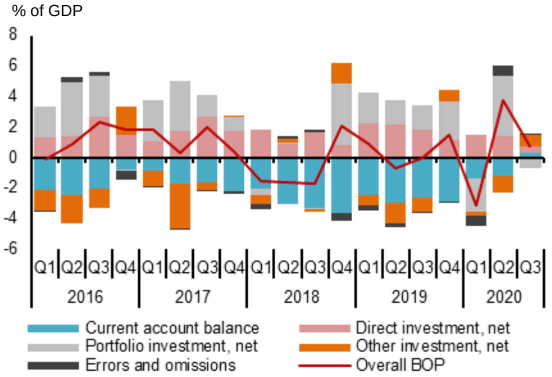
Source: Ministry of Finance, Jakarta Stock Exchange, AMRO Staff Calculations
Note: Monthly data are up to December 2020

Figure 4. Tradable Government Bonds Outstanding by Bond Holder



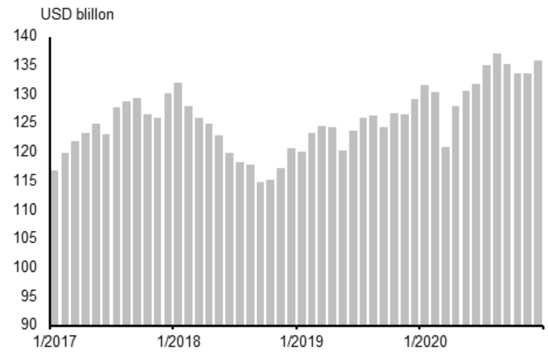
Source: Ministry of Finance
Note: Government bonds refer to rupiah-denominated government bonds issued in the domestic market only.

Figure 5. Overall Balance of Payments



Source: Bank Indonesia

Figure 6. Gross International Reserves

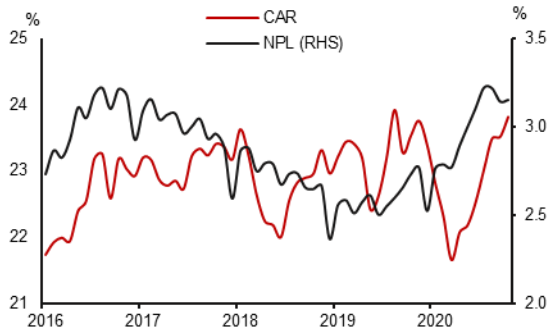


Source: Bank Indonesia
Note: Monthly data are up to December 2020.

[2] LCSs was introduced in 2018, with three partner countries joining as of present, namely Malaysia and Thailand since the end of 2018, and Japan since September 2020.
[3] The repo line facility for Foreign and International Monetary Authorities (FIMA) has been extended by the U.S. Federal Reserves to a number of central banks, including Bank Indonesia (of USD60 billion).
[4] Most notably, the current account balance recorded a surplus of 0.4 percent of GDP in Q3 2020 for the first time since Q4 2011.

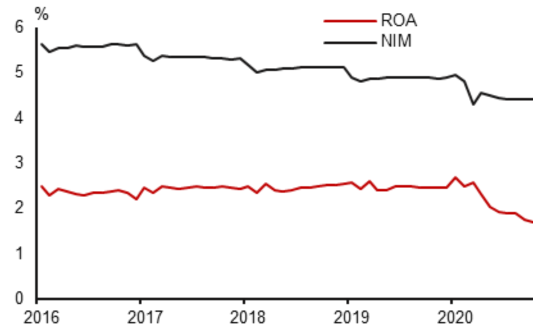
4. The pandemic has affected banks' asset quality and profitability. Weakened household and corporate sector balance sheets have spilled over to banks' asset quality, as reflected in an increase in the non-performing loan (NPL) ratio from 2.5 percent as of end-2019 to 3.2 percent in October (Figure 7).[5] To provide cushions for those businesses adversely affected by the pandemic, in particular micro, small and medium-sized enterprises (MSMEs), the Financial Services Authority (OJK) has allowed banks to relax loan quality assessment and restructuring criteria.[6] As of late October, loans worth of IDR932 trillion, or 16.8 percent of total loans outstanding, were restructured under the relaxed criteria, with signs of a flattening in tandem with the gradual relaxation of PSBBs. Increased provisioning for loans at risks, partly due to the implementation of International Financial Reporting Standards 9 (IFRS 9) early this year, as well as for restructured loans, meanwhile, has lowered banks' return on assets (Figure 8).

Figure 7. Capital Adequacy Ratio and Non-Performing Loans



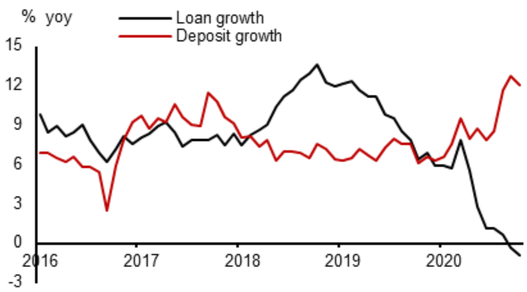
Source: OJK
Note: Monthly data are up to October 2020.

Figure 8. Return on Assets (ROA) and Net Interest Margin (NIM)



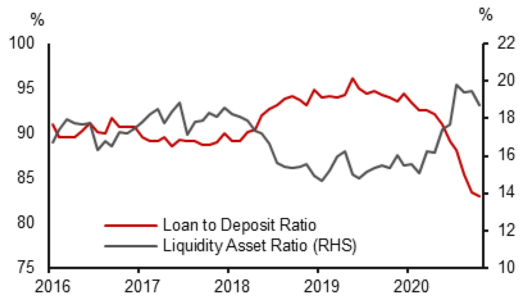
Source: OJK
Note: Monthly data are up to October 2020.

Figure 9. Deposit and Loan Growth



Source: OJK
Note: Monthly data are up to October 2020.

Figure 10. Loan to Deposit Ratio and Liquidity Asset Ratio



Source: OJK
Note: Monthly data are up to October 2020.

5. Notwithstanding the loan restructuring, the banking system remains resilient, supported by strong capital buffers and increased liquidity. Despite a recent dip, Indonesian banks' capital adequacy ratio, at 23.7 percent in October, has been among the highest in the region. Bank liquidity has increased on the back of sustained deposit growth amid slowing credit expansion (Figure 9), as reflected in the moderating loan to deposit ratio and increasing liquid asset ratio (Figure 10). Over the course of the pandemic, BI has conducted more frequent (term) repos and lowered the SRR for rupiah-denominated deposits

[5] That said, due to increased provisioning, the ratio of NPL net of provisioning declined from 1.2 percent in December 2019 to 1.0 percent in October 2020.
[6] According to OJK Regulation 11 dated March 2020, banks would assess the quality of a loan based on the borrower's timeliness in paying the loan's principal and interest without the need to assess the borrower's business prospects and financial conditions. Banks are also allowed to declare restructured loans as performing despite their declining quality due to the pandemic and not to set aside provisions for them. These relaxations are applicable for one year until 31 March 2021 and are prioritized for MSMEs and recipients of the government's micro credit program.

by 200 basis points for conventional banks and 50 basis points for sharia banks, both to 3.5 percent[7], to ensure sufficient liquidity in the system. Liquidity has been also supported with the placement of government funds at state-owned banks as well as regional development and sharia banks, so that they can provide loans with lower interest rates to MSMEs.[8]

A.2 Strong policy synergy safeguards stability and supports recovery

6. Bank Indonesia has actively recalibrated its policy mix to maintain stability and support economic recovery. The measures include providing substantial liquidity support to the markets via quantitative easing, and conducting triple interventions in the spot FX and domestic non-deliverable forward markets as well as purchasing government bonds in the secondary market**,** to maintain the relative stability of the exchange rate. BI's close cooperation with other members in the Financial System Stability Committee (KSSK) has been maintained, through an agreement between BI and OJK to strengthen the disbursement process for short-term liquidity assistance to the banking industry as well as BI's provision of liquidity backstop for the Indonesia Deposit Insurance Corporation (LPS) in handling problem banks through the repo and/or purchase of government bonds. In light of a low inflationary environment, BI has lowered its policy rate, the BI 7-day reverse repo (BI7DRR) rate, by 125 basis points, to 3.75 percent as of end-2020 (Figure 11). Besides policy rate cuts, BI has injected liquidity into the money market and banking system via the above-mentioned SRR lowering, and more regular term repos and FX swaps. According to BI's estimate, as of late November 2020, a liquidity amount of up to IDR727 trillion, or about 4.7 percent of GDP, was injected into the economy.[9] BI has also eased macroprudential policies to support economic financing. In particular, BI has temporarily lifted the additional reserve requirement for banks unable to meet the macroprudential intermediation ratio (MIR) range[10] until April 30, 2021. BI also raised banks' macroprudential liquidity buffer[11] by 200 basis points, matching the above-mentioned lowering of the SRR, to allow banks to increase their holdings of government bonds. Last, but not least, the minimum down payment requirement for green automotive loans/financing has been lowered to zero percent, from previously 5 to 10 percent.

7. As part of BI's policy mix, efforts to implement the Indonesia Payment System Blueprint 2025 have been stepped up to facilitate economic and financial digitalization. Non-cash transactions, in particular electronic money (e-money), experienced exponential growth in recent years, driven by a fast-growing digital economy (Selected Issue 1). With domestic demand held back by mobility restriction measures, transactions using credit cards, ATM, and debit cards declined, and e-money transactions also grew at a more moderate pace earlier this year (Figure 12).[12] That said, non-cash transactions are expected to expand in tandem with a shift in public preference and greater acceptance of digital transactions in an ongoing pandemic context. To ensure a smooth payment system, especially in light of rising non-cash transactions, Bank Indonesia has accelerated the implementation of the Indonesia Payment System Blueprint 2025 through expanding the digital ecosystem, including the imposition of a national standard for quick response code for payments (known as the Quick

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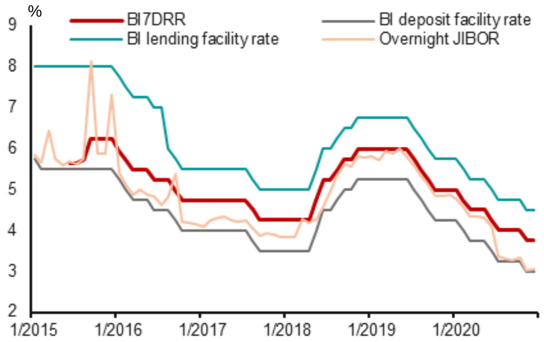
[7] For banks involved in lending to MSMEs, export-import activity, as well as priority sectors, the statutory reserve requirement has been lowered by an additional 50 basis points to 3.0 percent, with the effective period extended until June 2021 (from originally December 2020).
[8] The size of this package is budgeted at IDR70 trillion, of which IDR 64.5 trillion was already disbursed as of 13 October 2020. The funds have been deposited at banks with low interest rates ranging from 2.80 to 2.85 percent.
[9] Of which, about IDR155 trillion was injected into the system via SRR lowering, and the remaining IDR511.2 trillion was through term repos, FX swaps, and purchase of government bonds in the secondary market.
[10] Which is essentially the loan to funding ratio. Prior to this, banks with CAR below 14 percent were required to maintain their MIR within the range of 82 to 94 percent, and subject to additional reserve requirement if unable to do so.
[11] Which is essentially the secondary reserve requirement.
[12] According to data released by Bank Indonesia, the transaction value using e-money grew by about 34 percent (year-on-year) in August 2020, compared to 24 percent a month earlier.

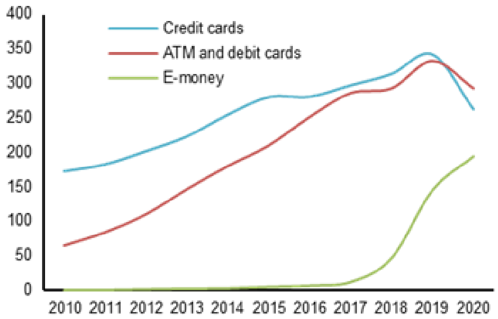
Response Indonesia Standard, or QRIS in Indonesia), utilizing big data, and strengthening surveillance systems against fraud and cyber risks, among others.

Figure 11. Policy and Overnight Interbank Rates



Source: Bank Indonesia
Note: Monthly data are up to December 2020.

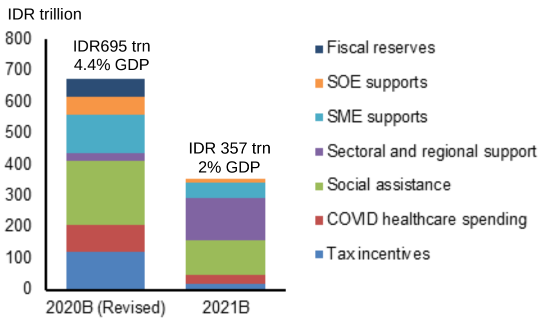
Figure 12. Total value of retail electronic transactions



Source: Bank Indonesia
Note: Annual data for 2020 are twelve months sum up to September.

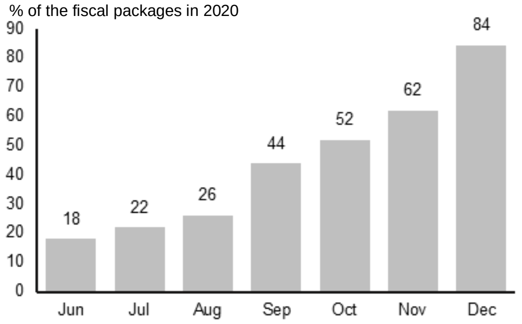
8. Sizeable fiscal packages have provided appropriate supports for affected households and businesses. Stimulus measures of about IDR695 trillion, equivalent to 4.4 percent of GDP, were introduced in the revised 2020 Budget (Figure 13).[13] In particular, a public goods package worth of IDR397.6 trillion, or 2.5 percent of GDP, has been budgeted to cover public healthcare spending related to COVID-19, social assistance extended to individuals and households affected by the pandemic, and regional and sectoral supports in 2020. The non-public goods package, meanwhile, includes supports provided to MSMEs worth of IDR123.5 trillion (in the form of credit guarantees, interest subsidies, and soft loans using government funds placed at banks), and (non-MSME) corporate supports worth IDR53.6 trillion, as well as other financing needs of IDR328.9 trillion. Tax incentives have been also offered, most notably through a lowering of corporate income tax rate from 25 percent to 22 percent. Efforts to accelerate the disbursement of those stimulus measures have been stepped up, with about 84.3 percent disbursed by year-end (Figure 14). Fiscal stimulus packages have been also approved for 2021 Budget, ensuring continued healthcare spending and social assistance, and more targeted supports to facilitate a sustainable recovery.

Figure 13. Fiscal Stimulus Packages



Source: Ministry of Finance and AMRO Staff Calculations

Figure 14. Fiscal Package Disbursement Rate



Source: Ministry of Finance. Data are provisional and unaudited.

9. Extraordinary policy measures have been well coordinated and communicated to the markets. To provide the government with policy flexibility in combating the pandemic while maintaining accountability, a forward-looking regulation, Perppu 1/2020 (converted into Law 2/2020), was issued earlier this year to regulate the state budget and financial system stability

[13] The size of the fiscal packages for 2020 in percent of GDP is based on AMRO staff's projection for 2020 nominal GDP of IDR15,811 trillion.

policies. In particular, the Perppu has lifted the fiscal deficit ceiling of 3 percent of GDP from 2020 to 2022. To finance the fiscal packages, the new law also allows BI to purchase government bonds directly in the primary market, guided by a set of prudent principles. In particular, the bonds being purchased by BI must be tradable and marketable, and purchased at market rates, with an amount which is not pre-set and guided by well-defined last resort criteria. The purchase is made in consideration of the impact on inflation (Box A). Bank Indonesia has purchased government bonds through market-based mechanisms in line with a Joint Decree between the Finance Minister and BI Governor dated April 2020, including auctions, green-shoe options, and private placements.[14] In accordance with the Joint Decree between the Finance Minister and BI Governor dated July 2020, the central bank has also agreed to a burden sharing scheme to fund the public goods package through private placements, and to bear the entire interest cost of the public goods package and share part of the interest cost of the non-public goods package related to MSME and (non-MSME) corporate financing. The burden sharing scheme was intended to be one-off. The extraordinary circumstances of the pandemic and the prudent framework applicable to BI's purchase of government bonds have been reassuring to the markets.

Box A. Bank Indonesia's Financing of Budget Deficit in 2020[15]

Facing the unprecedented COVID-19 pandemic, the government of Indonesia has taken extraordinary measures to contain the pandemic and mitigate its impact on the economy. The government issued a Government Regulation in Lieu of Law, Perppu 1/2020, in March 2020, which was later converted into Law 2/2020 in May, as the legal basis for adopting those extraordinary measures. While the fiscal deficit is expected to exceed the legal limit of 3 percent of GDP due to the implementation of extraordinary measures, the legal limit has been temporarily suspended until 2022 in Perppu 1/2020.

The special law has also authorized BI to purchase long-term government bonds in the primary market.[16] Such government bonds include conventional bonds (SUN) and sharia bonds (SBSN) issued in connection with the COVID-19 pandemic, which are intended to fund the government expenditures to assist sectors affected by the pandemic and to promote swift economic recovery. In other words, the BI's purchase of government bonds in the primary market is limited only to those issued in connection with the COVID-19 pandemic. With this legal basis, the government widened the budget deficit to 5.1 percent on April 3, 2020.

BI's purchase of government bonds in the primary market under prudent principles

A set of prudent principles have been introduced for BI's purchase of government bonds in the primary market. First, BI will act as a standby buyer or buyer of a last resort to support budget financing. This implies that the BI will participate in the primary market only when the market does not have enough capacity to absorb the issuance and/or would demand excessively high yields. The government also needs to exhaust other sources of financing such as accumulated cash surpluses, an endowment fund for education, and funds from public service agencies. Second, BI's purchase of government bonds should be conducted through market mechanisms, with bonds being tradable and marketable, and at market rates. Finally, BI's purchase of government bonds is conducted in consideration of the impact on inflation.

[14] An explanation on Bank Indonesia's purchase of government bonds through market-based mechanisms in line with the Joint Decree of the Minister of Finance and Governor of Bank Indonesia dated April 2020 could be found in the following link: https://www.bi.go.id/en/ruang-media/info-terbaru/Pages/Perkembangan-Terkini-Perekonomian-dan-Langkah-BI-dalam-Hadapi-COVID-19-28-Mei-2020.aspx.
[15] This box is prepared by Andriansyah.
[16] Under normal circumstances, BI is only allowed to buy government securities in the secondary market. Law No.23 Year 1999 regarding BI as amended by Law No. 6 of 2009, states that BI is prohibited from buying government securities in the primary market for its own account, except in the case of short-term government securities needed for monetary control operations. The law also stipulates that BI may buy government securities in the primary market as part of the provision of the emergency financing facility.

Ensuring market mechanism

To ensure a transparent market mechanism, BI's purchase of government bonds in the primary market is conducted in line with the following priority order: (1) a regular auction, (2) an additional auction, known as green shoe option (GSO), and (3) a private placement. The above-mentioned prudent principles and priority order were agreed by *a joint decree between Finance Minister and BI Governor dated April 16, 2020*. BI's purchase of bonds in the primary market under this scheme will apply to not only the 2020 Budget but also 2021 Budget.

- **[Regular auction] A regular auction is an open auction with a multiple price method**. There are two bidding options: competitive and non-competitive. In the competitive basis, winning bidders will pay according to the yields they applied in their bids. In the non-competitive bid, only on which BI participate the auction, BI bids only the volume and shall pay according to the weighted average of the yields in the awarded competitive bids. BI's maximum bid for this auction is 25 percent and 30 percent for the targeted amount of SUN and SBSN, respectively. The government usually announces the indicative target for each auction and reserves the right to offer to issue more or less than this announced target.

- **[Additional auction or GSO] A GSO is an additional auction to be held when the issuance target has not been fulfilled by the regular auction.** A GSO is held on one working day after the conventional auction. The GSO's participants can only bid the quantity they wish to buy at the weighted average yield of the conventional auction. The BI's maximum bid for GSO is the same as in the conventional auction.

- **[Private placement] A private placement will be held when the issuance target has not been fulfilled even with the GSO.** The amount that BI is able to buy is set in accordance with the agreement between the government and BI, with bond yields being determined with reference to the latest market price published by the Indonesia Bond Pricing Agency.

Burden sharing

In light of the government's increased financing needs due to the pandemic, the government and BI agreed on a burden sharing scheme in July 2020.[17] In order to contain the larger-than-expected impact of the COVID-19 pandemic and to support the economic recovery, the government widened the fiscal deficit again from 5.07 percent of GDP to 6.34 percent of GDP in June. To finance the government's higher financing needs, BI agreed on a burden-sharing scheme to support government spending on the so-called public goods and non-public goods packages, as stipulated in *another joint decree between Finance Minister and BI Governor dated 7 July 2020* (Figure A1). The burden sharing scheme was intended to be a one-off policy.

- **For financing of the public goods package worth of IDR398 trillion in total, BI will purchase bonds through private placements and bear the full interest expense until their maturity dates.** There are three programs under the public goods, i.e. health spending, social protection, as well as sectoral and local government support with allocated amount of IDR88 trillion, IDR204 trillion, and IDR106 trillion, respectively. These public goods programs will be financed by private placement of bonds at BI with maturities between 5 to 8 years and coupons equivalent to the weighted average of the 3 month reverse repo rate.

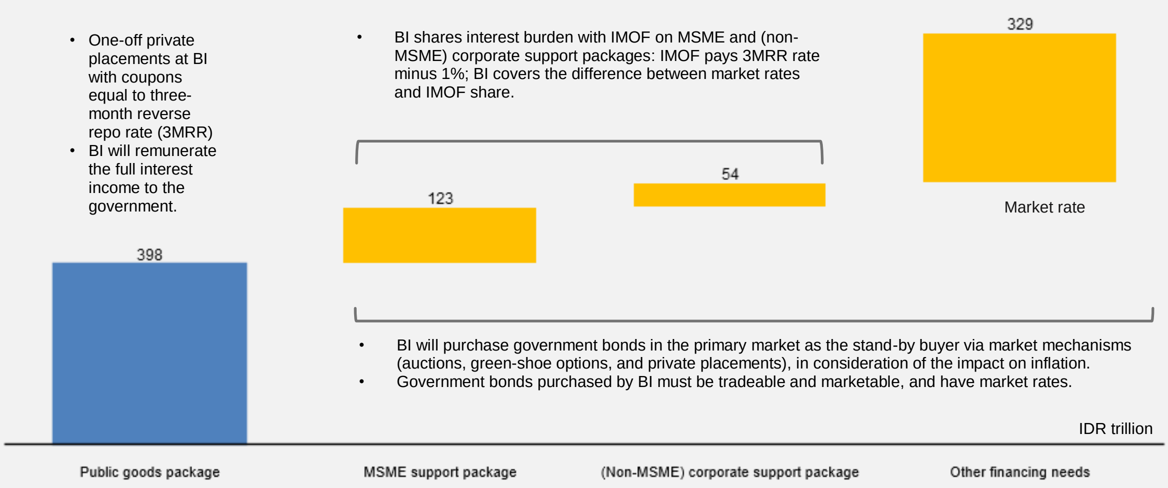
- **For financing of the non-public goods package related to corporate support and worth IDR177 trillion in total, the government and BI agreed to share the burden of interest payment.** The non-public goods package related to corporate supports includes IDR123 trillion for MSME supports and IDR54 trillion for (non-MSME) corporate supports.[18] Those supports

[17] President Jokowi has always emphasized that the efforts to combat the pandemic and support national economic recovery are of the national interests and the responsibility must be jointly shared. The share-burden scheme has also been approved by the parliament on 6 July 2020. (Source: MOF's press release dated 6 July 2020, available at the following link https://www.kemenkeu.go.id/publikasi/siaran-pers/siaran-pers-burden-sharing-pembiayaan-penanganan-pandemi-covid-19-antara-pemerintah-dan-bank-sentral/).
[18] Supports are in the form of interest rate subsidies, placement for credit restructuring, working capital injection, and government capital injection.

will be financed by the issuance of long-term government bonds, where BI will share a part of the interest cost of the package with the government. In particular, as shown in Figure A1, the government will bear the interest cost in the amount of 1 percent below the 3 month reverse repo rate, and BI will share the rest of the interest cost.

- **For other non-public goods spending, amounting to IDR329 trillion, financed by the issuance of government bonds, the government will fully bear the interest cost.** This would cover expenditure items such tax incentives, among others.

Figure A1. Burden-Sharing Agreement



Source: Ministry of Finance, Bank Indonesia, AMRO Staff Compilations

As of early November 2020, BI has purchased IDR253 trillion of government bonds, or 63.5 percent of the target, via private placements to finance the public goods package, and absorbed the full interest cost of those bonds, in line with the burden-sharing scheme stipulated in the second joint decree dated July 2020 (Table A1). Also in accordance with the burden sharing scheme, the government issued bonds amounting to IDR108.1 trillion, 87.5 percent of the target, for the MSME package, and about IDR19.4 trillion, 36.2 percent of the target, for (non-MSME) corporate packages - for which BI has shared a part of the interest cost. Separately, BI has purchased IDR69.8 trillion of government bonds via market mechanisms so far this year in line with the first joint decree dated April 2020.

Table A1. Fiscal Packages Financed under the Burden Sharing Scheme

In trillions of IDR	Target	Issuance up to 2 November 2020
Public goods package	397.6	252.6
MSME support package	123.5	108.1
(Non-MSME) Corporate support package	53.6	19.4
Other financing needs	328.9	-
Gross Bond Issuance	**903.5**	**-**

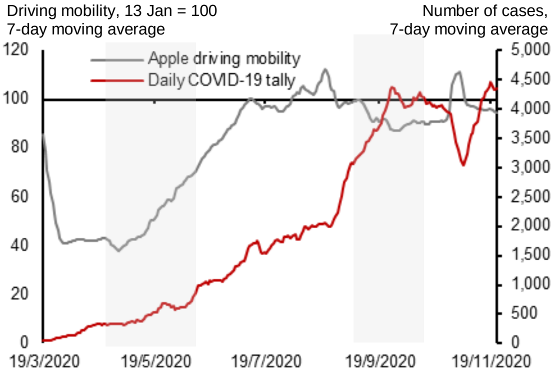
Source: Ministry of Finance (Directorate General of Budget Financing and Risk Management)

B. Risks, Vulnerabilities and Challenges

B.1 Downside risks may stem from the ongoing pandemic

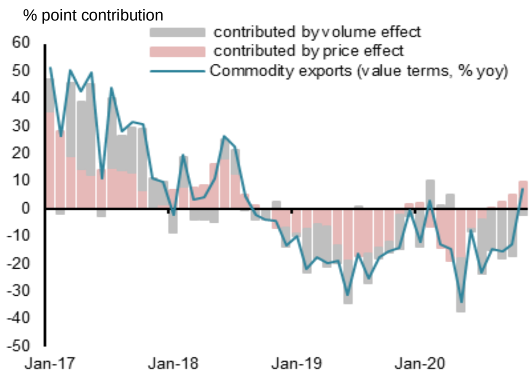
10. **With speedy vaccine developments lifting the growth outlook in 2021, downside risks stem from uncertainties in the pandemic trajectory over the short-run.** Continued accommodative monetary and fiscal policies are expected to support the economy to gain further growth momentum in 2021. However, current elevated infection rates and the re-tightened, albeit targeted, PSBBs, are likely to weigh on the pace of rebound in the short term (Figure 15).[19] Indonesia's commodity exports are expected to gain traction in tandem with a recovery in the global economy, following a recent rise in commodity prices (Figure 16). That said, possible delays in massive vaccination or weaker-than-expected vaccine efficacy, in particular to emerging coronavirus variants, could trigger renewed lockdowns elsewhere and cast a shadow on global prospects, which in turn may affect Indonesia's export performance. An uncertain pandemic outlook in the short-term may also trigger shifts in investors' sentiment, and expose Indonesia to the possibility of capital flow volatility, in light of a shallow capital market that still relies on foreign investors (Figure 17).[20] Strong capital buffer is expected to support banks in withstanding an increase in non-performing loans once the loan restructuring program is lifted (Selected Issue 2). As a tail risk, a prolonged pandemic that further weakens the household and corporate sector balance sheets may undermine banking sector soundness, particularly among those banks with higher exposure to retail and MSME loans, or other sectors hard hit by the pandemic. On the upside, a swift and effective vaccination program will facilitate a stronger recovery for Indonesia.[21] In addition, the recent passage of an Omnibus Law on Job Creation is a breakthrough in improving the investment climate and facilitating employment generation, hence supporting economic recovery (Box B).

Figure 15. Daily Covid-19 Tally versus Mobility



Source: Ministry of Health, Apple Mobility Database
Note: Daily data are up to 22 November 2020. Shaded areas refer to the period of PSBBs imposition in April-May, and PSBBs re-tightening in Jakarta from mid-September to mid-October.

Figure 16. Commodity Exports



Source: Statistics Indonesia, AMRO Staff Calculations
Note: Indonesia's commodity exports consist of oil and gas, coal, palm oil, rubber, and metal. Monthly data are up to November 2020.

[19] Rising Covid-19 infections triggered a re-tightening of PSBBs in Jakarta from mid-September to mid-October 2020, and again in 23 cities and regencies in Java and Bali islands, including Jakarta and its satellite cities, between January 11 to 25, 2021.
[20] Following the sell-off in March, foreign holding of rupiah-denominated government bonds has declined from a high 39 percent of total bonds outstanding in early 2020, but remained elevated at 26.4 percent as of end-October.
[21] According to local media reports, Indonesia has sourced its vaccine procurement from different sources of up to 329.5 million doses, and is set to start its massive vaccination program as early as in the second week of January 2021, targeting to vaccinate up to 70 percent of its 270 million population in 15 months.

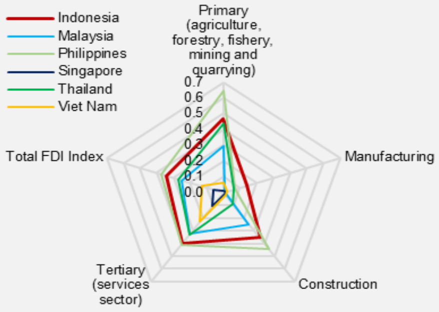
Box B. Omnibus Law on Job Creation [22]

The Omnibus Law on Job Creation is a massive deregulation effort to improve the investment climate and enhance Indonesia's competitiveness in the long run. The law consists of 15 chapters and 174 articles addressing cross-cutting issues pertinent to Indonesia's investment environment, namely business licensing, investment requirements, employment, SME protection, ease of doing business, research and innovation support, government administration, imposition of sanctions, land acquisition, public investment and government projects, and special economic zones. Endorsed by Parliament in early October 2020, the breakthrough law is expected to replace more than 1,200 articles in 73 existing laws.

Simplifying business licensing and enhancing the ease of doing business. In the Omnibus Law, the business licensing process will be greatly simplified based on a risk-based approach where licensing requirements would vary for projects of different risk levels.[23] The law has granted the central government with the sole authority to license national strategic projects. The law also seeks to enhance the efficiency of the public sector by facilitating the digitalization of the business permit application and approval process, and building a single database for SMEs. The minimum capital requirement (of IDR50 million) applicable to a limited liability company has been also removed.

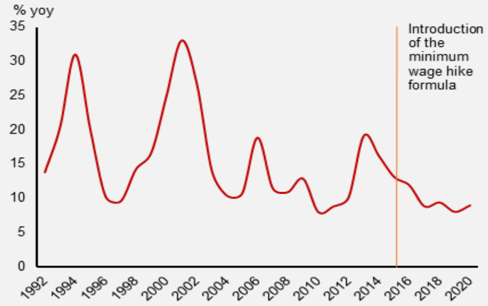
Further opening the economy. According to the FDI Regulatory Restrictiveness Index database constructed by the OECD, Indonesia has maintained more regulatory restrictions on FDI relative to most of ASEAN peers, including a relatively extended Negative Investment List (DNI) (Figure B1).[24] It is understood that the Omnibus Law will lay the groundwork for shortening the DNI to only six highly-restricted sectors that may pose risks to social security, health safety, and environment protection.[25] This will open the investment opportunity for the remaining sectors in the economy.

Figure B1. FDI Regulatory Restrictiveness Index in Selected ASEAN, 2019



Source: OECD (FDI Regulatory Restrictiveness Index Database). A score of 1 indicates the most restrictive FDI regulations, while a score of 0 indicates no regulatory impediments to FDI in the sector.

Figure B2. Indonesia's Minimum Wage Hike



Source: CEIC

Addressing labor market rigidities in balance with labor rights protection. Labor market rigidities, including elevated minimum wage hikes and high severance pay, have reportedly affected Indonesia's labor cost competitiveness and discouraged firms from engaging workers in formal labor contracts. With the introduction of the formula of minimum wage hike in line with real GDP growth

[22] This box is prepared by Nguyen Thi Kim Cuc

[23] Following the risk-based approach, low-risk businesses, including SMEs, are subject to online single submission (OSS) registration only and will be assigned with a business identification number. Medium-risk businesses, meanwhile, need to obtain a standard business registration certificate. Those businesses classified as posing high risks to the environment are required to apply for a business license, of which an assessment of environment impacts is mandatory.

[24] The FDI Regulatory Restrictiveness Index gauges the restrictiveness of a country's FDI rules by looking at the four main types of restrictions on FDI: (i) foreign equity limitations, (ii) screening or approval mechanisms, (iii) restrictions on the employment of foreigners as key personnel, (iv) operational restrictions, e.g. restrictions on branching and on capital repatriation or on land ownership. The highest score for any measure in any sector is 1 (the measure fully restricts foreign investment in the sector) and the lowest is 0 (there are no regulatory impediments to FDI in the sector). The score for each sector is obtained by adding the scores for all four types of measures, with the constraint that their sum is also capped at a value of 1. The Index covers 22 sectors, the scores for which are averaged to obtain a country score: the FDI Index for the country concerned.

[25] The six sectors include (i) narcotics cultivation and production, (ii) gambling and casinos, (iii) catching of protected fish species, (iv) extraction of natural coral, (v) chemical weapon production, and (vi) ozone depleting substance production industry.

and inflation rate in 2015, the pace of minimum wage hike in Indonesia has been more moderate than in the past (Figure B2). That said, Indonesia's minimum wages increase, at an average 9.4 percent annually in the past five years, is still faster than its neighboring countries.[26] Such an elevated pace of minimum wage hikes going forward may continue to push up the labour cost in Indonesia and deter investment in labor-intensive industries, such as garments and textile. While the minimum wage hike formula remains intact in the Omnibus Law, regional governments are now allowed to link it with their own regional GDP growth or inflation, and SMEs are exempted from abiding by the formula. Likewise, Indonesia's severance pay has been among the highest in the region.[27] According to the Omnibus Law, it is now lowered to 25 months' salary, of which up to 19 months will be paid by the employer, and the remaining of up to 6 months' salary will be covered by a to-be-established job loss guarantee fund.

Supporting national development. An investment vehicle in the form of strategic development sovereign wealth fund, the Lembaga Pengelola Investasi (or LPI in Bahasa Indonesian acronym, meaning Indonesia Investment Authority in English), has been established under the Omnibus Law and follow-up Government Regulations 73/2020 and 74/2020.[28] By forging strategic partnerships with global investors, the fund is expected to help finance part of infrastructure development projects, including the Medium-Term National Development Plan for 2020-2024[29], to close the infrastructure gap.[30] The Omnibus Law also allows the government to reserve space (land or forest areas) needed for national strategic projects to accelerate their implementation. In addition, other reform measures to accelerate land acquisition and faster land release for infrastructure development projects, have been adopted. In particular, a single, uniform land map, with land rights determined at the national level, is to be established under the Law to avoid contradictory land ownership claims, arising from the use of different land ownership maps by local governments.

B.2 Rising finance needs may put pressure on capital markets

11. Large fiscal packages are projected to raise the financing needs and may put pressures on the government bond market. According to AMRO staff projections, the fiscal deficit is expected to widen to 6.1 percent of GDP in 2020 and remain elevated at 5.5 percent in 2021, before moderating to about 3 percent in the subsequent years (Figure 18). This has led to a significant increase in the government's gross financing needs in 2020 and 2021 (Table 1). An increase in precautionary savings along with a reduction in private investment, and BI's funding under the burden sharing scheme, have funded the budget financing needs without pushing up bond yields this year. In addition, improved investor sentiments and increased global liquidity have sustained inflows to the government bond market in recent months. That said, pressures on the bond market may rise next year when the savings rate and bond appetite normalize in tandem with economic recovery.

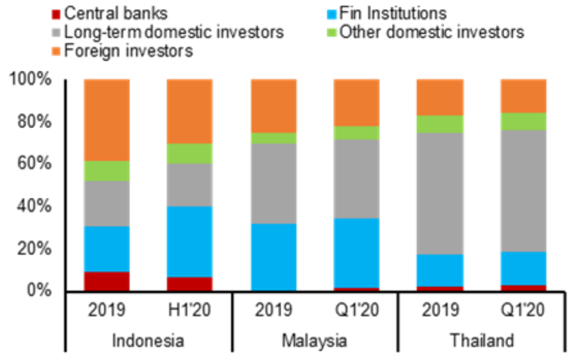
[26] For instance, Thailand increased its minimum wages by 4.5 percent on average in 2018 for the first time since 2013, and again by about 2 percent in 2020. The pace of hiking minimum wages in Vietnam has also slowed significantly in the past few years to 5.3 percent in 2019 and 5.7 percent in 2020.
[27] According to Indonesia's Labor Law in 2003, the severance pay package includes severance pay, reward for service, as well as right compensation. Following this formula, a firm is supposed to pay up to 28 months' salary for laying off a worker with 20 years of working experience, and up to 32 months for those who work for 24 years and more. From a comparative perspective, the severance pay for a laid-off worker that has worked from 20 years and above is about 13.3 months' salary in Malaysia, 20 months' salary in China, the Philippines and Vietnam, and 23.3 months in Thailand.
[28] According to the Omnibus Law on Job Creation, the LPI has been established to optimise the investment value under its management in the long term to support sustainable development. Government Regulation 73/2020 stipulates the LPI's initial capital, while Regulation 74/2020 stipulates the organization, operation, and management of the LPI.
[29] The funding need for the Medium-Term National Development Plan for 2020-2014 is estimated at IDR6,445 trillion in total, or USD430 billion, up from USD320 billion for the period of 2015-2019. The amount is equivalent to about 41 percent of Indonesia's GDP in 2019.
[30] According to AMRO annual consultation report on Indonesia (2019), despite significant progress made over the past years, infrastructure development in the areas of seaports, railways, clean water, and energy has lagged behind, hindering efforts on economic diversification towards tourism and export-oriented manufacturing.

Table 1. Budget Financing Needs and Sources of Funding: 2018-2021

Indicator, in trillions of rupiah, unless otherwise indicated	2018	2019	Budget			AMRO Projections	
			2020 (Original)	2020 (Revised)	2021	2020	2021
Revenue	1,944	1,961	2,233	1,699	1,744	1,634	1,798
% yoy			*13.9*	*-13.4*	*2.6*	*-16.7*	*10.0*
Expenditure	2,213	2,309	2,540	2,739	2,750	2,590	2,741
% yoy			*10.0*	*18.6*	*0.4*	*12.2*	*5.8*
Fiscal balance	-269	-348	-307	-1,039	-1,006	-956	-943
in percent of GDP	*-1.8*	*-2.2*	*-1.8*	*-6.3*	*-5.7*	*-6.1*	*-5.5*
Gross debt financing needs	**729**	**899**	**742**	**1,645**	**1,628**	**1,562**	**1,565**
Fiscal Deficit Financing	269	349	307	1,039	1,006	956	943
Investment Financing (net)	66	76	45	181	171	181	171
Debt maturing in the year	394	475	390	425	450	425	450
Sources of financing	**729**	**899**	**742**	**1,645**	**-**	**1,562**	**-**
Foreign loan withdrawal	89	74	51	151	-	151	-
Bond issuance	718	848	691	1494	-	1411	-
Global bonds	139	120	152	159	-	159	-
Domestic bonds	579	728	538	1335	-	1252	-
Issued via market-based mechanism				862	-	780	-
Issued via private placement at BI (under the burden sharing scheme)				398	-	398	-
Issued via retail channels (retail bonds)				75	-	75	-

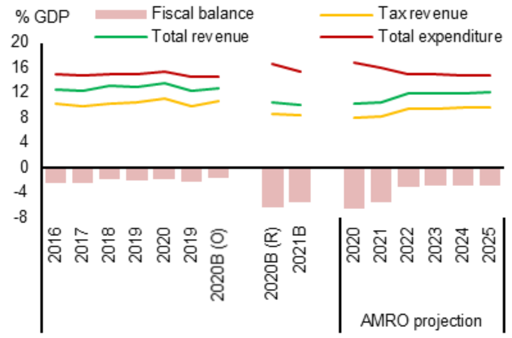
Source: Ministry of Finance for actual data in 2018-19, and 2020-21 Budgets, AMRO Staff Projections for 2020-21. AMRO projections for 2020 are based on the preliminary budget realization data reported by Ministry of Finance and AMRO staff's nominal GDP projection.

Figure 17. Government Bonds Holder Profile: Selected ASEAN



Source: ADB Asian Bonds Online Database
Note: Data refer to tradable local-currency denominated government bonds only. Financial institutions refer to banks.

Figure 18. Indonesia's Fiscal Position: 2016-2025

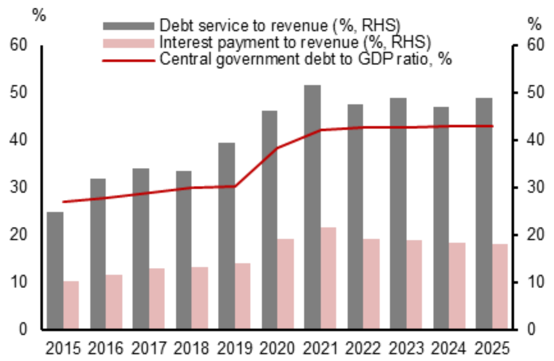


Source: Ministry of Finance, AMRO Staff Calculations
Note: Data for 2020-2025 are AMRO staff projections.

B.3 The pandemic underscores the task of rebuilding policy space

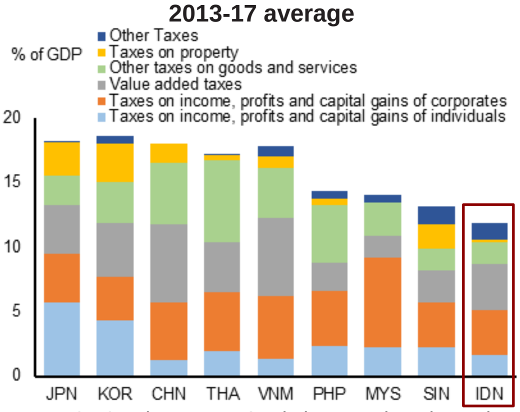
12. Fiscal space is narrowing. The implementation of consistently sound monetary and fiscal policy framework has helped Indonesia build up policy space over the years and gain credibility in the markets. However, with sizeable fiscal packages launched to combat the pandemic, the policy space is projected to shrink. In particular, the government debt is projected to increase by about 8 percentage points from 30 percent of GDP in 2019 to 37.7 percent in 2020 and to peak at 42.8 percent in 2024 (Selected Issue 3). A higher debt level leads to a commensurate increase in the interest burden which is projected at about 19.3 percent of budget revenue in the next five years, up from an average of 12.5 percent pre-pandemic (Figure 19). On the revenue front, concerted efforts to broaden the tax base and improve tax administration has helped to bolster tax revenue. Indonesia's tax revenue, nevertheless, remains modest compared to regional peers (Figure 20). According to AMRO staff projections, tax revenues may decline with the lowering of corporate income tax rate from 25 to 22 percent in 2020 and further to 20 percent in 2022. Post-pandemic fiscal consolidation amid rising interest burden and lower budget revenue may therefore lead to a squeeze in non-interest expenditure, including capital spending and other growth-supportive expenditures.

Figure 19. Central Government Debt and Debt Service Burden



Source: Ministry of Finance, AMRO Staff Calculations
Note: Data for 2008-19 are sourced from Ministry of Finance; data for 2020-25 are AMRO staff projections.

Figure 20. Tax Structure: Selected ASEAN+3, 2013-17 average



Source: OECD (Revenue Statistics Database), National Authorities, and AMRO Staff Calculations
Note: JPN stands for Japan, KOR – Korea, CHN – China, THA – Thailand, VNM – Vietnam, PHP – the Philippines, MYS – Malaysia, SIN – Singapore, and IDN – Indonesia.

C. Policy Discussions and Recommendations

C.1 Policy synergy gears towards a smooth exit from pandemic measures

13. Effective implementation of the current stimulus policy mix on both fiscal and monetary policy fronts, is expected to support economic recovery amid an ongoing pandemic situation. Recent efforts to speed up the disbursement of fiscal packages are encouraging and could be further stepped up (Table 2). BI should continue to work closely with the government and other agencies to strengthen economic recovery while maintaining macroeconomic and financial stability. To safeguard external stability, the exchange rate should remain flexible with judicious interventions to smoothen excessive volatility. BI's strong commitment to build a conducive ecosystem for foreign exchange and money markets, reflected in the Blueprint for Money Market Development 2025[31], is expected to accelerate financial market development going forward. As loan restructuring has been extended until March 31, 2022 to provide supports to households and businesses, banks should continue to be monitored closely, so that those with potential liquidity or solvency problems can be identified early and receive timely policy supports. It is a welcome move that the authorities, while extending loan restructuring program, have requested banks to assess if borrowers are able to survive the pandemic impacts and to make provision for those borrowers who are deemed non-viable.[32]

14. BI's extraordinary budget financing arrangement with the Ministry of Finance is appropriate given the exceptional circumstances of the pandemic but should be terminated as soon as feasible. Despite an expansion in broad money, the impact of the BI's budget financing on near-term inflation is expected to be contained against the backdrop of a weak domestic demand and an increase in precautionary savings. However, BI should be prepared to intervene in the interbank market to absorb excess liquidity as the economy recovers from pandemic downturn and demand strengthens while precautionary savings decline.

15. A smooth exit from the extraordinary policy measures is necessary to avoid cliff effects and to facilitate the transition to a full recovery. The termination of BI's exceptional financing of the budget deficit should be coordinated with the implementation of a fiscal consolidation plan through raising tax revenue and enhancing spending efficiency. In this regard, the government's commitment to restore the fiscal rule from 2023 onwards will help to anchor market confidence. Exit from stimulus packages will also allow the re-prioritization of budget expenditure toward capital spending and other growth-supportive projects. To avoid an abrupt withdrawal of stimulus measures, the timing and pace of exit should be guided by a careful assessment of developments and trends in the domestic economy and external environment, including those in the advanced economies.

[31] The Blueprint for Money Market Development 2025 was released in mid-December 2020 at BI's website https://www.bi.go.id/id/publikasi/kajian/Pages/Blueprint-Pengembangan-Pasar-Uang-2025.aspx. The initiative is part of an overall effort to accelerate financial market developments in Indonesia under the coordination of the Coordination Forum on Development Financing through Financial Markets which was established in 2016.

[32] According to the OJK's regulation POJK48 /POJK.03/2020 amending POJK11 / POJK.03/ 2020, the loan restructuring program has been extended to March 31, 2022 in order to provide time for banks and borrowers to improve their performance. For borrowers who are deemed non-viable, banks, meanwhile, are required to conduct the quality assessment for their loans in line with standard criteria and to establish adequate reserves for those loans. Bank are also required to to conduct periodic resilience tests against potential deterioration in credit quality of restructured loans and its impact on bank liquidity and capital.

Table 2. Indonesia's Pandemic Policy Matrix

Areas	Policy Mix Responses	Future Policy Considerations
Maintaining financial and external stability	• BI has stepped up its triple intervention mechanism via the FX spot, domestic non-deliverable forward, and secondary government bond markets, and lowered the SRR for USD-denominated deposits by 400 basis points. • The second line of defense has been strengthened with a USD60 billion repo facility with the Federal Reserve. • An extraordinary financing arrangement in which BI directly funds part of the fiscal packages and share the interest burden with the Government has been effectively communicated to the market.	• A flexible exchange rate should be maintained with judicious interventions to smoothen excessive forex volatility. • Maintaining effective communication with the market is essential. • Further efforts on financial deepening, in particular to broaden the domestic investor base, would strengthen resilience against capital flow shocks in the longer run.
Supporting households and corporates	• Fiscal packages of about 4.4 percent of GDP were promptly introduced in the revised Budget for 2020 to provide social assistance to individuals and households, as well as financial supports to MSMEs and other corporates.	• Further efforts to speed up the disbursement of fiscal packages are recommended.
Supporting the banking sector	• A loan restructuring program under relaxed criteria on loan quality assessment, together with the government's interest payment subsidy and soft loan program targeting MSMEs, are expected to help contain NPLs. • The loan restructuring program has been extended by one more year until 31 March 2022, while banks are required to assess if borrowers are able to survive the pandemic impacts and to make provision for those borrowers who are deemed non-viable. • BI's more frequent (term) repos and the lowering of SRR for rupiah-denominated deposits by 200 basis points for conventional banks and 50 basis points for sharia banks have underpinned improved liquidity conditions.	• The banking sector should continue to be monitored closely, so that those banks with potential liquidity and solvency problems could be identified early and receive timely policy supports.
Facilitating recovery	• BI lowered its benchmark, BI7DRR rate, five times by cumulative 125 basis points between February and November 2020, to 3.75 percent, to support economic financing. • A fiscal package of about 2 percent of GDP has been proposed in the 2021 Budget to provide more targeted support to economic recovery.	• The current subdued inflationary environment may allow BI to ease its monetary policy further in support of the economy.
Restoring policy space and strengthen resilience post-pandemic	• The authorities have committed to restore monetary, financial and fiscal disciplines once the economy is on a firm footing. • An Omnibus Law on Job Creation was passed by Parliament, which is expected to enhance the business climate, improve the ease of doing business, and address labor market rigidities.	• To finance increased spending needs without intensifying external vulnerabilities, it is crucial for Indonesia to raise tax revenue post-pandemic. • Continued structural reforms (economic diversification, financial deepening, investment climate enhancement, physical infrastructure and human capital development, and digital infrastructure) are crucial to strengthen resilience against future shocks.

Sources: Bank Indonesia, Ministry of Finance of Indonesia, OJK, AMRO Staff Compilations

C.2 Fiscal space could be rebuilt through raising tax revenue post-pandemic

16. Further policy measures have been adopted to broaden the tax base and enhance tax administration. Concerted efforts have been taken to broaden the tax base and improve tax administration over the past years (Table 3). Most recently, the value-added tax (VAT) has been extended to intangible goods and services provided by non-resident firms through cross-border digital transactions, starting from July 2020. The expansion of stamp duties, as well as the imposition of excise tax on plastic products from 2021 may also help boost tax revenue to some extent. On tax administration, two new Directorates in charge of data and information management, and information technology, have been established under the Directorate General of Taxes, to enhance data matching and to implement a core tax system.[33] This, coupled with other organizational reforms (such as business process and human resources), as well as an ongoing integration of the taxpayer identification system with the national identification system, are expected to further strengthen tax administration.

[33] The core tax administration system is an information technology system that provides integrated support for the duties' implementation of Directorate General of Tax including business process automation ranging from taxpayer registration process, processing of notification and other tax documents, tax payment processing, support on audit documents and tax collection letter, until tax payer accounting function. The implementation of a core tax system is expected to enhance the DGT capacity with regard to data matching and risk management, and hence speed up the tax refund process

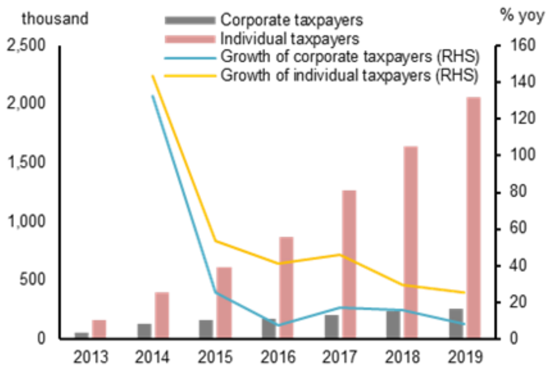
Table 3. Indonesia's Tax Administration Reforms

Timelines	Key Tax Administration Reform
2000-09	• Enhancement of tax law enforcement via taxpayer registration expansion, audit, arrear collection, and return filing enforcement programs. • Establishment of special tax office to administer large taxpayers (LTO) in 2002 and subsequently expanding the initiative to include medium and small taxpayers offices (MTO and STO). • Introduction of an electronic system for tax payment processing (electronic tax notification system). • Simplification of tax laws with gold-card program applicable for large taxpayers and subsequently expanded to those who are not large taxpayers but classified as low-risk taxpayers.
2010 - present	• Tax amnesty program in 2016-17 led to one-time revenue increase of 1.2 percent of GDP and 53,000 new taxpayers. • Raising formality by reducing the tax burden for MSMEs via increasing the annual turnover threshold for corporate income tax and VAT registration from IDR600 million to IDR4.8 billion in 2014. MSMEs with a lower annual sales turnover are subject to a final tax rate only, which was lowered from 1 percent of annual turnover to 0.5 percent in 2018. • Implementation of the Automatic Exchange of Information agreement from 2018. • Tax officers gained access to taxpayers' bank account information from 2018. • Simplification of VAT refund claims from 2018 with low risk taxpayers receiving VAT refunds within one month and income tax refunds within three months with audits conducted later. • E-invoice system piloted in 2015 and rolled out nation-wide from 2018. • Implementation of a new accounting system since mid-2020 to provide real-time information on tax arrears. • IT modernization program starting from 2018, planned for 7 years, with the procurement of a core tax system entering the last stage and starting trial operation from 2021. • Two Directorates in charge of data and information management, and information technology, were established under the Directorate General of Taxes in 2019, to enhance data matching and to implement the core tax system, respectively. • Ongoing integration of the taxpayer identification system with the national identification system.

Source: Ministry of Finance, IMF (2008), OECD (2019), AMRO Staff Compilations

17. The authorities are advised to embark on a plan to raise tax revenue as soon as the economic recovery is on a firm footing. Progressivity of the personal income tax could be enhanced by either lowering the income threshold of the top tax rate or raising the top tax rate to be on par with regional peers. As part of the effort to increase formality and encourage voluntary compliance through lowering the tax burden on MSMEs, the authorities raised the annual turnover threshold for corporate income tax registration from IDR600 million to IDR4.8 billion in 2014. Firms with an annual turnover below the threshold are subject to a final turnover tax only, which was set at 1 percent of annual turnover in 2014 and subsequently lowered to 0.5 percent in 2018, compared to a standard income tax of 22 percent. The scheme has been also made optional since 2018, allowing MSMEs to opt in the standard regime at their wish. The measures have seen the number of registered MSMEs taxpayers increase steadily in recent years (Figure 21).[34] That said, the current registration threshold and final tax rate scheme applicable to MSMEs could be revisited so that they would not provide firms with incentives to stay small to avoid the standard corporate income tax. Likewise, the VAT has the potential to be strengthened. In particular, a relatively high registration threshold and a broad range of exemptions have likely narrowed the VAT tax base and constrain the tax's performance in terms of revenue-raising (Box C). To bolster the VAT performance, the authorities could consider reviewing the current registration threshold as well as streamlining exemptions.

Figure 21. Registered MSME Corporate and Individual Taxpayers



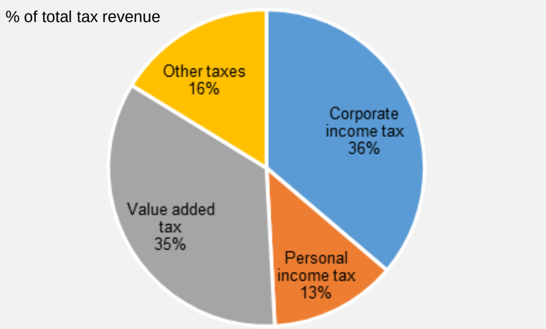
Source: Ministry of Finance (Directorate General of Taxes)

[34] The number of taxpayer registration increased sharply in 2014, the first year after the introduction of the new tax registration threshold, and continued to increase in the subsequent years at a moderating pace against a growing base.

Box C. Value Added Tax[35]

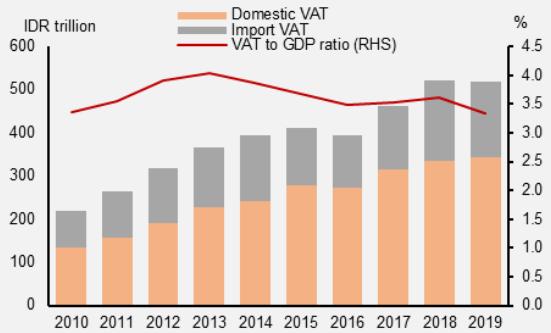
The value-added tax has been a main contributor to Indonesia's tax revenue. The value-added tax (VAT) is a consumption-based tax imposed on the value added to goods and services, applying the destination principle and using the invoice-based credit method. The latest legal basis for VAT in Indonesia is Law No. 42 issued in 2009 which amended Law No. 8 issued in 1983 on the *Value Added Tax of Goods and Services and Tax of Luxury Goods Sale*. The standard VAT rate is 10 percent, while a zero percent VAT rate applies to the export of goods and services, which are broadly in line with regional peers. VAT revenue has accounted for about a third of tax revenues, the second largest tax item only after the corporate income tax (Figure C1). VAT revenue has been dominated by the tax imposed on the consumption of good and services domestically (Figure C2).

Figure C1. Indonesia's Tax Structure, 2014-19



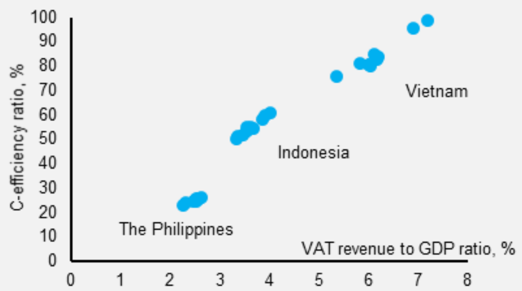
Source: Ministry of Finance

Figure C2. Indonesia's VAT Revenue



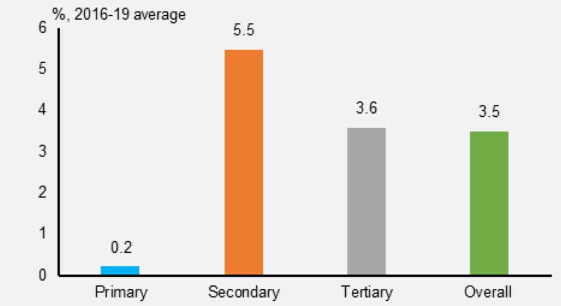
Source: Ministry of Finance

Figure C3. VAT Revenue and C-efficiency Ratio, Selected ASEAN: 2010-2019



Source: National Authorities, CEIC, AMRO Staff Calculations
Note: Data for the Philippines are up to 2018 only.

Figure C4. VAT to GDP ratio, by Sector



Source: Ministry of Finance, AMRO Staff Calculation

That said, Indonesia's VAT performance has the potential to improve further. VAT revenue averaged 3.6 percent of GDP in 2014-2019, higher than the Philippines (of 2.6 percent)[36] but below Vietnam (of 6.1 percent). Likewise, the C-efficiency measure which gauges how close the actual VAT revenue has been to its potential, is still well below 100 percent for Indonesia (Figure C3). [37] From a sectoral perspective, the contribution of VAT from the primary and tertiary sectors has been lower than the secondary sector, relative to their size in the economy (Figure C4). [38] This is in part due to a broad range of exemptions and incentives enjoyed by those sectors. Indonesia's VAT underperformance is also attributable to a narrow tax base due to a high registration threshold. An Indonesian company or individual/entrepreneur is designated as a taxable enterprise if its annual

[35] This box is prepared by Andriansyah and Nguyen Thi Kim Cuc.
[36] Data for the Philippines refer to the 2014-2018 period only.
[37] The C-efficiency measure is calculated as the ratio between the actual VAT revenue and its potential (defined as the VAT could collect from the final consumption base using the standard tax rate). Under an 'idealized' broad-based VAT that is being perfectly enforced and complied with, the C-efficiency measure would be 100 percent; any other value—higher or lower—indicates deviation from a single tax rate on all consumption.
[38] Primary sector include agriculture, forestry and fishery, and mining and quarrying. The secondary sector consists of manufacturing and processing activity, utilities, and construction. The tertiary sector consists of the rest of economic activity, meaning services.

sales turnover exceeds IDR4.8 billion, or equivalent to about USD322,700, which is high compared to regional peers (Table C1).[39]

Table C1. VAT Rates and Registration Thresholds: Selected ASEAN

	Indonesia	Philippines	Thailand	Vietnam
Standard rate (%)	10	12	7/10*	10
Annual turnover threshold for VAT registration (in LCY)	4,800,000,000	3,000,000	1,800,000	non
- in USD equivalent	*322,700*	*63,000*	*57,600*	-

Source: National Authorities' VAT Laws, AMRO Staff Compilations
Note: */ While the standard VAT rate in Thailand is 10 percent by law, it has been lowered to 7 percent from 1997 until 2021 by a royal decree.

C.3 Structural reforms will strengthen resilience against future shocks

18. Efforts on financial deepening, in particular to broaden the domestic investor base, will deepen trading in the secondary bond market and mitigate the impact on prices from capital flow volatility. The pandemic saw individual investors increased their holding of government bonds - through purchases in the secondary trading platform - by above 80 percent from a year earlier, to IDR149 trillion, or 4.1 percent of total bonds outstanding, as of October 2020. The number of retail investors in the capital market increased from 2.5 million as of end-2019 to about 4 million in 2020, thanks largely to the authorities' efforts to raise financial literacy about retail investment instruments among the population, in particular the millennials. To provide individual investors with greater incentives to hold government bonds, a lower withholding tax on interest income earned by those investors could be considered. To broaden the long-term institutional investor base, tax incentives could be also reviewed and adjusted to ensure equal treatment among different groups of investors. Furthermore, reforms of the existing mandatory provident and pension funds in the form of expanding the coverage and raising the contribution rates, could help increase the participation of these investors in the government bond market.[40] Last, but not least, a similar increase has been observed with the take-up of government bonds issued via retail channels, including fast-growing fintech platforms. Efforts to raise public awareness about this investment instrument and to expand the distribution network of retail bonds should be continued.

19. Structural reforms are crucial to strengthen resilience against future shocks. Efforts to diversify the economy and exports, including the establishment of industrial parks to attract FDI projects, and the promotion of exports to new markets via trade agreements, should continue. Effective implementation of the overarching Omnibus Law on Job Creation is expected to generate employment via increased investment. The establishment of the Indonesia Investment Authority, as mandated under the Omnibus Law, is aimed at facilitating infrastructure investment going forward. The pandemic has underscored the importance of developing an adequate healthcare infrastructure and social safety net to strengthen the country's resilience against pandemics and natural disasters – which is also an integral part of Indonesia's human capital development agenda. Indonesia stands to reap the benefits of a fast-growing digital economy and fintech sector, against the backdrops of rapid technological advancements and a young, tech-savvy population. Greater efforts to facilitate digitalization and foster a conducive ecosystem, including an accelerated implementation of the Indonesia Payment System Blueprint 2025 initiatives, are therefore welcome.

[39] As stipulated in the Ministry of Finance Regulation No. 197/PMK.03/2013, effective from 1 January 2014. Prior to 2014, the threshold was IDR600 million.
[40] The total contribution rate to mandatory provident and pension funds is 8.7 percent of basic salary, of which 3 percent contributed by the employee and 5.7 percent by the employer. This is considered low relative to regional peers, such as Singapore (37 percent), Vietnam (25 percent) and Malaysia (23/24 percent).

Authorities' Views

20. The authorities commented that AMRO staff's views on risks, vulnerabilities and challenges were not sufficiently balanced and rigorous, and supported by stronger arguments. The authorities also suggested that AMRO staff's risk assessment be strengthened by incorporating the authorities' concerted efforts in anticipating the risks, vulnerabilities, and challenges caused by the COVID-19 pandemic and swiftly responding with extraordinary policies to minimize its negative impacts. In particular, Indonesian authorities are committed to implement the follow-up policy measures required to support the national economic recovery program, while maintaining macroeconomic and financial stability for better outlook economy.

- In terms of economic outlook, the authorities pointed to recent increases in mobility along with optimism about vaccine availability. Also, the global economic outlook is expected to further improve, thus sustaining stronger export performance and supporting national economic recovery momentum. Better-than-expected world trade volume and international commodity prices will stimulate demand for export products from Indonesia. The promising export outlook is also bolstered by increasing global activity, reflected in an uptick in the global PMI, which will drive demand for Indonesian export products. Against these backdrops, the authorities expected the economy to achieve a higher growth than AMRO staff's projection of 4.9 percent in 2021.

- Regarding the financial sector soundness, the authorities highlighted that banks have remained resilient with high CAR and low NPLs. Ample liquidity conditions in the banking sector also have underpinned overall banking resilience in line with strong capital buffers. Such resilience would allow banks to absorb possible risks stemming from the corporate and household sector weakness.

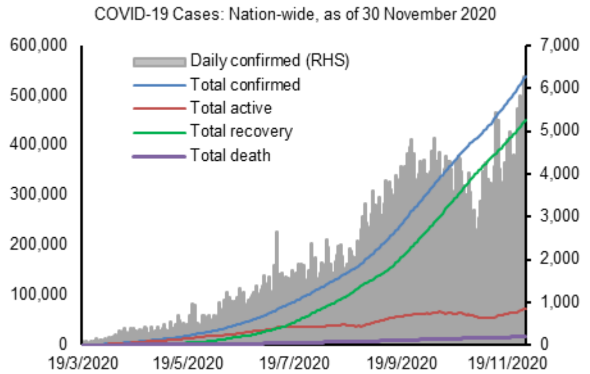
- With prudent and credible fiscal and monetary policy, the authorities are of the view that the risks associated with deficit financing are well managed. In terms of budget financing for 2021, Bank Indonesia will continue to purchase government bonds on the primary market as a standby purchaser in line with the Joint Decree of the Minister of Finance and Governor of Bank Indonesia dated 16 April 2020. Meanwhile, the direct purchase of government bonds by Bank Indonesia in accordance with the Joint Decree dated July 7, 2020 only applied in 2020 and will not continue in 2021. With improved global financial market conditions and attractive yields on rupiah-denominated investment assets, it is estimated that most of the government bonds issued in 2021 will be absorbed by the market. This will reduce the amount of government bonds purchased by Bank Indonesia in the primary market. The authorities also believe that investor confidence has been maintained, against the backdrop of continued capital inflows and a strengthened rupiah that support the attractiveness of rupiah-denominated assets. This is reflected in, among others, the recent moderation in the 10-year government bond yields to the pre-COVID-19 pandemic level.

Appendices

Appendix 1. Selected Figures for Major Economic Indicators

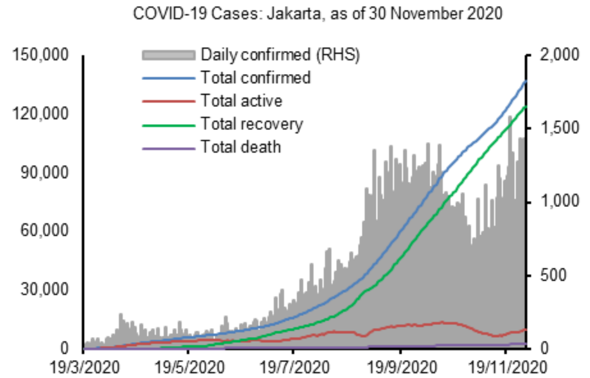
Figure 1.1. COVID-19 Pandemic Developments

Indonesia reported first confrmed COVID-19 cases in March, triggering the imposition of large-scale social restrictions (PSBB) in April-May.



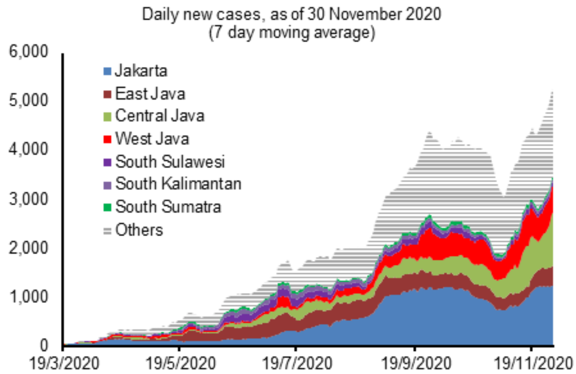
Sources: Minsitry of Health, AMRO staff calculations

Upon coming down during the re-tightening of PSBB from mid-September to mid-October, the daily tally resurged again in Jakarta...



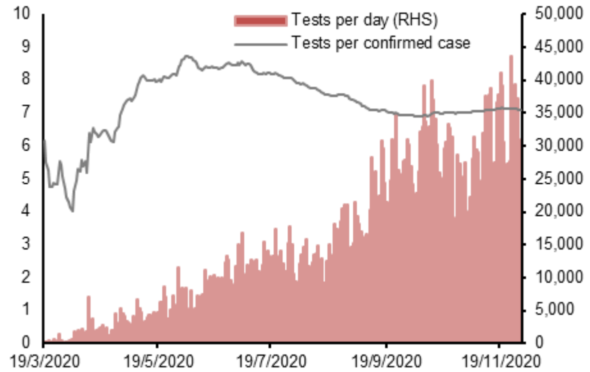
Sources: Minsitry of Health, AMRO staff calculations

… and elsewhere.



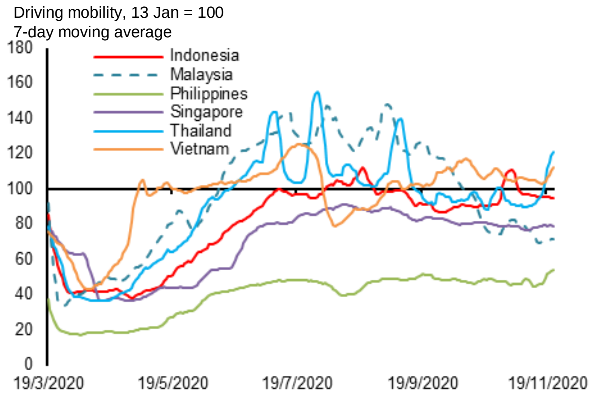
Sources: Minsitry of Health, AMRO staff calculations

Testing has ramped up and stabilized in recent months.



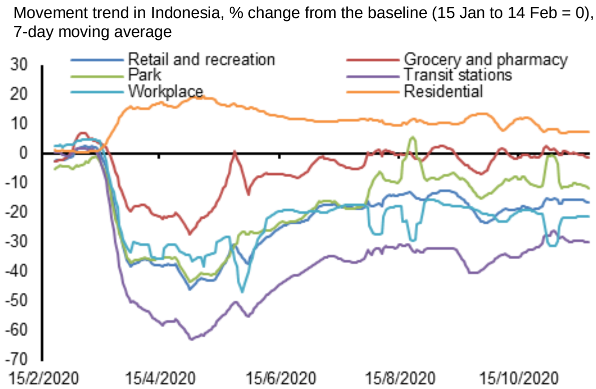
Sources: Minsitry of Health, AMRO staff calculations
Note: Daily data are up to 30 November 2020.

Mobility has generally rebounded since June.



Sources: Apple Mobility Database, AMRO staff calculations
Note: Daily data are up to 22 November 2020.

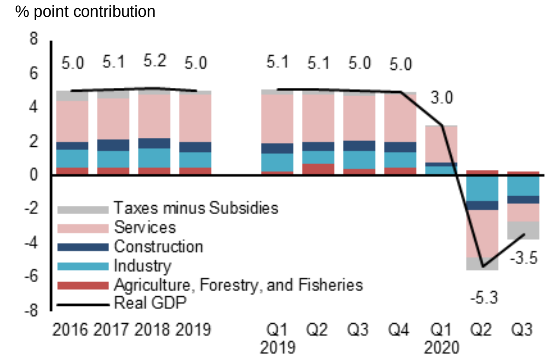
Mobility rebound remained strongest for getting basic necessities (grocery and pharmacy), and was more gradual for other activities.



Sources: Google Mobility Database, AMRO staff calculations.
Note: Daily data are up to 20 November 2020. A positive value for residential movement indicates people stay at home more than the baseline, which is consistent with negative values in other places than home.

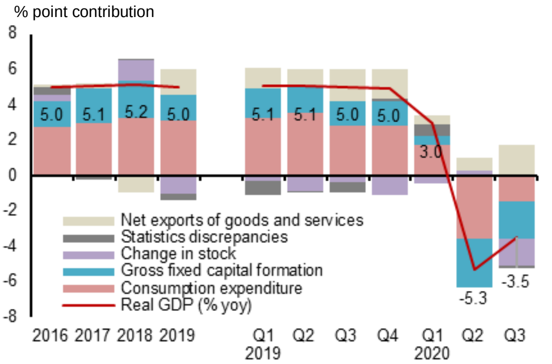
Figure 1.2. Real Sector

Economic activity has rebounded gradually from a sharp contraction in Q2 triggered by the imposition of PSBBs,…



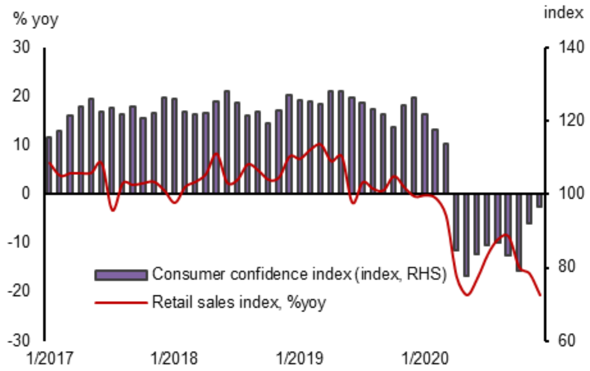
Source: Statistics Indonesia (BPS)

… as consumption turned around following the relaxation of PSBB in Q3…



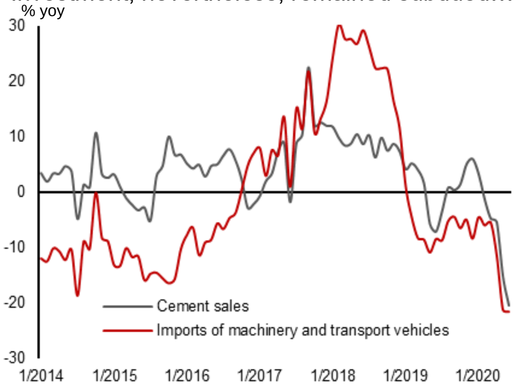
Source: BPS

…aided by improved consumer confidence.



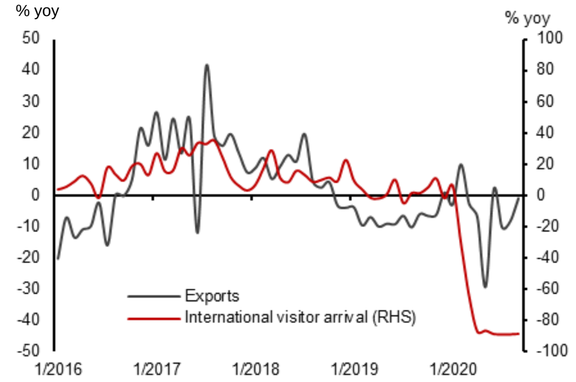
Sources: Bank Indonesia
Note: Monthly data are up to December 2020. The December retail sales number is preliminary only.

Investment, nevertheless, remained subdued…



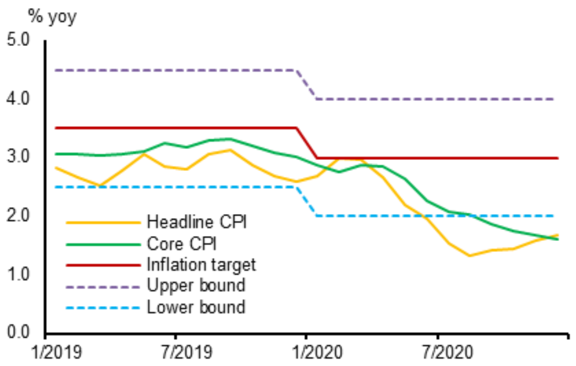
Source: Bank Indonesia, BPS
Note: Monthly data are up to September 2020.

Merchandise exports improved while foreign tourist arrivals remained halted due to international border shutdown.



Source: Bank Indonesia
Note: Monthly data are up to September 2020.

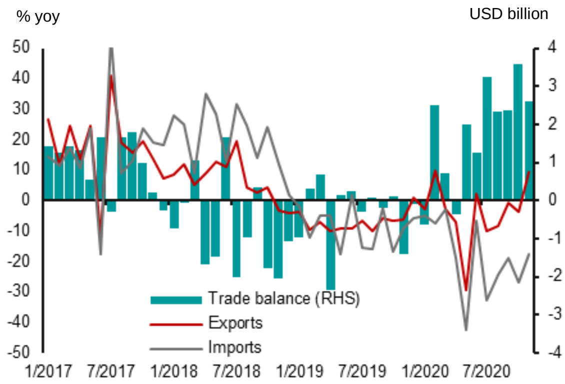
Softened domestic demand due to the pandemic and low commodity (fuel) prices underpinned subdued inflation.



Sources: BPS
Note: BI's target range was lowered to 3±1% from January 2020. Monthly data are up to December 2020.

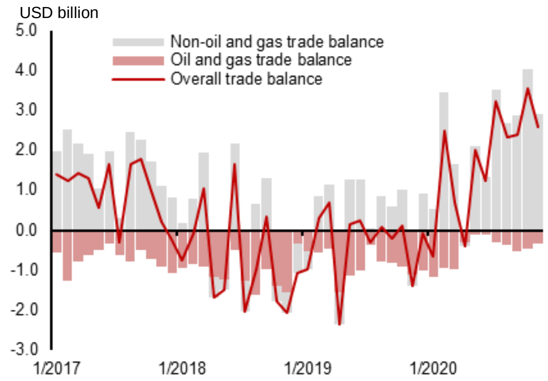
Figure 1.3. External Trade

A significant contraction in imports (relative to exports) underpinned an improvement in the trade balance …



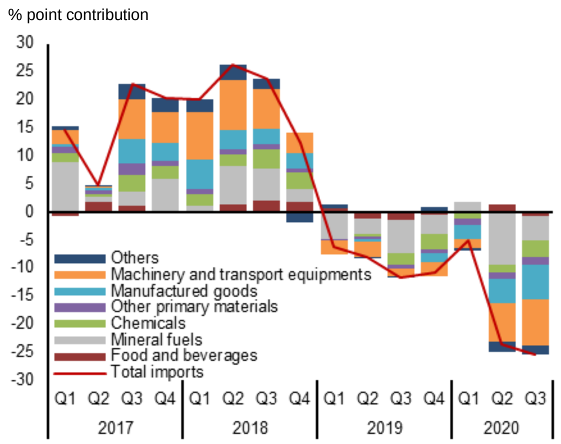
Sources: BPS, AMRO staff calculations
Note: Monthly data are up to November 2020.

… for both oil and non-oil balances.



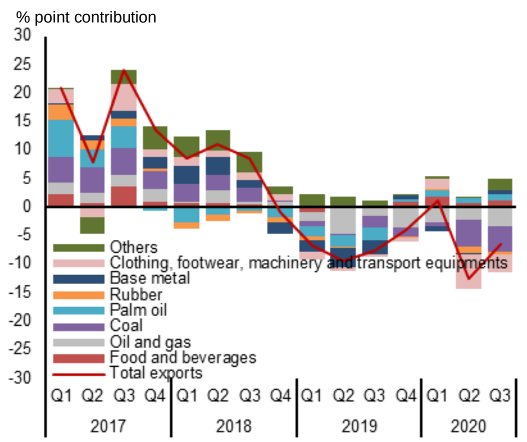
Sources: BPS, AMRO staff calculations
Note: Monthly data are up to November 2020.

Imports fell on a broad basis.



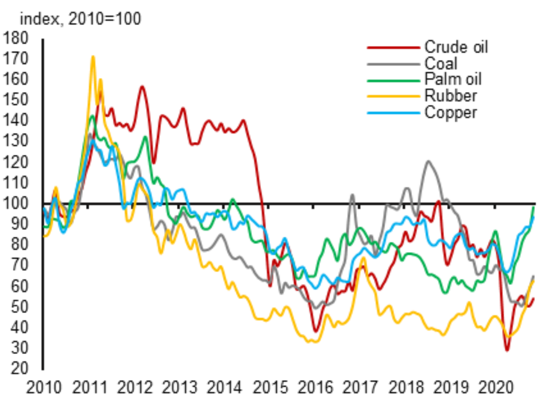
Sources: BPS, AMRO staff calculations

Overall exports, while contracting in 9M2020, have picked up in recent months, supported by commodities and agricultural exports.



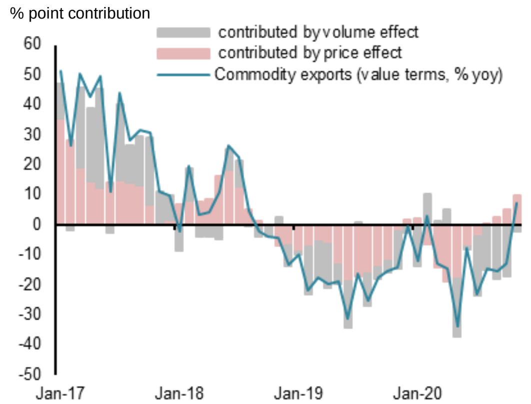
Sources: BPS, AMRO staff calculations

An improvement in terms of trade driven by higher palm oil and metal prices…



Sources: CEIC, AMRO staff calculations
Note: Monthly data are up to December 2020.

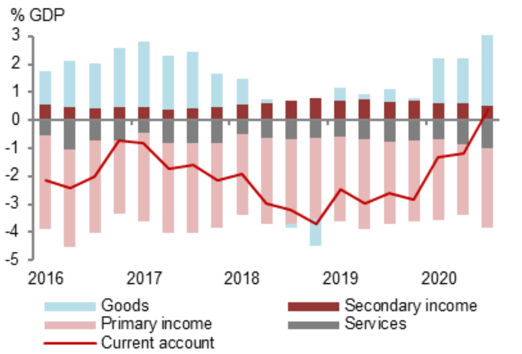
… has supported commodity exports in recent months.



Sources: BPS, AMRO staff calculations
Note: Monthly data are up to November 2020.

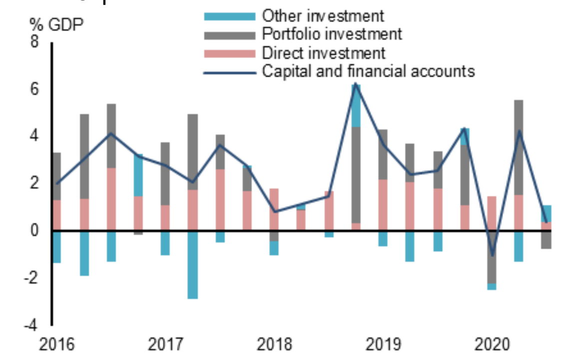
Figure 1.4. External Sector

Improved trade balance supported a reversal of the current account deficit into a surplus in Q3 2020.



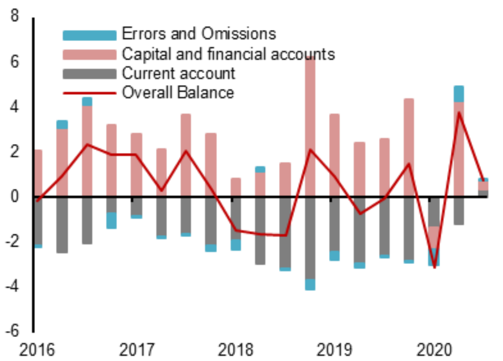
Sources: Bank Indonesia, AMRO staff calculations
Note: Quarterly data are up to Q3 2020.

Continued FDI inflows, coupled with global bond issuance and the return of foreign investors in the domestic capital markets, meanwhile, supported the capital and financial account balance …



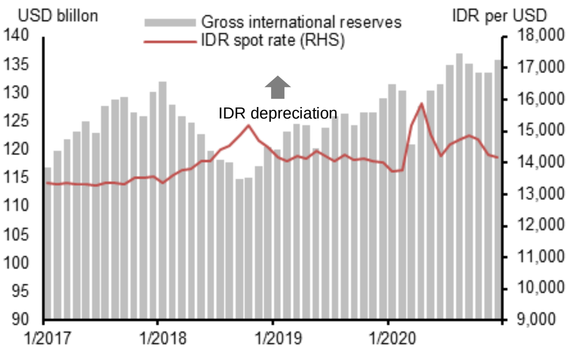
Sources: Bank Indonesia, AMRO staff calculations
Note: Quarterly data are up to Q3 2020.

… resulting in BOP surplus…



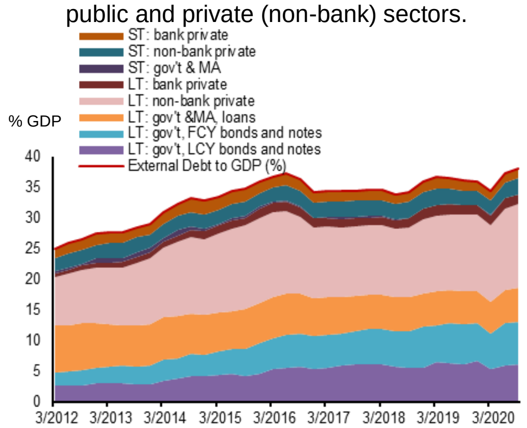
Sources: Bank Indonesia, AMRO staff calculations
Note: Quarterly data are up to Q3 2020.

… and reserves accumulation.



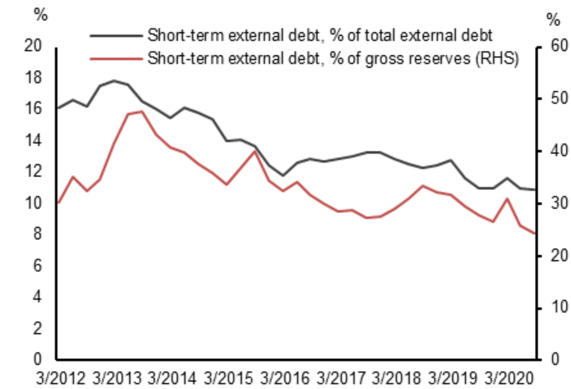
Sources: Bank Indonesia, CEIC, and AMRO staff calculations
Note: Monthly data are up to December 2020.

Gross external debt picked up to 38.1 percent of GDP in Q3 with increased borrowing by both public and private (non-bank) sectors.



Sources: Bank Indonesia, AMRO staff calculations
Note: Quarterly data are up to Q3 2020.

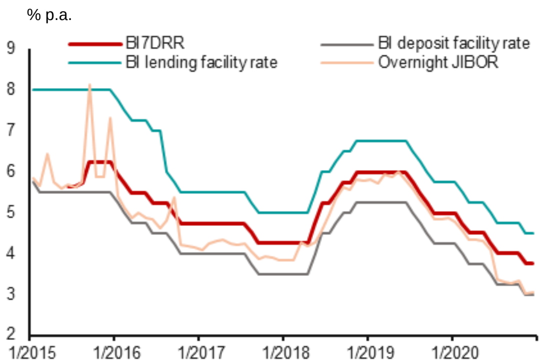
Short-term external debt meanwhile remained low as a percentage of total external debt, as well as of gross reserves.



Sources: Bank Indonesia, AMRO staff calculations
Note: Quarterly data are up to Q3 2020.

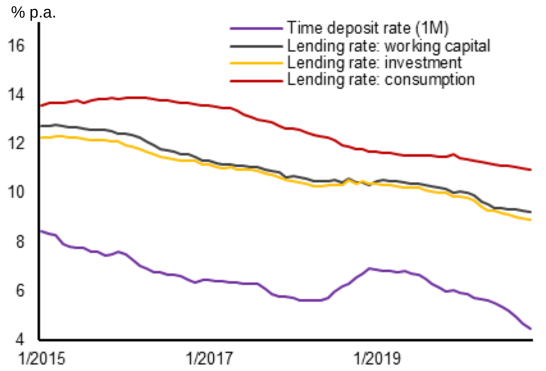
Figure 1.5. Monetary Sector

The interbank rate closely tracked the policy rate – which was lowered by 125 basis points, to fall significantly this year.



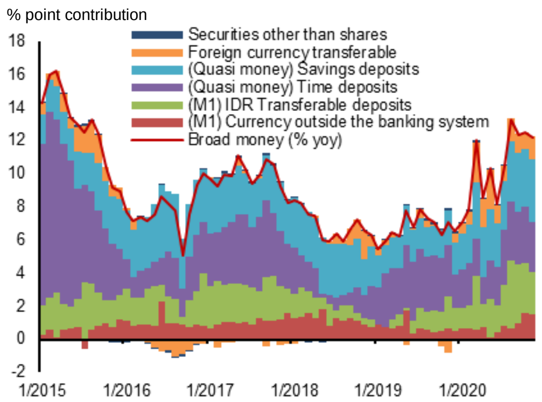
Sources: Bank Indonesia
Note: Monthly data are up to December 2020.

Deposit rates also moderated, followed by lending rates, albeit more gradually.



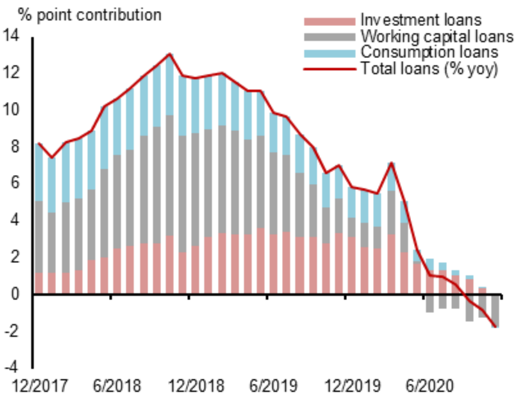
Sources: Bank Indonesia, AMRO staff calculations
Note: Monthly data are up to November 2020.

Broad money growth was boosted, driven by increased deposits into the banking system.



Sources: Bank Indonesia, AMRO staff calculations
Note: Monthly data are up to November 2020.

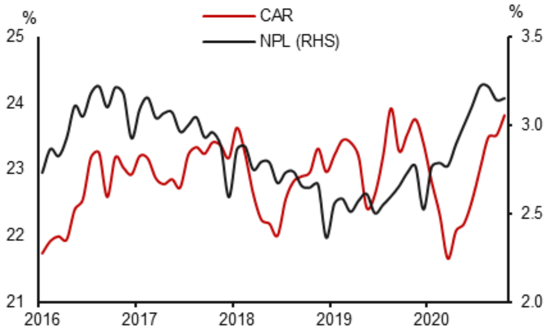
Dampened domestic activity, meanwhile, crippled bank loans, driving credit growth to record lows.



Sources: Bank Indonesia, OJK, AMRO staff calculations
Note: Monthly data are up to November 2020.

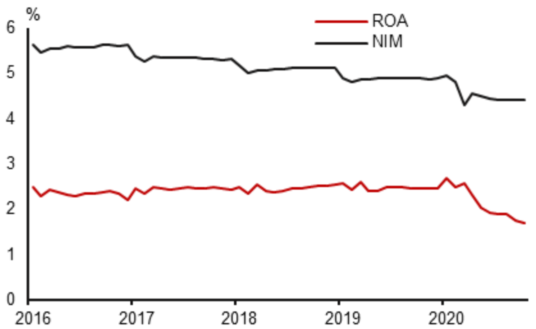
Figure 1.6. Banking Sector

The capital adequacy ratio dipped earlier this year but remains high, while NPLs have broadly increased.



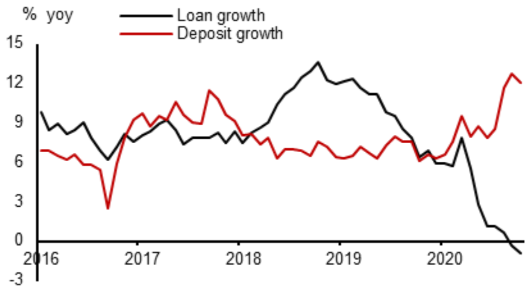
Sources: OJK, AMRO staff calculations
Note: Monthly data are up to October 2020.

Banks' profitability has also moderated on higher credit costs, as banks stepped up provisions, in part driven by the IFRS 9 implementation.



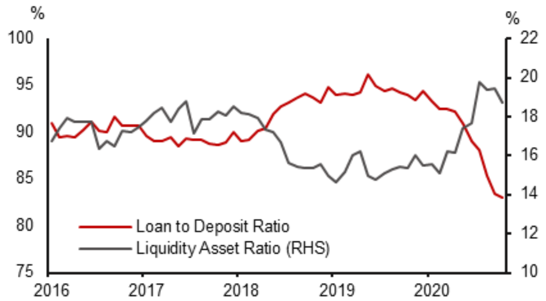
Sources: Bank Indonesia, AMRO staff calculations
Note: Monthly data are up to October 2020.

Loan growth fell significantly while deposit growth picked up, which….



Sources: OJK (via CEIC), AMRO staff calculations
Note: Monthly data are up to October 2020.

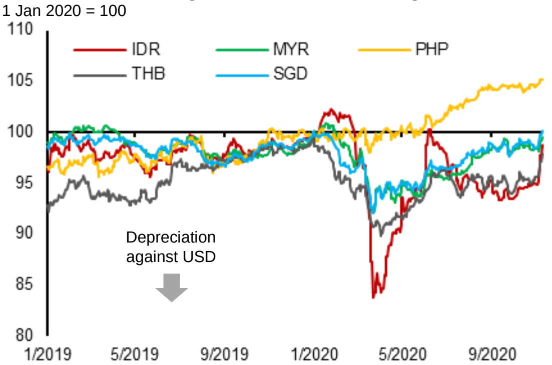
… supported an improvement in liquidity indicators.



Sources: OJK (via CEIC), AMRO staff calculations
Note: Monthly data are up to October 2020.

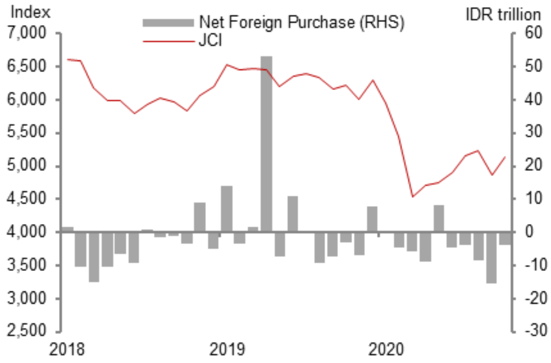
Figure 1.7. Forex and Financial Markets

The rupiah has rebounded from the March depreciation and has been relatively stable since, moving within a narrow range.



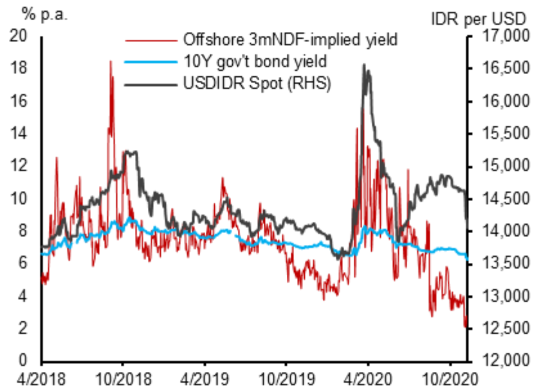
Sources: Thomson Reuters Datastream, AMRO staff calculations Note: Daily data are up to 11 November 2020.

The Jakarta Composite Index has also recovered some lost ground since March, although foreign investors continued to net sell Indonesian equities.



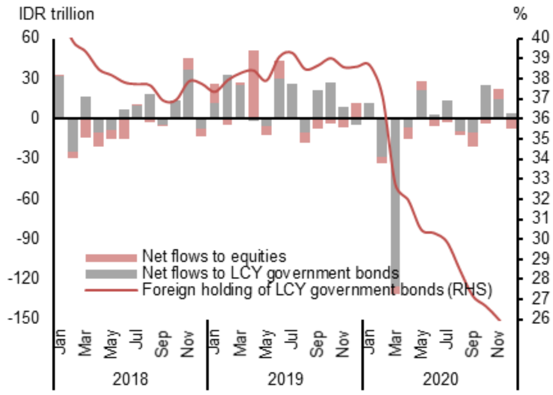
Sources: Jakarta Stock Exchange, CEIC, AMRO staff calculations. Monthly data are up to October 2020.

In the bond market, bond yields have moderated from the March peak, in tandem with lower rupiah hedging cost…



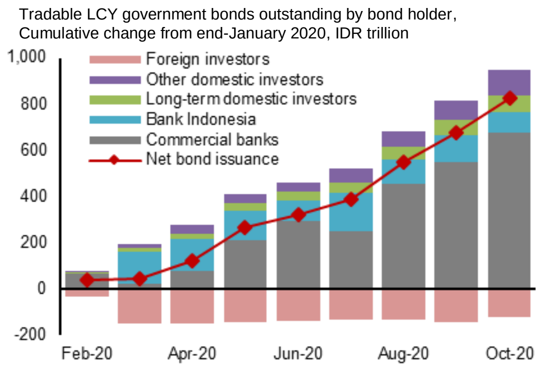
Sources: Thomson Reuters Datastream
Note: Daily data are up to 9 November 2020.

… and foreign investors have returned to purchase government bonds after the March sell-off.



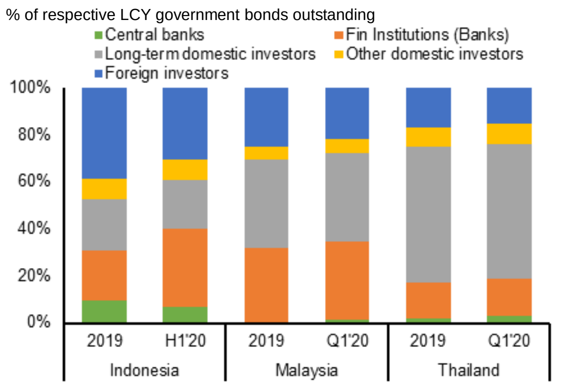
Sources: Ministry of Finance, Jakarta Stock Exchange, CEIC, AMRO staff calculations. A positive value indicates a net inflow and a negative value indicates a net outflow. Monthly data are up to December 2020.

BI's intervention supported the bond market during the sell-off in March; while ample liquidity amidst weak loan growth allowed banks to significantly increase their bond holding this year.



Sources: Ministry of Finance, AMRO staff calculations

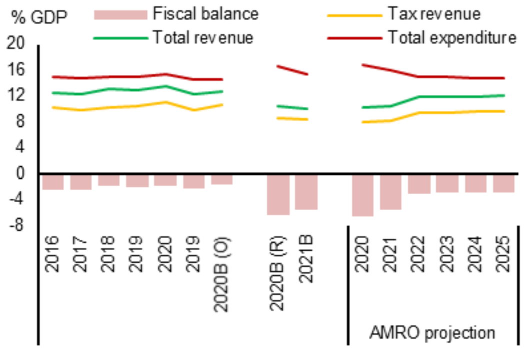
Foreign holding of rupiah-denominated government bonds has moderated, albeit remaining elevated relative to regional peers.



Sources: ADB (Asian Bonds Online Database), AMRO staff calculations

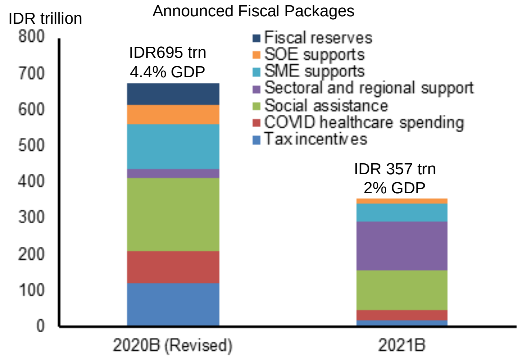
Figure 1.8. Fiscal Sector

The fiscal deficit is expected to widen in 2020-2021...



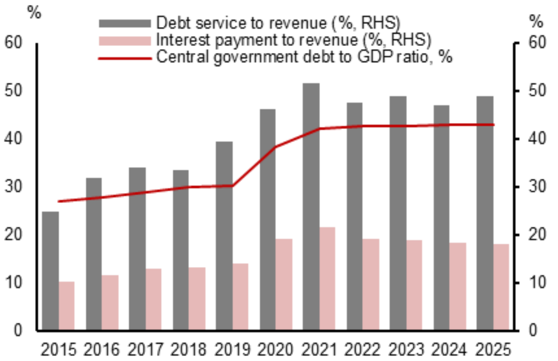
Sources: Ministry of Finance and AMRO staff estimates

...on the back of fiscal measures to combat the pandemic and support recovery.



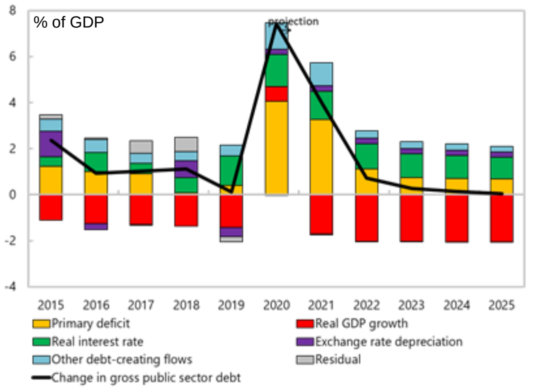
Sources: Ministry of Finance and AMRO staff estimates

Central government debt is expected to increase considerably, pushing up the debt service burden in the medium term.



Sources: Ministry of Finance and AMRO staff estimates

Enlarged primary deficits underpin the rising debt level in 2020-2021, while a contraction in real GDP also contributes to debt creation in 2020.



Sources: Ministry of Finance and AMRO staff estimates

Appendix 2. Selected Economic Indicators for Indonesia

	2015	2016	2017	2018	2019	AMRO Staff Projections	
						2020	2021
Real GDP (percent change yoy)	4.9	5.0	5.1	5.2	5.0	-2.1	4.9
Household consumption	5.0	5.0	4.9	5.1	5.0	-2.0	4.9
Government consumption	5.3	-0.1	2.1	4.8	3.2	4.0	3.6
Gross fixed capital formation	5.0	4.5	6.2	6.6	4.4	-2.1	5.1
Exports	-2.1	-1.7	8.9	6.5	-0.9	-7.1	8.1
Imports	-6.2	-2.4	8.1	11.9	-7.7	-16.2	14.6
Balance of payments (percent of GDP)							
Current account balance	-2.0	-1.8	-1.6	-2.9	-2.7	-0.8	-1.9
Trade balance	1.6	1.6	1.9	0.0	0.3	2.3	1.3
Oil and gas	-0.7	-0.5	-0.7	-1.1	-0.9	-0.4	-0.4
Non-oil and gas	2.3	2.2	2.6	1.1	1.2	2.6	1.7
Financial account balance	2.0	3.1	2.8	2.4	3.3	1.4	2.0
Foreign direct investment (net)	1.2	1.7	1.8	1.2	1.8	1.0	1.4
Portfolio investment (net)	1.9	2.0	2.1	0.9	2.0	0.4	0.9
Other investment (net)	-1.2	-0.6	-1.1	0.3	-0.5	0.0	-0.3
Overall balance	-0.1	1.3	1.1	-0.7	0.4	0.6	0.2
Central government (percent of GDP)							
Revenue and grant	13.1	12.5	12.3	13.1	12.4	10.3	10.4
Expenditure	15.7	15.0	14.8	14.9	14.5	16.4	15.9
Budget balance	-2.6	-2.5	-2.5	-1.8	-2.2	-6.1	-5.5
Central government debt	27.0	28.0	29.4	30.4	30.6	37.7	41.7
Money and credit (percent change yoy)							
Broad money	9.0	10.0	8.3	6.3	6.5	14.5	7.0
Private sector credit	9.0	9.1	8.0	12.5	5.5	-0.8	12.3
Memorandum Items:							
Headline inflation (yoy, end of period)	3.4	3.0	3.6	3.1	2.7	1.7	3.0
Headline inflation (yoy, period average)	6.4	3.5	3.8	3.2	3.0	2.0	2.5
BI Policy Rate	7.50	4.75	4.25	6.00	5.00	3.75	-
Exchange rate (rupiah/USD, period average)	13,392	13,305	13,385	14,246	14,148	14,582	14,873
Gross foreign reserves (USD bn)	105.9	116.4	130.2	120.7	129.2	135.9	137.7
External debt (percent of GDP)	36.1	34.3	34.7	36.0	36.1	39.0	38.6
Nominal GDP (USD bn)	861	933	1,015	1,041	1,119	1,084	1,148
Nominal GDP (IDR trn)	11,526	12,402	13,590	14,838	15,834	15,811	17,067

Source: Bank Indonesia, Ministry of Finance, Statistics Indonesia, CEIC, AMRO Staff Calculations
Note: Data for 2020-2021 are AMRO staff projections. 2020 inflation and BI policy rate are actual. AMRO fiscal estimates for 2020 are based on preliminary budget realization data as of end-December.

Appendix 3. Balance of Payments

in % of GDP, unless otherwise indicated	2015	2016	2017	2018	2019
Current Account	-2.0	-1.8	-1.6	-2.9	-2.7
Goods	1.6	1.6	1.9	0.0	0.3
Exports	17.3	15.5	16.6	17.4	15.1
Oil	0.9	0.7	0.7	0.8	0.4
Gas	1.1	0.7	0.8	0.9	0.7
Non-Oil & Gas	15.3	14.1	15.1	15.7	14.0
Imports	15.7	13.9	14.8	17.4	14.7
Oil	2.4	1.7	2.0	2.5	1.7
Gas	0.2	0.2	0.3	0.3	0.2
Non-Oil & Gas	13.0	12.0	12.5	14.6	12.7
Services	-1.0	-0.8	-0.7	-0.6	-0.7
Primary Income	-3.3	-3.2	-3.2	-3.0	-3.0
Secondary Income	0.6	0.5	0.4	0.7	0.7
Capital Account	0.0	0.0	0.0	0.0	0.0
Financial Account	2.0	3.1	2.8	2.4	3.3
Direct Investment, net	1.2	1.7	1.8	1.2	1.8
Portfolio Investment, net	1.9	2.0	2.1	0.9	2.0
Other Investment, net	-1.2	-0.6	-1.1	0.3	-0.5
Net Error & Omissions	-0.1	0.0	-0.1	-0.2	-0.1
Overall Balance	-0.1	1.3	1.1	-0.7	0.4
Memorandum items:					
International reserves (USD bn)	105.9	116.4	130.2	120.7	129.2
External debt	36.1	34.3	34.7	36.0	36.1
Exchange rate (rupiah/USD)	13,389	13,308	13,381	14,237	14,148
Nominal GDP (USD bn)	861	933	1,015	1,041	1,119

Source: Bank Indonesia, AMRO Staff Calculations

Appendix 4. Central Government Budget

In trillions of IDR, unless otherwise indicated	2017	2018	2019	2020 Budget		Annual change (% yoy)				2020 Budget Realization		
						2017	2018	2019	2020B (Rev)	IDR trillion	% yoy	% of Revised Budget
	Act	Act	Act	Original	Revised	f/r 2016	f/r 2017	f/r 2018	f/m 2019			
A. Total Revenue and Grants	1,666	1,944	1,961	2,233	1,699	7.1	16.6	0.9	-13.4	1,634	-16.7	96.2
1. Taxes Revenue	1,344	1,519	1,546	1,866	1,405	4.6	13.0	1.8	-9.2	1,265	-18.2	90.1
a. Income Taxes	647	750	761	930	670	-2.9	16.0	1.5	-11.9	590	-22.5	87.9
- Oil and Gas	50	38	59	57	32	39.3	-24.3	55.3	-46.1	32	-45.2	101.7
- Non-Oil and Gas	597	817	702	872	639	-5.3	37.0	-14.1	-9.0	557	-20.6	87.3
b. VAT	481	537	532	686	508	16.6	11.8	-1.1	-4.5	439	-17.4	86.5
c. Excise	153	160	172	181	172	6.8	4.1	8.0	-0.1	172	0.0	100.2
d. International Taxes	39	46	41	43	33	10.4	17.1	-10.6	-18.4	36	-11.7	108.3
2. Non tax Revenue	311	409	409	367	294	18.8	31.5	-0.1	-28.1	334	-18.4	113.5
a. Natural resources	111	181	155	160	79	71.2	62.6	-14.2	-48.9	96	-38.3	120.8
b. Others	200	229	254	207	215	1.5	14.3	11.1	-15.4	238	-6.2	110.8
3. Grants	12	16	5	3	1	28.9	34.5	-67.9	-90.0	12	130.2	2301.8
B. Government Expenditures	2,007	2,213	2,309	2,540	2,739	7.7	10.2	4.3	18.6	2,590	12.2	94.5
1. Central Government	1,265	1,455	1,496	1,683	1,975	9.7	15.0	2.8	32.0	1,756	17.4	88.9
2. Transfer to Region & Village Funds	742	758	813	857	764	4.5	2.1	7.3	-6.0	763	-6.2	99.8
C.Primary Balance	-124	-11	-73	-12	-700	-	-	-	-	-642	-	91.7
% of GDP	-0.9	-0.1	-0.5	-0.1	-4.3	-	-	-	-	-4.1	-	-
D.Overal Balance	-341	-269	-349	-307	-1,039	-	-	-	-	-956	-	92.0
% of GDP	*-2.5*	*-1.8*	*-2.2*	*-1.8*	*-6.3*	-	-	-	-	*-6.1*	-	-

Source: Ministry of Finance, AMRO Staff Calculations. 2020 Budget realization data are preliminary numbers reported by Ministry of Finance.

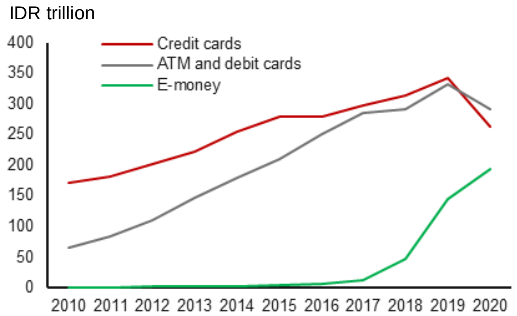
Annexes: Selected Issues

1. E-money in Indonesia: Recent Developments, Regulatory Framework, and Monetary Policy Implications[41]

Recent Developments

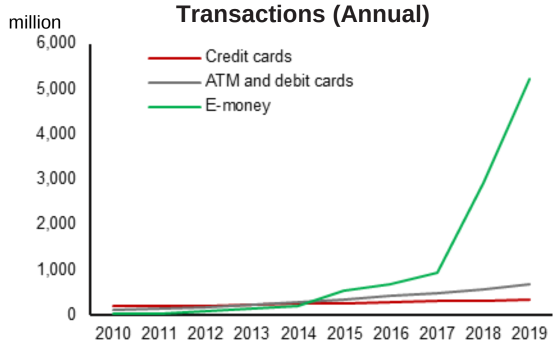
1. While the retail electronic payment system in Indonesia is still largely dominated by credit and debit cards, e-money has emerged as an increasingly popular means of payment. In terms of value, bank-issued cards, in the form of credit and debit cards, still account for the lion's share of retail electronic transactions, representing 82 percent of total value as of 2019 (Figure A1.1). However, in terms of number of transactions, e-money has eclipsed credit and debit cards in recent years, accounting for 84 percent of total retail economic transactions in the same period (Figure A1.2). More recently, the COVID-19 outbreak has boosted the popularity of e-money, to the detriment of bank-issued cards.

Figure A1.1 Total Value of Retail Electronic Transactions (Annual)



Source: Bank Indonesia, CEIC, and AMRO calculations
Note: Data for 2020 are twelve-month sum up to September.

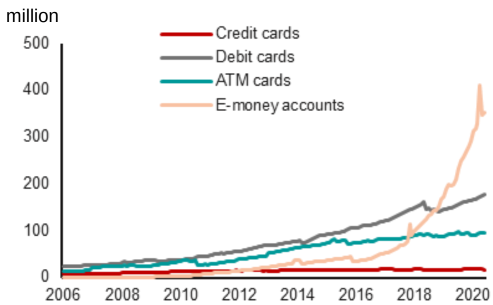
Figure A1.2 Total Number of Retail Electronic Transactions (Annual)



Source: Bank Indonesia, CEIC, and AMRO calculations

2. Among the key drivers of growth in e-money usage are low transaction costs, fast expansion of the digital economy, and a large population of unbanked individuals. On the supply side, the primary driver is lower transaction costs (compared to traditional electronic payment methods such as credit cards), which are passed on to users in the form of discounts and promotions. Meanwhile, the rapidly expanding digital economy (e-commerce), especially over the past five years, has naturally translated into rising demand for digital payment, for which e-money is one of the more convenient and cheaper methods. In addition, the rapid growth of e-money in Indonesia benefits from the country's relatively low rate of bank penetration, with some e-money issuers specifically targeting unbanked individuals; by 2019, the number of e-money accounts overtook all types of bank-based card accounts combined (Figure A1.3).

Figure A1.3 Total Value of Retail Electronic Transactions



Source: Bank Indonesia, CEIC, and AMRO calculations

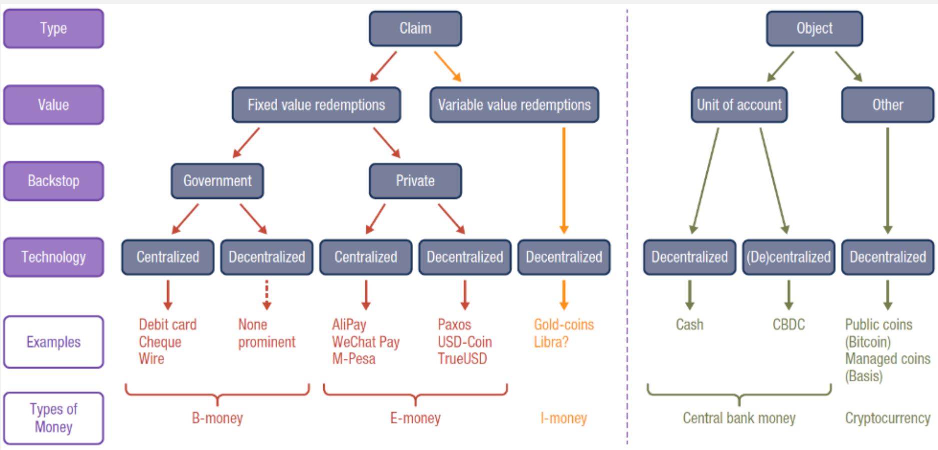
[41] This selected issue is prepared by Jade Vichyanond.

3. To some extent, the relatively small value of e-money transactions compared to bank-card transactions is due to regulatory limits on account balances and monthly usage. As of 2019, the average value of an e-money transaction is about 28,000 rupiah, while those of credit-card and ATM/debit-card transactions are around 1,008,000 rupiah and 492,000 rupiah, respectively. In part, such disparity between e-money and bank cards reflects the nature of spending that differs between the two methods, whereby higher-value transactions are more likely to take place in brick-and-mortar stores. But the disparity could also be a consequence of regulations on the maximum amount of e-money held in an account and on the maximum monthly usage (also see below). The maximum account balance is 2 million rupiah for an unregistered e-money account and 10 million rupiah for a registered e-money account, and the total transaction value of an e-money account cannot exceed 20 million rupiah per month.[42]

Box A1.1. E-Money, Concepts, Risks, and Implications on Monetary Policy

E-money is a fixed-value claim with a private backstop. To understand the implications of e-money on the economy, it is useful to understand the nature of e-money compared to other types of money, as illustrated by what is commonly referred to as a money tree (Figure A1.1.1).[43] In contrast to some types of money, such as cash or central bank digital currency (CBDC) that can be considered an object (physical or virtual), e-money is a claim.[44] In terms of value, similar to bank deposits, the value of e-money is fixed, as opposed to some types of money with variable value such as Bitcoin or Libra. However, e-money differs from bank-issued money, or "b-money," (such as bank deposits) in that it has a private backstop (largely in the form of the e-money issuer's prudent business practice and legal frameworks), whereas b-money has a government backstop, in the form of deposit insurance as well as the central bank's role as a lender of last resort. Lastly, e-money transactions may be centrally processed, as is the case for most types of e-money currently in use, or decentralized, as is the case for certain types of e-money such as Paxos or TrueUSD.

Figure A1.1.1: Money Tree



Source: Adrian and Mancini-Griffoli (2019)

Market risk, liquidity risk, and fraud risk are some of the key risks facing an e-money issuer. An e-money issuer's balance sheet primarily consists of funds it has received from customers and other assets on the asset side and e-money balances and capital on the liability side. As such, one

[42] The main difference between unregistered and registered e-money is that unregistered e-money is generally in the form of prepaid cards, whereby the issuer does not record owner identification data, while registered money is usually in the form of e-wallets, which contain owner identification data. Unregistered e-money transactions tend to take place offline, such as electronic toll cards used on toll roads, whereas registered e-money are transacted online (Rasyid and Natali 2019).
[43] See Bech and Garratt (2017) and Adrian and Griffoli (2019) for more details on the taxonomy of money.
[44] In the case of Indonesia, CBDC is still a tentative project. Bank Indonesia is considering developing its own CBDC, but usage will be relatively limited (i.e. only for non-retail transactions) in the foreseeable future.

of the main risks is what is usually referred to as market risk, i.e. volatility in the value of assets. Liquidity risk constitutes another key risk facing e-money issuers, which need to have adequate funds to meet redemption requests. In addition, e-money issuers have to manage fraud and other cyber risks sufficiently well to ensure security for customer funds and transactions.

A number of regulatory requirements are thus essential in containing risks associated with e-money. As suggested by Adrian and Mancini-Griffoli (2019), a prudent regulatory framework is one that makes e-money resemble a currency board. First, assets backing e-money should be invested in safe and liquid assets, such as cash, government securities, or central bank reserves. Second, the amount of e-money created should not exceed the funds e-money issuers receive from customers; in other words, e-money issuers should not be allowed to act like commercial banks as far as money creation is concerned.[45] Third, assets backing e-money should be unencumbered (i.e. not pledged as collateral for loans) and kept in an account that backs e-money balances, separate from other accounts belonging to e-money issuers (e.g. accounts for their other lines of business). Lastly, e-money issuers should have adequate capital to cushion market losses and ensure that they can fully meet redemption requests.

As far as e-money's implications on monetary policy are concerned, there is a potential that it may increase the velocity of money. Compared to conventional forms of money such as cash or bank deposits, the velocity of e-money may be higher to the extent that e-money transactions are easier to facilitate. As e-money is increasingly becoming a common method of payment, the average velocity of the monetary aggregate can be expected to rise accordingly. This could potentially result in a decline in monetary policy's effectiveness, as has been suggested by Craig, Lindley, and Bergh (1996) and Palley (2001).

Meanwhile, e-money's effect on money supply depends on the extent to which it replaces cash, as well as on regulations governing assets that back e-money balances. To the extent that in the long term, demand for e-money replaces demand for cash and bank deposits (the same way that bank deposits overtook cash in the past), there may not be a significant change in overall money demand, only a compositional change that leaves money supply unchanged. Another factor that may affect money supply is what e-money issuers are allowed to do with the funds (i.e. non-e-money) that they receive to exchange with e-money balances. For example, if the funds received by e-money issuers is legally mandated to be put in accounts at commercial banks only for the purpose of backing e-money balances, then such funds are no longer in circulation and thus cease to be part of the money supply (until e-money balances are redeemed).[46] If, however, e-money issuers are allowed to invest in, say, government securities and they do so, the funds that they receive will be transferred to other parties, who may use the funds for any economic transactions, thus keeping the funds as part of the money supply.

Furthermore, over the longer term, widespread adoption of e-money may lead to a decline in seigniorage revenue for the central bank. The magnitude of the decline depends on the extent to which e-money adoption results in a decrease in the central bank's interest-free liabilities (i.e. cash in circulation and any interest-free central bank reserves).[47]

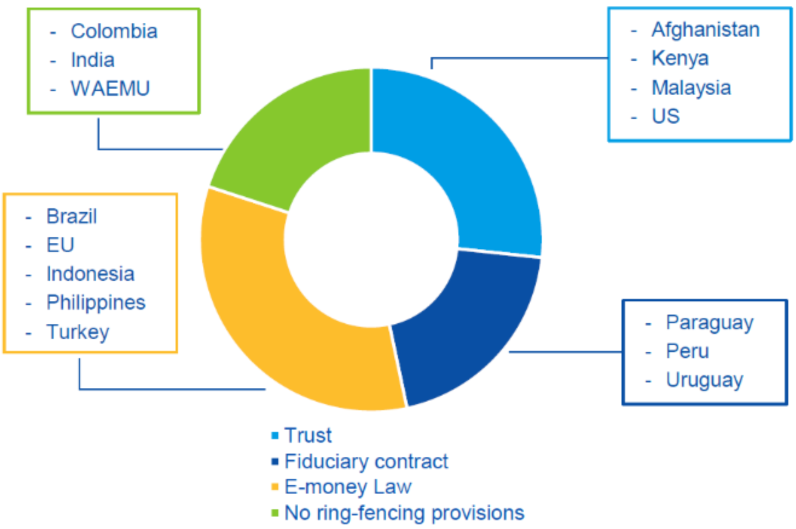
[45] See, for example, Werner (2014) for more details on how banks generate money in practice.
[46] See Popovska-Kamnar (2014), for example, for further discussion on e-money's impact on monetary aggregates and monetary policy.
[47] If the central bank itself starts issuing a digital currency, such as CBDC, it can potentially reverse part of the loss in seigniorage revenue if the digital currency is non-interest-bearing.

Regulatory Framework[48]

4. In Indonesia, e-money's market and liquidity risks are relatively low, as funds are required to be placed in full in relatively safe and liquid assets. The e-money regulation specifies that 30-100 percent of the funds be placed in cash if the e-money issuer is a BUKU4 (category 4, i.e. very large) bank or in a current account at a BUKU4 bank if the issuer is not a BUKU4 bank and the remainder of the funds be placed in an account at Bank Indonesia (BI) or in securities issued by BI or the Indonesian government. As the requirement implies full backing of e-money balances, it effectively prevents the type of money creation that banks perform. Thus, Indonesia is comparable to most countries as far as the scope of assets in which e-money issuers are entitled to invest. A study by Olivero and Pacheco (2016) shows that most countries require 100-percent backing of e-money balances in the form of safe and liquid investments, for the most part as deposits in commercial banks. A number of countries also require a certain degree of diversification, stipulating that a fraction of funds be invested in other safe and liquid assets such as government securities, as is the case in Peru and Brazil. The European Union, however, stands out in not requiring 100-percent backing in bank deposits or government securities, as long as the funds are covered by private insurance.

5. Consumer protection is also prioritized in Indonesia, with funds required to be unencumbered and kept in a separate account (i.e. ring-fenced). The funds need to be recorded and placed separately from other financial accounts belonging the e-money issuer and cannot be used for purposes other than fulfilling the e-money issuer's obligations towards e-money users and providers of goods and services. In addition, consumer protection is also undergirded by relatively prudent capital requirements (see below). As such, Indonesia is similar to the rest of the world regarding ring-fencing. Most countries with e-money regulations have some form of ring-fencing mechanism to separate the assets backing e-money from other accounts belonging to the e-money issuer (Figure A1.4). In common law countries, the concept of trust is a popular method of ring-fencing, used in, for example, the US and Malaysia. In civil law countries, however, methods vary but the e-money regulation usually requires ring-fencing of some form.

Figure A1.4: Ring-Fencing Mechanisms



Source: Olivero and Pacheco (2016)

[48] See BI's Peraturan No. 20/6/PBI/2018 for details on the regulation.

6. However, e-money capital requirements in Indonesia take a different form from those of many countries. In a number of countries, besides requirements on initial capital, there are no requirements on ongoing capital.[49] When there are such requirements, they generally take the form of a percentage, usually around 2-3 percent, of e-money balances. In Indonesia, in addition to requirements on initial capital, there are relatively high requirements on ongoing capital—even exceeding the average value of floating funds (i.e. funds backing e-money balances)—for small e-money issuers, while such requirements for large issuers are comparable to those of other countries.[50]

7. Growth of e-money is likely to have limited impact on money supply, while money velocity may increase with greater e-money adoption. Base money will be affected to the extent that e-money replaces cash, but since cash is a relatively small fraction of base money, the impact of e-money on base money is likely to be small. Meanwhile, the level of broad money is affected to the degree that floating funds are invested in non-money assets (government or central bank securities), but most of the movements in broad money are largely driven by banks' multiplier effect (i.e. credit extension).[51] Money velocity is expected to increase in tandem with increasing use of e-money due to the convenience of e-money transactions relative to other types of payment.

Opportunities and Challenges

8. Business models of e-money issuers are varied, but the use of customer data for commercial purposes could be the most important source of revenue in the medium to long term. At present, the regulatory frameworks governing e-money issuers' latitude in asset allocation in Indonesia, as with most countries in the world, is relatively strict, rendering earnings from their asset holdings relatively modest. Instead, transaction-based income is the major source of revenue, but it will likely decline going forward with greater competition in the field.[52] Furthermore, discounts offered by e-money issuers to attract new customers have considerably eroded their income. As such, the use of customer data for commercial purposes has come to be seen as the main revenue generator going forward. In particular, considerable potential lies in the use of customer data for e-money issuers' other activities, such as the selling of financial products (such as insurance and investment products) through the existing platform and peer-to-peer (P2P) lending.

9. One of the key challenges going forward is how to appropriately regulate a new technology-based payment instrument to mitigate risks without dampening its healthy development. Limits on e-money balances as well as monthly transaction value have been cited by e-money issuers as a potential challenge to growth, although they are in line with BI's intention for e-money to be a payment instrument for fast, micro, and daily payments such as transportations. These limits were also designed to mitigate risks related to money laundering and terrorism financing. Another regulatory challenge is the limit on foreign ownership in e-money business (currently at 49 percent). While the limit may encourage cooperation among foreign and domestic issuers and support knowledge and technology transfer, it may dampen foreign investors' interest and therefore deprive domestic e-money issuers of funding of a greater scale than is available at the moment, particularly as e-money issuers are competing—against each other as well as against traditional payment service providers—by "burning cash"

[49] The implicit assumption is that requirements on the backing of e-money balances are sufficiently prudent.
[50] The minimum initial capital of a non-bank issuer is 3 trillion rupiah. If the average annual floating fund is 3-5 trillion rupiah, then capital has to be at least IDR 6 trillion. If the average annual floating fund is 5-9 trillion rupiah, then capital has to be at least 10 trillion rupiah. If the average annual floating fund is above 9 trillion rupiah, then capital has to be at least 10 trillion rupiah plus 3 percent of the floating fund.
[51] The money supply will not increase, however, if those securities are purchased from banks using bank deposits.
[52] Merchant Discount Rate (MDR) revenue, which constitutes the main revenue source for many e-money issuers, is relatively low, with MDR currently set at 0.7 percent. MDR revenue is split among different parties for certain transactions (e.g. transactions involving merchants that are not in direct partnership with the e-money issuer).

(i.e. offering steep discounts and numerous promotion schemes). Furthermore, e-money issuers have to continue expending resources on technological improvements to limit fraud and other cyber risks. Lastly, raising financial literacy could be a challenge for e-money providers who expand their business models to other financial activities, such as P2P lending and financial investment, for the lowest-income segment of the population.

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2. Pandemic-Related Loan Restructuring and Impacts on Banks' Performance[53]

Similar to other countries, the COVID-19 pandemic has had a devastating impact on the economy of Indonesia, which in turn affects the banking sector's performance. The pandemic affected a wide range of economic activity due to the imposition of mobility restrictions to contain the infection inside the country. This disrupted the demand for goods and services and caused a sharp decline in firms' revenues and households' incomes, weakening their ability to service their bank loans. To mitigate the negative impact of the COVID-19 spread on the economy and maintain financial sector stability, the government, Bank Indonesia and the Financial Services Authority (Otoritas Jasa Keuangan/OJK) have implemented various policy measures, including a credit restructuring program. This selected issue is an attempt to estimate the impact of the credit restructuring program on the performance of Indonesian banks, in particular large-sized banks (BUKU4)[54].

1. The impact of the restrictions to contain the COVID-19 pandemic on the real sector was transmitted to the banking sector, as reflected in a significant slowdown in the credit growth. The pandemic did not spread to Indonesia until March, hence, the economy was relatively unaffected until the second quarter when it contracted sharply due to the imposition of the mobility restriction measures. As shown in Table A2.1 below, the economy decelerated in the first quarter, followed by a sharp contraction in a wide range of economic activity in the second quarter, except for the information technology and communication, and agriculture. Credit growth, which already slowed in 2019 due to a combination of factors such as rising trade tensions and weaker economic growth in major trading partner countries, has slowed further this year, especially for loans extended to trade, consumer goods and manufacturing sectors (Table A2.2).

Table A2.1 GDP Growth by Economic Sectors

Economic Sectors	2017	2018	2019	Q1 '20	Q2 '20	Share
	(% yoy)					(%)
Agriculture	3.9	3.9	3.6	0.0	2.2	12.4
Mining	0.7	2.2	1.2	0.4	-2.7	7.4
Manufacturing	4.3	4.3	3.8	2.1	-6.2	20.8
Construction	6.8	6.1	5.8	2.9	-5.4	10.1
Wholesale and Retail Trades	4.5	5.0	4.6	1.6	-7.6	13.2
Transportation and Storage	8.5	7.1	6.4	1.3	-30.8	4.2
Accommodation and Food Services	5.4	5.7	5.8	1.9	-22.0	3.0
Information and Communications	9.6	7.0	9.4	9.8	10.9	5.4
Financial Services	5.5	4.2	6.6	10.6	1.0	4.0
Others	6.2	7.2	6.8	4.8	-6.6	19.5
GDP	5.1	5.2	5.0	3.0	-5.3	100.0

Source: BPS; Bank Indonesia

Table A2.2 Credit Growth by Sectors

Economic Sectors	2017	2018	2019	Q1 '20	Q2 '20	Q3 '20	Share
	(% yoy)						(%)
Agriculture	12.0	11.7	4.6	8.5	4.5	4.6	6.8
Mining	-10.1	21.4	-2.6	8.9	7.7	14.9	2.4
Manufacturing	5.4	9.1	3.6	10.7	1.2	-0.1	16.6
Construction	20.6	22.1	14.6	9.1	4.4	1.0	6.4
Trade	5.2	9.4	3.7	3.7	-4.0	-4.7	19.9
Transportation and storage	6.3	19.0	13.6	18.3	10.0	11.3	4.4
Business Services	8.0	13.0	5.4	10.3	-0.7	-4.3	9.2
Social Services	24.0	13.2	14.0	11.3	9.0	4.6	2.9
Electricity	7.9	16.5	16.5	15.1	1.9	-2.6	3.5
Consumer and Other	10.3	10.3	5.8	5.5	2.4	0.8	27.8
Total	8.2	11.8	6.1	8.0	1.5	0.1	100.0

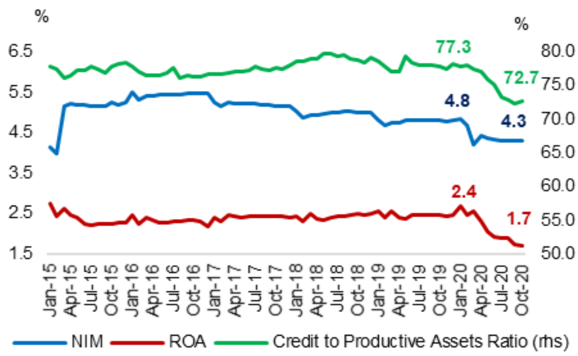
Source: Bank Indonesia

2. Strong capital buffers supported by regulatory forbearance have provided banks with a cushion against a weakening in asset quality. Credit growth slowdown, as reflected in a lower credit to productive assets ratio, have pushed down banks' profitability indicators, including the ratio of net interest margin (NIM) and returns to assets (ROA). In particular, banks' ROA declined from an average of 2.3 percent in the 2015-2019 period to 1.7 percent in October 2020 (Figure A2.1). Likewise, the net interest margin (NIM) ratio also decreased from 5.1 percent to 4.3 percent over the same period. The economic slowdown has affected the ability of corporate and households to service their debt, resulting in an increase in the gross NPLs from 2.5 percent of total gross loans as of end-2019 to 3.2 percent in October

[53] This selected issue is prepared by Muhammad Firdauz Muttaqin.
[54] BUKU stands for Bank Umum Kegiatan Usaha or Commercial Bank Business Activities which classify bank business activities based on the size of their core capital. Bank BUKU4 is the group of seven large banks with core capital of at least IDR30 trillion which can carry out all commercial bank business activities, both in rupiah and foreign currency as well as equity participation in financial institutions in Indonesia and/ or in all regions overseas.

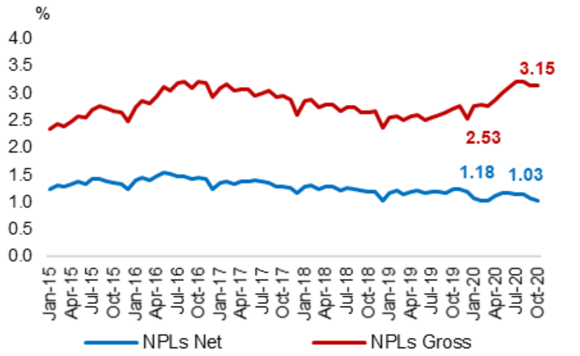
2020 (Figure A2.2). Meanwhile, loan-loss provision has increased, in part due to the implementation of International Financial Reporting Standards (IFRS) 9 from January 2020[55], sufficient to cover about 165 percent of NPLs, as of September.[56] Banks' capital adequacy ratio dipped earlier this year in tandem with an increase in loan-loss provision, but has rebounded to above 23 percent, providing buffers against further weakening of banking performance (Figure A2.3).

Figure A2.1. Bank's Credit and Profitability



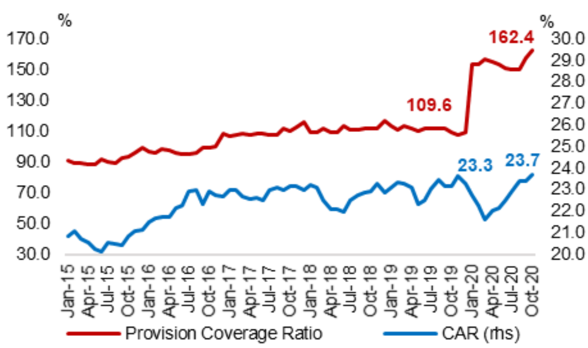
Source: OJK and Bank Indonesia

Figure A2.2. Bank's Non-Performing Loans Ratio



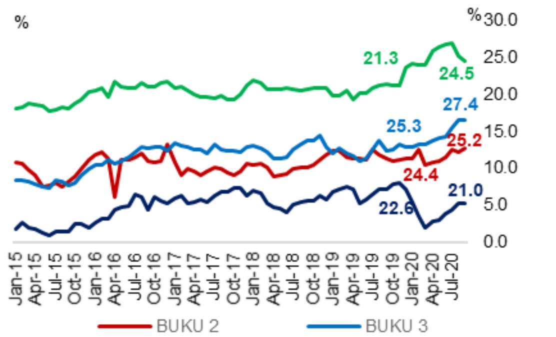
Source: OJK and Bank Indonesia

Figure A2.3. Bank's Provision Coverage and Capital Ratio



Source: OJK and Bank Indonesia
Note: The provision coverage ratio is the ratio of provision to non-performing loan.

Figure A2.4. Bank's Capital Adequacy Ratio



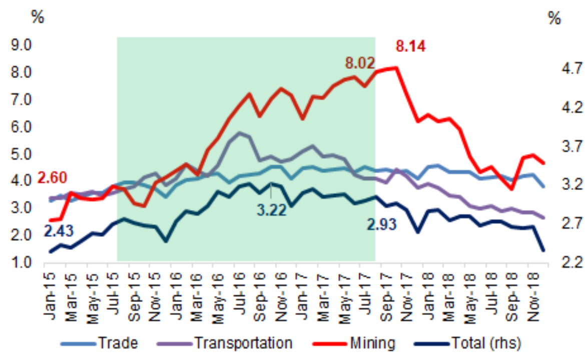
Source: OJK and Bank Indonesia

3. To support the households and businesses hit by the pandemic, a regulation, known as POJK11/2020, was issued and later amended by POJK48/2020, by the Financial Services Authority (OJK) to allow bank to restructure loans under relaxed loan classification criteria. In accordance with Regulation POJK11/2020, banks may assess the quality of loans worth up to IDR10 billion based on the timeliness of principal and/or interest payment by the debtor without a need to consider other aspects such as the debtor's business prospects and performance. Banks are also allowed to restructure loans and keep their classification as "current", hence no specific provision is required, although banks must identify those loans and monitor them continuously.[57] Restructuring can be given to all debtors affected by the COVID-19 pandemic, including micro, small and medium-sized enterprises (MSMEs), considering the needs of debtors and bank capacity. As of October 2020, loans worth of about IDR932.4 trillion, or about 16.8 percent of total loans outstanding, have been

[55] The application of IFRS 9, which is also in line with the national financial accounting standards (PSAK71), requires banks to use the expected credit loss approach in determining the provision for credit losses. This approach requires banks to recognize the expected credit loss in a forward looking manner, including consideration of macroeconomic outlook. Previously, banks used an incurred loss model which recognized credit losses or impairment when the default occurred. The adoption of IFRS9 led to an increase in the provision that banks must set aside since January 2020.
[56] Source: OJK.
[57] Loan restructuring could take the form of lowering the interest rate, extending the loan tenor, reducing interest or principal payments, adding new loan facilities, and/or converting the loan into a temporary equity participation arrangement.

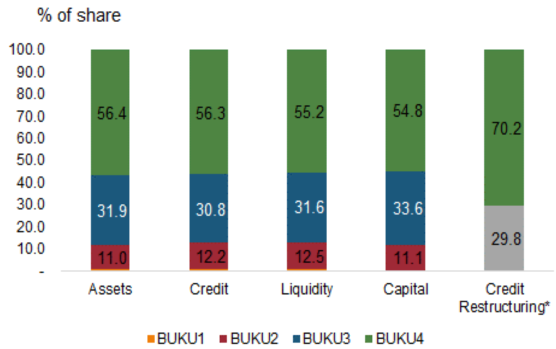
restructured.[58] Regulation POJK11/2020 was amended by POJK48/2020 which has extended loan restructuring by one year until March 31, 2022 to provide more time for banks and debtors to improve their performance. However, the amended regulation requires banks, while restructuring loans, to assess if borrowers are able to survive the pandemic impacts and to make provision for those borrowers who are deemed non-viable. Bank are also required to conduct periodic resilience tests against potential deterioration in credit quality of restructured loans and impacts on bank liquidity and capital.

Figure A2.5. Bank NPL for the 2015-2017 Credit Restructuring Program by Sector



Source: Bank Indonesia

Figure A2.6. Share of Bank BUKU4 in the Total Banking System in 2019



Source: OJK
Notes: * Realization of credit restructuring as of mid-October 2020

4. The implementation of regulation POJK 11/2020 will limit a further increase in bank NPLs, however, the lifting of this regulation could lead to a considerable increase in the NPL ratio and a decrease in capital buffer of banks. A similar credit restructuring program was conducted from July 2015 to June 2017 to alleviate the stress of commodity shocks on the banking system. The program successfully held back the increase in the NPL ratios, except for the mining sector[59], and allowed for a more gradual adjustment after the program ended (Figure A2.5). The success of the previous program may be due to the fact that only a small number of sectors, such as mining, transportation and some trade activities, were hit by the commodity shock, resulting in only about 5.0 percent of total loans being restructured. In addition, banks were encouraged to write off bad loans to maintain their credit quality even during the restructuring period. In contrast, the current COVID-19 pandemic has affected almost all sectors in the economy, and as mentioned above, 16.8 percent of total loans have already been restructured as of October 2020. The severe impact of the current pandemic shock can also be seen in the sharp rise in the NPL ratio to 3.2 percent in October 2020 from 2.8 percent in March 2020. Therefore, the loan restructuring program under POJK11/2020 and subsequently POJK48/2020 may have a more significant impact on the bank sector's soundness once it is lifted, and those restructured loans that are not recoverable, will turn into NPLs.

5. A smooth exit from the loan restructuring program is therefore crucial to avoid cliff effects. In this regard, OJK's recent announcement in POJK48/2020 to extend the loan restructuring program while requiring banks to assess if borrowers are able to survive the pandemic impacts and to make provision for those borrowers who are deemed non-viable, is

[58] In addition, the OJK also postponed the mark to market valuation for Government Securities and other securities issued by the Government, including securities issued by Bank Indonesia for six months. During the postponement period, banks may use the quoted price on March 31, 2020 for valuation of these securities. This policy helps banks to protect their securities assets from decreasing which will affect the bank's avoidance of losses.
[59] The decline in global commodity prices had a significant impact on the deterioration of the financial condition of a large number of mining companies.

a welcome move. The extension will allow banks, businesses and households, with more time to recover from the pandemic, while encouraging banks to recognize and write-off loans by non-viable borrowers as soon as possible. Baudino and Yun (2017) have found that delaying the write off will usually lead to a further deterioration of the bank's balance sheet, and higher resolution costs. Meanwhile, banks should continue to be monitored closely, so that those with potential liquidity and solvency problems can be identified and receive timely support. In addition, the implementation of IFRS9, which has increased banks' provision coverage ratio significantly since early 2020, is a welcome measure that strengthens the regulatory framework as a buffer against heightened uncertainties in banks' asset quality in the future.

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3. Indonesia: Debt Sustainability Analysis and Medium-term Fiscal Projections[60]

Facing the negative impact of the COVID-19 pandemic, the government have enacted large fiscal stimulus packages to support the economy in 2020-2021, which will inevitably raise the public debt to GDP ratio moving forward.[61] This selected issue focuses on the impact of fiscal stimulus packages on the medium term debt sustainability of Indonesia and addresses its policy implications.

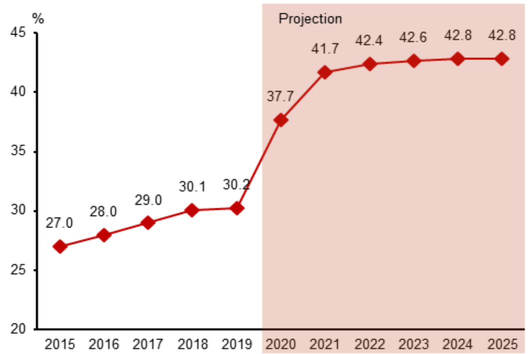
1. The large fiscal stimulus packages to withstand the impact of COVID-19 pandemic will raise Indonesia's public debt to GDP ratio significantly in 2020 and 2021. Substantial fiscal packages of about IDR695 trillion, equivalent to 4.4 percent of GDP, were introduced in the revised 2020 Budget to increase healthcare spending and provide reliefs to households and businesses. The government has budgeted another IDR357 trillion, or 2 percent of GDP, to support economic recovery in 2021. Based on AMRO's baseline projections, the primary fiscal deficit is expected to widen to 4.1 percent of GDP in 2020, and remain elevated at 3.3 percent in 2021 (Table A3.1). Against these backdrops, the debt to GDP ratio is projected to increase by 7.5 percentage points to 37.7 percent in 2020, and by 4.0 percentage points to 41.7 percent in 2021 (Figure A3.1). Significantly larger primary deficits against the backdrop of sizable fiscal packages underpin the rising debt level in 2020-2021, while a contraction in real GDP also contributes to debt creation in 2020 (Figure A3.2). These two years are in a sharp contrast with the pre-pandemic period when debt creation was contained by low primary deficits and robust GDP growth.

Table A3.1. Scenario Design for the DSA

Baseline Scenario		AMRO projection					
Year	2019	2020	2021	2022	2023	2024	2025
Real GDP growth (%)	5.0	-2.1	4.9	5.3	5.2	5.2	5.2
Inflation (GDP deflator)	1.6	2.0	2.5	3.0	3.0	3.0	3.0
Primary Balance (% GDP)	-0.4	-4.1	-3.3	-1.1	-0.7	-0.7	-0.7
Exchange rate depreciation (% yoy)	-3.5	3.1	2.0	2.0	2.0	2.0	2.0

Sources: Ministry of Finance of Indonesia, AMRO staff projections (for 2020-2025).

Figure A3.1. Public Debt to GDP Ratio (Baseline)



Source: CEIC, Ministry of Finance of Indonesia, AMRO staff projections (for 2020-2025).

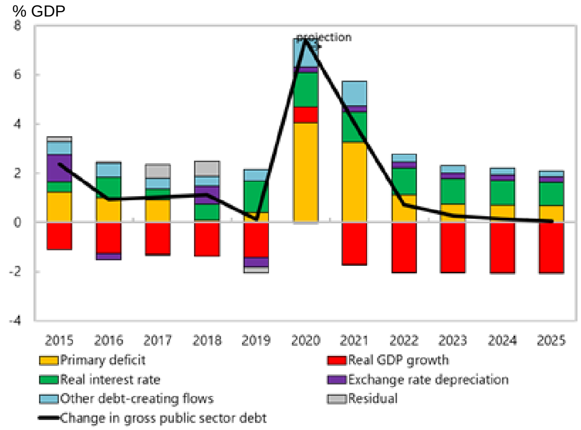
2. Over the medium term, the public debt to GDP ratio, albeit remaining elevated, will increase at a more gradual pace with the return to low primary deficits and robust economic growth. With the pandemic contained, real GDP growth, projected at -2.1 percent in 2020, is expected to return to pre-pandemic level at around 5.2-5.3 percent, over the medium term (Table A3.1). The negative impact of economic slowdown on revenue may ease after 2022 and fiscal revenue is expected to recover to around 12 percent of GDP. The economy should require less government support and the expenditure may decline to around 15 percent of GDP. This will reduce the primary deficit substantially to less than 1 percent of GDP. Robust GDP growth and lower primary deficits are expected to contain debt creation at

[60] This selected issue is prepared by Yang Chunyu.
[61] Public debt refers to central government debt only. According to the law, local governments are not allowed to incur debts.

below 0.5 percentage points from 2022 onward and stabilize the public debt to GDP at around 42-43 percent of GDP until 2025 (Figure A3.1).[62]

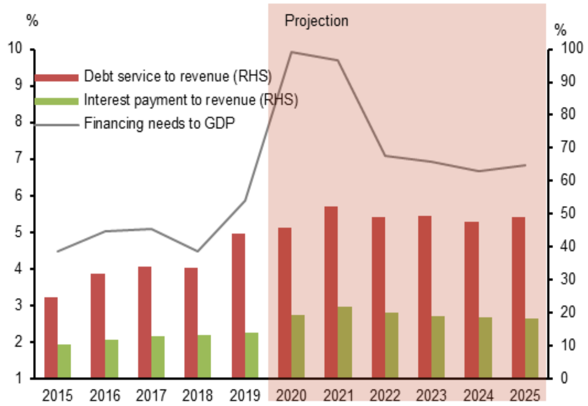
3. Elevated debt levels will increase the government's gross financing needs and debt service burden over the medium term. Indonesia's public gross financing needs increased significantly from 5.9 percent of GDP in 2019 to 9.9 percent in 2020, mainly due to the large stimulus fiscal packages (Figure A3.3). Although the gross financing needs moderates in the following years in tandem with lower fiscal deficits, it will remain at around 6.5 percent of GDP after 2022, compared to the pre-pandemic level of around 5 percent of GDP. The higher gross financing needs is attributed to larger debt service burden as well as relatively high fiscal deficits. A higher debt level leads to a commensurate increase in interest burden which is projected at about 19 percent of budget revenue in the next five years, up from an average of 12.5 percent pre-pandemic (Figure A3.3). This implies the government may need to squeeze non-interest expenditures, which may narrow the fiscal space going forward.

Figure A3.2. Debt Creating Flow (Baseline)



Sources: Ministry of Finance of Indonesia, AMRO staff projections (for 2020-2025).

Figure A3.3. Debt Service and Interest Payment (Baseline)



Source: Ministry of Finance of Indonesia, AMRO staff projections (for 2020-2025). Financing needs cover the fiscal deficit, investment financing, and debt principal repayment.

4. In light of increased debt burden and the constraint of the fiscal rule, the authorities should aim to raise more revenue in order to provide more room in the budget for development expenditure. In the baseline scenario, fiscal revenue is projected to recover to 12.0 percent of GDP while expenditure is contained at 14.8 percent of GDP in 2025. Over this period, fiscal deficit is expected to return to 3 percent of GDP in 2023 and stay below 3 percent of GDP in 2024 and 2025, which is in line with Perppu 1/2020 (Table A3.2). However, as noted above, the debt service burden would be much higher, reflecting the higher public debt to GDP ratio. This implies that the non-interest expenditure would be squeezed moving forward. As a result, capital expenditure may need to be cut which would jeopardize the implementation of the Medium-Term National Development Plan for 2020-2024, particularly the national strategic projects to narrow the infrastructure gap. To address this issue, the government should take measures to raise more tax revenue. Indonesia's modest tax revenue relative to regional peers suggests scope for improvement after the economic recovery is on a firm footing.[63]

[62] According to the authorities' medium-term fiscal framework projection as of December 2020, public debt to GDP ratio is expected to increase to 44 percent in 2021 and peak at 45.8 percent in 2022 before moderating gradually. This is against a backdrop of lower revenue collection post-pandemic than AMRO staff's projections. From the debt management perspective, the debt ratio is affected by factors that could be difficult to control, such as uncertain economic conditions, interest rates, exchange rates, and nominal GDP growth.

[63] Indonesia's tax revenue averaged 11.9 percent of GDP in 2013-2017. In comparison, the ratio was close to 15 percent for the Philippines and Malaysia, and above 17 percent for Plus-3 countries, Thailand, and Vietnam.

Table A3.2. Medium Term Fiscal Projections (Baseline)

		AMRO projection					
(In percent of GDP)	2019	2020	2021	2022	2023	2024	2025
Total revenue	12.4	10.3	10.4	11.5	11.9	11.9	12.0
Tax revenue	9.8	8.0	8.4	9.4	9.6	9.6	9.7
Income tax	4.8	3.7	3.6	4.2	4.4	4.4	4.4
VAT	3.4	2.8	3.2	3.6	3.6	3.6	3.6
Excise	1.1	1.1	1.1	1.2	1.2	1.3	1.3
Other tax revenues	0.5	0.4	0.4	0.4	0.4	0.4	0.4
Non tax revenue	2.6	2.1	2.0	2.1	2.3	2.3	2.3
Natural resources	1.0	0.6	0.7	0.7	0.7	0.7	0.7
Other non-tax revenue	1.6	1.5	1.3	1.4	1.6	1.6	1.6
Total expenditure	14.6	16.4	15.9	14.9	14.9	14.8	14.8
Central gov't expenditure	9.5	11.1	10.7	9.7	9.7	9.6	9.6
Personnel expense	2.4	2.4	2.3	2.3	2.3	2.3	2.3
Material purchase	2.1	2.5	2.1	2.1	2.1	2.1	2.1
Capital spending	1.1	1.0	1.2	1.2	1.2	1.2	1.2
Subsidy	1.3	1.0	1.1	1.1	1.1	1.1	1.1
Social assistance	0.7	1.3	0.9	0.6	0.6	0.6	0.6
Interest payment	1.7	2.0	2.3	2.3	2.2	2.2	2.2
Other spending	0.1	1.7	0.8	0.1	0.1	0.1	0.1
Regional transfers and village funds	5.1	5.5	5.2	5.2	5.2	5.2	5.2
Overall fiscal balance	-2.2	-6.1	-5.5	-3.4	-3.0	-2.9	-2.8
Primary fiscal balance	-0.5	-4.1	-3.3	-1.1	-0.7	-0.7	-0.7
Real GDP Growth (% yoy)	5.0	-2.1	4.9	5.3	5.2	5.2	5.2
Inflation (GDP deflator, % yoy)	1.6	2.0	2.5	3.0	3.0	3.0	3.0

Source: CEIC, Ministry of Finance of Indonesia, AMRO staff projections (for 2020-2025).

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