ICP MONTHLY ALERT

POLITICAL & POLICY ISSUES TO WATCH

The Bank Indonesia Law Revision Bill – The Central Bank's Independence at Stake?

The current state of the Indonesian parliament's (DPR) draft bill for the revision of the 1999 Bank Indonesia law has rattled the markets with the fear that it is putting the central bank's independence at risk. JCI fell 2% closing the week at 5,240 while the Rupiah/USD lost 1.6% closing at 14,792 after news of the proposed revisions hit headlines.

The government, through a statement release by Finance Minister Sri Mulyani on 4 September, has said it has not yet started to discuss the DPR's initiative bill and dismissed reports that it seeking to undermine the central bank's authority.

The minister said: "The President's explanation, in this case it is the government's position, is very clear that (our) monetary policy must be credible, effective and independent. Bank Indonesia and the Government are working together to maintain stability and confidence in the economy … the Government is of the view that the restructuring and strengthening of the financial system must advance the principles of good governance, clear division of duties and responsibilities between institutions as well as adequate mechanism of checks and balances."

What's Cooking?

What's quickly become controversial is news of the currently ongoing discussions within the DPR's Legislation Body (Baleg) on the draft BI bill and the ensuing polemics pitting views opposed to the current proposal against those who are in favor.

According to lawmaker Hendrawan Supratikno (PDIP), Baleg is currently drafting the bill on the DPR's initiative not in response to the government's. This, he said, follows the parliament's recent plenary decision to prioritize it for immediate deliberation with the government and passage this year. The bill is a necessary follow up to the earlier emergency Perppu (Government Regulation in Lieu of Law) signed by President Jokowi last March and subsequently approved and passed by the DPR later in May as the present Law no. 2/2020 on the State Finance Policy and Stability of the Financial System for the Handling of the Covid-19 Pandemic and/or Overcoming Threats Endangering the National Economy and/or Stability of the Financial System.

Under Law 2/2020, the government has taken a series of drastic and unprecedented measures as part of its ongoing efforts to grapple with the pandemic outbreak and its social and economic aftermath. One of the drastic measures includes the recent burden-sharing initiative signed with Bank Indonesia, said Hendrawan.

But there's current thinking among some policy makers in both the executive and legislative that the central bank's independence got in the way of speedy and decisive measures considered necessary in the emergency conditions of the Covid pandemic and going forward. These concerns are what have led to current the proposals to revise with the bank's monetary authority, said Hendrawan.

"BI's independence is really extraordinary in that even the government is obligated to coordinate with BI when it wishes to issue bonds. Even more so in monetary policy, where BI is obliged only to consider, [but necessarily] not support, the government's policy. This led to the thinking of improving the legislation on the bank's independence," the lawmaker added.

The result of these concerns is series of at least 14 proposed changes to the 1999 BI law, which if passed, will affect the bank's governance and the exercise of its main tasks and duties vis-à-vis the government.

Included in the current draft bill are provisions to expand Bank Indonesia's mandate to cover economic growth and employment, in addition to managing the value of the rupiah. The draft also recommends that cabinet ministers be given voting rights at BI's monthly monetary policy reviews. Moreover, and to the chagrin of critics and concern of the markets, it also lays ground for the formation of a Monetary Council to supervise BI. The finance minister and a minister in the economics sector would have seats on the supervisory council. A similar arrangement was in place before the Asian financial crisis in the late 1990s.

As quoted by Reuters, Moody's Investors Service Senior Analyst Anushka Shah commented: "The inclusion of additional and more varied panelists (on the monetary policy committee) is not unusual and could lend itself to rigorous and consensus-based policy decisions and add a layer of oversight." He warned, however, that if the government's representation in the policy-making committee became too dominant it would put risk at BI risk of political interference or delay an exit from pandemic-led debt monetization. But some economists also perceive BI has had too limited a role in supporting the economy during the pandemic.

Apparently in an effort to cover for BI's recent unprecedented move to agree to the financial burden sharing of Covid handling costs with the government, the current bill draft also permits the central bank to purchase government bonds in the primary market, zero-interest bonds under certain conditions and/or provide temporary financing for the government. As widely reported, the central bank has only recently resorted to some of these purchases, in response to the pandemic.

Currently, BI has a six-member board of governors, who are recommended by the president and approved by parliament. They can come from any background, but career BI officials tend to dominate and, in fact five of the current members are career central bankers and one has a long career as noted economist.

What's next?

In the heat of current criticisms and concerns over the policy initiatives from the DPR, it is worth to recall that the current state of the draft is still undergoing DPR's internal debates, especially within Baleg that is preparing the draft bill which will then be sent to the government for review and input before it is returned to parliament for formal deliberation.

The DPR now has until 9 October when its current session ends to complete the drafting process and the final bill may not include all of the provisions that are currently under discussion or recommended by the parliament's internal experts.

Once completed, the final bill will be handed over to the government. The government will then accept or reject the bill. The latter, however, seems unlikely given the bill's current status as one of the priority bills the DPR has determined to pass this year. Despite reports that some senior government and central bank officials are backing plan to expand BI's role to support economic growth, the pressure will then be in the government court to prove its commitment to ensuring the country's monetary policy to remain credible, effective and independent.

In fact it seems to be more the timing of the bill than its content that has rattled the market. As one senior advisor told CastleAsia, "On a practical level, central bank independence is important otherwise the case of BLBI (flush of liquidity to trouble banks) in the 1998 Asian Financial Crisis could easily happen again. Even with independent status, however, BI will still find it difficult to ignore the will of the government for deficit financing." He said, "it is more a question of timing" than content. Bank Indonesia is highly respected in the market and any efforts to revise its mandate during a crisis like the current covid situation is sure to unsettle the market.

MARKET OUTLOOK

No Growth This Year, 2021 Up 4-5% with Budget Flat

Finance Minister Sri Mulyani submitted the government's 2021 budget to parliament. It is virtually the same as last year at US$186 billion. She expects flat to -2.0% Q3 GDP and says the downside for the year is 0.0% to -1.1%. This compares with the World Bank's Best Case for 2020 of Indonesian GDP at 0.0% if world growth declines only 5.2%. If the world declines 7.8%, then Indonesia will contract 2.0%, but can recover to 4.0% in 2021 and 6% in 2022 off this low base, according to the bank.

The Minister told parliament the 2021 growth target of 4.5-5.5% set in the 2021 Draft State Budget (RAPBN) is "moderate enough" given the current low baseline, which is between (1.1) and 0.2% in 2020. The minister acknowledged, however, that the outlook is based on the "optimistic" assumption that the spread of Covid-19 can be contained next year and "lockdowns" as sporadically imposed this year will not recur. With these assumptions, she said there's a good chance for domestic consumption and investment to recover. She added a warning however that: "As long as consumption hasn't recovered, and as long as consumer confidence remains low and the purchasing power of the lower middle income group hasn't recovered, it will be hard to see any positive GDP growth."

According to the ministry, aggregate domestic demand in household consumption and investment, which respectively contributed about 57% and 32% to GDP growth in 2019, contracted 5.5% and 8.6% in Q2 this year. "If in the second quarter next year we see a return to [just] 0% in consumption, it would mean there's been a V-shape recovery," she said. Barring a recurrent wave of Covid infections, the next challenge following the expected V-shape recovery would be to sustain growth through continued fiscal support for and effective implementation of the National Economic Recovery (PEN) and social assistance programs, she said. As presented by President Jokowi to the DPR on 14 August, the 2021 budget sets a target of Rp1.78 quadrillion (US$120 billion) for state revenues while allocates Rp2.75 quadrillion ($186 billion) for state expenditures, leaving a deficit of Rp971 trillion ($66 billion), or 5.5% of GDP, down from the 6.3% set for this year. [See Budget at the end of this report].

Bank Indonesia Keeps 4.00% Policy Rate

Bank Indonesia (BI) has left its key policy rate (the 7-Day Reverse Repo Rate) unchanged at 4%, already an historic low, to prioritize market stability, although it also loosened some lending rules to boost domestic consumption. In a statement following its Board of Governors' meeting on 18-19 August, BI said the decision is consistent with the bank's continued efforts to maintain external stability in times when inflation remains low. The bank believes that quantitative measures are more effective in supporting economic recovery, including helping the government to speed up its realization of the 2020 budget. BI also kept its two other policy rates unchanged with the deposit facility staying at 3.25% and the lending facility rate at 4.75%. BI has trimmed its 7-DRR four times this year, totaling 100 basis points (bps), in response to Covid-19 and to support economic growth. These revisions follow cuts also totaling 100 bps in 2019. In its latest decision, the central bank has also removed loan down-payment requirements for the purchase of environmentally friendly vehicles from the current 5-10%. This change will be effective on 1 October for lenders with low non-performing ratio levels. "We believe that quantitative measures are more effective to support economic recovery [by] monetary easing through the banking system," BI Governor Perry Warjiyo said. He added the central bank would monitor developments in the economy, the financial markets and coronavirus cases in its future monetary policy reviews. The bank has so far injected Rp651.54 trillion (US$44 billion) of liquidity (quantitative easing) into the banking system this year. It has also agreed to a $40 billion fiscal deficit-financing scheme with the government that involves the central bank buying $28 billion of bonds while relinquishing interest payments.

Inflation Cools Further in August

Indonesia's annual inflation rate declined further in August, coming in at 1.32%, the lowest level since May 2000, marking a third month the rate fell below the central bank's target range of 2-4. Annual inflation came in at 0.18% and 1.5% in June and July. BPS reported softer prices for housing and utilities (0.64% vs 0.93% in July), food, drinks, tobacco (0.79% vs 1.73%), food services and restaurant (2.45% vs 2.57%), recreation, sport and culture (1.16% vs 1.26%) and education (1.61% vs 2.66%). In the meantime furnishings prices continued to rise (1.55% vs 1.52%) while prices for transport fell (-0.13% vs 0.71%) as well as for information, communication and financial services (-0.24% vs -0.31%). The annual core inflation was 2.03%, or slightly below July's 2.07%, BPS said. On a monthly basis, consumer prices deflated 0.05% in August, the second straight month of decline after a 0.1% fall in July.

Rupiah Steady, Forex Reserves at Record High

The Rupiah remained steady through August with exchange rate against the USD averaging at 14,725, down 0.5% from end-July or 5.3% weaker than end-last year, remaining one of the worst performing Asian currencies this year. Foreign exchange reserves increased, reaching a record high of US$135.1 billion and the end of July, up 2.6% over June's $131.7 billion. The amount is equivalent to 9.0 months of imports and 8.6 months of imports plus foreign debt service. Bank Indonesia says the increase in foreign exchange reserves was primarily due to the issuance of global bonds and foreign loans drawn by the government. "Bank Indonesia considers these forex reserves adequate for supporting the external sector as well as for maintaining the stability of the macro economy and the financial system," the bank said in a statement. On the equities front, the JCI closed at 5,239 at end-August, up 1.7% from end-July but down 20% from end-2019.

Trade Surplus Increases in July

Indonesia recorded a US$3.26 billion trade surplus in July, the third straight month of surplus and the largest since August 2011 as exports dropped less than imports amid the pandemic. Exports fell 9.9% over a year earlier to $13.73 billion, mainly due to lower sales of oil and gas products (-49.7%). Non-oil and gas exports dropped 5.9%. Imports fell 32.6% over a year earlier to $10.47 billion, as purchases of both oil and gas (-45.2%) and non-oil and gas (-31%) plunged. This brings the January-July trade balance to a surplus of $8.75 billion, shifting from a $2.15 billion deficit in the same period last year.

Manufacturing PMI Moves into Optimistic Territory, at 50.8 in August

Indonesia's August manufacturing sector conditions showed signs of improvement for the first time in six months, with headline PMI crossing over the neutral threshold of 50.0 to 50.8 from 46.9 in July, IHS Markit reported. "For the first time since February, Indonesian manufacturers reported an improvement in business conditions in August, with output growing at the fastest rate in over six years as businesses continue to adjust to a loosening of COVID-19 restrictions," said Bernard Aw, Markit's chief economist. The survey also found signs of revival in demand that helped to dampen the pace of job losses. It also reported improvement in business confidence from July. It says the latest data show the Indonesian economy is seeing a stronger rebound after the collapse in the second quarter. The survey, however, notes that there remain downside risks to the outlook as there continue to be backlogs of work and employment. Aw said, “The concern is that the recovery stems primarily from the release of pent-up demand brought about by the lockdown measures and could falter after the initial rebound. Demand therefore needs to continue to recover in the months ahead, but the fear is that rising unemployment and the ongoing need to maintain social distancing may undermine the recovery.”

Draft State Budget (RAPBN) 2021

(in trillion rupiah

Item	2020		2021
	APBN (State Budget)	Perpres 72/2020	
A. STATE REVENUES	2,233.2	1,699.9	1,776.4
I. DOMESTIC REVENUES	2,232.7	1,698.6	1,775.5
1. Tax Revenues	1,865.7	1,404.5	1,481.9
2. Non-tax Revenues	367.0	294.1	293.5
II. GRANTS	0.5	1.3	0.9
B. STATE EXPENDITURES	2,540.4	2,739.2	2,747.5
I. CENTRAL GOVERNMENT EXPENDITURES	1,683.5	1,975.2	1,951.3
1. Ministry/Agency	909.6	836.4	1,029.9
2. Non Ministry/Agency	773.9	1,138.9	921.4
II. TRANSFERS TO REGIONS AND VILLAGES	856.9	763.9	796.3
1. Regional Transfers	784.9	692.7	724.3
2. Village Funds	72.0	71.2	72.0
C. PRIMARY BALANCE	(12.0)	(700.4)	(597.9)
D. BUDGET SURPLUS/ (DEFICIT) (A-B)	(301.2)	(1,039.2)	(971.2)
% of GDP	(1.8)	(6.3)	(5.5)
E. BUDGET FINANCING	307.2	1,039.2	971.2

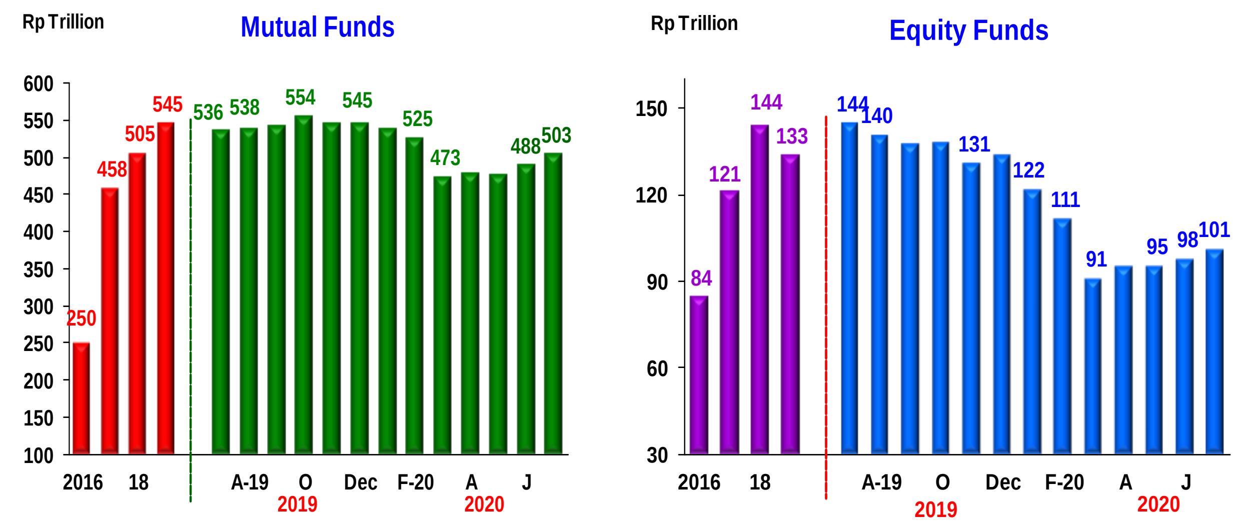
Source: Ministry of Finance

	2018	2019	Latest		2020*
GDP Growth (real)	5.17%	5.02%	-1.26%	1st H-20	***0.00%***
CPI yoy *1)*	3.13%	2.59%	*1.32%*	*Aug*	***2.00%***
Core CPY yoy	3.07%	3.02%	*2.03%*	*Aug*	**-**
X-rate to US$, year end	14,481	13,945	14,792	4-Sep	***14,850***
JSX, year end	6,195	6,300	5,281	4-Sep	**-**
BI 7-day RR rate	6.00%	5.00%	4.00%	19-Aug	***3.75%***

1) Starting January 2020, the base year was changed to 2018 and the CPI covers 90 cities

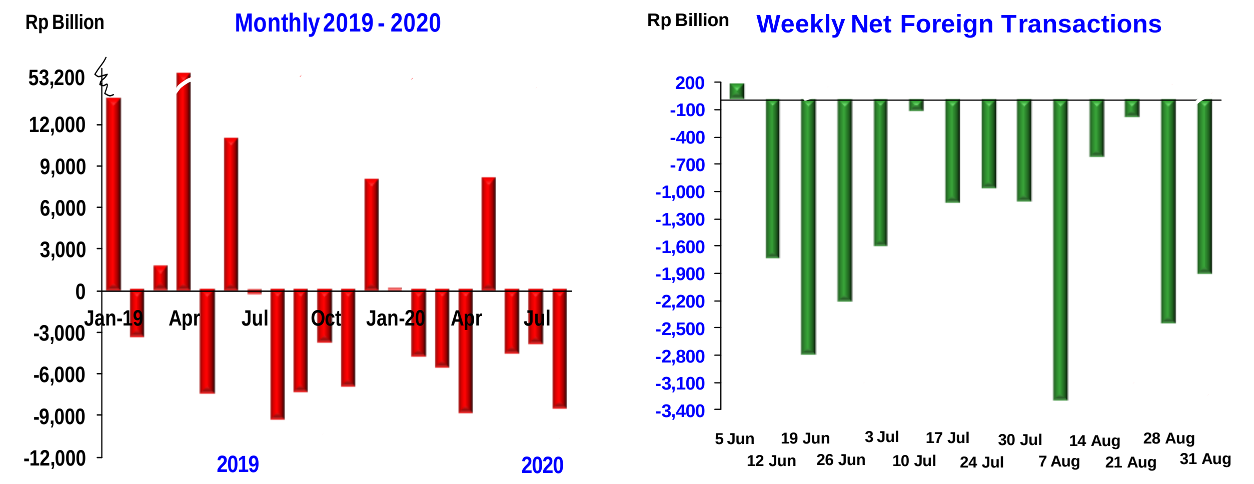
*Sources: CBS, BI, *CastleAsia forecast*

Net Asset Value of Indonesian Investment Funds



Source: Capital Markets Supervisory Agency (Bapepam)

Indonesian Stock Exchange: Net Foreign Investment Flow



Source: Capital Markets Supervisory Agency (Bapepam)