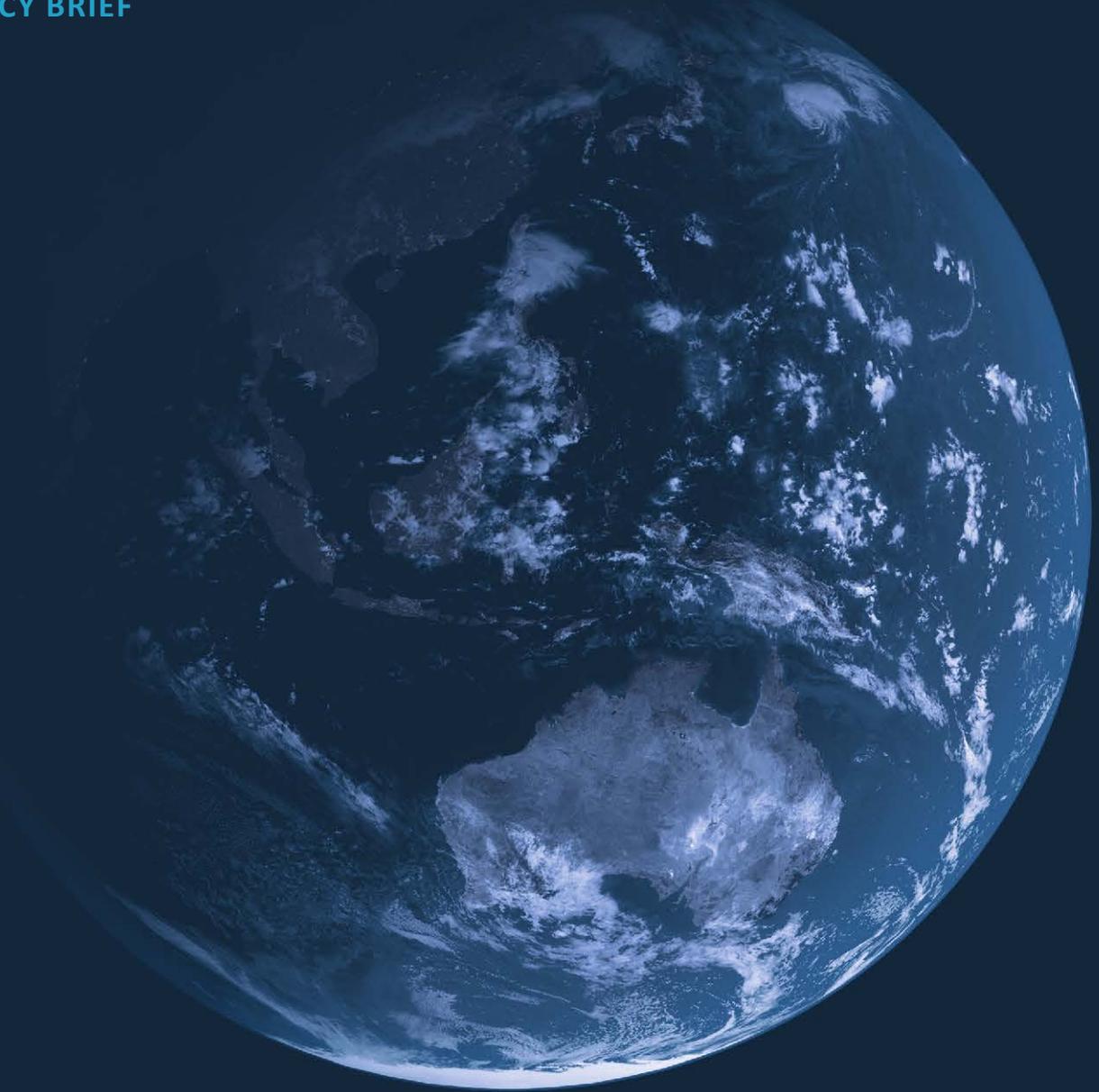


**LOWY
INSTITUTE**
POLICY BRIEF



Keeping Indonesia's economy afloat through the COVID-19 pandemic

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JULY 2020

KEEPING INDONESIA'S ECONOMY AFLOAT THROUGH THE COVID-19 PANDEMIC

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Lowy Institute Policy Briefs are designed to address a particular, current policy issue and to suggest solutions. They are deliberately prescriptive, specifically addressing two questions: What is the problem? What should be done?

The views expressed in this paper are entirely the authors' own and not those of the Lowy Institute.

KEY POINTS

- The principal economic problem facing Indonesia amid COVID-19 is financing the budget deficit needed to respond to a once-in-a-lifetime shock.
- In a world of self-help, Indonesia has been right to turn to Bank Indonesia, which could establish a clear policy of yield curve stabilisation as a basis for providing a readily scalable amount of deficit financing.
- Key bilateral partners, such as Australia, could complement this by providing a large standby loan facility to help reduce some of the inherent risks of Indonesia relying on its central bank.

EXECUTIVE SUMMARY

Indonesia faces one of the most difficult outlooks in Asia amid the economic pandemic unleashed by COVID-19. The principal economic problem is not the old one of capital flight, but about funding the fiscal response necessary to address a massive once-in-a-lifetime shock. With little on offer from the international system, Indonesia is rightly looking to find its own way, including by having taken the unorthodox step of allowing the central bank to directly finance part of the budget deficit. To enable this, the central bank could establish a clearly defined policy of yield curve stabilisation — buying government bonds in the primary and secondary markets to stabilise bond yields close to 'normal' market rates, while providing a readily scalable amount of budget financing. This would provide a clearer policy framework than both the current approach and alternatives presently under consideration in Indonesia. It would, however, still carry some risks. Indonesia could therefore also look to bilateral partners, notably Australia, to provide a large-scale standby loan facility as a complement to the budget backstop being provided by Bank Indonesia.

INTRODUCTION

Emerging economies almost everywhere need help. In Asia, Indonesia faces one of the most difficult outlooks. Its ability to contain the coronavirus remains uncertain and its economy has already been rocked by a major episode of capital outflows. The principal economic risk, however, is not the old one of a reversal in capital flows prompting a currency crisis, as in the Asian Financial Crisis of the late 1990s. The central problem is primarily a domestic issue — financing a budget deficit large enough to provide adequate health spending, as well as fiscal support to cushion what is likely to be the most severe global economic downturn since the Great Depression.

This policy brief argues that desperate times justify unusual methods.

The key is expanding the policy space available to Indonesian policymakers to keep the economy (and society) afloat through the pandemic. Ideally, substantial financial support from the international system would be readily available to countries such as Indonesia, who are otherwise in good economic health. But that is not the world we live in. Indonesia needs to find its own way. It has already begun to do so by temporarily suspending its budget deficit limit and taking the unorthodox step of allowing the central bank, Bank Indonesia, to directly finance part of the deficit.

This policy brief argues that desperate times justify unusual methods. If the alternative is an inability to run the necessary budget deficit, then central bank financing is well justified as a temporary emergency measure, to be unwound when the crisis is over. In a world of self-help, Indonesia is on the right path. But Indonesia may need to go much further, especially as its deficit financing shortfall could prove larger than expected, while its fiscal response to the virus has so far been relatively small, and significantly more might be needed.

NOT YESTERDAY'S CRISIS

Indonesia's economy was doing reasonably well before the pandemic, steadily expanding by around 5 per cent a year for some time and with good prospects to continue doing so. But its reliance on foreign capital inflows has long been a weak point. Indonesia was one of the worst-affected by the mass exodus of foreign capital from emerging markets as COVID-19 became a global pandemic in March of this year (Figure 1, top-left panel). More than US\$10 billion was withdrawn from Indonesian capital markets and the rupiah plunged at one point by almost 20 per cent. Markets stabilised in May, particularly as the US Federal Reserve rolled out massive emergency liquidity measures. Nonetheless, the threat of renewed capital outflows lingers, playing on fears nested in memories of the *Krisis Moneter* of the late 1990s.

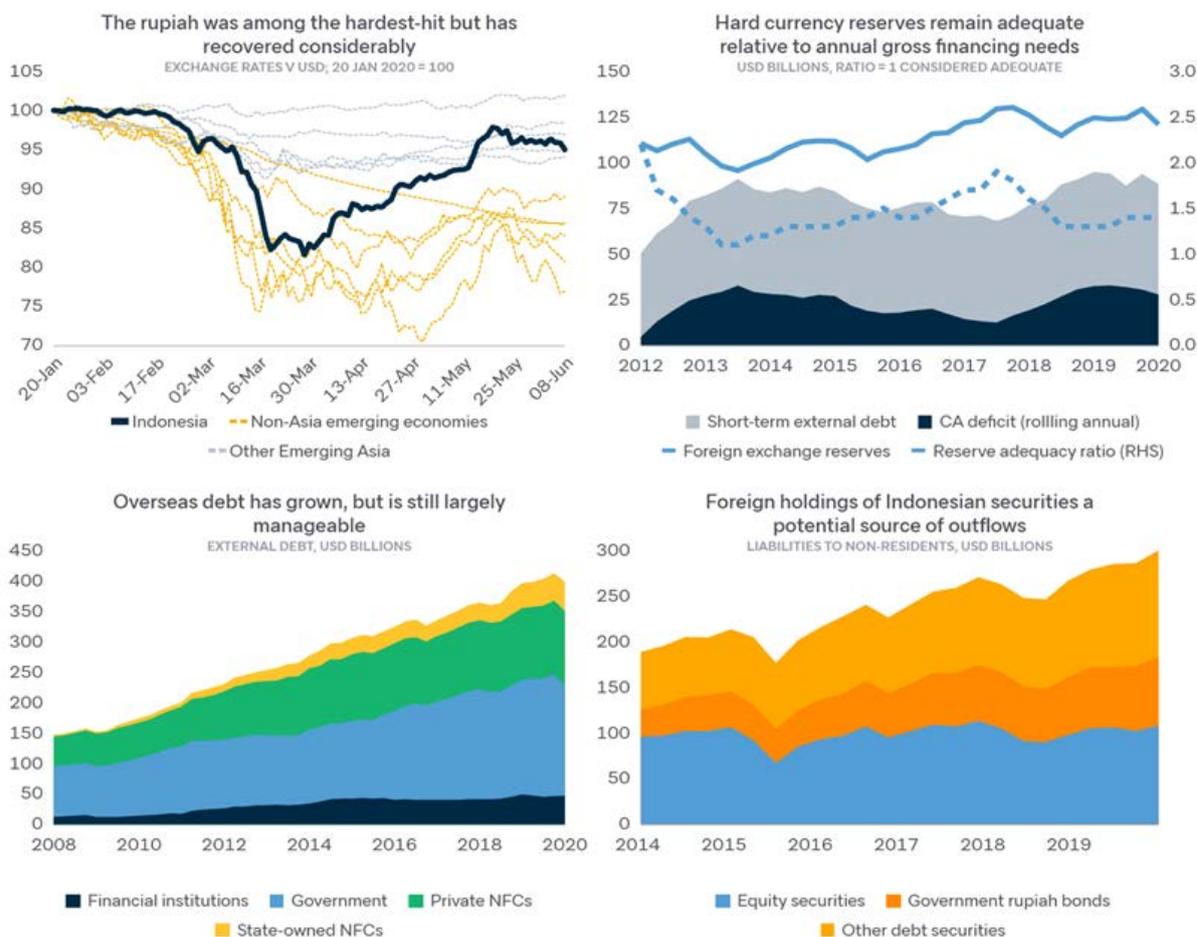
Indonesia's hard currency reserves are its first line of defence. These may not be as substantial as those of some other emerging economies.¹ But at US\$131 billion, they are still ample enough for most purposes (Figure 1, top-right panel). Bank Indonesia's foreign exchange reserves could provide more than enough hard currency to refinance all of Indonesia's external debt coming due over the next year — including that of the banking system. Bank Indonesia would also still have enough left over to finance the entire current account deficit for the year, even if this rose to be twice as large as last year's deficit.

Indonesia's hard currency reserves are its first line of defence.

Indonesia's stockpile of around US\$400 billion in gross overseas debt is a point of vulnerability. But a largely manageable one.² On the negative side, most is owed in foreign currencies, exposing Indonesia to negative balance sheet effects when the currency falls. But the banking system is largely domestically funded, while almost half of all external debt is owed by the government, which remains in a strong overall debt position (Figure 1, lower-left panel). Total government debt was only 30 per cent of GDP in 2019, one of the lowest ratios in Asia. Another sizeable portion of overseas debt is owed by state-owned firms, many of which are now under considerable financial stress. Some of this will need to be restructured. Nonetheless, just as their substantial overseas borrowing in recent years was enabled by their implicit government guarantee, so too does this serve as the ultimate backstop if need be.

Non-resident investors hold around US\$300 billion in Indonesian financial securities (Figure 1, lower-right panel). Theoretically, this provides plenty of raw material for significant capital outflows.

Figure 1: Indonesia's external sector vulnerabilities are being tested



1/ Other Emerging Asia: includes China, India, Philippines, Thailand, & Malaysia.
 2/ Non-Asia emerging economies includes: Argentina, Brazil, Mexico, Russia, South Africa, & Turkey.
 3/ NFCs = Non-financial corporations.

Source: Central Statistics Agency, Bank Indonesia, CEIC Data, author's calculations

However, Indonesia has now seen itself through many episodes of capital flow reversals — in 2008, 2013, and 2018. Indonesian policymakers have worked out what to do, and did it over recent months. In response to outflows in rupiah-denominated government bonds, Bank Indonesia allowed the rupiah to fall by 15–20 per cent and bond yields to rise around 100 basis points. But it also intervened heavily in both the foreign exchange and government bond markets to prevent these price shifts from developing dangerous momentum. Foreigners who exited after the commencement of the sell-off lost out (providing some market discipline), while those who retained their

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holdings were given an incentive to stay as the currency and bond prices stabilised.³

This strategy has its limits of course, given the scale of foreign holdings relative to Bank Indonesia's reserves. Yet, while the outsized role of foreign investors makes prices in Indonesia's financial markets highly sensitive to capital outflows, this also means that foreign investors would have to pay a very steep price if they chose to liquidate en masse. Barring the extreme scenario of a total loss of confidence in the Indonesian economy, there would be little reason for a foreign sell-off to go as far as this, since Indonesian assets would remain fundamentally attractive.

The key, therefore, is maintaining confidence in the underlying good health of the Indonesian economy and the credibility of policymakers' ability to do what is needed to keep it that way. In the current crisis, that means containing the virus itself, keeping the economy (and society) afloat through the pandemic, and providing enough stimulus to get the economy moving again out the other end. While markets can be irrational, the best way to reduce the external risks is for the authorities to manage the domestic economic situation as effectively as possible.

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FACING TODAY'S CRISIS

The COVID-19 pandemic is expected to deliver the biggest contraction in global economic activity since the Great Depression.⁴ Indonesia is not immune. The Indonesian government has said it expects the economy to grow between -0.4 per cent and 2.3 per cent in 2020.⁵ In a downside scenario, the World Bank has suggested output could contract by 3.5 per cent in 2020 and only see a partial recovery in 2021 — remaining around 8 per cent below what it otherwise would have been but for the virus.⁶

Even these projections could prove too optimistic, especially if there is insufficient support from fiscal policy. Growth declined to 3 per cent in the March quarter compared to the same period last year. On a seasonally-adjusted quarterly basis, growth collapsed to zero (Figure 2, top-left panel). Given activity in January and February was probably normal, activity in March must have seen a very sharp contraction. And all this was before social distancing restrictions were imposed on 10 April. For the second quarter, Indonesia's headline purchasing managers index for manufacturing (a key forward-looking indicator) suggests that output will have collapsed to a similar degree or worse than that in many other major emerging economies (Figure 2, top-right panel). A wide range of economic indicators confirms the bleak picture across the economy.⁷

Indonesia's outlook depends — as it does for all economies — on what happens with the virus itself. Official figures at the time of writing show Indonesia has over 50 000 COVID-19 cases, with more than 2700 deaths. However, those figures could represent a significant underestimate.⁸ The lack of credible numbers makes it difficult to assess whether Indonesia is heading in the right direction. In any case, the government is lifting restrictions out of concern for the economy and livelihoods. Yet, this might only offer limited economic relief as consumers and businesses remain cautious, while the very real risk of a surge in infections could mean a more drawn out recovery and even a return to public lockdowns.

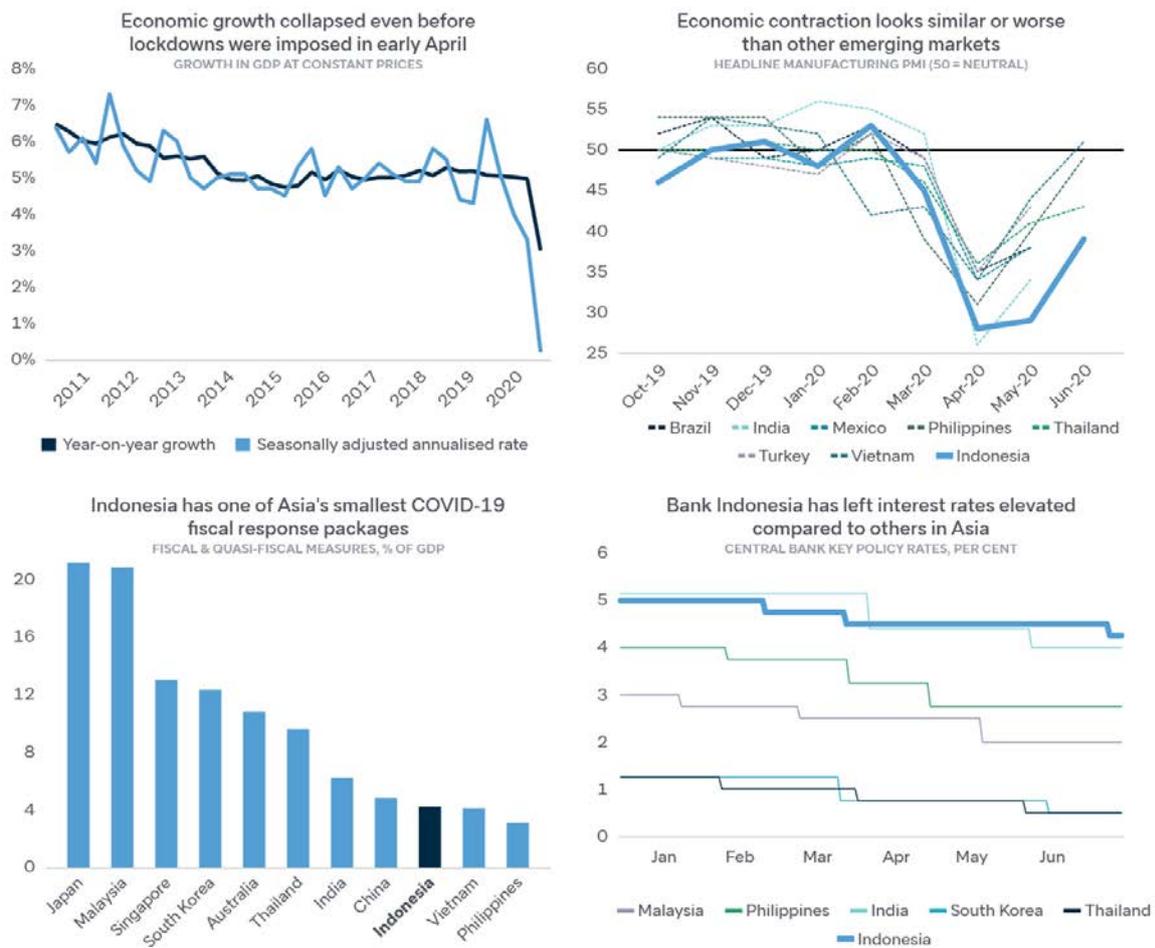
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On economic policy, the government has taken the necessary step of temporarily allowing the budget deficit to go beyond the legal limit, normally 3 per cent of GDP, until 2022. That allowed it to raise its 2020 deficit target to 6.3 per cent of GDP, including a range of COVID-19 response measures. These focus on expanded social protection, financial support to state-owned firms, credit assistance to small

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private businesses, cuts to corporate income tax, and more healthcare spending to combat the virus. However, the total package – amounting to 4.2 per cent of GDP – is one of the smallest in Asia (Figure 2, lower-left panel). It also pales in comparison with those in most advanced economies, where the total size of fiscal and credit support has generally been 10 per cent of GDP or more. Bank Indonesia has also cut interest rates 75 basis points to 4.25 per cent, but refrained from going further out of concern for the value of the rupiah – leaving interest rates elevated compared to others in the region and globally (Figure 2, lower-right panel). In any case, lower interest rates would do little to address the core problem, which needs to come from the fiscal side.

Figure 2: Collapsing growth and the constrained policy response



Source: National accounts, IHS Markit, CEIC Data, International Monetary Fund, author's calculations

At a time when Indonesia, and many others, need to be borrowing more, market appetite has either dried up or gone into reverse.

The key factor limiting Indonesia's fiscal response has been the lack of policy space to go further. Indonesia's economic officials worry, with cause, that they would be unable to raise adequate funds from capital markets to finance a much larger budget deficit. At a time when Indonesia, and many others, need to be borrowing more, market appetite has either dried up or gone into reverse. Even funding the targeted deficit for this year will be difficult, given the nervous bond market. Indonesia's finance ministry will need to raise around US\$100 billion this year alone.⁹ It has successfully floated some US\$4.3 billion in USD-denominated bonds overseas, but may have reached the limit of investor appetite.

Indonesia has thus taken the unorthodox step of authorising Bank Indonesia to help finance part of the deficit by buying government debt securities directly in the primary market as a last resort. Bank Indonesia has so far said it would fund up to Rp 125 trillion (US\$8.25 billion) of the deficit, though policy discussions have begun for expanding this further.¹⁰

Given the well-established orthodoxy against the direct monetisation of budget deficits, it would not be surprising if foreign investors reacted negatively. The persisting view is that this would produce a surge in inflation and capital flight. Money-funded budget deficits may have become the norm in most advanced economies since the 2008–09 crisis, with no sign of runaway inflation. But the presumption has been that this is something emerging economies like Indonesia cannot, or should not, replicate.

So far, investors do not seem too unnerved, possibly because they recognise it is a temporary necessity with the benefits outweighing the risks. A number of other emerging economy central banks have also launched bond purchase programs, though Indonesia appears to be towards the forefront of this trend.¹¹ It helps that the scale of bond purchases is still small, at 0.8 per cent of GDP in planned primary purchases, or 1.7 per cent of GDP if recent secondary market purchases are also added. That compares to expected central bank bond purchases in leading advanced economies of 15–23 per cent of GDP by the end of 2020.¹²

Sticking to a modest amount of deficit financing by Bank Indonesia, however, might not be desirable. For one, Indonesia's fiscal response looks too small compared to the scale of the virus shock. Without

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adequate fiscal support, the economic slump from the virus will be much deeper and longer lasting. Household and corporate balance sheets will be damaged, bankruptcies will proliferate, and the financial system will take losses. Weak demand will persist as cautious consumers and businesses cut back spending, banks reduce credit, tourists stay absent, and global demand remains depressed. Institutional weaknesses create some obstacles, but there is scope for useful additional fiscal stimulus — for instance, increased transfers under well-running social protection programs and expanding these to include middle-class households.¹³

Even if the government goes no further in virus-related fiscal response measures, there could still be considerable pressure on Bank Indonesia to go well beyond its current plans. If capital inflows do not return in a sizeable way, this will likely leave the government with a large financing shortfall. Indonesia's finance ministry must raise more than US\$9 billion each month on average for the rest of the year.¹⁴ Foreign investors dumped more than that in government rupiah bonds in March alone. A second risk is a larger-than-expected drop in government revenue (as economic activity collapses), which could see the budget deficit expand well beyond the targeted level. The deficit will very likely also need to remain sizeable into 2021 and beyond. The government may continue to look to Bank Indonesia to help fund this. Importantly, in all cases, the undesirable alternative to increased central bank financing would be to withdraw fiscal support from an already depressed economy.

INDONESIA IS (LARGELY) ON ITS OWN

Theoretically, the Fund stands ready to help. But the searing experience with the IMF during the 1997–98 crisis means that Indonesia would not turn to the Fund until it was too late, and the situation had reached disaster stage.

Ideally, the international system would remove the need for this recourse by providing ample financial support to countries such as Indonesia, otherwise in good economic health, and in response to a once-in-a-lifetime exogenous shock. The role of providing emergency liquidity falls to the IMF. Theoretically, the Fund stands ready to help. But the searing experience with the IMF during the 1997–98 crisis means that Indonesia would not turn to the Fund until it was too late, and the situation had reached disaster stage. New light-touch IMF instruments introduced specifically to raise its attractiveness to countries like Indonesia have done little to change that reality.

One useful option would be for the IMF to issue a large new round of Special Drawing Rights (SDR) — an international reserve asset created by the Fund that gives members a claim on a basket of global reserve currencies. Following past practice, these would be allocated to all countries, thus removing the stigma for countries such as Indonesia. Despite numerous calls from leading international figures, the G20 chose not to go down this route.¹⁵ Nor has the G20 heeded proposals to put a moratorium on all public debt repayments by emerging economies — choosing instead to limit its focus to the poorest developing countries. Indonesia has also missed out (again) on gaining access to the emergency dollar liquidity swap lines of the US Federal Reserve. Instead, it has access to a central bank repo facility that does little more than provide Bank Indonesia with marginal assistance to turn its own holdings of US treasuries into liquid dollars.

Other multilateral sources of financing are available. Indonesia has so far received about US\$3 billion in total additional financing from the Asian Development Bank (ADB), World Bank, and Asian Infrastructure Investment Bank (AIIB). More from these institutions might be available as part of their COVID-19 response financing efforts, as well as a reprioritisation of funds from less urgent projects. Indonesia could also look to Asia's own regional financial safety net — the Chiang Mai Initiative Multilateralization (CMIM). CMIM could provide Indonesia with almost US\$7 billion in emergency liquidity. More is available, but would require an IMF program as a precondition, therefore running into the same problems of political stigma that beset the IMF.¹⁶

In fact, the Fund's standard approach is not well adapted to Indonesia's situation. In response to capital outflows, the usual IMF approach would

be to raise interest rates, tighten fiscal policy, and let the exchange rate float freely. This is, more or less, diametrically opposite to the successful approach taken by Indonesian policymakers focused on stabilising excessive short-term market fluctuations. Where Indonesia has followed the standard prescription, it has been to shift towards borrowing in its own currency as much as possible, thereby reducing the so-called 'original sin' of borrowing in foreign currencies, which can move against you. But that formula has proven only a very partial solution. Indonesia's main capital flow vulnerability has come from its rupiah-denominated bonds.¹⁷

Rather than rely on standard policy prescriptions and financing solutions, Indonesia is right to focus on stabilising bond and currency markets, while allowing the budget to respond to a large exogenous shock. But the scale of the COVID-19 shock is huge. Indonesia should be prepared to go substantially further if needed.

FORGING INDONESIA'S OWN PATH THROUGH 'YIELD CURVE STABILISATION'

In having Bank Indonesia help fund the budget deficit, Indonesia is merely following the new global norm. This is given various names: quantitative easing (QE); yield curve control (YCC); helicopter money; and modern monetary theory. These are all variants on a common theme — the central bank creates new money, and this helps finance the budget deficit.

If Bank Indonesia makes clear that this is an emergency measure that will be unwound when the economy recovers, there is a case for acting.

Indonesia has room to forge its own path in a way befitting its circumstances and policy objectives. If Bank Indonesia makes clear that this is an emergency measure that will be unwound when the economy recovers, there is a case for acting. Of course, there is still some danger that this would undermine foreign investor confidence and scare off capital. But now that the flightiest investors have left, a well-defined program of bond purchases, accompanied by careful explanation, is feasible. The central goals would be to stabilise Indonesia's bond markets and ensure adequate financing is available to meet the government's fiscal needs during the current crisis and its immediate aftermath.

One way to do this could be for Bank Indonesia to define its own version of yield curve stabilisation. This could be similar to the yield curve *control* currently adopted by the Reserve Bank of Australia (RBA), but with some important modifications. The advantage of targeting the yield curve, rather than the amount of bond purchases (as in QE), is that it provides a clearer signal to the market, thereby likely reducing the volume of bonds that need to be bought by the central bank in the first place.¹⁸ It also means the amount of deficit financing can be readily scalable. Like the RBA, Bank Indonesia would undertake to buy government bonds in the secondary market to keep yields at the targeted rate. However, there is no reason Bank Indonesia could not extend this approach to purchase bonds directly in the primary market. Nothing would be lost, other than the illusion that the central bank is not actually financing the budget deficit. Similar to the RBA, Bank Indonesia could also target medium-term (say, three years) rather than longer-term bonds, as this will be easier to unwind.

The most significant difference in approach is in how Indonesia sets its yield targets. The principal goal of the RBA, and other advanced

economy central banks, is to provide stimulus by substantially lowering longer-term interest rates, as well as expectations of future short-term rates.¹⁹ This is neither relevant nor desirable for Indonesia. Lowering bond yields would encourage capital outflows by reducing the interest advantage for investors of Indonesian assets over advanced economy ones. If lowering rates is appropriate, Bank Indonesia can always cut its key policy rate, which is still at 4.25 per cent. Instead, Bank Indonesia could aim to cap bond yields close to their 'normal' rates, say about 100 basis points above their recent historical average. That would allow Bank Indonesia to argue that it is not overly manipulating the market or providing excessively cheap government financing. It is merely acting to ensure normal market functioning through abnormal times.

Some will naturally fret that any central bank financing of the deficit is a recipe for a surge in inflation and even more capital outflows. Milton Friedman convinced just about everyone that too much money would chase too few goods and ongoing inflation would result.²⁰ More than a decade of recent experience in advanced economies suggests otherwise. Despite huge 'money printing' by many central banks, inflation has remained below target. Instead, the extra 'cash' printed by central banks when they bought bonds was simply held as excess reserves by commercial banks — where it does nothing beyond weighing down these balance sheets with a low-earning asset — rather than being turned into new loans and deposits as in the textbook scenario.²¹

The results in Indonesia during a steep global downturn would likely be similar. The Indonesian banking system is already characterised by excess liquidity. Pumping in additional reserves is unlikely to lead to an explosion in new credit growth, especially if the policy rate, deposit facility rate, and bond yields remain unchanged and the economy is battling recession. And to the extent it does facilitate new credit, this would unlikely be enough to trigger significant inflation in a severely depressed economy. Any credit growth would likelier prove to be a feature rather than a bug. In any case, Bank Indonesia could always lift interest rates or impose macroprudential controls if there were signs of excessive credit growth.²² Nor is there any reason for the extra money to result in significant capital outflows as long as Bank Indonesia does not push bond yields artificially low, and thereby preserves an attractive interest advantage for investors.

Even if inflation and capital outflows are not an immediate threat, some might still worry that yield curve stabilisation today could turn into reckless money printing and currency debasement tomorrow. Any

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deficit financing by the central bank will need to be explicitly temporary, used only to enable useful counter-cyclical fiscal stimulus during periods of market dysfunction. There is no need to go back to the hyperinflation of the Weimar Republic in the 1920s to find an example of the dangers of sustained money-financed budget deficits. Indonesia's central bank helped to fund President Sukarno's excesses in the 1960s, with 1000 per cent hyperinflation the result. But perhaps because of this searing experience and that of the 1997–98 crisis, Indonesia has since been a model of fiscal rectitude and its policymakers quick to invoke a mantra of 'stability over growth' whenever needed.²³ As it stands, the budget deficit is set to revert to the legal maximum of 3 per cent of GDP from 2023.

Adopting yield curve stabilisation would give Bank Indonesia a clear and consistent policy framework for responsibly providing a scalable amount of budget deficit financing.

Adopting yield curve stabilisation would give Bank Indonesia a clear and consistent policy framework for responsibly providing a scalable amount of budget deficit financing. This would itself have benefits for market confidence and stability. Currently, it is unclear how Bank Indonesia would respond if the government's deficit financing shortfall greatly expanded, or how its purchases in the primary bond market — currently priced off prevailing market yields — relate to its efforts to stabilise bond prices in the secondary market during episodes of sizeable capital outflows.²⁴

The suggested approach would also have advantages over alternatives currently being discussed in Indonesia, such as the central bank purchasing zero-coupon bonds.²⁵ While the initial monetary implications would be similar, the bond approach would be more difficult to exit. At first, a zero-coupon bond would shift the interest costs to Bank Indonesia, which must still pay interest on the resultant excess bank reserves. But, over time, this would simply reduce the dividend the central bank pays to government by an equivalent amount. Little would be gained in terms of the intended 'burden sharing' between government and the central bank. What it would do is reduce the transparency of government borrowing — making the cost seem lower than it really is — possibly encouraging a political preference for relying too much on the central bank to finance the deficit. A zero-coupon bond may also be unmarketable, making it more difficult for Bank Indonesia to unwind when conditions allow. Yield curve stabilisation, as proposed here, would offer a much cleaner framework for providing flexible central bank financing as a temporary emergency measure.

MOBILISING COMPLEMENTARY BILATERAL SUPPORT

Although there is a clear economic case for temporary central bank financing, market perceptions, even when misguided, can still trigger renewed capital flight. In such an unprecedented and uncertain global situation as COVID-19, there are many possible scenarios for renewed market turmoil and a return to rampant capital outflows from emerging markets.²⁶ Outside support could therefore be very useful in helping Indonesia get through the economic pandemic. Multilateral sources of support are either limited or face deep political constraints. Instead, Indonesia could turn to some of its key bilateral partners, such as Australia, for additional assistance.

The Australian Government should be willing to provide large-scale financial support, if requested. Australia has a clear national interest in a strong and stable Indonesia, given its geographic proximity and Indonesia's centrality to regional security, stability, and prosperity. The question is how best to provide the necessary scale of support at a time when Australia is itself facing a steep economic downturn and massive domestic calls on its own budget that must necessarily take precedence.

At little cost to the Australian budget, well-structured Australian support could make a material contribution to Indonesia's economic recovery. At Indonesia's request, Australia could put in place a US\$10 billion (roughly A\$15 billion) standby loan arrangement that would be readily available if Indonesia were unable to raise enough from the market to finance its budget deficit. Existing Australian legislation would require this to involve an international financial institution such as the World Bank or ADB.²⁷ This should not be too difficult to arrange, since both multilateral development banks are already providing COVID-19 financing assistance to Indonesia.

The Australian loan terms could be anchored against Indonesia's own 'normal' sovereign borrowing costs, thereby complementing Bank Indonesia's yield curve stabilisation. Funds from the facility could be drawn down in tandem with any financing from Bank Indonesia, perhaps once a certain threshold was reached in central bank bond purchases within a specific period. If the loan funds were called upon, the cost to the Australian budget would be minimal, since the lending terms would effectively include pricing for the risk of default.

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As an additional form of support, Australia could also provide a currency swap facility to reinforce Bank Indonesia's hard currency reserves and ability to defend against excessive currency movements. However, this should be a second-order priority compared to focusing directly on supporting the budget deficit. As discussed earlier, Indonesia's foreign exchange reserves are broadly adequate. And the budget loan advocated here would in any case help bolster reserves, directly if drawn upon, and indirectly by encouraging market inflows.

Australia has participated in similar standby loan facilities for Indonesia in the past — in 2009 during the global financial crisis, and again in response to the 2013 'taper tantrum'.²⁸ On both occasions, Australia committed about A\$1 billion as part of an approximate US\$5 billion multilateral facility led by the World Bank. These loans were seen as helping boost market confidence in providing financing to Indonesia, which in turn meant that the Australian funds were never actually drawn upon. The key difference today is that a far larger sum is needed. But this can be facilitated by anchoring the loan terms to Indonesia's normal sovereign borrowing costs, instead of the approach of past arrangements where the loan terms were effectively on a semi-concessional basis and therefore carried a greater budgetary cost.

In today's crisis, Indonesia does not need a modest amount of cheap financing. What it needs is to be able to borrow, at scale and with certainty, at normal market rates.

In today's crisis, Indonesia does not need a modest amount of cheap financing. What it needs is to be able to borrow, at scale and with certainty, at normal market rates. A US\$10 billion standby loan facility from Australia would provide meaningful support, equivalent to 0.9 per cent of Indonesian GDP, and even more if it encouraged greater financing from the market or from other bilateral partners. This provides a strong argument for Australian support to be provided in a pre-emptive way, rather than only in reaction once problems have already escalated. This would ease some of the pressure on Bank Indonesia and help the Indonesian government run the budget deficit needed in response to a once-in-a-lifetime shock.

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- ¹⁶ Hal Hill and Jayant Menon, “Asia’s New Financial Safety Net: Is the Chiang Mai Initiative Designed Not to be Used?”, VOC CEPR Policy Portal, 25 July 2012, <https://voxeu.org/article/chiang-mai-initiative-designed-not-be-used>.
- ¹⁷ The Bank for International Settlements has recently written about how, at the global level, foreign capital flows into local currency bond markets in emerging economies have been highly procyclical, including during the current crisis: Boris Hofmann,

Ilhyock Shim and Hyun Song Shin, "Emerging Market Economy Exchange Rates and Local Currency bond markets Amid the Covid-10 Pandemic", *BIS Bulletin*, No 5, 7 April 2020, <https://www.bis.org/publ/bisbull05.htm>.

- ¹⁸ For instance, Japan's adoption of a target of around zero per cent for 10-year government bond yields appears to have allowed it to purchase fewer bonds, while keeping yields at the desired rate: Sage Belz and David Wessel, "What is Yield Curve Control?", Brookings Institute, 5 June 2020, <https://www.brookings.edu/blog/up-front/2020/06/05/what-is-yield-curve-control/>.
- ¹⁹ In the case of the RBA, its target of a three-year bond yield of just 0.25 per cent is intended to both lower a key benchmark used in setting mortgage interest rates, as well as reinforce the central bank's commitment to keep interest rates at near-zero for as long as it takes.
- ²⁰ Milton Friedman, "Quantity Theory of Money" in *The New Palgrave: A Dictionary of Economics*, ed John Eatwell, Murray Milgate and Peter Newman, Vol 4, (New York: Stockton Press; and London: Macmillan), 1987, pp.3–20, https://miltonfriedman.hoover.org/friedman_images/Collections/2016c21/Palgrave_1987_c.pdf.
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- ²² E.g. by raising bank reserve requirements.
- ²³ Roland Rajah, *Indonesia's Economy: Between Growth and Stability*, Lowy Institute Analysis (Sydney: Lowy Institute for International Policy, 15 August 2018), <https://www.lowyinstitute.org/publications/indonesia-economy-between-growth-and-stability>.
- ²⁴ Bank Indonesia currently will purchase government bonds in the primary market in one of three ways: (i) up to 25 per cent of the auction target, priced at the weighted average yield of the auction; (ii) a greenshoe option up to the market offer of the previous day, priced at the weighted average yield of the auction; or (iii) private placements based on the latest yields in the

secondary market: Bank Indonesia, "Latest Economic Developments and BI Measures Against COVID-19", 28 May 2020, <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>.

- 25 Adrian Wail Akhlas, "Government open to possibility of BI buying zero-coupon bonds to aid state budget", *The Jakarta Post*, 30 June 2020, <https://www.thejakartapost.com/news/2020/06/29/government-open-to-possibility-of-bi-buying-zero-coupon-bonds-to-aid-state-budget.html>
- 26 For example, problems in certain emerging market economies sparking a wider financial 'contagion', a renewed global surge in virus outbreaks, escalating US–China tensions, or the upcoming US presidential election.
- 27 International Monetary Agreements Act 1947, Australian Federal Register of Legislation: <https://www.legislation.gov.au/Details/C2017C00371>.
- 28 Taper tantrum refers to the sharp sell-off in global financial markets in 2013 triggered by comments from the then chairman of the US Federal Reserve that its policy of quantitative easing would eventually begin to taper off.

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