LPEM FEB UI
UNIVERSITAS INDONESIA

MACROECONOMIC ANALYSIS SERIES

Indonesia Economic Outlook

Q2-2020

Key Figures

- GDP Growth (Q4' 2019)
  4,97%
- Inflation (y.o.y. Mar '20)
  2,96%
- Credit Growth (y.o.y. Feb '20)
  5,93%
- BI Repo Rate (7-day, Mar '20)
  4,50%
- Current Account Deficit (CAD) (Q4 '20)
  -2,84%
- IDR/USD (Apr '19)
  IDR16.427

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Enduring the COVID-19 Pandemic Crisis

Highlights

- Nearly all economic sectors are affected by the Covid-19 pandemic; we predict GDP to grow slower at around 2.4-2.6% for overall 2020.
- Fiscal stimulus is critically needed to help individuals and businesses get through the Covid-19 crisis so that they could rebound in the post-crisis recovery.
- In the short-term focus, fiscal stimulus is aimed at tackling pandemic transmission by increasing the budget for healthcare and accelerating the social assistance program for protecting the lower-income group.
- In the long-term focus, fiscal stimulus is aimed at recovering economic activity by applying tax incentives and relaxing loans.
- With the fiscal deficit is expected to widen as much as 5.07% of GDP, the government needs additional funds from bonds issuance, such as the IDR450 trillion Pandemic bonds.
- The government have to maximize the issuance of Pandemic bonds in USD denomination which will help maintain Rupiah stability through higher forex reserves.

The case of Covid-19 pandemic in Indonesia has increased dramatically, reaching more than 2,400 recorded cases with an increasingly widespread distribution. The presence of this pandemic certainly poses a major risk, both to the society and the Indonesian economy. The economic slowdown in both real and financial sectors is inevitable. Amid the risk of significant disruption in domestic economic activity, the government requires strategic, massive and well-targeted fiscal policies to be executed swiftly. So far, the stimulus has been issued by the government aiming at two focuses. For the short-term focus, the government has increased the healthcare budget and accelerated the realization of the social assistance program. Compared to other affected countries, the amount of the health sector budget in Indonesia is relatively higher, around 0.5% of GDP. For the long-term focus, the government has prepared a strategy to recover economic activity through several initiatives, such as tax incentives and credit relaxation. So far, the total amount of fiscal stimulus packages has amounted to 2.5% of GDP.

Table 1: LPEM FEB UI Forecasts

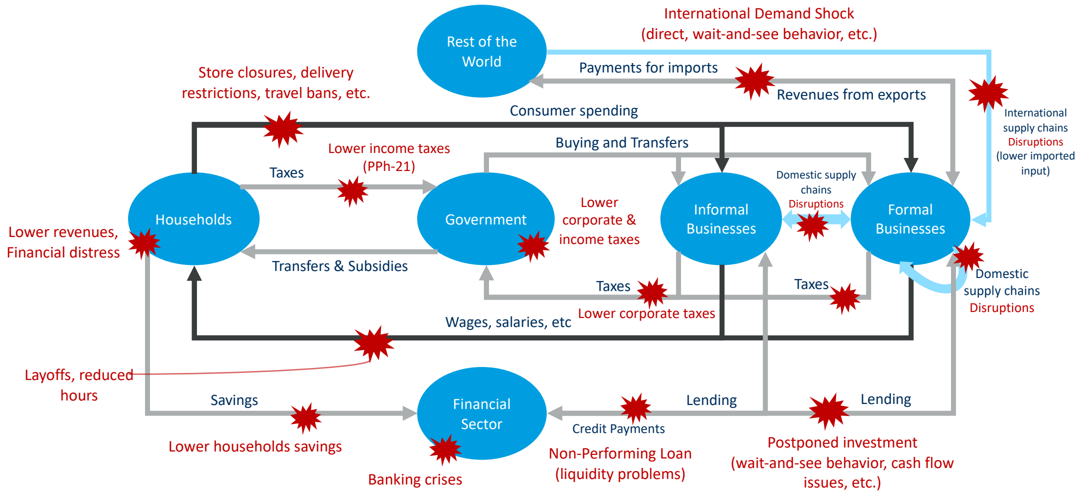
Indicators	2019	FY 2020
GDP Growth	5.0%	2.4-2.6%
Inflation	2.7%	3.0-3.3%
Credit Growth	6.1%	4.5-5.5%
BI Repo Rate (end of period)	5.0%	5.0%
CAD	2.7%	2.7-3.2%
IDR/USD	14,100	16,500-17,500

Source: LPEM FEB UI

GDP in 2020 is expected to contract significantly given that many sectors are affected by the Covid-19 pandemic, including several largest contributing industries, such as manufacturing and wholesale trade, and retail sectors. GDP is projected to grow slower at around 2.4-2.6% for overall 2020. The falling-off in economic activity might also lead to a decline in demand for loans; thus, slowing the credit growth. On the other hand, the slowdown in the global economic activity will dampen international trade; hence raising the risk of widening CAD. Looking at the trend of capital outflows which suppressed forex liquidity during the pandemic, Rupiah would still be under pressure until the Covid-19 pandemic tapered down. BI and related policymakers need to ease the risks of further weakened Rupiah by accumulating foreign reserves, one of which by issuing government bonds in USD denomination. Likewise, BI needs to maintain the portfolio yield gap by increasing its policy rates after the pandemic emergency is over.

HOW DOES PANDEMIC COVID-19 AFFECT THE ECONOMY?

Figure 1: Covid-19's multiple strikes in the circular flow of macroeconomic diagram



Source: LPEM FEB UI, adopted from Baldwin 2020, COVID-19 Crisis

"… shocks hit all the economic agents in the circular flow of macroeconomic diagram, including corporations which consist formal and informal business entities, small and medium-sized enterprises (SMEs), households, government, and the financial sectors."

How does pandemic Covid-19 affect the economy? Mainly, shocks hit all the economic agents in the circular flow of macroeconomic diagram, including corporations which consist formal and informal business entities, small and medium-sized enterprises (SMEs), households, government, and the financial sectors. Starting from the formal business sector, the current weakening of global demand and supply chain disruptions, caused by the termination of input goods production in several major global producers such as China, triggers a major production shock. This indirectly results in a negative domino effect that interferes with domestic business activities. Furthermore, the implementation of physical distancing policy also reduces households demand for goods and services. As a result, the companies' revenue also declines, potentially leading to layoffs and even to the risk of bankruptcy.

The physical distancing policy implemented by the government has severely impacted group of people who rely on the daily basis income, such as employees in the informal sectors and SMEs. In total, around 57% of the Indonesian labour force (74 million people) working in the informal sector – such as online ride-hailing and mobile food vendors – and more than 52 million units of SMEs across Indonesia which experience difficulties to meet their loan obligation due to the falling income.

The deterioration of economic activity also impacting government revenues due to lower individual and corporate taxes. Furthermore, formal business entities and SMEs might be under pressure to fulfil their loan obligations, leading to an increase of Non-Performing Loan (NPL) ratio in the financial sector. Amid high financial market volatility, banks and financial institutions might face serious liquidity problems.

In order to anticipate the economic slowdown due to the pandemic, the government has released two stimulus packages, the first stimulus (phase I) focuses on the tourism sectors and the second stimulus (phase II) focuses on sustaining industrial activities. However, realizing the first stimulus (phase I) is not entirely relevant anymore due to the shutdown of borders, the government has taken a necessary step through the implementation of the third stimulus (phase III) with a more substantial amount of money and beneficiaries. Table 2 lists four main focuses of the third stimulus (phase III) package.

"… the government has taken a necessary step through the implementation of the third stimulus (phase III) with a more substantial amount of money and beneficiaries"

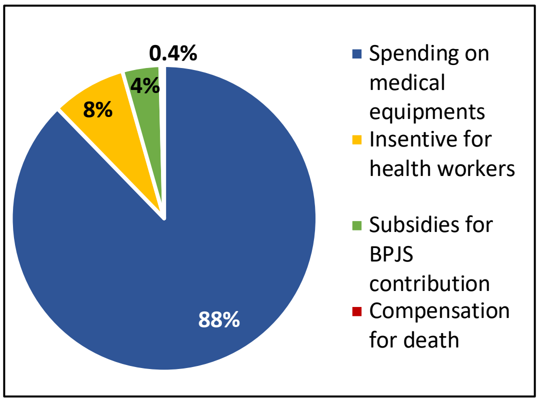
Table 2: Fiscal Stimulus Package Phase - III

	Fiscal Stimulus Phase - III	(IDR Trillion)
1	Covid-19 countermeasures in Healthcare	75
2	Social Safety Net	110
3	Industry support: Tax incentives and KUR stimulus	70,1
4	Funding for the National Economic Recovery Program	150
	Total	**405,1**

Source: Ministry of Finance, Indonesia

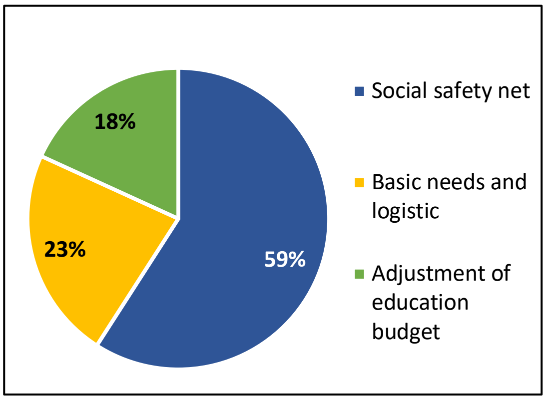
FISCAL STIMULUS IN SHORT-TERM FOCUS (HEALTHCARE & SOCIAL ASSISTANCE)

Figure 2: : Health Budget Allocation in Fiscal Stimulus Phase – III



Source: Ministry of Finance, Indonesia

Figure 3: Social Assistance Allocation in Fiscal Stimulus Phase – III



Source: Ministry of Finance, Indonesia

The Covid-19 outbreak is expected to last for another four to six months. National Disaster Management Authority (Badan Nasional Penanggulangan Bencana, BNPB) estimates that the pandemic will reach its peak in between June to July 2020 with the projection of 106.000 cases. Amid the global and domestic economic slowdown, fiscal stimulus is imperative to weather the short-term and long-term impact of the Covid-19 pandemic. One key point of the short-term focus for the fiscal stimulus that must be prioritized is the expansion of the health sector budget, which related to the efforts of reducing the level of transmission and controlling the outbreak. In the latest stimulus package, the government has issued additional stimulus for health budget amounting IDR75 trillion (0.5% of GDP) from the expenditure side of APBN. The allocation of supplemental budget focusing on four groups (Figure 2), starting from spending on medical equipment, subsidies for BPJS contribution, and death compensation for labors.

The additional budget for the health sector in Indonesia is relatively high, compared to other countries with the greater value of total stimulus, such as Singapore (10.9% of GDP) and Australia (9.7% of GDP). The additional budget is undoubtedly in-line with the fatality rate. Singapore government allocated SGD800 million (0.2% of GDP) for health budget with 1,375 cases and 0.4% fatality rate. Meanwhile, with higher occurrences of 5,797 and 0.7% fatality rate, Australian government allocated AUD5 billion (0.3% of GDP) for the health budget. Since the first case announced at the beginning of March 2020, Indonesia has recorded 2,491 cases with 8.3% fatality rate. With that number of cases, Indonesia is now becoming the country with the second-highest fatality rate in Asia, placed right after China as the country origin of the plague.

"The social safety net budget must be the next priority considering that some groups of people are highly vulnerable to the economic disruption caused by the pandemic."

Furthermore, the social safety net budget must be the next priority considering that some groups of people are highly vulnerable to the economic disruption caused by the pandemic. Currently, the government has allocated at least IDR110 trillion (0.7% of GDP) for the social assistance program. Similar to the health sector budget, social assistance budget in Indonesia is relatively high compared to other countries such as Singapore. The social assistance program is provided in the form of conditional cash transfers through the PKH program, electricity subsidies, and basic food cards. In addition, for the informal group, the benefit is provided in the form of skills training followed by another amount of post-training support. The additional stimulus in the form of social assistance could buffer the vulnerable groups, especially in maintaining their purchasing power for the basic needs.

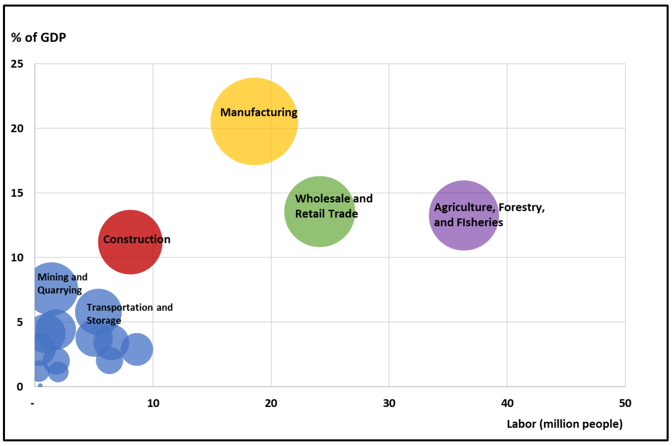
FISCAL STIMULUS IN LONG-TERM FOCUS (TAX INCENTIVES AND CREDIT RELAXATION & RECOVERY PROGRAM

Along with the escalation of the Covid-19 pandemic around the world, including Indonesia, an economic slowdown in both the real and financial sectors is inevitable. Sectors that contributing more than 30% to domestic economic activity - manufacturing and wholesale & retail trade sectors - are also affected. Manufacturing sector that relies on imported raw materials will be severely affected by the production limitations experienced by major raw materials exporter such as China. Besides, the number of labors working in this sector is among the highest. On the other hand, the decline in economic activity and outdoor social mobility certainly disrupts the income of the agent in wholesale & retail trade sector, in addition to its nature as labor-intensive sector.

"Manufacturing sector that relies on imported raw materials will be severely affected by the production limitations experienced by major raw materials exporter such as China."

Moreover, other highly affected sectors include the transportation and the accommodation, food & beverage sector. Domestic and international travel restrictions, as well as outside activities limitation, make these two sectors experienced the most severe impacts. This can be seen from the reduced number of foreign tourists entering Indonesia, especially in the regions that rely on the tourism sector as one of their primary sources of income. Massive travel cancellations also harm the sector, coupled with the shutdown of shopping centres and restaurants due to the government's policy on calls for restrictions on physical interaction.

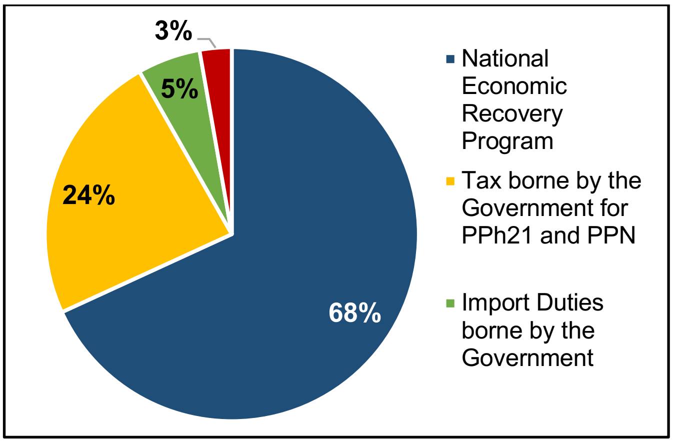
Figure 4: Proportion of Sectoral GDP and Labor



Source: LPEM FEB UI, CEIC

The government has issued two stimulus packages totalling almost IDR3.8 trillion for the tourism sector and IDR22.92 trillion for the manufacturing sector to facilitate export and import. As of March 31, 2020, the government issued additional expenditure and financing for the 2020 state budget which includes support for the industries affected of IDR70.1 trillion and funding to support the National Economic Recovery Program amounting to IDR150 trillion. National Economic Recovery Program includes stimulus for ultra-micro businesses and non-fiscal policies such as simplifying the restriction and limitation also accelerating export and import through the National Logistic System. In this stimulus package, one of the strategies is to reduce the Corporate Income Tax rate to 22% in 2020-2021 and 20% in 2022. The policy catalyzed by the decline in economic activity in the real sector is a significant step that also has the potential to influence the state's tax revenue in the long run.

Figure 5: Economic Recovery Allocation in Fiscal Stimulus Phase – III



Source: Ministry of Finance, Indonesia

Overall, the stimulus provided by the government for the industries has reached 0.6% of GDP. This figure is relatively high, compared to Japan which provides an incentive of 0.03% of GDP with a total number of cases of 3,654 and a mortality rate of 2.3%. However, it is still lower compared to Australia, which is willing to spend 3.0% of its GDP, considering the number of cases there have reached 5,797 with a mortality rate of 0.7%. Meanwhile, the United States, the country with the highest number of cases in the world with 337,971 cases with a 2.9% mortality rate, decided to allocate stimulus of 5.4% of GDP to the affected industries, in the form of tax and credit relaxation and assistance directly to the workers.

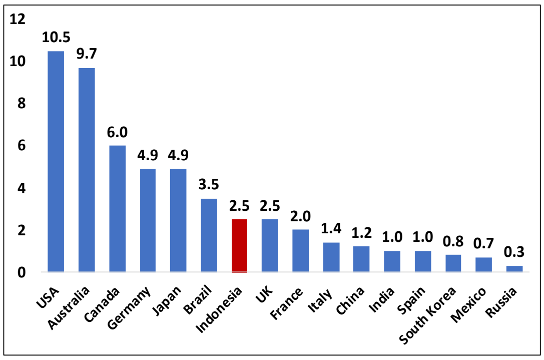
FISCAL INCENTIVES IN OTHER COUNTRIES AND SOURCE OF FISCAL STIMULUS

Most countries have taken immediate action to provide fiscal stimulus, with the amount and form of incentives tailored on each country's fiscal capacity. As in the United States with the most extensive economic stimulus program, the government has released US$ 2.1 trillion (10.5% of GDP) of funds allocated to the business sector in the form of conditional tax exemptions and various forms of social assistance. Australia has also announced its economic stimulus of A$189 billion or US$128 billion (9.7% of GDP) with salary and loan incentives for vulnerable sectors groups, such as SMEs and informal sector. As for other countries, such as Canada, has budgeted US$138 billion (6% of GDP) including US$85 billion to support business sustainability, and Germany with a stimulus of EUR156 billion (4.5% of GDP) including EUR50 billion grants to small business owners and self-employed persons severely affected by the Covid-19. This shows that fiscal support is critically needed as a short-term policy strategy to reduce the impact of Covid-19, along with the synergy of monetary and financial policy incentives.

Similar to other countries in the world, Indonesia has provided additional economic stimulus and budget financing to mitigating the impact of Covid-19 with a total budget of IDR405.1 trillion, equal to 2.5% of GDP. Nevertheless, with a sluggish economy, government revenue is expected to decrease by 10% as a result of various tax incentives and a reduction in income tax rates and non-tax revenues as a result of declining commodity prices. With the increase in government spending for stimulus and the projected decline in revenue, the government budget deficit is predicted to be widened at 5.07% of GDP.

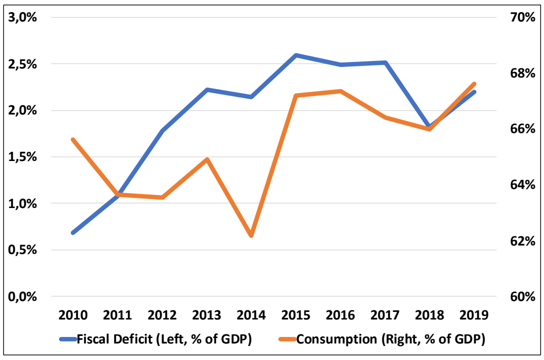
".. the fiscal stimulus provided by the government during the Covid-19 period is required to maintain demand from declining and to protect potential sectors which are engines of the economy from dying during the Covid-19 deployment period, in order to support economic growth towards v-shaped recovery after the crisis is over.."

Figure 6: Fiscal Stimulus of 16 Countries with the Largest GDP (% of GDP)



Source: IMF and LPEM FEB UI calculation

Figure 7: Ricardian Equivalence Conditions in Indonesia



Source: CEIC

Furthermore, how effective is the provision of fiscal stimulus in Indonesia? In Ricardian Equivalence theory, people are assumed to have forward-looking behaviour. When the government offers a stimulus by raising the deficit in order to drive the economy, however, this is not inherently effective since people would not substantially increase their consumption. People anticipate a future tax rise to finance the current state budget deficit. Nevertheless, the rule of Ricardian Equivalence does not apply to Indonesia. As shown in Figure 7, when the government provides economic stimulus, which is marked by an increase in the fiscal deficit, the consumption also rises. This implies that the fiscal stimulus provided by the government during the Covid-19 period is imperative to maintain demand from declining further and to ensure the potential sectors could survive the storm, as these sectors would play a crucial role in accelerating economic recovery once the crisis is over.

To finance the stimulus, the government plans to issue Pandemic bonds of IDR450 trillion. In addition, with the expected widening of fiscal deficit to 5.07% of GDP, the government also plans to increase the issuance of IDR160 trillion in government securities (SBN) to IDR550 trillion, in addition to loans and SAL utilization.

"To finance the stimulus, the government plans to issue Pandemic Bonds of IDR450 trillion. In addition, with the expected widening of fiscal deficit to 5.07% of GDP, the government also plans to increase the issuance of IDR160 trillion in government securities (SBN) to IDR550 trillion, in addition to loans and SAL utilization"

Table 3: Source of Fiscal Stimulus

Projection of Fiscal Deficits (IDR Trillion)	
GDP 2020F (APBN)	16.829
Fiscal Deficit (% of GDP)	5,07%
Total Estimated of Fiscal Deficit	**853**

	Allocation of Budget Financing (IDR Trillion)	
1	Debt Financing	1.006
	- Government Securities (SBN)	550
	- Loans	7
	- Pandemic Bond	450
2	Investment Financing	(229)
3	Lending	6
4	Guarantee Obligation	(1)
5	Other Financing (SAL)	71
	Total Budget Financing	**853**

Source: Ministry of Finance, Indonesia

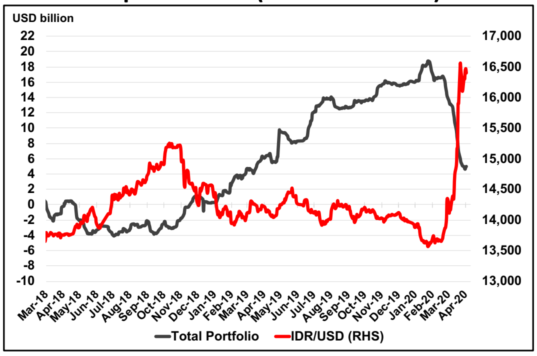
BANKING AND FINANCIAL SECTOR IN INDONESIA

Covid-19 pandemic, which originated from China and has been spreading across the globe, put a massive shock into real and financial sectors worldwide. In a global scale, the pandemic increases a substantial amount of global uncertainty which drives up volatility and plummet investors' confidence in global capital markets. Investors tend to take a "flight-to-safety" measure and shift their portfolio from risky assets into safe-have assets.

"IDR depreciation rate is comparatively among the highest, both during the last month and year-to-date performance, compared to its emerging peers."

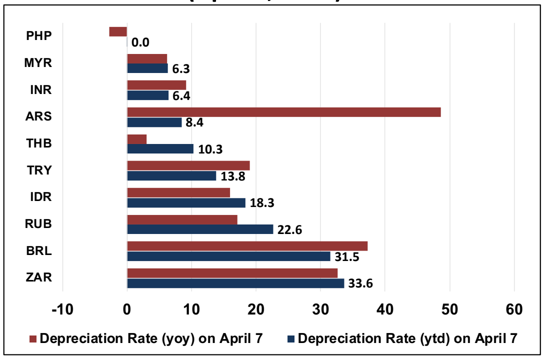
"flight-to-safety" behaviour by global investors is reflected by massive capital outflows from emerging markets, including Indonesia. As shown in Figure 8, since the beginning of Covid-19 outbreak, capital has flown out rapidly from Indonesia during the last couple of weeks. Since the end of February until now, accumulated capital flows have deteriorated drastically, amounting to USD11.7 billion (more than 70%) from USD16.7 billion to USD5.0 billion. An enormous amount of capital outflow from Indonesia has put high pressure on the exchange rate, reflected by 15.4%% of IDR depreciation to IDR16,427.

Figure 8: IDR/USD and Accumulated Portfolio Capital Inflow (Last 24 Months)



Source: CEIC

Figure 9 : Depreciation Rates of Selected EMs (April 7, 2020)

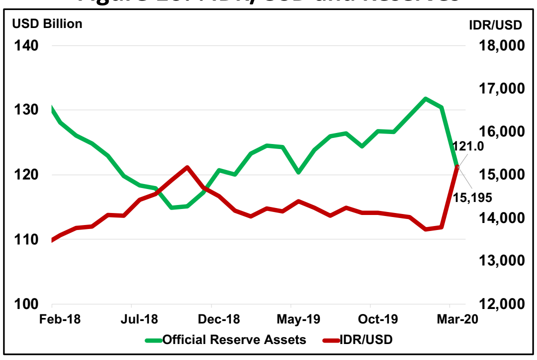


Source: Investing.com

On a broader scale, compared to several emerging market countries, Indonesia is relatively not performing rather well. From exchange rate aspect, IDR depreciation rate is comparatively among the highest, both during the last month and year-to-date performance, compared to its emerging peers. This indicates that Indonesia's currency is relatively less favoured by foreign investors. BI has also put an efffort to tame the depreciation rate by using its reseves. As shown in Figure 10, foreign exchange reserves decreased by USD9.1 billion to USD121 billion during last month. That being considered, in addition to the general characteristic of emerging markets which have a limited fiscal space even in normal circumstances, put an arduous task for GoI to handle the economic turmoil by Covid-19. Creating well-measured and strategic plans by GoI in order to buffer the damage to the domestic financial sector is of utmost importance.

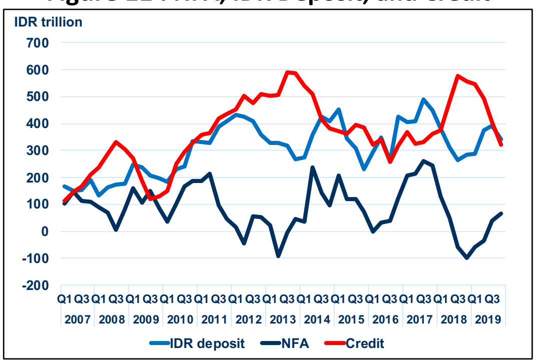
"Massive capital outflows during the Covid-19 crisis have an impact on slowing money supply growth in the economy due to the declined liquidity."

Figure 10: : IDR/USD and Reserves



Source: CEIC

Figure 11 : NFA, IDR Deposit, and Credit



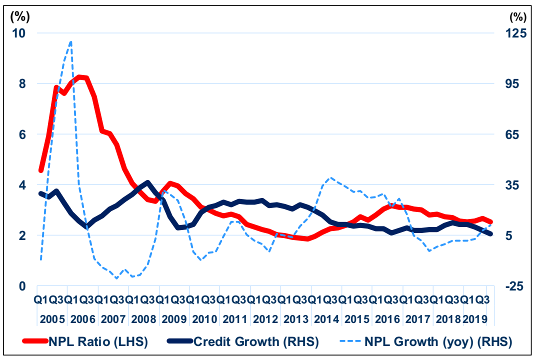
Source: CEIC

Massive capital outflows during the Covid-19 crisis have an impact on slowing money supply growth in the economy due to the declined liquidity. The weakening BI's forex reserves, illustrated by a decrease in Net Foreign Assets (NFA), has always been followed by the lowered Rupiah deposits and pledged loans in the next 2-3 quarters. It shows that the reduction of forex currency in the market might simultaneously reduce banks' liquidity both in foreign currency and Rupiah. On the other hand, the liquidity for the banking industry as demonstrated by Loan-to-Deposit ratio (LDR %), is already tight; remarkably in BUKU 3 group (104%). Considering banks' liquidity is a central factor in the money circulation cycle, particularly in terms of loan creation, the threat of liquidity shortages needs to be addressed immediately.

Aside from the risk of banking liquidity stemming from the declining forex reserves, shocks to economic activity during the Covid-19 crisis might be potentially followed by an upsurge in NPL.

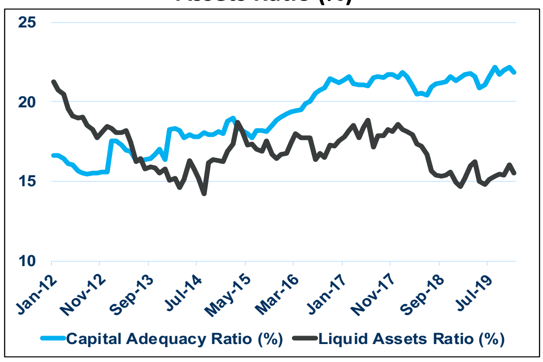
The increase in NPL is predicted to arise in the most affected sectors, such as manufacturing, wholesale and retail trade sector, construction sector, and the provision of accommodation & food and beverage. These potential bad loans will affect banks' cash flow, placing additional pressure on their liquidity. We estimate that the potential default on loan instalments and interests will reduce liquidity in banking by around IDR140-160 trillion throughout 2020. We also see that banks' deposits will be declined in line with the weakening personal income. Hence, the contraction economic activity from the pandemic could reduce loans creation due to the bank's limited liquidity.

Figure 12: Credit Growth and NPL



Source: CEIC

Figure 13: Capital Adequacy Ratio and Liquid Assets Ratio (%)



Source: CEIC

"Collecting loans like business as usual could not benefit anyone either in the short term or long term."

Lower banks' liquidity stemming from three main factors - drop of forex liquidity, upsurge in bad loans, and shrink in personal deposits - will have an impact on slowing loans distribution in the future. Last year, credit growth at 7% (y.o.y) showed a fairly low value compared to the historical trend. This value has continued to degrade since 2018 with the relatively high growth at 10% (y.o.y). The decline in credit growth for the last two years is in line with the downward trend in economic growth. The estimated contraction in bank loans this year, thus, indicates that economic growth will slow in the coming periods.

Moreover, lending to business activities, especially SMEs, which currently accounts for 19% of total loans, might be disrupted due to the lower bank capacity. In the short term, it must be addressed immediately given by the high need of working capital credit from local SMEs in the wholesale and retail trade sector for welcoming the Ramadhan and Eid period in April-May 2020. If this condition is left unhindered, there will be a risk of food supply shortage which can cause spikes in inflation due to supply shock.

In the case of economic slowdown, banks' buffer to alleviate the income loss from the potential bad loans is critically needed. The adequate cushion in the form of owned capital by banks is able to protect the solvency of banks from the unexpected shocks in the long run. Based on the Capital Adequacy Ratio (CAR), the banking industry in Indonesia still has sufficient capital compared to the other emerging countries. The benign performance should boost banks' confidence in releasing liquidity loss from the loan restructuring regulations.

AGENDA IN TACKLING SHOCKS FOR MONETARY AND FINANCIAL SECTOR

Loan Restructuring in Financial Institution

To deal with the risk of bad loans in financial institutions, OJK has issued regulations relating to the relaxation of loan restructuring. Through POJK No.11/2020, the quality of loan or financing from financial institutions, both banks and non-banks, are able to be upgraded after restructured. The regulation ensures that financial institutions will not be constrained by NPL surges during the Covid-19 crisis. However, even if the NPL does not increase, the bad loans will still reduce banking liquidity. Thus, it is expected that banks and financial institutions (e.g. multi-finance) become very selective in determining which loans can be restructured. This condition has caused several affected groups, particularly SMEs and informal workers, still experiencing difficulties in reaching the credit restructuring agenda.

Several factors might play a role. First, the lack of awareness of financial institutions to see restructuring as an effort to maintain the sustainability of loans. In the short term, liquidity risk is undeniably the issue that must be faced by financial institutions, but keep in mind that all the debtors are currently experiencing problems of liquidity. Credit relaxation initiatives for debtors are needed to be understood in the long-term context. Collecting loans like business as usual could not benefit anyone either in the short term or long term. Conversely, if this continues, the risk of declining institution's credibility up to the potential losing debtors will almost certainly occur in the future without resolving current banks' liquidity problems.

"The lower banks' liquidity stemming from three main factors, explicitly the drop of forex liquidity, upsurge in bad loans, and shrink in personal deposits, will have an impact on slowing loans distribution in the future."

Looking deeper, both banks and financial institutions industry still have sufficient capacity to cover liquidity problem in the short term. A higher risk might be seen in the companies with limited buffer. The government through the OJK needs to immediately identify the worst possible escalation of liquidity problems in financial institution. For banks, BI might support the banks by lending money as the role of lender of the last resort. For financial institutions that are experiencing a crisis, OJK should prioritize them to get the bank loans' relaxation, given that around 45% of multi-finance's funds come from domestic banks.

Another problem arises from the unavailability of reliable data related to SME and informal workers so that the financial sector will face difficulties in determining loans that meet classification of loans restructuring regulation. To target SMEs appropriately in a limited time, the government might incorporate SMEs data from e-commerce. Third, the government socialization effort to develop public understanding related to the loan restructuring is very limited. Appropriate and broad financial educations related to this are crucial. The information can be provided through public service announcements or developed technology systems to assist the debtors in proposing the loan restructuring. The integrated assessment system should greatly help OJK. Thus, the effectiveness of the policies can be evaluated by clearer and more measurable tools. In addition to take these strategic steps, OJK must also acts swiftly to optimally minimize the risks in financial sector.

The Issuance of "*Pandemic Bonds*"

Stimulus package to contain the damage of Covid-19 launched by GoI is on an extensive scale and needs an immense amount of financing. A most likely financing scheme that will be used by GoI is to issue government bonds which called "Pandemic bonds". Regarding the issuance, GoI has to be extra careful and put more consideration on its impact on the macro aspect. Considering the current situation, issuance of Pandemic bonds is relatively difficult as domestic purchasing

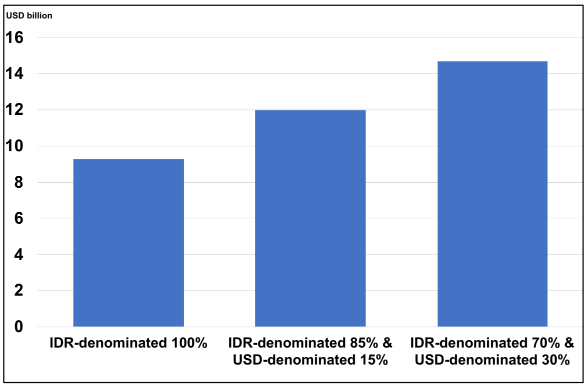
"…with the issuance of Pandemic bonds approximated at USD27 billions (around IDR450 trillions), GoI would increase its foreign reserves until USD15 billions."

power to absorb the bonds is quite sluggish, especially if the bonds are issued in IDR denomination. This is reflected by an authority given to BI to buy government bonds in the primary market, as stated by government regulation in-lieu-of Law No.1/2020. On the other hand, USD-denominated Pandemic bonds issuance will benefit the policymakers as it will increase BI's foreign reserves more compared to IDR-denominated issuance, in consideration of the USD shortage in the forex markets, both in developed countries and emerging markets.

In technical terms, Pandemic bonds issuance denominated in IDR and USD has its own mechanism. In IDR-denominated issuance, the fund collected by GoI could directly be spent on the intended policies. Under current circumstances, the fund raised by the government through bonds issuance could be allocated directly to finance fiscal stimulus to curb the Covid-19 damage. Considering a current weak domestic capacity to buy government bonds, mandated by government regulation in-lieu-of Law No.1/2020, BI could directly buy government bonds in the primary market. Having Central Bank backs government bonds issuance could make the yield offered is on a competitive level. However, this mechanism of issuance would not increase BI's foreign reserves as much as IDR-denominated issuance.

On the other hand, USD-denominated issuance of Pandemic bonds would give the government the fund in USD. Next, BI will convert this fund into IDR-denominated funds and ready to be spent by Fiscal Authority to finance the stimulus. The conversion of USD-denominated funds into IDR-denominated funds by BI would increase BI's foreign reserves. Furthermore, realistically, it is rather challenging to auction USD-denominated government bonds as there is a liquidity shortage of USD in circulation. The issuance of USD-denominated bonds also bears a risk of significant rise of the bond's yield.

Figure 14: Foreign Reserves Increase by Pandemic Bonds Issuance



Source: LPEM FEB UI

As the value of currency serves as a crucial indicator in financial markets and real economic activity, foreign reserves play a major role in determining its value. One possible way to increase foreign reserves is by optimizing the issuance of government bonds in USD denomination. As per our calculation, with the issuance of Pandemic bonds approximated at USD27 billions (around IDR450 trillions), GoI would increase its foreign reserves until USD15 billions (as we consider the optimum issuance of USD-denominated is 30% and 70% in IDR-denominated, Figure 14). Meanwhile, if all the Pandemic bonds are issued in IDR denomination, then the increase of foreign reserves is estimated only USD9 billions, using the assumption of 34% foreign investors' ownership of IDR-denominated government bonds (as per current ownership condition).

Without the government regulation in-lieu-of Law no.1/2020 which gives an authority to BI to buy government bonds in the primary market, we estimate the issuance of USD50 billions (around IDR816 trillions) of Pandemic bonds would shoot up the yield significantly. Based on our estimation, 10-year government bonds yield could reach up until 18%, while if 30% of the issuance is USD-denominated, the yield would "only" increase to 15%. However, considering current developments, GoI could obtain a competitive yield by having BI as the buyer of Pandemic bonds. Also, keep in mind that the estimation of yield increase will also be higher if GoI decides to increase the amount of Pandemic bonds issued.