Monetary Finance of Public Debt in Indonesian Perspectives

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Can Monetary Finance be an Financial Instrument for Fiscal Deficit?

• Monetary Finance—the financing of government via money creation.

• Abused in many countries, which resulted in hyper-inflation, e.g., Zimbabwe and still used in some countries such as Iraq.

Why is Monetary Finance, now?
The COVID-19 forces Developing Country Governments to take fiscal reactions.

1. Fiscal space for the developing country government is limited.
2. Access to finance for the COVID-19 related spending is also constrained due to low level of savings.
3. Donors are also busy with their own COVID-19.

Monetary Finance
Net Claims on Central Government (Assets) and Monetary Base (Liability) of the Central Bank (mn Indonesian Rupiah)

- Central Bank, Net Claims on Central Government, Claims on Central Government, Domestic Currency
- Central Bank, Monetary Base, Domestic Currency
Pros and Cons of Monetary Finance

• Powerful impact on demand than a debt-financed fiscal stimulus due to no increase in debt. No need to worry about future tax increase or interest hike through Ricardian equivalence. Ricardian equivalence is not likely in Indonesia since there are many cash-constrained Non-Ricardian households in addition to early stage of bond secondary markets, which reflects on country’s credit conditions.

• Doubt about fiscal dominance whereby monetary policy decisions are driven by the state of public finance which may have a consequence of loss of confidence in the central bank’s capability to control inflation and stable, which raise inflationary expectation.
Monetary Finance is effective if

1. The country is under a low or moderate level of inflation.
2. The fiscal deficit is small.
3. The Central Bank is independent of the government’s fiscal need.

Debt to GDP in Indonesia and fiscal deficit are 41.6% and 4.9%, respectively in 2021 while the country’s threshold for debt and for fiscal deficit is 60% since 2003 and 3% of GDP since

Reference
1. Itai Agur, Damien Capelle, Giovanni Dell’Ariccia, and Damiano Sandri, 2022, *Monetary Finance Do Not Touch, or Handle with Care?* IMF Departmental Paper, IMF.
Debt (RHS axis), Inflation and Fiscal Balance (both in LHS Axis) of Indonesia

General government gross debt (% to GDP)
Inflation, average consumer prices (% Changes)
General government structural balance (% to GDP)
Response to Cholesky One S.D. (d.f. adjusted) Innovations
± 2 analytic asymptotic S.E.s

Response of CPI_G to BM_G Innovation

Response of CPI_G to TRADEBALANCE Innovation

Response to Cholesky One S.D. (d.f. adjusted) Innovations
± 2 analytic asymptotic S.E.s

Response of CPI_G to BASE_G Innovation

Response of CPI_G to TRADEBALANCE Innovation