

CHAPTER I

INTRODUCTION

1.1 Background

As a developing country, Indonesia in its efforts to increase the country's economy and increase productivity certainly requires a lot of funds, but the funds needed are not enough if it only relies on sources of state revenue such as taxes, nontaxes and other income. Indonesia needs funds that are fast and efficient with minimal risk, these funds can come from foreign debt. Foreign debt is one of the fiscal policy instrument and alternative used by the government to obtain additional funds and increase foreign exchange reserves. Foreign debt has been done since the beginning of independence. In the era of Soekarno's government, Indonesia began to access foreign debt, from other countries such as the Soviet Union, the United States and other Allies. Then this foreign debt continued and increased until now.

According to data from Bank Indonesia (SULNI), foreign debt based on borrower groups can be grouped into government debt and private debt, This study focuses on foreign debt owned by the government, because government foreign debt has a direct relationship and impact on fiscal policy, government foreign debt is used to finance development projects that affect economic growth such as infrastructure, education, health and other strategic sectors. Government foreign debt also has major implications for economic stability, if foreign debt increases and continues to increase in large amounts without being balanced by economic growth and efficient debt management policies, then the debt can pose a risk of default due to an increase in the burden of debt interest payments and its pressure on the exchange rate.

In the context of fiscal sustainability, there are two important components that determine whether the debt burden can be managed sustainably or not, namely primary balance and economic growth. Primary balance is the difference between government revenue and expenditure, excluding debt interest payments. If the government is able to create a primary surplus, then the debt burden can be reduced. Conversely, a prolonged primary deficit will increase the accumulation of debt structurally. Economic growth also plays an important role in maintaining debt. The higher the rate of economic growth, the lighter the debt burden relative to national

output. Thus, the balance between debt interest burden, primary balance, and economic growth is the main key to maintaining the country's fiscal sustainability.

The primary balance is a key indicator in evaluating a country's fiscal sustainability. This indicator represents the difference between government revenues and expenditures, excluding debt interest payments. A consistent surplus in the primary balance indicates that the government has sufficient fiscal capacity to finance its debt, even before accounting for interest expenses. Amidst the rise in Indonesia's foreign debt over the past decade, questions have arisen about the extent to which the government has responded to this debt burden through fiscal adjustments. One way to measure this fiscal response is to examine how the primary balance changes in response to increased debt and macroeconomic conditions, such as inflation, interest rates, and industrial activity.

In the Indonesian economic context, several challenges impact fiscal stability, including fluctuating inflation, rising interest rates on debt, and dependence on financing from foreign debt. Therefore, it is important to determine whether the government is actively engaging in fiscal adjustments through the primary balance when changes in foreign debt or other macroeconomic conditions occur.

According to data from Bank Indonesia (SULNI), the position of the total government's foreign debt by economic sector from 2015 to 2024 has increased, the sectors that receive foreign debt include agriculture, forestry and fisheries; mining and quarrying; processing industry; electricity and gas; water supply, waste management, waste and recycling; construction; wholesale and retail trade, car and motorcycle repair; transportation and warehousing; provision of accommodation and food and beverage; information and communication; financial services and insurance; real estate; corporate services; government administration; defense and compulsory social security; education services; health services and social activities; and other services.

Table 1. 1 Government's Foreign Debt by Economic Sector Position (Trillion Rupiah)

Month / Year	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
Jan	2146	2288	2600	2980	3095	3389	3485	3296	3213	3215
Feb	2138	2344	2615	2941	3156	3309	3460	3325	3179	3221
Mar	2114	2417	2685	2995	3103	2992	3360	3245	3208	3179
Apr	2116	2452	2710	2985	3087	3137	3399	3151	3209	3127
May	2124	2406	2718	2964	3080	3177	3364	3112	3184	3158
Jun	2140	2534	2749	2918	3184	3250	3390	3098	3184	3158
Jul	2141	2553	2817	2933	3217	3290	3404	3068	3194	3212
Agu	2129	2566	2830	2945	3200	3309	3431	3057	3168	3314
Sept	2134	2617	2850	2912	3214	3264	3399	3014	3113	3375
Oct	2174	2579	2807	2899	3293	3304	3387	2971	3061	3326
Nov	2193	2496	2859	2984	3284	3368	3343	3002	3184	3357
Des	2272	2561	2932	3029	3305	3412	3310	3083	3251	3359

Source : Bank Indonesia (Indonesian Foreign Debt Statistics)

Based on Table 1.1, the Indonesian government's foreign debt position from January to December for each year from 2015 to 2024, it can be seen that the value of foreign debt has an increasing trend from year to year. In 2015, the debt position was around 2,100 trillion rupiah, and continued to increase until it reached more than 3,300 trillion rupiah in 2024. The significant increase mainly occurred in the 2015-2020 period, before then, relatively stable with slight fluctuations in 2021-2024.

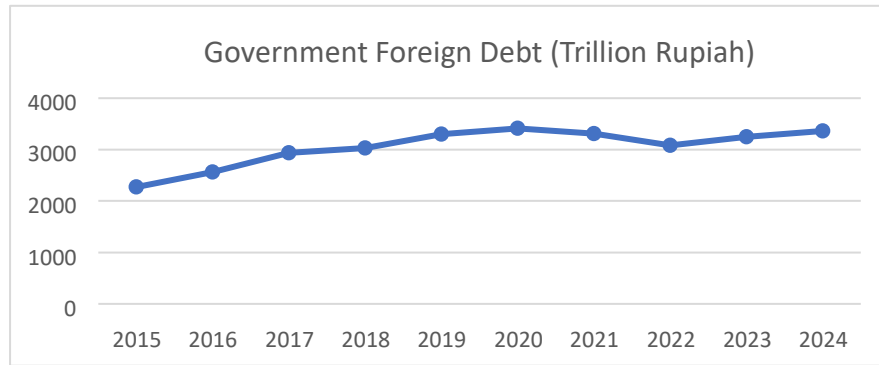


Figure 1.1 Government Foreign Debt

Source : Bank Indonesia (Processed)

Figure 1.1 illustrates the annual trend of total government foreign debt. There is an increase from 2015 to its decrease in 2020. After that, there was a slight decline in 2021 and 2022, but the trend increased again in 2023 and 2024. This graph illustrates that even though it was stable, the government's foreign debt burden continues to show an increasing trend. It is important to assess whether this increase in debt is still within safe limits and can still be controlled or whether it is uncontrolled and causes economic problems.

To see how the Indonesian government's fiscal performance has been in recent years, especially in terms of fiscal sustainability, one important indicator that can be used is the primary balance. The primary balance describes the difference between government revenue and expenditure without taking into account debt interest payments. This indicator is important because it reflects the extent to which the government is able to finance its expenditure independently without increasing the debt burden from the interest side. Therefore, the graph below presents the development of the Indonesian government's primary balance from 2015 to 2024, as an initial illustration in understanding the dynamics of fiscal policy during the period.

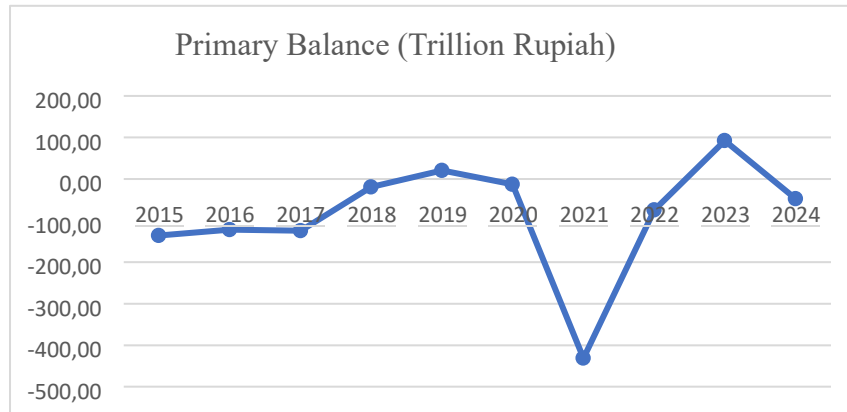


Figure 1.2 Primary Balance

Source: Ministry of Finance of Indonesia (Processed)

Based on Figure 1.2, Indonesia's primary balance from 2015 to 2024 has fluctuated. It can be seen that the primary balance is often in negative numbers (deficit), in 2015, 2016, and 2017, where the deficit was quite large. Conditions improved in 2018 to 2019, which showed a surplus. In 2020, there was a decline and in 2021, the primary balance experienced a very sharp deficit. The year 2023 showed the highest surplus, but returned to deficit in 2024. This graph illustrates that the government's fiscal position is not stable and tends to fluctuate every year.

In addition to the primary balance, the other important factors that affect the sustainability of government foreign debt are the level of debt interest rates. Debt interest rates determine how much interest the government must bear on loans made, especially from abroad. To understand the trends and dynamics of these variables in the context of debt sustainability, the following graph presents data on interest rates of Indonesian government debt during the period 2015 to 2024.

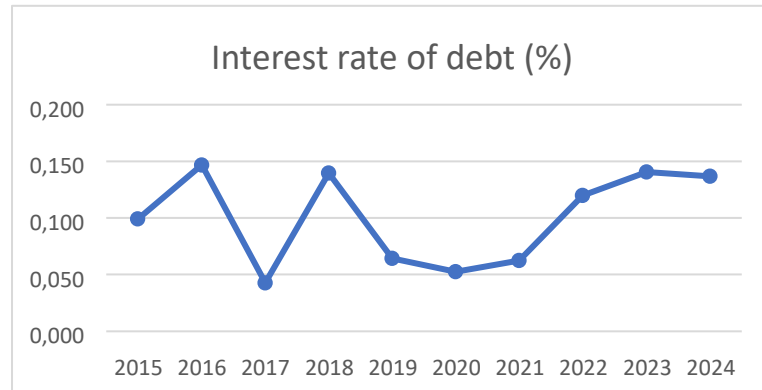


Figure 1.3 Interest of Debt

Source: Bank Indonesia (Processed)

Based on Figure 1.3, Interest on debt shows a more volatile trend. with high spikes, especially after 2022. It can be seen that despite stable economic growth. the interest burden on debt continues to rise. which could pose a threat to fiscal sustainability in the future.

In addition to debt interest rates, the condition of the industrial sector is also an important factor in analyzing a country's fiscal sustainability. One indicator that describes the activity of the industrial sector in Indonesia is the Industrial Production Index. The Industrial Production Index measures the production volume of the manufacturing industry sector, which has a large contribution to Indonesia's Gross Domestic Product. In the context of fiscal sustainability and government foreign debt, the performance of the industrial sector is crucial because it is directly related to the capacity of state revenues, especially from taxes. The increase in Industrial Production indicates healthy industrial output growth, which in turn strengthens the country's tax base and supports the formation of a positive primary balance. An improving primary balance is an important signal for fiscal sustainability, because it shows the government's ability to pay interest obligations without having to add new debt. The following graph presents the development of Indonesia's IPI during the period 2015 to 2024:

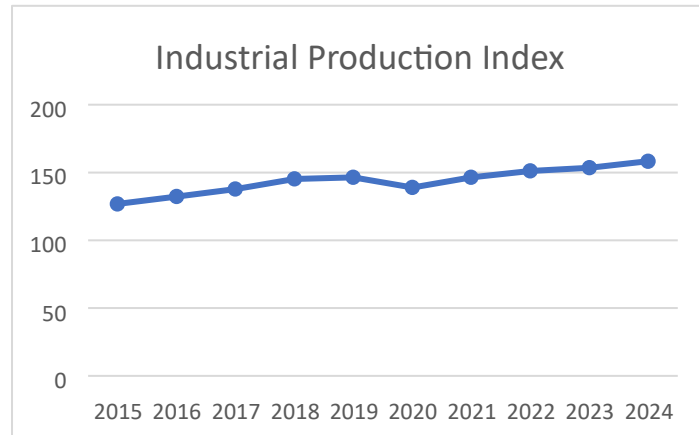


Figure 1.4 Industrial Production Index

Source: Central Bureau of Statistics (Processed)

Based on Figure 1.4, it can be seen that Indonesia's IPI has experienced a gradual increasing trend from 2015 to 2024. In 2015, the index value was around 125 and continued to increase almost every year, although there was a slight decline in 2020 which was most likely caused by the impact of the COVID-19 pandemic on industrial activity. However, after 2020, the index trend again showed a slow and stable recovery, reaching around 150 in 2024. This indicates a recovery and growth in the industrial sector that has the potential to support state revenues through increased output and taxes.

This condition is important in the context of fiscal sustainability, because the performance of the industrial sector can have an impact on the primary balance and the government's ability to respond to foreign debt. In other words, the stronger the industrial activity, the greater the government's opportunity to increase revenue and manage debt more healthily.

To provide a further overview of Indonesia's macroeconomic conditions, in addition to the factors explained previously, another factor that also affects foreign debt is inflation. The following presents data on the development of Indonesia's annual inflation rate during the period 2015 to 2024. This graph aims to show the pattern of inflation movements during this period and is one of the bases for analyzing fiscal stability and the government's debt burden from a macroeconomic perspective.

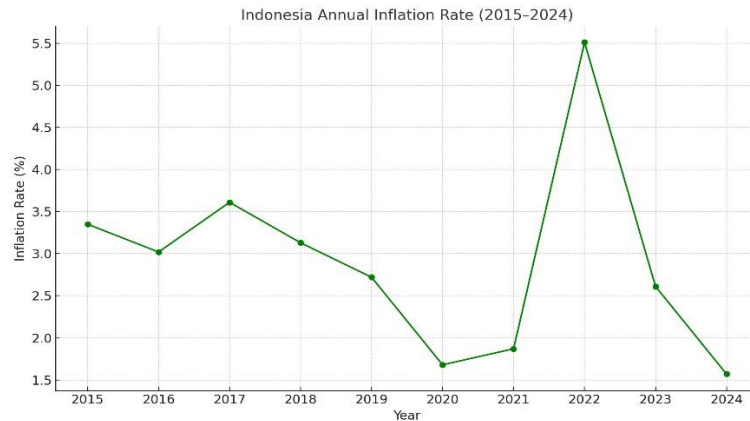


Figure 1.5 Inflation rate in Indonesia

(by december per year)

Source: Bank Indonesia (Processed)

Based on figure 1.5, it can be seen that the inflation rate experienced quite dynamic fluctuations. From 2015 to 2019, inflation tended to be stable in the range of 2.7%–3.6%. However, there was a significant decline in 2020 and 2021, to 1.68% and 1.87%, respectively. This decline was closely related to the impact of the COVID-19 pandemic, which caused a decline in economic activity broadly. Then, in 2022, the inflation rate jumped sharply to 5.51%, reflecting price pressures due to the global economic recovery, rising commodity prices, and supply disruptions. However, after the spike, inflation declined again to 2.61% in 2023 and reached its lowest point of 1.57% in 2024.

This inflation fluctuation is important to analyze because high inflation has the potential to increase interest rates and government debt interest burdens, while inflation that is too low can reflect weak aggregate demand. Therefore, inflation dynamics need to be taken into account in formulating foreign debt management strategies so that they remain sustainable in the long term.

Based on the background explanation above, the researcher is interested in conducting research entitled "Measuring the Sustainability of Indonesia's Primary Balance: A Fiscal Response to the Government's Foreign Debt and Macroeconomic Factors". With this research, it is hoped that it can provide a contribution in the form of a deeper understanding of the development of the Indonesian government's

foreign debt, determine how the government responds to the government foreign debt by primary balance and the other macro variable, and providing policy recommendations for the government in managing debt and keep positive primary balance so that it remains sustainable and can be controlled.

1.2 Problem Statement

- a. How the development of government foreign debt according to economic sector during the period 2015-2024?
- b. Is the Indonesian government respond to changes in foreign debt by adjusting the primary balance?
- c. Is there a significant influence of macroeconomic variables such as the industrial production index, debt interest rates, and inflation on the government's primary balance in the short term and long term?
- d. Is there a difference (asymmetry) in the government's fiscal response to increases and decreases in foreign debt?
- e. What are the implications of fiscal policy and debt management obtained from empirical findings on fiscal sustainability?

1.3 Research Objectives

- a. To find out how the development of government foreign debt according to economic sector during the period 2015-2024
- b. To determine whether the Indonesian government responds to changes in foreign debt by adjusting the primary balance
- c. To analyze whether there is a significant influence of macroeconomic variables such as the industrial production index, debt interest rates, and inflation on the government's primary balance in the short term and long term
- d. To determine whether there is a difference (asymmetry) in the government's fiscal response to increases and decreases in foreign debt
- e. To analyze what are the implications of fiscal policy and debt management obtained from empirical findings on fiscal sustainability

1.4 Research Benefits

This research was conducted to provide a deeper understanding of the sustainability of the Indonesian government's primary balance from the perspective of government foreign debt and macroeconomic variables. In addition to contributing to the academic field, this research is also expected to provide practical benefits for interested parties. The benefits of this research are as follows:

a. Theoretical Benefits

This study is expected to contribute to enriching the literature in the field of public economics, especially those related to fiscal sustainability and fiscal reaction functions in developing countries such as Indonesia. In addition, this study also aims to provide empirical evidence regarding the influence of government foreign debt and macroeconomic variables on the development of primary balance.

b. Practical Benefits

The results of this study are expected to be input for the government, especially for related agencies such as the Ministry of Finance in formulating fiscal policies that are more responsive to the dynamics of primary balance and foreign debt. This study can also help fiscal authorities in designing sustainable government primary balance and government foreign debt management strategies by considering macroeconomic conditions, such as interest rates, industrial production index, and inflation. In addition, the results of this study can also be a reference or guideline for other researchers and academics who are interested in further studying the issue of fiscal sustainability and foreign debt management.