On the horns of a dilemma

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Summary

- Despite the widened real rate differentials, foreign investors continue to add pressure to the domestic financial market, which may tempt BI to continue raising the policy rate in 2023.
- Domestic investors provide a succour for the domestic bond market in 2023. However, higher rates necessary to attract domestic investors would contradict the government's objective to limit its interest burden.
- Despite the higher rate, domestic investors' ability to absorb more SBN may also start to weaken given the declining liquidity within the private sector.

- As we know, Bank Indonesia has decided to lift the interest rate by another 25bps to 6.00% in last week's meeting. Alas, the pressure on the domestic financial market does not seem to abate just yet. The Rupiah still face considerable downward pressures, having declined to its lowest YTD point of 15,875/USD as the market closed in the last week and now flirts with the 16,000/USD psychological barrier as the market opens today.
- Meanwhile, the higher discount rate also discourages foreign investors in the domestic stock market, which recorded a net sell of USD 208.29 Mn as chatters about weakening corporate income growth have also started to bubble. However, some flash of positive signals were seen in the domestic bond market, courtesy of foreign capital inflows to the tune of USD 58.87 Mn observed following the rate increase announcement last week (leading to a net inflow of USD 19.07 Mn for the whole week).
- What is encouraging from foreign capital inflows into the domestic bond market observed last week is that they appear to have come from private sources, unlike investments from foreign governments or central banks which, although more consistent and dependable, may not affect the yield to a large degree in the short-term given their less-dynamic nature.
- However, given the meagre inflows, it may be too soon to declare that BI has won its staring contest against the market. **Bond vigilantes remain active in the Indonesian bond market**, as evident from the widening bid-ask spread in the SBN market, which shows that the widening rate differentials

have so far failed to calm investors in the market ***(see Chart 1).*** The current condition brings some semblance of the pre-rate hike angst in mid-2022, when the central bank finally started its rate-tightening campaign amidst increasing bond market volatility in Q3 2022, ending the campaign in January 2023 by increasing the BI 7DRR to 5.75% as a safe measure despite the already lower bid-ask spread at that time.

- The bid-ask spread, which continues to widen following BI's unexpected rate hike, combined with the relatively mild USD relative to the previous year (with DXY now at 106.2 compared to the 2022 peak of 114.1), may lead to a prolonged standoff between the central bank and the market. Knowing that BI could be forced to blink due to signals of a weakening Rupiah, the market may continue to besiege the Indonesian market. **Since the central bank has made it clear that they would not tolerate attacks on the Rupiah, we now anticipate that BI may be inclined to implement another 25bps increase**, bringing the policy rate to 6.25%. A further policy tightening may also be on the cards, contingent on how the external condition would develop in the months ahead.

"BI's main focus on Rupiah stability may requires the central bank to continue increasing the policy rate in 2023"

- Foreign investors' intensifying attacks on the domestic bond market have led to a surge in the yield on Indonesian 10Y government bonds to 7.102% today. It is important to note that this current level of yield is still within the range of the government's target, which is set at 6.95-8.02% in 2023. The domestic bond market appears to still be protected from the full extent of foreign bond traders' vigilantism, thanks to domestic investors' still-high appetite for Indonesian government bonds.

- Given its role in maintaining the hitherto relative stability in the domestic bond market, the question of which domestic investors continue to maintain the demand for Indonesian government bonds merits some discussion. Investors from the domestic non-financial sector are the ones to thank ***(see Chart 2)***, as evidenced by the IDR 143.71 Tn YTD increase in SBN ownerships by domestic insurance and pension funds while the combination of individual and other investors (including corporate investors) absorbed an additional IDR 126.16 Tn of SBN in the same period.

- However, **the government appears to have paid a steep price to lure domestic investors into the domestic bond market.** Data from Indonesia's Ministry of Finance shows that domestic investors started to collect government bonds more aggressively around late July 2023, which coincides with bottoming yields and coupons offered in the bond market ***(see Chart 3)***. Domestic investors, especially individual investors, often hold the security they purchased to maturity, meaning that coupon rates offered by a specific bond may be more relevant to their investing behaviour compared to the yield on such a bond.

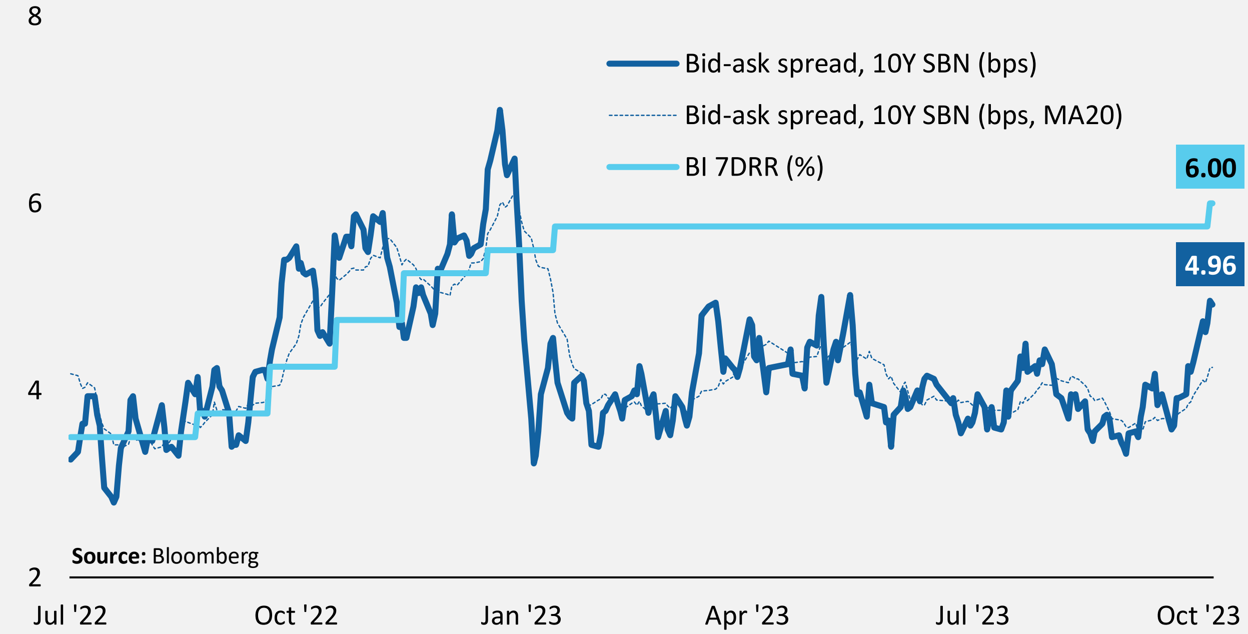
- Alas, the higher coupon rate may increasingly become a problem in 2024. The government, we should recall, is looking to increase debt issuance by 59.5% to IDR 648.1 Tn in 2024. The necessity to offer a higher coupon rate to attract more domestic investors contradicts the government's other objective of reducing its interest burden. This contradiction is rather subdued in 2023, thanks to the lower SBN issuance. The government's debt burden, however, is already projected to rise from 2.05% to 2.18% of GDP in 2024; meaning that the only available avenue for the government to reduce its future interest burden is to rely on accumulated savings and thus continue limiting its SBN issuance.
- Simply relying on the SAL account and cutting SBN issuance below the projected IDR 648.1 Tn in 2024 may not be enough to bring the market back to the low-yield days of Q2-Q3 2023. For instance, **the success of BI's SRBI has now provided a yardstick for an ideal market price for Indonesian short-term bonds**, a condition which may lead to subsequent repricing in the longer-tailed market such as the SBN market. SRBI's shorter maturity may also be more suitable for the needs of some investors such as the domestic banks and corporate sector, meaning that SBN may need to offer more yields to protect its market share.
- Conserving the budget to increase the SAL balance and thus limiting SBN issuance may also translate negatively to domestic investors' ability to continue investing in the SBN market. Recalling our report on the domestic liquidity condition, the private sector's liquidity condition is dictated by the fiscal cycle. More limited fiscal spending, then, may deny the private sector a chance to refill its liquidity coffers, leading to a continued decline in the private sector's aggregated saving balance as declining largesse (or business) from the government may lead to a failure to save. **The private sector's inability to increase its savings would limit its ability to invest *(see Chart 4)***, although the higher SBN rate may continue to fuel its appetite.
- Adding further challenges for the government to pummel its lending rate back to the targeted 6.7% in 2024 is the trove of maturing global bonds in the early days of 2024, which amounts to around USD 4.1 Bn in Q1 2024. It is fair to say, then, that the government may need to choose either to face the Scylla of increasingly demanding foreign investors and the Charybdis of domestic investors' declining ability to increase their position in the bond market in the few months ahead.

"SRBI's shorter maturity may also be more suitable for the needs of some investors, increasing the competition faced by SBN for market share"

Chart 1

Blood in the water

Bank Indonesia may have locked itself towards more policy tightening as bond traders remain restless despite the now-widened rate differentials

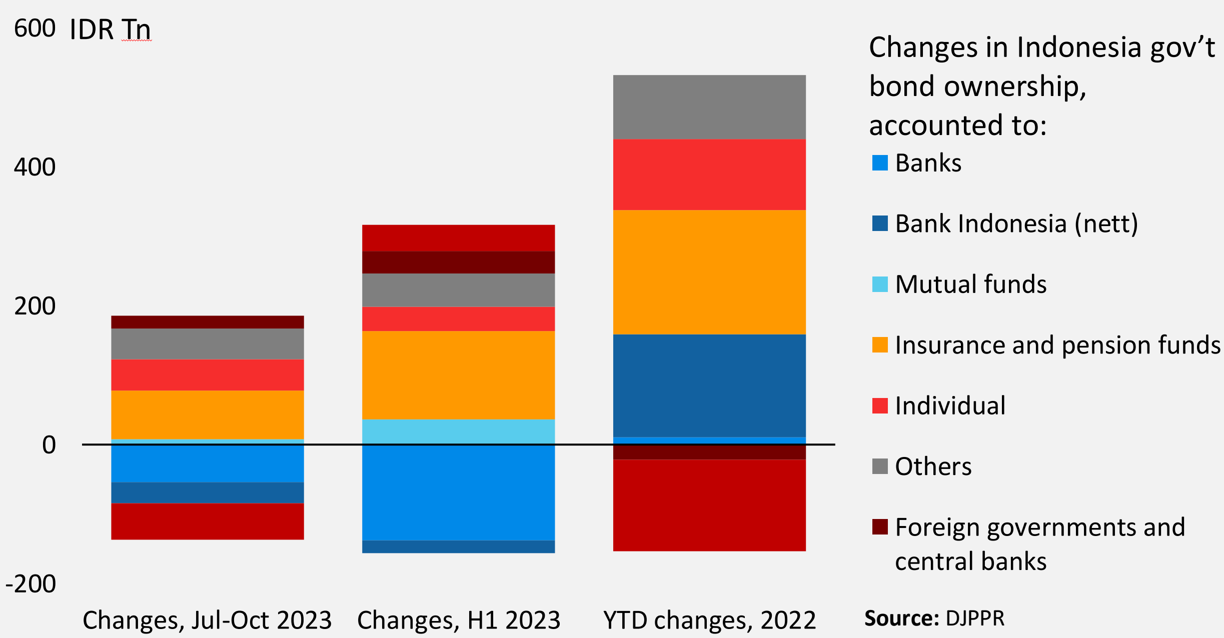


Source: Bloomberg

Chart 2

Looking for demand from the hinterland

Domestic "yield-seeking" investors control the demand for Indonesian bonds in H2-2023 as foreign investors run for safety while lower liquidity hamstrung the domestic banking sector

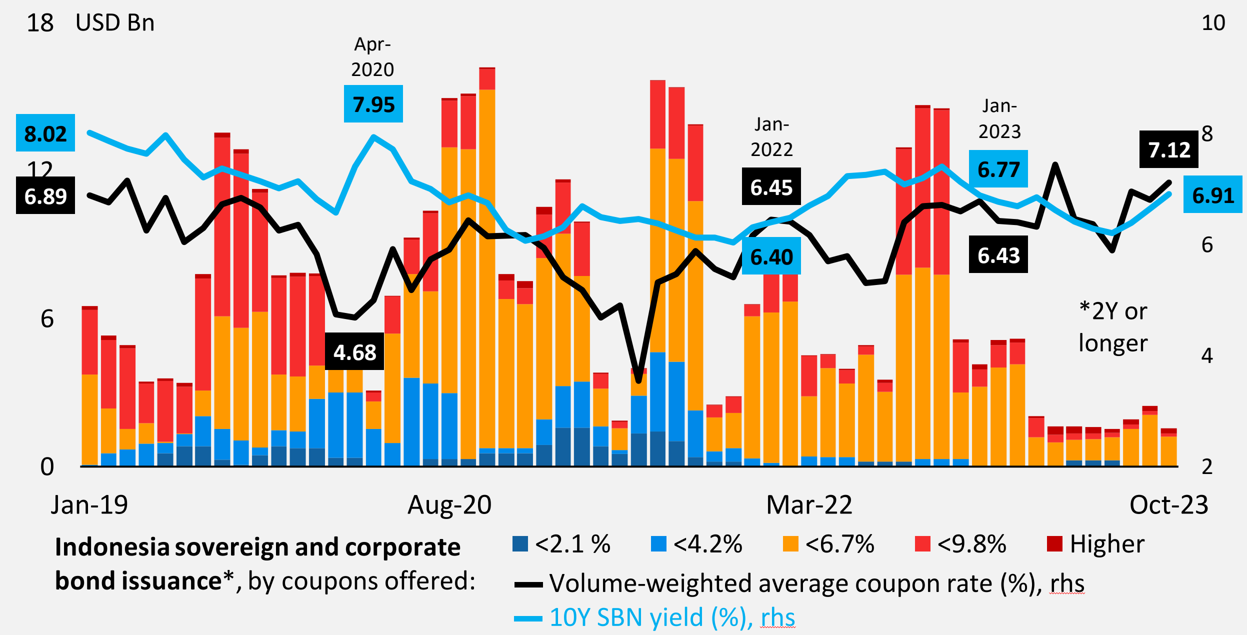


Source: DJPPR

Chart 3

A bountiful season for local "rate" farmers

The coupon rate on available SBN appears to bottomed out in Jul-23, which coincides with subsequent pick-ups by individual and other investors

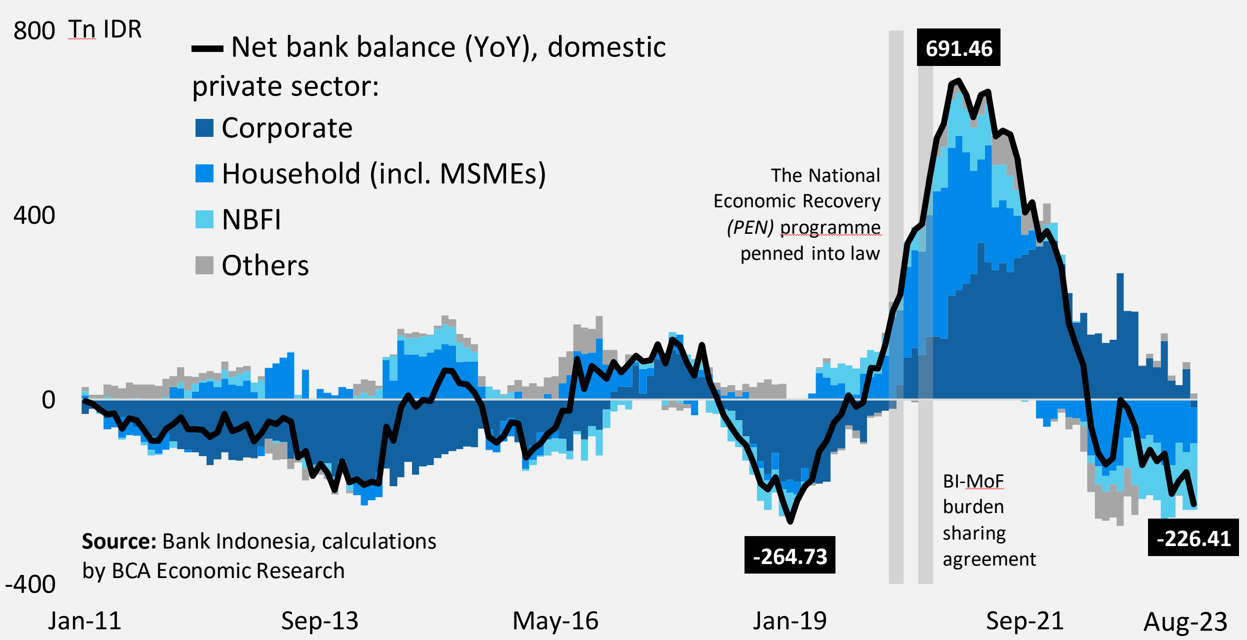


Source: Bloomberg, calculations by BCA Economic Research

Chart 4

Running out of dry powder

Despite the attractive coupon, domestic investors' ability to absorb more SBN may soon diminish, given the continued decline in private sector liquidity



Source: Bank Indonesia, calculations by BCA Economic Research

Economic Calendar

		Actual	Previous	Forecast*
1 October 2023				
CN	Caixin Manufacturing PMI	50.6	51.0	51.2
2 October 2023				
ID	S&P Global Manufacturing PMI	52.3	53.9	53
ID	**Inflation rate YoY**	**2.28%**	**3.27%**	**2.23%**
US	ISM Manufacturing PMI	49	47.6	48.1
3 October 2023				
US	JOLTs Job Openings (USD Mn)	9.6	8.8	8.6
5 October 2023				
US	Balance of Trade (USD Bn)	-58.3	-65	-58.3
6 October 2023				
ID	**Foreign Exchange Reserves (USD Bn)**	**134.9**	**137.1**	**136.0**
US	Unemployment Rate	3.8%	3.8%	3.8%
7 October 2023				
CN	Foreign Exchange Reserves (USD Tn)	3.12	3.16	3.15
9 October 2023				
ID	Consumer Confidence	121.7	125.2	125
10 October 2023				
ID	Retail Sales YoY	1.1%	1.6%	1.3%
ID	Motorbike Sales YoY	-0.9%	1.8%	-
11 October 2023				
ID	Car Sales YoY	-20.1%	-8.3%	-
12 October 2023				
US	Inflation rate YoY	3.7%	3.7%	3.8%
13 October 2023				
CN	Inflation Rate YoY	0%	0.1%	0.2%
CN	Balance of Trade (USD Bn)	77.7	68.36	64.0
16 October 2023				
ID	**Balance of Trade (USD Bn)**	**3.42**	**3.12**	**2.6**
EA	Balance of Trade (EUR Bn)	6.7	6.5	12.5
19 October 2023				
ID	Loan Growth YoY	8.96%	9.06%	-
ID	**Interest Rate Decision**	**6.00%**	**5.75%**	**5.75%**
20 October 2023				
ID	Foreign Direct Investment YoY	16.2%	14.2%	-

*Forecasts of some indicators are simply based on market consensus
Bold indicates indicators covered by the BCA Monthly Economic Briefing report

Selected Macroeconomic Indicator

Key Policy Rates	Rate (%)	Last Change	Real Rate (%)
US	5.50	Oct-23	1.80
UK	5.25	Oct-23	-1.45
EU	4.50	Oct-23	0.20
Japan	-0.10	Jan-16	-3.10
China (lending)	2.50	Oct-23	4.35
Korea	3.50	Oct-23	-0.20
India	6.50	Oct-23	1.48
Indonesia	6.00	Oct-23	3.72

Money Mkt Rates	20-Oct	-1 mth	Chg (bps)
SPN (1M)	6.19	5.64	55.5
SUN (10Y)	7.08	6.75	33.1
INDONIA (O/N, Rp)	5.79	5.62	16.8
JIBOR 1M (Rp)	6.62	6.40	22.5

Bank Rates (Rp)	Jul	Jun	Chg (bps)
Lending (WC)	8.95	8.93	2.84
Deposit 1M	4.24	4.19	4.92
Savings	0.67	0.67	-0.41

Currency/USD	20-Oct	-1 mth	Chg (%)
UK Pound	0.822	0.807	-1.84
Euro	0.944	0.936	-0.80
Japanese Yen	149.9	147.9	-1.33
Chinese RMB	7.315	7.297	-0.24
Indonesia Rupiah	15,875	15,380	-3.12

Capital Mkt	20-Oct	-1 mth	Chg (%)
JCI	6,849.2	6,980.3	-1.88
DJIA	33,127.3	34,517.7	-4.03
FTSE	7,402.1	7,660.2	-3.37
Nikkei 225	31,259.4	33,242.6	-5.97
Hang Seng	17,172.1	17,997.2	-4.58

Foreign portfolio ownership (Rp Tn)	Sep	Aug	Chg (Rp Tn)
Stock	2,833.3	2,869.7	-36.44
Govt. Bond	823.0	846.3	-23.30
Corp. Bond	10.8	11.1	-0.26

Trade & Commodities	20-Oct	-1 mth	Chg (%)
Baltic Dry Index	2,046.0	1,526.0	34.1
S&P GSCI Index	600.8	617.5	-2.7
Oil (Brent, $/brl)	92.2	94.3	-2.3
Coal ($/MT)	150.5	175.9	-14.4
Gas ($/MMBtu)	2.61	2.47	5.7
Gold ($/oz.)	1,981.4	1,931.4	2.6
Copper ($/MT)	7,879.8	8,233.5	-4.3
Nickel ($/MT)	18,406.0	19,671.3	-6.4
CPO ($/MT)	787.4	773.0	1.9
Rubber ($/kg)	1.44	1.40	2.9

External Sector	Sep	Aug	Chg (%)
Export ($ bn)	20.76	22.00	-5.63
Import ($ bn)	17.34	18.88	-8.15
Trade bal. ($ bn)	3.42	3.12	9.61
Central bank reserves ($ bn)*	134.9	137.1	-1.60

Prompt Indicators	Sep	Aug	Jul
Consumer confidence index (CCI)	121.7	125.2	123.5
Car sales (%YoY)	-20.1	-8.3	-6.7
Motorcycle sales (%YoY)	-0.9	1.8	45.6

Manufacturing PMI	Sep	Aug	Chg (bps)
USA	49.0	47.6	140
Eurozone	43.4	43.5	-10
Japan	48.5	49.6	-110
China	50.6	51.0	-40
Korea	49.9	48.9	100
Indonesia	52.3	53.9	-160

Source: Bloomberg, BI, BPS
Notes:
^Data for January 2022
*Data from an earlier period
For changes in currency: **Black indicates appreciation against USD, **Red** otherwise
***For PMI, **>50** indicates economic expansion, **<50** otherwise

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Indonesia – Economic Indicators Projection

	2018	2019	2020	2021	2022	2023E
Gross Domestic Product (% YoY)	5.2	5.0	-2.1	3.7	5.3	5.1
GDP per Capita (US$)	3927	4175	3912	4350	4784	5285
Consumer Price Index Inflation (% YoY)	3.1	2.7	1.7	1.9	5.5	2.6
BI 7-day Repo Rate (%)	6.00	5.00	3.75	3.50	5.50	6.25
USD/IDR Exchange Rate (end of the year)**	14,390	13,866	14,050	14,262	15,568	16,114
Trade Balance (US$ billion)	-8.5	-3.2	21.7	35.3	54.5	32.8
Current Account Balance (% GDP)	-3.0	-2.7	-0.4	0.3	1.0	-0.7

*Estimated number

** Estimation of the Rupiah's fundamental exchange rate

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