A game of transposition

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Summary

- The strong demand for Indonesian government bonds in 2022-2023 appears to be primarily driven by state-run insurance firms and pension funds, with contributions from the private sector being more limited.
- The substantial accumulation of SBN in state-run insurance and pension funds' portfolios seems to crowd out liquidity from other asset markets.
- The domestic non-bank investors' already negative liability growth, combined with the expected increase in issuance in the upcoming periods, could put upward pressure on the yield of Indonesian government bonds.

- Indonesia experienced some isolated rain showers last week, but the prevailing climate conditions continue to be characterised by excessive heat. A similar description can be applied to the state of the domestic financial market. Despite experiencing notable strengthening early in the week, the Rupiah quickly deteriorated to its new YTD low, shifting the defensive line for Bank Indonesia to protect the currency closer to the 16,000/USD psychological barrier.
- The Rupiah's apparent fickleness is unsurprising, given the continued outpours of foreign capital from Indonesia's financial market. Foreign investors recorded a net sell-off to the tune of USD 483.21 Mn in the past week, significantly higher than the -USD 171.24 Mn recorded in the week prior, which now cuts the YTD foreign capital stocks to USD 2.86 Bn from its peak of USD 7.14 Bn in August 2023. A notable portion of these outflows was observed in the bond market, signalling the continued presence of bond vigilantism in Indonesia's bond market.
- Or perhaps, what causes these capital outflows might not be solely attributable to external factors. After all, foreign investors last week were still in a wait-and-see mode, awaiting news on US Treasury targeted borrowing in Q4 2023 (USD 776 Bn, USD 76 Bn less than first expected) and policy signals from the FOMC and Bank of Japan's monetary policy meeting to be held this week. Amidst this wait-and-see environment, one peculiarity emerged in the form of seemingly divergent trajectories: while UST securities appreciated during the last week, the yield on Indonesia's SBN *spiked* ***(see Chart 1)*** – a trend that we have not witnessed since the early days of January 2023.

- Despite constant foreign capital outflows in recent months, internal factors such as lower SBN issuance and strong appetite from domestic investors have helped to keep the yield on the Indonesian government bonds stable. Alas, these two stabilising factors appear to be senescent. Despite the still positive budget balance, which stands at 0.32% of GDP by September 2023, recent statements indicate that the government remains committed to achieving its ~2.3% deficit target for FY 2023; leaving fewer resources for the excess budget balance which could be used to fund government spending in the next year.
- Fortunately, the government's commitment to fiscal spending does not take away its ability to shape its SBN issuance strategy according to gyrations in the market, at least for the moment. Indeed, the government have announced its intention to issue fewer SBN in Q4 2023, assuming better control over the supply of SBN at a time when bond vigilantes closely monitor the domestic bond market. Unfortunately, **such a strategy may not provide succour for the government from the world of higher lending rates in the upcoming year**, considering the significant fiscal commitments due to the election in February 2024, large amounts on bonds maturing in Q1 2024 ***(see Chart 2)*** and domestic investors' seemingly maxed-out capacity to absorb more SBN in its portfolio.

> ***"Maturing bonds, high fiscal commitments, and maxed-out domestic investors may send the yield on SBN on an upward trend"***

Domestic investors and the bond market: From the right pocket to the left

- As stated earlier, other than better control of SBN supply in the market, the government has been increasingly reliant on domestic investors to keep the yield on SBN stable. However, **the role of absorbing additional supply of SBN does not seem to be shared equally among domestic investors**, with the banking sector showing limited activity in the SBN market due to the dwindling liquidity condition and general shifts to loans (partly to fulfil the RPIM requirement). It is investors from the domestic non-bank sector, then, that the government primarily relies on to drum up the demand in the SBN market in recent periods ***(see Chart 3).***
- Domestic non-bank investors' penchant for Indonesian government bonds should come as no surprise. As noted in a previous report, coupon rates offered by the government are trending upward, offering around 2-3% of positive real rate return for investors. Given the limited upside risk with the headline inflation number and the stock market's declining earning yield, the domestic bond market may remain an attractive destination for domestic investors – provided their resources allow them to continue participating in the market.
- Hence, rather than questioning the attractiveness of the SBN market to domestic investors, we question how long these

insurance firms, pension funds, and individual investors could afford to remain active in the market. Our observations of net bank balance positions show that the household sector (i.e. private investors) has struggled to increase its savings balance since the end of 2021. This reading suggests that the share of consumption in a typical household's disposable income is increasing, and as a result, the ability of individual investors to remain active in the market may continue to decrease over time.

- Fortunately, private investors only hold around 7.44% of SBN supplies and rarely sell, a characteristic that should limit the impact of vicissitudes in their investment behaviour on market volatility. But what about the other group of non-bank domestic investors? The unfortunate part is that **the problem of dwindling dry powder may hamstrung insurance and pension funds' ability to continue building their SBN portfolio as well** ***(see Chart 4)***. The already negative growth in its liability indicates that the domestic insurance and pension funds do not benefit from an additional dry powder to sustain its oversized role to drive up demand in the SBN market – a role that may become increasingly challenging given the expected back-loading by the government and the projected increase in SBN issuance in the next fiscal year.

"Domestic non-bank investors may afford to continue buying more SBN by reducing its holding of other assets"

- In retrospect, the hitherto significant role played by domestic insurance and pension funds in the domestic bond market may not be supported by an equally sufficient liquidity position in the first place. Indeed, **for insurance firms the spike in SBN holdings in their asset portfolio occurred simultaneously with the decline in their holdings of other financial assets**, indicating the need to refocus their asset portfolio to free up some resources to purchase the additional bonds. This condition also resembles the classic crowding-out effect, where the build-up of government financing leads to a decrease in liquidity in other asset markets. We observed a similar dynamic happening in the domestic pension funds, although the recent increase in banks' deposit rates still tempts pension funds to increase their asset allocation in term deposits.

- Further examination of data from the domestic insurance sector may lead to a more discouraging outlook for the yield on the Indonesian government bonds. While private insurance firms also play the same "buy bonds, sell anything else" strategy ***(see Chart 5)***, their limited absorption capacity means that **most government bonds may ends up on the balance sheet of government-funded insurance companies.** Such a condition may resembles a "drawing from the right pocket to fill the left pocket" scenario, where government financing is (in some part) funded by its reallocation of existing resources rather than drawing additional resources from the private sector.

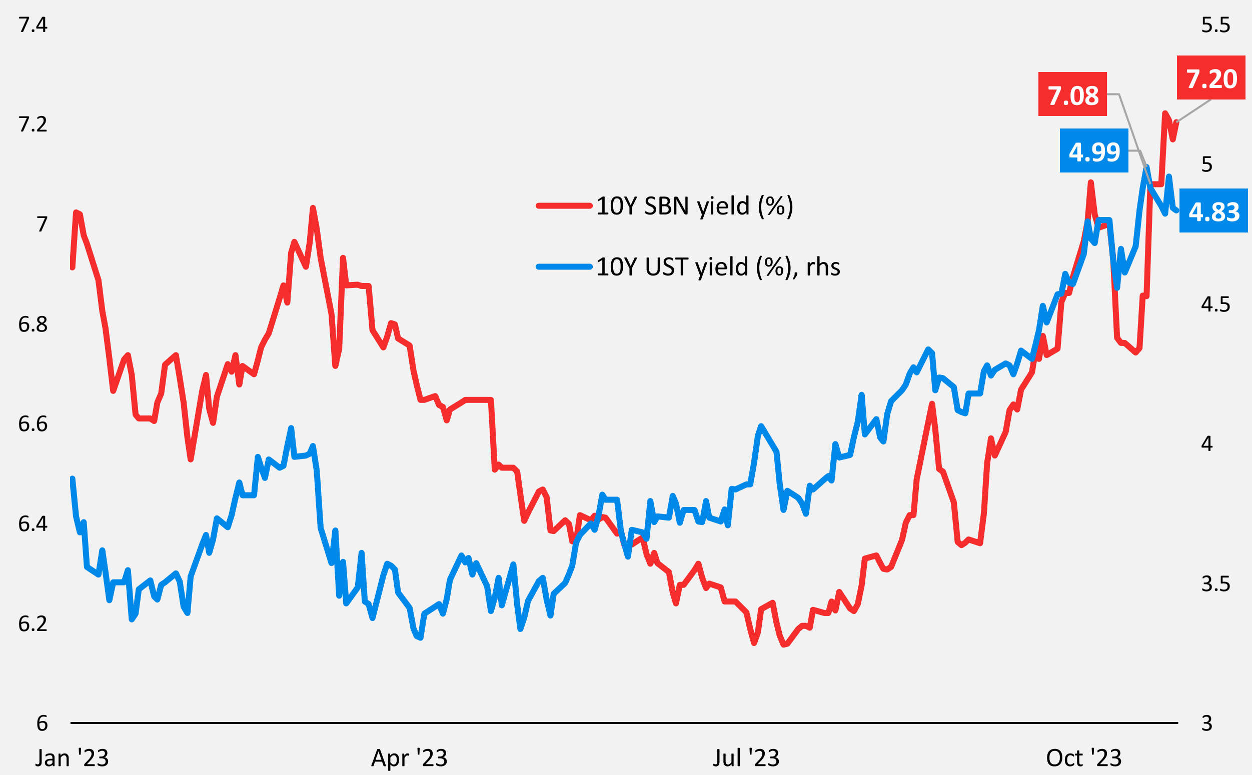
- The condition in the domestic bond market, then, appears to be trapped in a zugzwang: given the high fiscal commitments and domestic non-bank sectors' limited ability, **the government would need banks to resume their activity in the bond market. However, banks may need the government to improve their liquidity condition by realising its fiscal spending first**, which may lead to the government issuing SBN as planned and thus increasing the yield on Indonesian government bonds. The halcyon days of low government lending rates may have truly come to an end, exposing the Indonesian economy to a "high rate, high growth" environment, which now resembles the Western (US) economy.

> ***"State-run firms' outsized role in driving the demand for SBN means that private liquidity contributes less to fund government spending"***

Chart 1

Diverging paths

Inimical price actions were observed between the UST market and Indonesia's bond market in the past week as SBN declined despite the UST market betting against a Fed rate hike in the upcoming FOMC meeting



Source: Bloomberg

Chart 2

New Year headache

The government would be hit by USD 22.23 Bn in matured bonds in Q1 2024, which might need to be refinanced at relatively higher rates

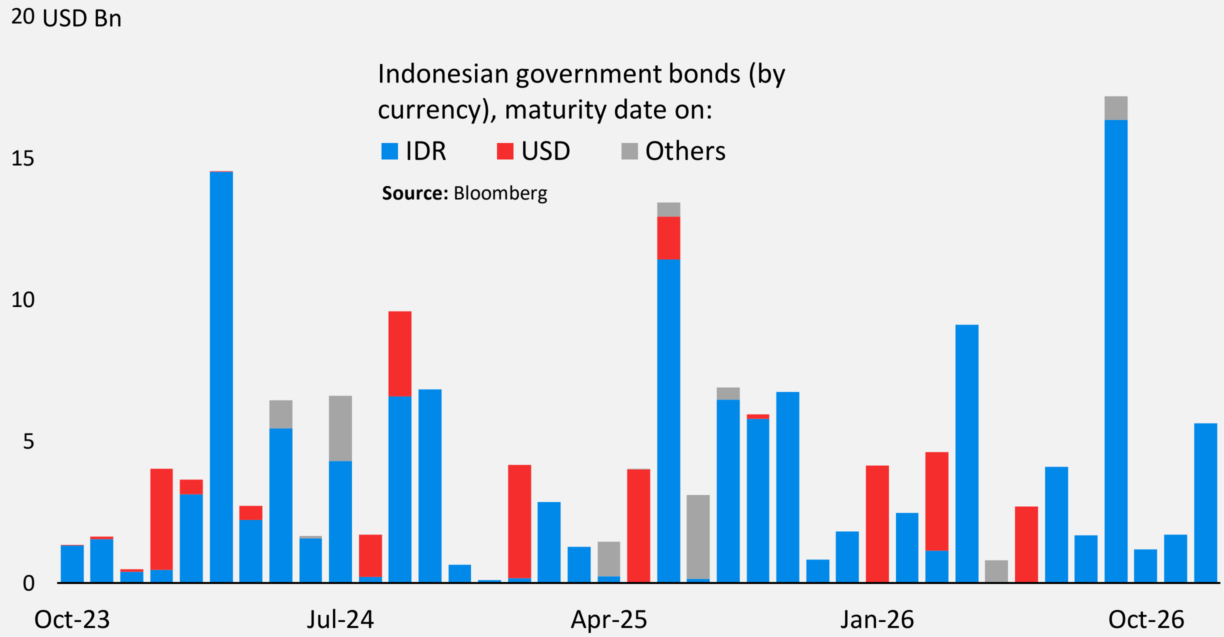
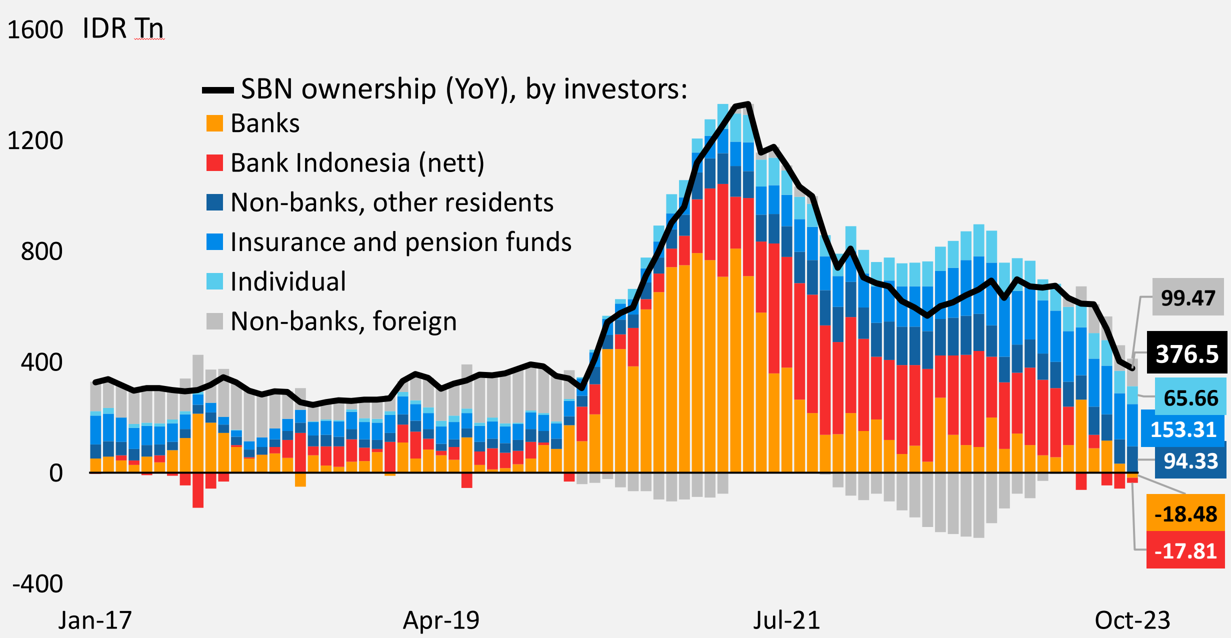


Chart 3

Full throttle

The domestic non-bank sector, especially the insurance sector, is increasingly relied upon to absorb SBN supplies as domestic banks and foreign investors leave the market

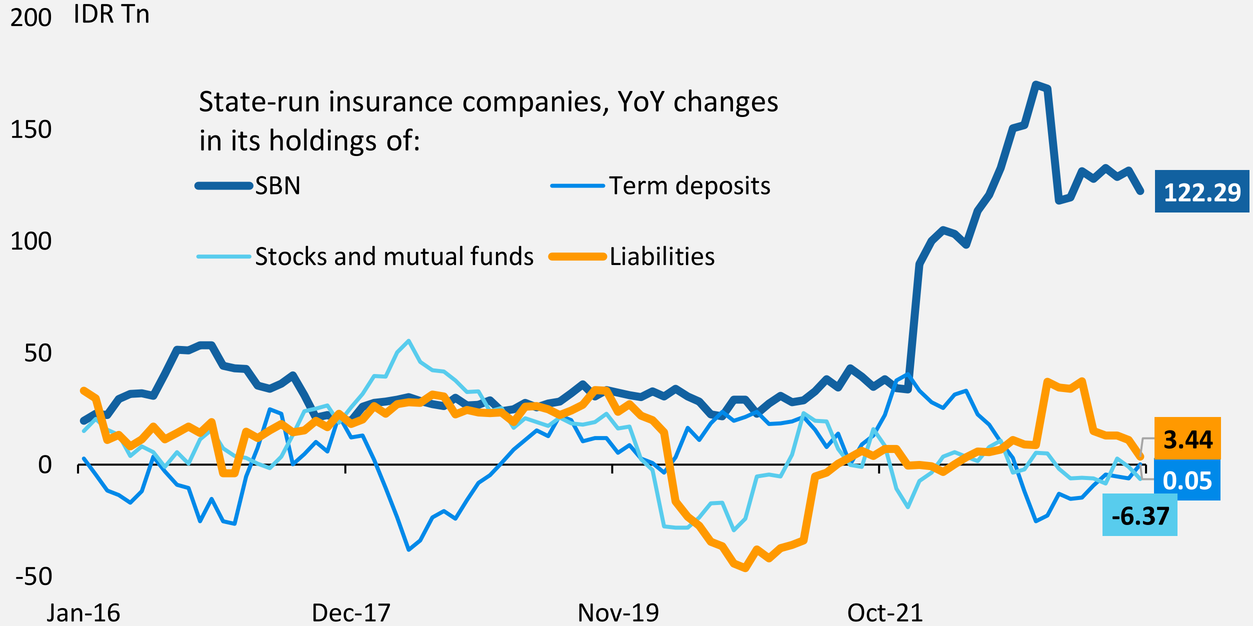


Source: DJPPR

Chart 4

Dead end ahead

Despite its still-high appetite, state-run insurance companies' ability to absorb more SBN may be increasingly limited given its dwindling resources

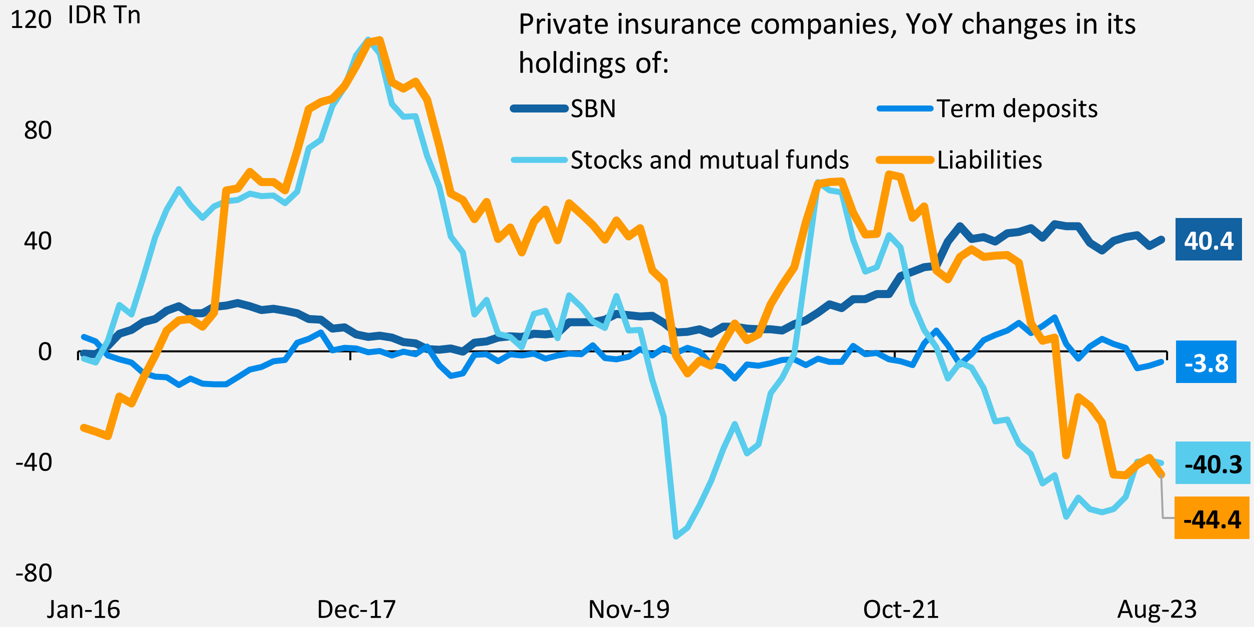


Source: OJK

Chart 5

Same strategy, different pasture

Despite its dwindling resources, private insurance companies remain in the market for some SBN while reducing their footprint in the market for other portfolio assets



Source: OJK

Economic Calendar

		Actual	Previous	Forecast*
1 November 2023				
CN	Caixin Manufacturing PMI		50.6	50.8
ID	**Inflation rate YoY**		**2.28%**	**2.4%**
US	ISM Manufacturing PMI		49	49.5
3 November 2023				
US	Unemployment Rate		3.8%	3.8%
US	Non-Farm Payroll ('000)		336	190
6 November 2023				
ID	**GDP Growth Rate YoY**		**5.17%**	**5.1%**
7 November 2023				
CN	Balance of Trade (USD Bn)		77.7	81.0
US	Balance of Trade (USD Bn)		-58.3	-59.5
ID	**Foreign Exchange Reserves (USD Bn)**		**134.9**	-
8 November 2023				
ID	Consumer Confidence		121.7	-
9 November 2023				
CN	Inflation Rate YoY		0.1%	0.2%
ID	Retail Sales YoY		1.1%	2.9%
14 November 2023				
US	Inflation Rate YoY		3.7%	3.8%
ID	Motorbike Sales YoY		-0.9%	-
ID	Car Sales YoY		-20.1%	-
15 November 2023				
EU	Balance of Trade (EUR Bn)		3.42	-
ID	Balance of Trade (IDR Bn)		6.7	22.3
ID	Export YoY		16.1%	-
ID	Import YoY		12.4%	-
17 November 2023				
ID	Current Account (USD Bn)		-1.9	-0.9
CN	Balance of Trade (USD Bn)		68.36	64.0
23 November 2023				
ID	Loan Growth YoY		**8.9%**	**-**
ID	**Interest Rate Decision**		6%	6%

*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	30-Oct	-1 mth	Chg (bps)
SPN (1M)	6.19	5.64	55.5
SUN (10Y)	7.11	6.89	21.2
INDONIA (O/N, Rp)	5.82	5.63	18.9
JIBOR 1M (Rp)	6.66	6.40	25.6

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	30-Oct	-1 mth	Chg (%)
UK Pound	0.822	0.820	-0.24
Euro	0.942	0.946	0.40
Japanese Yen	149.1	149.4	0.18
Chinese RMB	7.311	7.298	-0.18
Indonesia Rupiah	15,890	15,455	-2.74

Capital Mkt	30-Oct	-1 mth	Chg (%)
JCI	6,735.9	6,939.9	-2.94
DJIA	32,929.0	33,507.5	-1.73
FTSE	7,327.4	7,608.1	-3.69
Nikkei 225	30,697.0	31,857.6	-3.64
Hang Seng	17,406.4	17,809.7	-2.26

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	30-Oct	-1 mth	Chg (%)
Baltic Dry Index	1,502.0	1,701.0	-11.7
S&P GSCI Index	579.5	609.7	-4.9
Oil (Brent, $/brl)	87.5	95.3	-8.2
Coal ($/MT)	134.3	162.5	-17.4
Gas ($/MMBtu)	3.17	2.68	18.3
Gold ($/oz.)	1,996.1	1,848.6	8.0
Copper ($/MT)	8,068.8	8,212.5	-1.8
Nickel ($/MT)	18,267.0	18,440.0	-0.9
CPO ($/MT)	763.6	785.3	-2.8
Rubber ($/kg)	1.43	1.39	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:

Car and motorcycle sales data to be released on the third week of January 2022

^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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