

Fragile no more

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Summary

- The Indonesian government bond has been performing robustly in 2023, which is significant given Bank Indonesia's nominal exit from the bond market and the weakening demand from domestic banks.
- Strong demand from foreign investors and domestic non-bank investors explains the increase in Indonesian bond value. However, declining liquidity in the domestic household sector may start to limit the demand from domestic buyers.
- Foreign investors' ability to continue absorbing Indonesian bonds is also limited, given the prospect of massive UST issuance.
- Improving the liquidity condition within the domestic banking sector may help to revive banks' demand for bonds, which would help to keep yields on Indonesian bonds per the government's budget assumption.

- Hawkish fedspeaks and the release of robust PCE and non-farm payroll data by the end of May-2023 have fuelled speculation that the Fed may raise the interest rate by a total of 50 bps in the next two FOMC meetings. Such expectations seem to have been short-lived, as data released during the ongoing pre-FOMC blackout period suggests that the US economy may not be as resilient as initially thought. While the expanding US trade deficit (USD 74.6 Bn in Apr-23, USD 60.6 Bn previously) continues to indicate robust consumption, the initial jobless claims data suggests a weakening US labour market, a damning signal for the real sector but nevertheless an important development in neutralising the threat of inflationary wage-price spiral.
- While it is still too early to call a recession in the US, another major economy across the

Atlantic has duly slipped into a technical recession. The third revision to the GDP data reveals that the Eurozone contracted by 0.1% QoQ in Q1 2023, extending the streak from the previous quarter. Europe's economic problems, of course, are manifold. In addition to the energy crisis, which is easing only due to declining demand, European economies are also short on consumption resulting from eroded disposable income. In normal times, European economies may look to expand their fiscal commitment to cushion the fall in domestic consumption. However, the dwindling global liquidity may complicate such a Keynesian intervention given the increase in bond yields.

- Unlike in Europe, Indonesia is one place where the bond market has not posed an issue for the economy (*see Chart 1*), which is

striking as it illustrates Bank Indonesia's success in executing the exit from the pandemic era burden-sharing agreement (*see Chart 2*). This continued decline in yields on Indonesian bonds is due to the basic economic equation. On the supply side, high commodity prices throughout last year, coupled with rebounding tax and non-tax revenue, have significantly bolstered liquidity in the public sector. Thus, bond traders in the Indonesian market are not dealing with an impecunious government, one that may afford to issue new bonds tactically following the ebb and flow in global liquidity. Moreover, the relatively conservative budget out-look in 2023 and 2024 diminishes the likelihood of a significant increase in the supply of Indonesian bonds, effectively transforming the domestic bond market into a seller's market.

"The government's prudent control over the budget help to improve Indonesia's risk profile"

- Foreign investors' interest in Indonesian IOUs is hardly surprising, given the positive outlook for the Indonesian economy. We expect the Indonesian economy to achieve another 5.0% YoY GDP growth in 2023, similar to IMF's recent forecast. Amidst the darkening global outlook in 2023-2024, this growth rate places Indonesia in a league of its own, with only Vietnam (5.0% YoY) and India (4.9% YoY) as comparable counterparts. These favourable growth prospects contribute to the attractiveness of Indonesian IOUs to foreign investors, who shall look to balance between yield potential and risk profile amidst the dwindling global liquidity.

- Indonesia's improving risk profile, as indicated in the declining CDS, enhances the appeal of Indonesian bonds for foreign investors. This improvement distinguishes Indonesia from its peer countries, particularly the other "fragile five" countries such as Brazil, South Africa, and Turkey. In contrast to Indonesian bonds, the CDS spreads on these three countries' bonds have worsened in 2023 compared to a decade ago during the debilitating Taper Tantrum episode.
- While the improvement in Indonesia's risk profile can be partially attributed to the still-high commodity prices, it is important to note that the worsening CDS spreads on the IOU of other economies with a similar commodity-driven profile, such as South Africa, indicate that this hypothesis alone is insufficient. The divergence in risk profiles between Indonesia and its peers reflects the fundamental improvement in the Indonesian economy relative to its counterparts.
- As mentioned earlier, one factor that set Indonesia apart from other fragile five countries is the government's prudent control over the budget (*see Chart 3*). Unlike the Indonesian economy, other peer countries often found it hard to introduce a more conservative budget following the pandemic, which is either due to the stratospheric level of deficit recorded in 2020-2021 (as in the case of Brazil) or the threat of a weakening economy that necessitates continued fiscal expansion in

2022. The UK's mini-budget crisis shows that bond traders are not too keen on a liberal budget, which explains the strong demand for Indonesian bonds compared to alternatives.

- Substantial fiscal deficits that inhibit some “fragile five” economies (and even developed economies) for years give way to another factor that separates Indonesia from its peers; the relative safety from the risk of fiscal dominance (*see Chart 4*). Central banks in highly-leveraged EM, such as Brazil and South Africa, may be tempted to use monetary policy tools to help with the debt issues, keeping their focus away from more-traditional monetary policy goals such as price and exchange rate stabilisation. Such a threat, of course, is not particularly relatable to the Indonesian case, thanks to the regulatory-mandated

“The improving CA posture has addressed Indonesia's Achilles' heel that brought the economy down in 2013”

conservative fiscal budget (deficits cannot exceed 3% of GDP) and the market's stable outlook for the Rupiah as indicated by the narrowing NDF spread for the Rupiah.

- The other equally striking factor is the shift in Indonesia's current account posture. Unlike in 2012-2015, when the country consistently recorded significant deficits, Indonesia has managed to maintain a positive CA in recent years. The improvement in the CA posture following the pandemic recession has been attributed to higher income from commodity exports. Additionally, the nickel downstreaming programme has shown a promising impact in boosting Indonesia's

earning outlook, while further expansion to the programme (including further development in the domestic downstream nickel industry) should reflect well on Indonesia's earnings outlook in the coming periods. The improving CA posture has addressed Indonesia's Achilles' heel that brought the economy down in 2013, which should bode well for foreign investors looking to acquire more Indonesian bonds.

- Foreign investors are not the only ones showing interest in Indonesian bonds. Domestic non-bank investors, such as mutual funds and insurance funds, have also been increasing their holdings of Indonesian bonds in 2023. As of June 2023, their collective share of total government bond ownership has reached 20.3%, representing an increase of IDR 84.02 trillion since early January 2023. However, it is important to

note that mutual funds mainly reflect the demand from individual investors, and liquidity in the household sector has been decreasing over time (*see Chart 5*). This suggests the possibility of lower demand from domestic non-bank sectors in the future, potentially allowing foreign investors to acquire more Indonesian bonds in the upcoming periods.

- Alas, there is also a limit on foreign investors' ability to absorb Indonesian bonds in the coming period. Massive UST issuance following the debt-ceiling agreement may siphon capital from emerging bond markets, including Indonesia especially if the yield

spread between Indonesian government bond and the UST continue to narrow.

- Thus, the domestic bond market may eventually need to look for other domestic buyers to supplant the weakening demand from existing buyers such as domestic non-banks and foreign investors. One potential measure to achieve this is by lowering the Reserve Requirement Ratio (RRR) for banks. By reducing the RRR, banks would have more liquidity available to invest in bonds, addressing the current limitations they face in absorbing more bonds due to the decreasing liquidity in the domestic banking

sector. This could help stimulate domestic demand and provide a more balanced market for Indonesian bonds, which would help to keep Indonesian bond yields at the 6.49-6.91% range per the proposed 2024 budget assumption.

“The domestic bond market may eventually need to look for other domestic buyers to supplant the weakening demand from existing buyers”

Chart 1

A good year indeed

2023 has been a historically good year for the Indonesian bond market despite the declining global and domestic liquidity

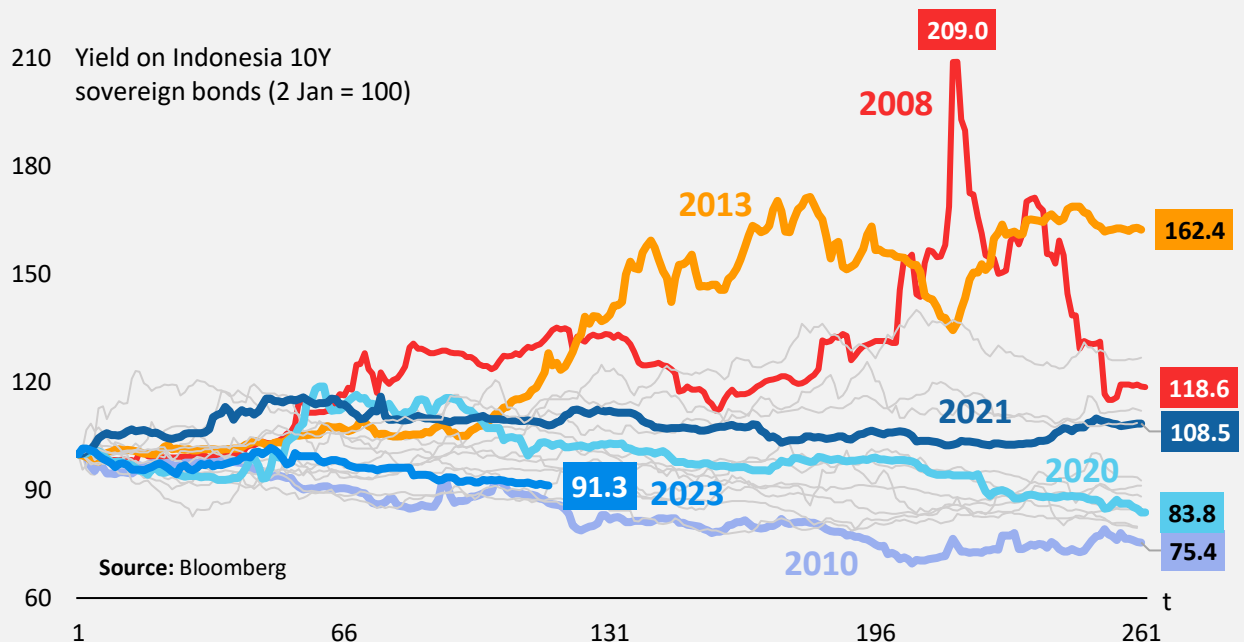


Chart 2

Not a pyrrhic victory

Indonesian bonds' colourful performance is particularly significant considering BI's exit from the burden-sharing agreement and limited demand from domestic banks



Chart 3

Leaving the fragile five (and others) behind

Indonesia's quick and seamless exit from pandemic-era deficit financing separates it from other economies

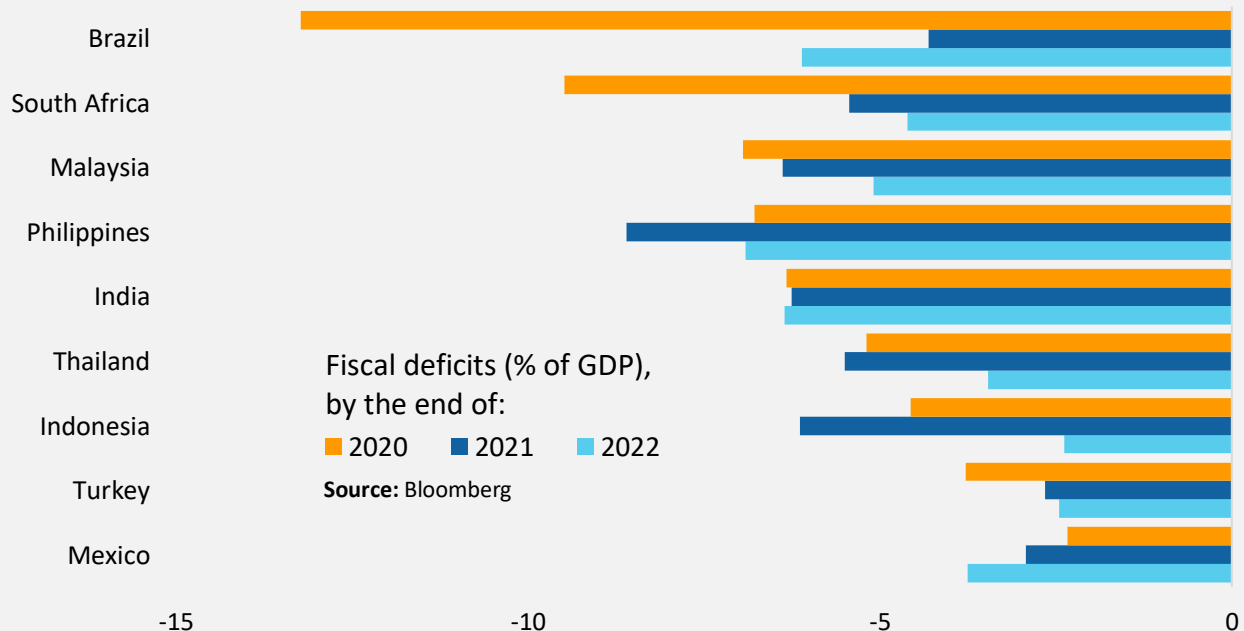


Chart 4

Borrow responsibly

Indonesia's limited exposure to short-term debt limits the threat of fiscal primacy, solidifying the outlook for the IDR which should bode well for foreign investors

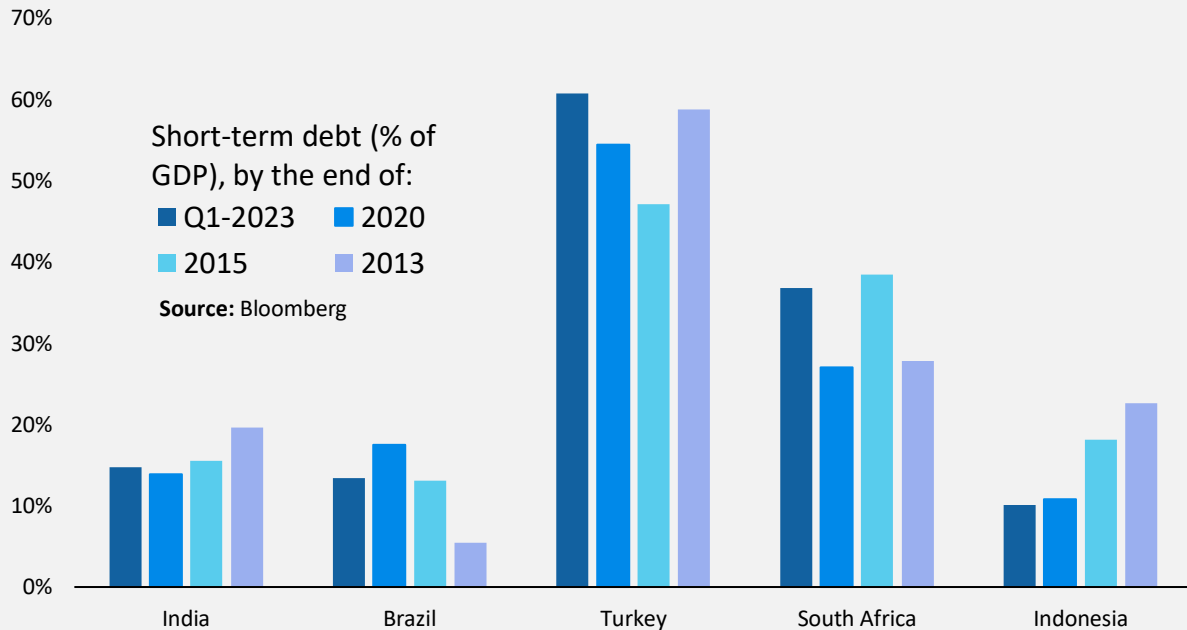
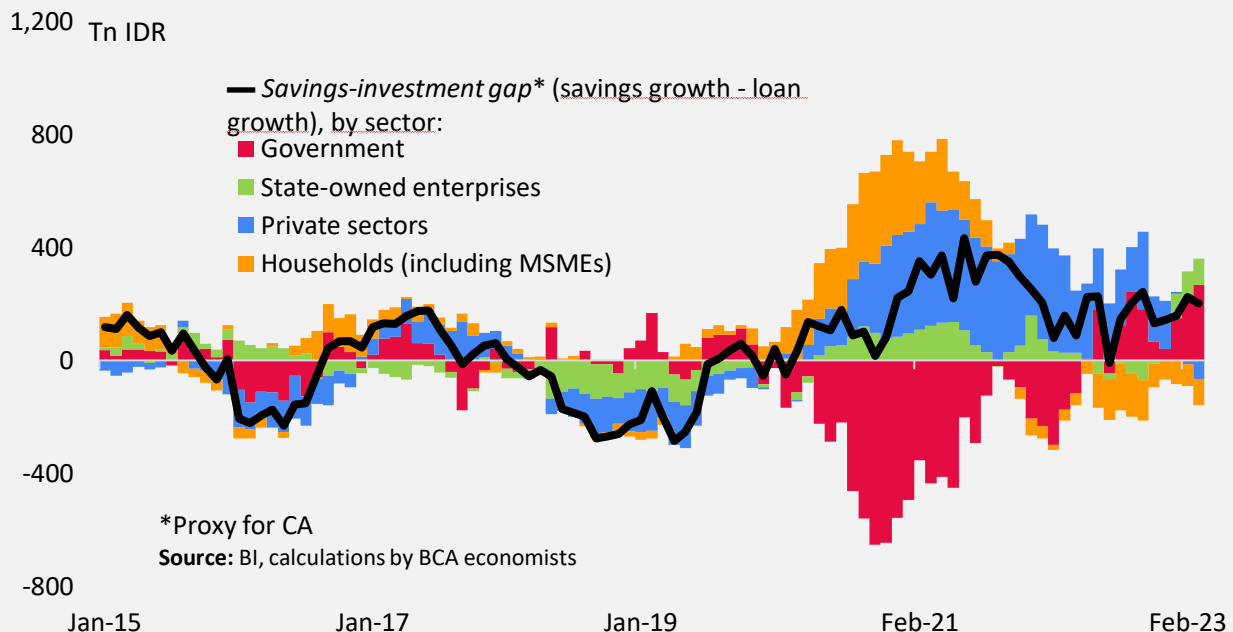


Chart 5

Good times must come to an end

Despite the stable outlook, dwindling liquidity in the household sector provide one indication that the decline in Indonesian government bond yields may soon hit its limit



Economic Calendar				
		Actual	Previous	Forecast*
1 June 2023				
US	ISM Manufacturing PMI	46.9	47.1	48
5 June 2023				
ID	S&P Global Manufacturing PMI	50.3	52.7	52.3
ID	Inflation Rate YoY	4.0%	4.33%	4.2%
7 June 2023				
CN	Balance of Trade (USD Bn)	65.81	90.21	91.0
US	Balance of Trade (USD Bn)	-74.6	-64.2	-78.2
9 June 2023				
CN	Inflation rate YoY	0.2%	0.1%	0.2%
ID	Foreign Exchange Reserves (USD Bn)	139.3	144.2	144.0
12 June 2023				
ID	Consumer Confidence	128.3	126.1	128
13 June 2023				
ID	Retail Sales	-	4.9%	5.0%
US	Inflation rate YoY	-	4.9	4.7%
14 June 2023				
ID	Car Sales YoY	-	-28.8%	-
15 June 2023				
US	Fed Interest Rate Decision	-	5.25%	5.25%
ID	Balance of Trade (USD Bn)	-	3.94	3.2
21 June 2023				
ID	Motorbike Sales YoY	-	-19.4%	-
22 June 2023				
ID	Loan Growth YoY	-	8.08%	-
ID	Bank Indonesia policy announcement		5.75%	5.75%

*Forecasts of some indicators are simply based on market consensus

Bold indicates indicators covered by the BCA Monthly Economic Briefing report



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Selected Macroeconomic Indicator

Key Policy Rates	Rate (%)	Last Change	Real Rate (%)	Trade & Commodities	9-Jun	- 1 mth	Chg (%)
US	5.25	Jun-23	0.35	Baltic Dry Index	1,055.0	1,598.0	-34.0
UK	4.50	Jun-23	-4.20	S&P GSCI Index	539.8	554.2	-2.6
EU	3.75	Jun-23	-2.35	Oil (Brent, \$/bbl)	74.8	77.4	-3.4
Japan	-0.10	Jan-16	-3.60	Coal (\$/MT)	146.7	178.0	-17.6
China (lending)	4.35	Jun-23	4.15	Gas (\$/MMBtu)	1.85	2.22	-16.7
Korea	3.50	May-23	0.20	Gold (\$/oz.)	1,961.2	2,034.6	-3.6
India	6.50	Jun-23	1.80	Copper (\$/MT)	8,349.0	8,562.3	-2.5
Indonesia	5.75	May-23	1.75	Nickel (\$/MT)	21,031.0	23,409.5	-10.2
Money Mkt Rates	9-Jun	- 1 mth	Chg (bps)	CPO (\$/MT)	727.5	900.7	-19.2
SPN (1M)	3.59	4.13	-53.5	Rubber (\$/kg)	1.32	1.38	-4.3
SUN (10Y)	6.32	6.47	-14.8	External Sector	Apr	Mar	Chg (%)
INDONESIA (O/N, Rp)	5.53	5.64	-11.0	Export (\$ bn)	19.29	23.42	-17.62
JIBOR 1M (Rp)	6.39	6.40	-1.1	Import (\$ bn)	15.35	20.59	-25.45
Bank Rates (Rp)	Mar	Feb	Chg (bps)	Trade bal. (\$ bn)	3.94	2.83	39.43
Lending (WC)	8.95	8.89	6.13	Central bank reserves (\$ bn)*	144.2	145.2	-0.70
Deposit 1M	4.20	4.18	2.24	Prompt Indicators	Apr	Mar	Dec
Savings	0.69	0.67	1.92	Consumer confidence index (CCI)	126.1	123.3	119.9
Currency/USD	9-Jun	- 1 mth	Chg (%)	Car sales (%YoY)	-28.8	2.7	9.0
UK Pound	0.795	0.792	-0.39	Motorcycle sales (%YoY)	-19.4	40.5	24.6
Euro	0.930	0.912	-1.94	Manufacturing PMI	May	Apr	Chg (bps)
Japanese Yen	139.4	135.2	-2.99	USA	46.9	47.1	-20
Chinese RMB	7.131	6.920	-2.95	Eurozone	44.8	45.8	-100
Indonesia Rupiah	14,840	14,730	-0.74	Japan	50.6	49.5	110
Capital Mkt	9-Jun	- 1 mth	Chg (%)	China	50.9	49.5	140
JCI	6,694.0	6,780.0	-1.27	Korea	48.4	48.1	30
DJIA	33,876.8	33,561.8	0.94	Indonesia	50.3	52.7	-240
FTSE	7,562.4	7,764.1	-2.60				
Nikkei 225	32,265.2	29,242.8	10.34				
Hang Seng	19,390.0	19,867.6	-2.40				
Foreign portfolio ownership (Rp Tn)	May	Apr	Chg (Rp Tn)				
Stock	2,738.1	2,789.1	-51.06				
Govt. Bond	822.7	822.7	0.00				
Corp. Bond	11.8	11.8	-0.01				

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

Indonesia – Economic Indicators Projection

	2018	2019	2020	2021	2022	2023E
Gross Domestic Product (% YoY)	5.2	5.0	-2.1	3.7	5.3	5.0
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	3.4
BI 7-day Repo Rate (%)	6.00	5.00	3.75	3.50	5.50	5.75
USD/IDR Exchange Rate (end of the year)**	14,390	13,866	14,050	14,262	15,568	15,173
Trade Balance (US\$ billion)	-8.5	-3.2	21.7	35.3	54.5	35.3
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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