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Indonesian Capital Market Developments and Challenges

Summary

Since its revival in the early 90s Indonesia's capital market has seen significant development. The market saw significant volatility during the Asian Financial Crisis in the late 90s. A repeat was also seen during the Global Financial Crisis in 2007–8. Since then it has gone up and down on the back of the commodity boom and bust.

Also, structural issues have held back its potential to support economic growth. In particular, its role in providing investments in infrastructure is limited.

The government should raise the capital market's role in economic growth. But this must go together with other policies outside the financial sector itself. In particular is labor market reform. This will raise public participation in the capital market. Also it will mobilise funds that are not yet channeled through the modern financial sector.

Background

Indonesia is one of the most important countries in South East Asia. In recent years the Indonesian economy has weathered global slowdown, but it is not immune to global volatility.

The Indonesian capital market developed quite late. Only in the early 90s did the government reform the capital market. This was a response to the government's own need to revamp state-owned enterprises.

But then the Asian Financial Crisis (AFC) hit. And the capital market along with banking sector crashed. To recapitalize the banking sector the government issued bonds to the banks. Then in the early 2000s the government developed the government bond market to refinance them. Today this is one of the largest segments of the capital market. But it is also one major source of risk.

Meanwhile, in the equity market, privatization continued apace, especially after the AFC and before the Global Financial Crisis (GFC). Besides the government, private firms—in particular, those in the natural resource sector— also showed interest to raise capital. After the GFC a lot of funds flowed into the market from loose monetary policy in the US and Europe.

But then the global market got a shock with the announcement of US Fed plan to start raising rates. This also resulted in pressure against the Indonesian market. Next, came the news of China's economic slowdown which triggered a commodity bust. The Indonesian equity market with its heavy reliance on commodity stocks was hit hard.

Similar volatility also took place in the government bond market. One overhanging risk in this market is the large share of foreign ownership, up to about 40% as of late May 2016. This is the window through which global volatility impacts prices and trading volume. Bond price movements impact the balance sheets of banks, pension funds and insurance companies. It also affects the cost and availability of government funding.

Another issue is the limited contribution of the capital market to the economy. This comes from the small size of the financial sector and that the sector is still dominated by the banking sector which has its own issues.

Structure of the Financial Sector

In 2012 the financial sector in Indonesia was only around 100% of GDP (see table 1). This is a much smaller share compared to other ASEAN countries. Domestic credit is about 40% of GDP, corporate bonds about 13% and the stock market around 50%. The role of bank loans to GDP has fallen further (see below).

The financial market's size has remained the same. But its structure has changed a lot. The role of the equity market has risen at the cost of banking and the corporate bond market.

The dominant banking sector is a legacy of the state-directed financial sector up to the 1980s. It is also the result of the late development of the non-banking financial sector.

There is also a large foreign investor holding in equity and bonds. In the equity market, foreign investors own around 43% of capitalization. In the government bond market, offshore investors hold around 40% of outstanding amounts.

The dominant banking sector limits the funding horizon for the entire economy. Around 78% of total deposits are in the 1–3 months horizon. This restricts banks' ability to finance long-term borrowing. Meanwhile, the small non-banking sector (NBFI) also limits long-term borrowing.[*1]

Stage of Financial Sector Development in Indonesia

As stated earlier, the Indonesian financial sector is small in comparison with its neighbors. The interesting question is why is this the case. One potential reason is the country's history with political upheavals altering key financial institutions. Second is the geographic spread. And third is underlying economic structure. We will confine the analysis here to the third rationale.

The Indonesian monetary base is smaller than its neighbors. In 2015, M2 to GDP for Indonesia was only 39% compared to an average of 186% for East Asian economies.[*2]

Another indicator is the relatively large size of the informal sector. We use the percentage of unpaid working population as a proxy. For Indonesia in 2014 it stood at 63%, compared to 42% in the Philippines and 25% in Malaysia (2012 data). It also reflects the large agricultural sector in Indonesia.[*3]

The labor force that works in agriculture usually has little education beyond elementary level. The labor arrangement is usually without contract and paid in kind. Outside of the agricultural sector there are also a lot of non-contract labor arrangements. These include hawkers, household help, drivers and others. Most of these workers get cash payments and keep their savings in cash. Hence, they do not take part in the modern financial sector.

We have seen that the early stage of the financial sector in Indonesia accounts for its small size. The next question is what are the consequences?

We will argue that such a small financial sector has two key characteristics. First, it is vulnerable to global shocks. And second, it may not provide enough resources to finance growth in the country.

The small financial sector is also not inclusive. That means a sizable part of the population do not take part and enjoy the benefit from this sector. Also resource mobilization is minimal. A related issue is the limited number of participants. This means there is not enough variation in behavioral pattern. As a result the probability of herd behavior is more prevalent. For example, when the stock market tanks most local investors are in panic-selling mode. There are not enough opportunistic players on the other side of the fence. This leaves the stock index being volatile.

Table 1: Structure of the Financial Sector in ASEAN members

% of GDP

	Banks (domestic credit)	Bond market issue balance	Stock market capitalization	Total
Indonesia	39.4	12.7	48.8	100.9
Malaysia	135.3	107.3	153.1	395.7
Philippines	52.4	39.6	91.7	183.7
Singapore	99	81.2	269.1	449.3
Thailand	131.5	76.1	106.5	314.1

Source: Asian Bonds Online (ADB) , World Economic Outlook Database (IMF)

Developments in the Equity Market

Since the early 90s before the AFC Indonesia's equity market saw tremendous growth. Its main drive was privatization of State-Owned Enterprises (SOEs). Today the market value of SOEs is a substantial 25% of the Indonesia Stock Market Capitalization. They are among the most liquid stocks traded and are part of the LQ45 (the 45 most traded stocks in the exchange).

The largest SOE by market capitalization is PT Telekomunikasi Indonesia (Telkom). It has a market capitalization of about 7.2% of the market. Its IPO was in 1995 and it is also the second largest company by capitalization in the stock exchange. It has a virtual monopoly on terrestrial telecommunications. Its cellular subsidiary is the market leader with 55% subscriber share.

Another bellwether stock is Bank Mandiri with about 4.5% share of market capitalization. It is the largest bank in Indonesia. And two other state-owned banks are also among the largest in the country. Together these three banks occupy close to 11% of market capitalization.

The main issue with the Indonesian stock market is its limited size and liquidity. The market was only 47% of GDP in 2015, which is a much smaller share than in other ASEAN countries. Liquidity is also quite low, with 0.14% (of market capitalization) daily trading in 2015.[*4]

A further issue is concentration. Out of the 532 listed companies, just 11 companies make up 50% of market capitalization. The top 45 liquid traded stocks make up about 69% of market capitalization.

There is also unequal liquidity by ownership. Foreign investors usually trade in blue chip stocks and in large ticket sizes. Hence, these blue chip stocks are the most traded and drive the index itself. Domestic investors, especially the retail segment, often follow what foreign investors do. The rationale is simple: foreign investors trade in large volumes and can move the price. But then foreign investors usually have a longer horizon. That opens a short lived window for domestic investors to arbitrage.

A market dominated by global investors is prone to volatility, as happened for example, in the taper-tantrum and Chinese devaluation episodes. From mid-2013 to early 2014 Indonesia's market tanked after the US Fed signaled an interest hike. But it rose along with the Shanghai stock market to historically high levels in April 2015. Then, as the Chinese market melted for domestic reasons the Indonesian market tanked. It has since recovered with the delayed Fed rate hike and stabilization in China.

Another issue in the Indonesian equity market is the low amount of free-floating shares. For example, Bank Negara Indonesia has only 37% free float. The rest is still government owned. This is typical for state owned enterprises. Another bellwether stock, Unilever Indonesia, also has 31% free float. Even Astra International, one of the largest firms in the country only has close to 37% free float. This means the founders are in control of the firm's direction. This does not bode well for corporate governance. This is also the reason several big global funds shun the Indonesian market.

Developments in the Bond Market

In contrast to the equity market, the Indonesian bond market remained nascent well into the AFC. A notable feature of the bond market is that there were no government bonds issued until after the AFC. The market now has a small corporate bond segment and a large government bond segment. The shift to the bond market is part of the government's move towards market-based deficit financing. This is a strategic move toward global best practice and away from multilateral arrangements. Also there was the need to have a liquid bond market to finance recapitalization bonds.

The corporate bond market remains small due to banking sector dominance. This is despite the advantages of issuing bonds—such as not requiring specific collateral and greater flexibility in use of funds. Bank loans have their benefits as well. One is the tailoring of fund draw down to project expenditure.

Market participants have long complained about the challenges of issuing bonds. These are: First, the tedious process to get approval from the capital market authority;[*5] second, the disclosure requirements which are at par with and IPO;[*6] and third, the 6-month validity of financial records. This creates a 2–3 month issuance window for end-of-year audited statements. These issues limit the development of the corporate bond market. (With corporate bonds outstanding comprising only about 2.2% of GDP, as of March 2015).

Since recapitalization bonds started trading in the early 2000s, market liquidity has picked up. And with the shift to bonds to finance the budget deficit, the supply has also been steady. The government made policy changes and institutional setup to build up its issuance capacity. The main policy initiative was a 2002 law governing government bond issuance. This legislation guarantees payment of principal and interest. And the institutional initiative was to setup first a directorate of bond management.[*7] That unit has evolved into a new directorate general. This unit is one of the most progressive inside the Ministry of Finance. It has a close relationship with market participants hence having support from the market.

The volume of government securities at the end of 2015 was about USD170 billion, about 26% in foreign currency and the rest in IDR. The legacy bilateral and multilateral debt remains at USD54.2 billion for the same period. With a few exceptions the government is not borrowing more from non-market sources.

The share of foreign loans in GDP is low, at around 26.8% at the end of 2015. Thus, despite Indonesia's non-investment grade rating, foreign investors favor the government bonds. This has resulted in foreign ownership rising from 18.6% at the end of 2009 to 39.1% at the end of June 2016. And, as in the equity market, foreign holders in the government bond market are the market movers.

The significant presence of foreign investors in the government bond market has created vulnerabilities. These are contagion and market risks. Still, in recent years the foreign ownership has taken on a longer term investment horizon. About 7.25% foreign investors are foreign central banks and governments. They are presumed to have a longer investment horizon and to be less prone to panic. At the same time the presence of hedge-funds has declined in recent years.

Even so, market risk remains. Following talk of Fed rate normalization in mid 2013, the 10-year yield rose to 2.5%. Between then and mid 2016 the yield fluctuated between 7% and 9%. This yield movement reflects global volatility stemming from two main sources: the global economic slowdown and the US Fed rate hike (see figure 1).

Other Salient Features of the Indonesian Capital Market

Besides its limited size the capital market also lacks a variety of instruments. For example, in the equity market almost all traded instruments are common stocks. There are almost no other types of instruments worth mentioning. In particular, the market lacks hedging instruments.

The main reason for the dearth of instruments is the unsophisticated buy-side. The retail investor base is small, estimated at only 440,000 in January 2016.[*8] Many observers believe that only a handful of that number are actively trading in the market. There are also about 270,000 individual mutual fund accounts. Some of this is investment linked insurance products.

On the institutional side, there are a small, sophisticated fund management sector and a larger but unsophisticated group of insurance and pension fund firms. Most pension funds were established by firms to cater to their employees. At the end of 2015, total assets of the pension fund industry stood at IDR207 trillion or about 1.8% of GDP. Pension funds are not allowed to invest in derivatives and only recently were they allowed to invest outside the country. Until recently most pension funds followed the defined benefit model, which constrained their cash flow and curtailed risk appetite. That is why they placed a preponderance of their investible funds in term-deposits.[*9]

Implications of Capital Market Size and Structure on Economic Development

Despite the dominance of the banking sector, it plays a less important role in the economy than might be expected. A recent World Bank report stated that Indonesian banks' credit stood only at around 35% to GDP.[*10] This is small compared to other ASEAN countries like Malaysia and Thailand. Meanwhile, equity and corporate bond markets are not providing enough funds to finance growth.

In its planning documents the government of Indonesia said the economy needs over IDR26 thousand trillion in investment fund over the next 5 years to grow at a rate of 6.9%.[*11]

The financing for this will come from domestic savings and borrowing. The private sector will tap banks and capital markets for its investment funding. Banks will contribute 8.3% of GDP by 2019. The equity market's role is expected to rise from 0.9% of GDP to 1.4% by 2019. The bond market's role will grow from 1% of GDP to 1.4% also by 2019. The role of internal corporate financing will remain around 15%. Hence, even in the optimistic scenario the capital market is not seen to play a significant role. And most funding is still expected to come from the banking sector and from firms' internal resources. This will be an interesting topic for further studies.

Because banking sector funding remains short-term, its ability to fund longer term projects is also limited. This is due to banks' effort to reduce market risk. When interest rates go up banks' cost of funds goes up and loan rates go up in a staggered manner. But when interest rates go down banks' net income immediately goes up. But its liquidity position might come under pressure to service rising loan demand. Hence, banks usually limit the average loan term to 3–5 years.

Tentative Policy Recommendations

For its longer term growth Indonesia needs to invest in infrastructure. Infrastructure investment is best funded by the capital market owing to its long-term nature. For the capital market to develop, introduction of new instruments must become a priority. And of special importance are hedging instruments to address interest and exchange rate risks. Government bond benchmark issues are available to provide pricing guidance for these.

To address the issue of insufficient monetization, the labor market must undergo structural reform. More formal labor arrangements will create huge demand for financial services. At the same time this will raise the supply of funds to the financial system.

Another important policy is to move from short-term deposits into longer-term instruments. One way is by raising financial literacy.

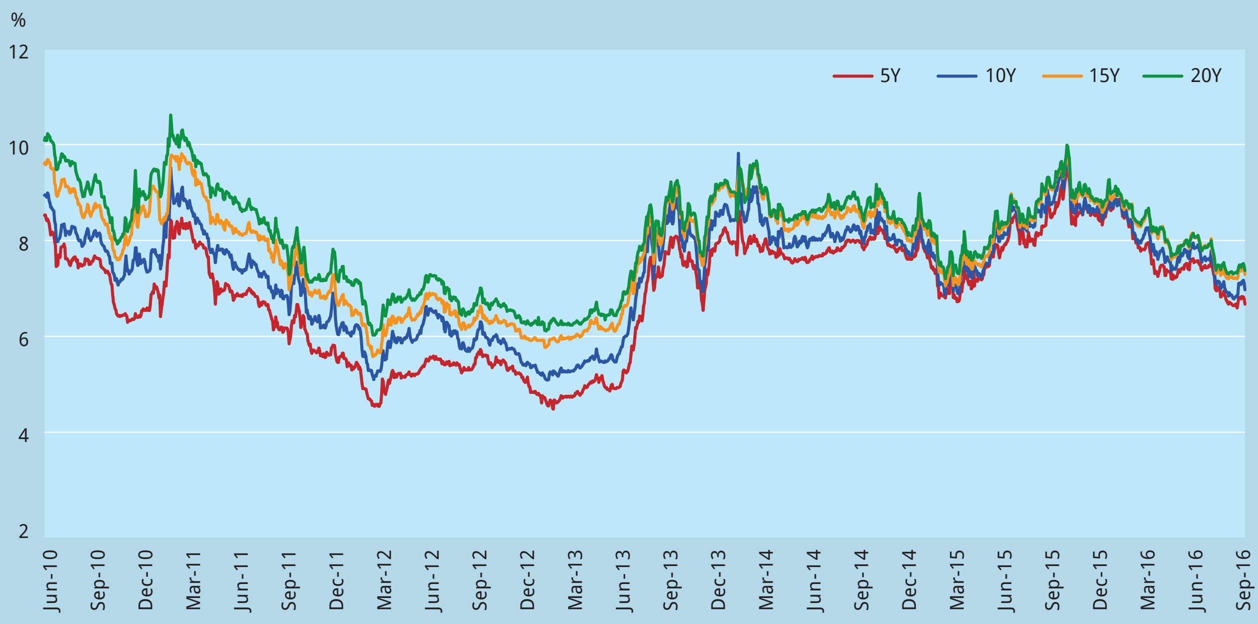
To increase capital market transparency the share of free float needs to rise, including at state-owned companies. One instrument the government can use is tax incentives. At the moment the threshold for this discount is 40%.[*12] In the future the government should consider tiered discounts. The government can also bring more state-owned enterprises into the market.

Conclusions

Indonesia's financial sector, especially its capital market is at an early stage of development. There are two consequences. First, it has a limited ability to fund economic growth and second, it is prone to global market volatility. Market volatility limits the participation of the public to sophisticated individuals and corporations.

Developing the capital market requires the government to look beyond the financial sector. The main reason for its small size is the large role of the informal sector in the economy. Hence developing the capital market entails reforming the labor market as well. At least those services that the government gets should come from the formal sector.

Figure 1: Government Bond Yield Movements



Note: 6.64 (5Y), 6.94 (10Y), 7.26 (15Y), 7.34 (20Y) - As of September 2, 2016

Source: Ministry of Finance Republic of Indonesia

Notes

*1 Data from World Bank Financial Development dataset show that in 2014 NBFI only occupied 3.3% of GDP in Indonesia. In comparison, the average for East Asian developing economies stood at 25% and for Thailand the figure stood at 46% for the same year.

*2 World Bank Financial Development dataset.

*3 Agriculture accounts for about 14% of GDP in Indonesia, 8% in Malaysia and an average of 10% in East Asia.

*4 Market capitalization was IDR4.872 trillion and annual trading stood at IDR1406 trillion with 244 trading days.

*5 All bonds issued in Indonesia with public distribution are listed in the stock exchange.

*6 Including periodic reporting to the stock exchange and the investor gatherings.

*7 A directorate is two steps below ministerial level in the Indonesian bureaucratic system.

*8 Jakarta Post, 26 January 2016.

*9 In 2016 pension fund assets were allocated 30% in term-deposits, 22% in corporate bonds, 18% in government bonds, and 14% in equity. The rest consists of investments in property and others. Data source: Otoritas Jasa Keuanganan, Statistik Dana Pensiun, June 2016.

*10 Indonesia: Systematic Country Diagnostic, September 2015.

*11 Rencana Pembangunan Jangka Menengah Nasional, 2015–2019, Kementerian Perencanaan Pembangunan Nasional, 2014.

*12 Additional requirements are 5% maximum ownership per party and a minimum of 300 parties.

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Kahlil also lecturers at Universitas Indonesia's Graduate School of Management. He is a frequent contributor to foreign and domestic newspapers and speaks at international seminars.