Indonesia—Update

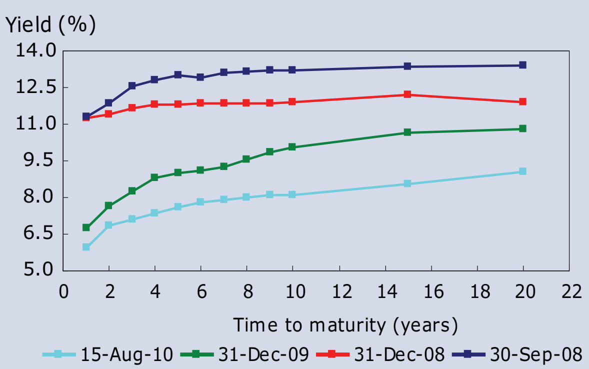
Yield Movements

Indonesia's government bond yield curve shifted downward between end-December 2009 and mid-August 2010 as yields fell for all maturities **(Figure 1)**. The government bond yield curve flattened from the short-end to the long-end of the curve. Yields fell the most for the 15-year tenor, shedding 209 basis points. The yield spread between 2-year and 10-year maturities narrowed to 124 basis points in mid-August from 241 basis points at end-December.

Yields for Treasury bills have fallen below the Bank Indonesia (BI) rate. The new regulation requiring a 1-month holding period for *Sertifikat* Bank Indonesia (SBI) has led investors to switch funds and invest in Treasury bills. This has bolstered the demand for Treasury bills and resulted in a much lower yield rate. As of mid-August, 1-year bills returned a yield of only 5.968%.

BI has kept its benchmark interest rate at a record-low level of 6.5% since August 2009. According to BI, it is closely monitoring the recent rise in inflation and the current BI rate remains adequate to safeguard against expectations of future inflation. Consumer price inflation rose sharply to 6.22% year-on-year (y-o-y) in July, compared with 5.05% y-o-y in June, mainly due to rising food prices and an electricity price hike that took effect on 1 July. For the first 7 months of the year, inflation stood at 4.02%, which was still within the central bank's annual inflation target of 4.0%–6.0%.

Figure 1: Indonesia's Benchmark Yield Curve—LCY Government Bonds



LCY = local currency.
Source: Bloomberg LP.

Gross domestic product (GDP) grew 6.2% y-o-y in 2Q10 on account of strong household consumption and domestic investment, as well as the continued recovery in exports. GDP growth in 2Q10 was up from the 5.7% y-o-y growth recorded in 1Q10. Household consumption expanded 5.0% y-o-y, while exports and investments grew 14.6% and 8.0% y-o-y, respectively. Most major sectors recorded higher annual growth in 2Q10, compared with the previous quarter, led by manufacturing which expanded 4.3% y-o-y. On a quarter-on-quarter (q-o-q) basis, Indonesia's GDP expanded 2.8% in 2Q10, following a 1.9% expansion in 1Q10. For the full year 2010, the Ministry of Finance estimated a growth target of 5.8% based on the 2010 revised state budget.

Size and Composition

The size of Indonesia's local currency (LCY) bond market expanded 13.8% y-o-y as of end-June, with the total volume of LCY bonds outstanding reaching IDR985.4 trillion (USD109 billion) **(Table 1)**. On a q-o-q basis, however, growth in LCY bonds outstanding remained flat from 1Q10.

Total government bonds outstanding climbed 13.5% y-o-y to IDR892.3 trillion (USD99 billion), with both central government bonds (issued by the Ministry of Finance) and central bank bonds (issued by BI in the form of SBI) posting double-digit growth. The stock of central government bonds increased 12.3% y-o-y in 2Q10, higher than the 8.5% y-o-y growth in 1Q10. On a q-o-q basis, central government bonds rose 4.7% in 2Q10, following a 2.0% q-o-q rise in 1Q10.

The government continued to implement a strategy of frontloading its financing requirements

Table 1: Size and Composition of the LCY Bond Market in Indonesia

	Amount (billion)								**Growth Rate** (%)						
	Mar-10		**Apr-10**		**May-10**		**Jun-10**		**Mar-10**		**Apr-10**	**May-10**	**Jun-10**		
	IDR	**USD**	**IDR**	**USD**	**IDR**	**USD**	**IDR**	**USD**	**y-o-y**	**q-o-q**	**m-o-m**	**m-o-m**	**y-o-y**	**q-o-q**	**m-o-m**
Total	985,619	108	1,042,418	116	1,002,121	109	985,359	109	15.6	6.0	5.8	(3.9)	13.8	(0.03)	(1.7)
Government	893,420	98	949,945	105	910,185	99	892,328	99	14.6	6.2	6.3	(4.2)	13.5	(0.1)	(2.0)
Central Govt Bonds	593,165	65	603,280	67	609,677	66	621,226	69	8.5	2.0	1.7	1.1	12.3	4.7	1.9
Central Bank Bills	300,255	33	346,666	38	300,509	33	271,103	30	29.0	15.5	15.5	(13.3)	16.5	(9.7)	(9.8)
Corporate	92,199	10	92,473	10	91,936	10	93,030	10	25.8	4.2	0.3	(0.6)	16.5	0.9	1.2

LCY = local currency, m-o-m = month-on-month, q-o-q = quarter-on-quarter, y-o-y = year-on-year.
Notes:
1. Calculated using data from national sources.
2. Bloomberg end-of-period LCY—USD rates are used.
3. Growth rates are calculated from LCY base and do not include currency effects.
Source: Bank Indonesia, Indonesia Stock Exchange, and Bloomberg LP.

through the issuance of bonds in the domestic and global markets. In 2010, the government had raised about IDR128.3 trillion worth of bonds as of 3 August, which was 72.1% of its original target (gross) of IDR178.0 trillion. The Ministry of Finance also announced that it will reduce its issuance of debt securities as the budget deficit is now expected to be equivalent to only 1.5% of GDP, compared with an original estimate of 2.5% of GDP in the 2010 revised state budget. Since the beginning of the year, the government has issued various types of debt securities, including conventional and Islamic (*sukuk*) debt instruments.

In June, the Ministry of Finance conducted a buy-back of short-dated government debt in exchange for longer-tenor paper. The swap allowed investors to exchange bonds maturing between 2011 and 2013 for 10-year bonds maturing in 2020. The debt exchange was valued at IDR80 billion.

In August, the government raised IDR8.0 trillion from the sale of its seventh series of retail bonds. The government initially planned to raise IDR5.0 trillion, but increased its target to IDR8.0 trillion amid strong demand from investors. The retail bonds carried a maturity of 3 years with a coupon of 7.95%.

The growth in central bank bills, while remaining positive, eased to 16.5% y-o-y in 2Q10, compared with 29.0% in 1Q10. On a q-o-q basis, the growth of central bank bills fell by 9.7% q-o-q, following growth of 15.5% in 1Q10. The lower growth rate in 2Q10 can be attributed to new regulations imposed by BI that seek to encourage banks to manage liquidity over a longer period and support more active transactions in the interbank market. In addition, the auction of SBI was changed from a weekly basis to a monthly basis in June. BI has pushed for longer-tenor maturities with issuance to include more 3-month and 6-month tenors as a replacement for 1-month tenors. BI also announced a policy package to strengthen monetary management and develop financial markets, which is discussed in detail in the Policy, Institutional, and Regulatory Developments section.

Following these new regulations, BI issued SBI with 9-month maturities for the first time in August. At present, investors no longer hold 1-month SBI.

Meanwhile, corporate bonds outstanding rose to IDR93.0 trillion (USD10 billion) in 2Q10, expanding 16.5% y-o-y, compared with 25.8% in 1Q10. On a q-o-q basis, corporate bonds grew by only 0.9% in 2Q10.

As of end-June, the top 30 corporate issuers in Indonesia accounted for about 81% of total corporate bonds outstanding **(Table 2)**. State-power firm PLN remained Indonesia's top corporate issuer of LCY bonds, with total outstanding bonds valued at IDR12.1 trillion. Telecommunications firm PT Indosat ranked second with IDR8.1 trillion in outstanding LCY bonds, while Bank Tabungan Negara was third with outstanding LCY bonds of IDR4.9 trillion. About half of the top 30 LCY bond issuers were from the financial sector. Most were banks that were raising funds to help boost their capital adequacy ratios and fund lending activities.

Among Indonesia's top 30 corporate issuers, only six companies have issued foreign currency (FCY)-denominated bonds. Indonesia's top LCY issuer, PLN, has issued FCY bonds that are the equivalent of nearly three times its outstanding LCY bonds. PLN also issues both conventional bonds and *sukuk*. In contrast, Indosat has issued FCY bonds that are the equivalent of about one-third of its outstanding LCY bonds.

In 2Q10, corporate bond issuance reached IDR7.3 trillion (USD0.8 billion), primarily comprising issuance from financial sector firms. Most of the bonds issued in 2Q10 had coupons of 10% or more and were consistently oversubscribed. Notable issues in 2Q10 are listed in **Table 3**.

State-owned lender Bank Tabungan Negara raised nearly IDR1.7 trillion worth of bonds in June. The bonds carried a maturity of 10 years and a coupon of 10.25%. The bonds were oversubscribed with total order book reaching IDR3.4 trillion.

Table 2: Top 30 Corporate Issuers, June 2010

Top 30 Corporate Issuers	Outstanding Amount		
	LCY Bonds (IDR billion)	**LCY Bonds** (USD billion)	**FCY Bonds** (USD billion)
PLN	12,100	1.34	4.00
Indosat	8,090	0.89	0.34
Bank Tabungan Negara	4,900	0.54	—
Jasa Marga	4,150	0.46	—
Bank Panin	3,900	0.43	—
Indofood Sukses Makmur	3,610	0.40	—
Bank Mandiri	3,500	0.39	—
Perum Pegadaian	3,000	0.33	—
Astra Sedaya Finance	2,862	0.32	—
Federal International Finance	2,845	0.31	—
Bank Ekspor Indonesia	2,541	0.28	—
Oto Multiartha	2,500	0.28	—
Bank Tabungan Pensiunan Nasional	2,050	0.23	—
Bank Rakyat Indonesia	2,000	0.22	—
Bank Jabar	1,750	0.19	—
Excelcom	1,500	0.17	0.25
Medco Energi Internasional	1,500	0.17	0.28
Bentoel	1,350	0.15	—
Berlian Laju Tanker	1,340	0.15	0.13
Bank Danamon	1,250	0.14	—
Danareksa	1,080	0.12	—
Bank Negara Indonesia	1,000	0.11	0.10
Bank Mega	1,000	0.11	—
Bank OCBC NISP	880	0.10	—
BCA Finance	850	0.09	—
Pupuk Kaltim	791	0.09	—
WOM Finance	775	0.09	—
Bank DKI	750	0.08	—
Salim Ivomas Pratama	730	0.08	—
Lontar Papyrus	725	0.08	—
Total Top 30 Corporate Issuers	**75,319**	**8.32**	
Total Corporate Bonds Outstanding	**93,030**	**10.28**	
Top 30 as % of Total Corporate	**80.96%**	**80.96%**	

FCY = foreign currency, LCY = local currency.
Source: Indonesia Stock Exchange.

Table 3: Notable Corporate Issuance in 2Q10

Corporate Issuers	Amount Issued (IDR billion)
Bank Tabungan Negara	1,650
Federal International Finance	1,500
Bank Tabungan Pensiun Nasional	1,300
Bank OCBC NISP	1,000
Bank Sulut	500
Titan Petrokimia Nusantara	273
Reliance Securities	40
Total	**6,263**

Source: Indonesia Stock Exchange.

Motorcycle-financing firm Federal International Finance issued bonds worth IDR1.5 trillion in four tranches in April. The bonds consisted of the following tranches:

(i) 1-year bonds worth IDR300 billion, coupon of 8.10%;

(ii) 2-year bonds worth IDR200 billion, coupon of 8.75%;

(iii) 3-year bonds worth IDR400 billion, coupon of 10.15%; and

(iv) 4-year bonds worth IDR600 billion, coupon of 10.55%.

Mid-sized lender Bank Tabungan Pensiunan Nasional sold IDR1.3 trillion in bonds in May with maturities of 3–5 years. The bonds consisted of the following tranches:

(i) 3-year bonds worth IDR715 billion, coupon of 9.90%; and

(ii) 5-year bonds worth IDR585 billion, coupon of 10.6%.

Leasing company Oto Multiartha issued IDR1.3 trillion in bonds in a four-tranche deal in June, which was an increase from its initial plan of only IDR1.0 trillion. The bonds consisted of the following tranches:

(i) 370-day bonds worth IDR300 billion, coupon of 7.90%;

(ii) 2-year bonds worth IDR225 billion, coupon of 8.70%;

(iii) 3-year bonds worth IDR575 billion, coupon of 10.05%; and

(iv) 4-year bonds worth IDR200 billion, coupon of 10.65%.

Also in June, Bank OCBC NISP raised IDR880 billion from a 7-year subordinated bond issue. The subdebt issue carried a coupon of 11.35%.

Foreign Currency Bonds

In August, the government cancelled its planned issue of FCY-denominated *sukuk*. The global *sukuk* issuance has been re-scheduled for early next year.

Rating Changes

In June, Moody's Investor Service (Moody's) revised the outlook for Indonesia's sovereign credit rating to positive. The revised outlook applies to the Ba2 level for Indonesia's LCY and FCY sovereign ratings, as well as to the Ba1 FCY bond ceiling and Ba3 FCY deposit ceiling. According to Moody's, the positive outlook reflects the country's capacity for sustained strong growth, the overall stability and effectiveness of the government's fiscal and monetary policies, and expectations of further improvements in the government's financial and debt positions.

Indonesia's sovereign rating was also raised to investment grade by Japan Credit Rating Agency (JCR) on 13 July. Specifically, Indonesia's FCY long-term debt and LCY long-term debt were upgraded by JCR to BBB- from BB+ and BBB from

Table 4: Selected Sovereign Ratings and Outlook for Indonesia

	Moody's	S&P	Fitch
Sovereign FCY LT Ratings	Ba2	BB	BB+
Outlook	positive	positive	stable

FCY = foreign currency, LT = long term.
Source: Rating agencies.

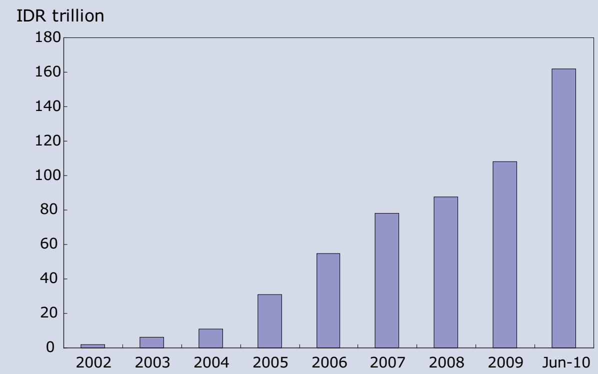
BBB-, respectively, while the ratings outlook for both was stable. According to JCR, the upgrade reflects the country's sustained growth, which is being accompanied by strong domestic demand, a reduced public debt burden, increased resilience to external shocks, improved political and social stability, as well as government efforts to deal with structural issues.

Investor Profile

As of end-June, banking institutions remained the biggest holders of Indonesian LCY government bonds, with holdings equivalent to 38% of total central government bonds outstanding **(Figure 2)**. However, the banks' share of total holdings has declined significantly in recent years. In 2002, banks were holding as much as 82% of total government bonds outstanding.

Foreign investors were the second biggest holder of Indonesian central government bonds as of end-June. Foreign investors' share in LCY bonds has exhibited an upward trend from less than 1% in 2002 to 26% in 2Q10. As of end-June, bonds held by foreign investors reached IDR162.1 trillion **(Figure 3)**.

Figure 3: Foreign Holdings of Government Bonds

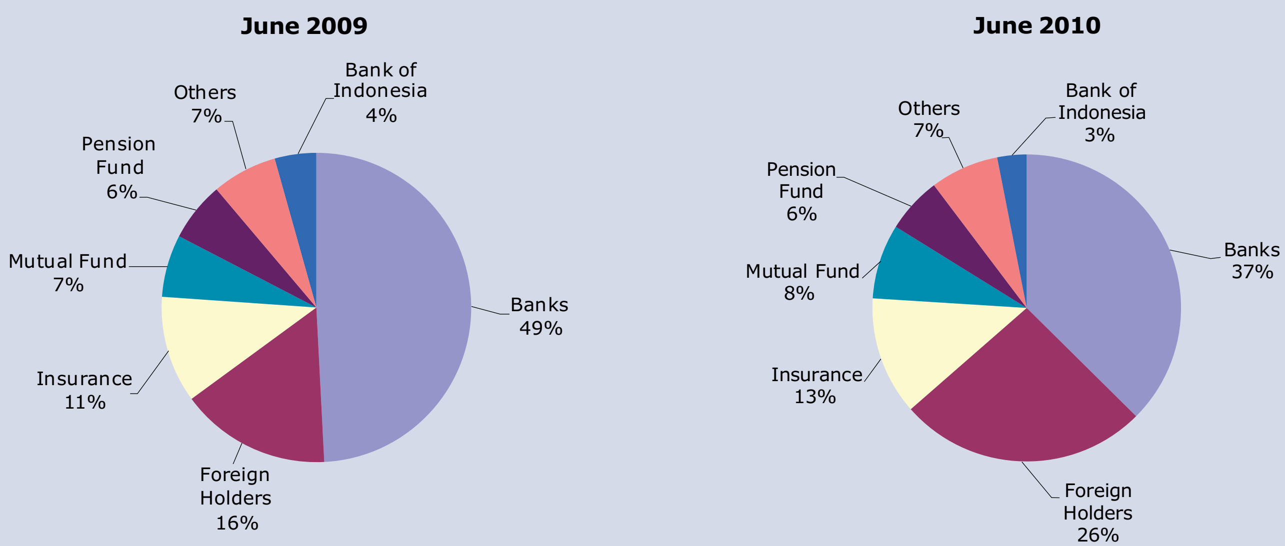


Source: Indonesian Debt Management Office.

As of end-June, about 72% of bonds held by foreigners were invested in long-dated tenors, or those with maturities of 5 years and above. On the other hand, only 10% of bonds held by foreigners carried maturities of 2 years and below.

Meanwhile, the share of LCY bond holdings of insurance companies (12%) and mutual funds (8%) also increased as of end-June compared with their levels 1 year ago.

Figure 2: LCY Government Bonds Investor Profile



LCY = local currency.
Source: Indonesia Debt Management Office.

Policy, Institutional, and Regulatory Developments

Policy Package to Strengthen Monetary Management and Develop Financial Markets

In June, BI announced a policy package that aimed to boost the effectiveness of monetary policy transmission, shore up financial system stability, and encourage financial market deepening. The package includes the following measures:

(i) Effective 17 June, BI widened the range of its overnight interbank money market rate from 6.0%–7.0% to 5.5%–7.5%.

(ii) Effective 1 July, the net open position holding limit of foreign exchange by banks was capped at 20% of capital.

(iii) Effective 7 July, a minimum 1-month holding period is required for investors of SBI with 1-month maturities. Also, new monetary instruments in the form of term deposits were introduced.

(iv) BI began issuing longer-tenor SBI with maturities of 9-months, effective the second week of August, and 12-months, effective the second week of September.

(v) By 2011, BI will introduce three-party repurchases of government bonds.

According to BI, these policies are not being instituted to control the foreign exchange market, but rather to support sustainable macroeconomic stability and strengthen the momentum of economic recovery.

Debt Issuance to be Trimmed

In late July, the Ministry of Finance reported that government spending was sluggish in the first half of the year, resulting in a lower-than-projected budget deficit for 2010. The government managed to spend only IDR395.8 trillion, or 35.1% of the target set in the 2010 revised state budget, in the first half of the year. Revenue collection reached 44.7% of the annual target. This resulted in a budget surplus amounting to IDR47.9 trillion in the first half of 2010. The Ministry of Finance now estimates a deficit equivalent to only 1.5% of GDP for the year as a whole, compared with its earlier forecast of 2.1%.

In line with this development, the government will trim its remaining debt issuance by 26%. The debt issuance target will be reduced by IDR15 trillion out of the IDR58 trillion worth of debt still to be issued in 2010.

Treasury Bill Issuance to be Reduced

The government is considering a plan to reduce treasury bill issuance due to strong foreign capital flows into various commercial paper, especially short-term bonds. To curb hot money flows, the government may try to align its policies with the BI policy of channeling foreign capital towards long-term investments.

In mid-August, Rahmat Waluyanto, Director General of Debt Management announced that the Ministry of Finance will reduce treasury bill issuance to control refinancing risks. He explained that the value of short-term treasury bonds with tenures of less than 5 years (including treasury bills) accounts for 18% of total IDR-denominated treasury notes. In the future, this percentage will be cut to less than 10% to attract more capital into the long-term treasury bond market to lessen the market's vulnerability to the risk of capital flight.

BI Announces New Regulations on Reserve Requirements and Bank Lending

In September, BI announced new regulations on reserve requirements and bank lending to help contain inflation and boost economic growth. Beginning in November, the primary reserve requirement will be raised to 8.0% of deposits—from 5.0%—while the secondary reserve requirement will remain at 2.5%. Banks that are able to comply with the new primary reserve requirement will earn 2.5% interest on the amount covering the

3-percentage-point increase in primary reserves. On the other hand, those banks that fail to meet the new 8.0% primary reserve requirement will be fined the equivalent of 125% of the average 1-day overnight Jakarta Interbank Offered Rate (JIBOR). BI also announced a new regulation designed to give banks incentives for maintaining their loan-to-deposit ratio within a range of 78%–100%, effective 1 March 2011.