The impact of global capital flows on financial intermediation and monetary transmission in Indonesia

Bank Indonesia

Introduction

The evolution of Indonesia's economic landscape has occurred in tandem with the globalisation of capital flows, engendering substantive consequences for financial intermediation and monetary policy transmission within the predominantly bank-based economy. This essay explores the multifaceted effects of global capital flows on Indonesia's financial sector and the measures adopted by Bank Indonesia to navigate the evolving economic landscape, including the impact of the Covid-19 pandemic.

Since the 2008 global financial crisis, Indonesia's economy has been marked by resilience and adaptability. Despite the tumultuous global economic climate, the nation has demonstrated remarkable strength. This strength was also shown recently, with predictions that the Indonesian economy will continue to grow and remain resilient amid global spillovers. In the fourth quarter of 2023, the economy grew 5.04% year on year (yoy). This growth is supported by:

- private consumption, including by the younger generation, which will rise in line with increasing consumption in the services sector; and
- consumer confidence, which remains high.

Investment continues to grow driven by the ongoing completion of National Strategic Projects. With these developments, economic growth is predicted to increase in the range of 4.7–5.5% in 2024. Continued economic improvement in 2024 will be mainly driven by domestic demand along with increases in salaries for state civil servants, general elections and development of the new National Capital City (IKN). To support economic growth, especially from the demand side, Bank Indonesia has implemented a pro-growth macroprudential policy and accelerated the digitalization of the payment system in close synergy with the government's fiscal policy.

Inflation has been maintained within the target range of 3 ± 1% in 2023. Consumer price index (CPI) inflation in December 2023 was 2.61% yoy. This decline in inflation was supported by core inflation, which fell to 1.80% yoy and inflation in the administered prices group, which was also lower at 1.72% yoy. Meanwhile, the volatile food group recorded inflation of 6.73% yoy. Controlling inflation has been the result of consistent monetary policy and close synergy between Bank Indonesia and the (central and regional) Government through strengthening the Central and Regional Inflation Control Teams (TPIP and TPID) as well as the National Movement for Food Inflation Control (GNPIP) in various regions. Bank

Indonesia will continue to monitor several risks that could put pressure on inflation, including the impact of rising global energy and food prices, as well as the depreciation of the Rupiah, which could put pressure on imported inflation. For this reason, Bank Indonesia continues to strengthen the monetary policy mix and synergy with the central and regional governments to ensure inflation remains under control, in the range of 2.5 ± 1% in 2024.

Global capital flows and their influence

One of the key driving forces behind Indonesia's economic performance has been the inflows of foreign capital, comprising both foreign direct investment and portfolio investments. These global capital flows have penetrated Indonesia's financial markets, including for government bonds and corporate equities. The impact on these markets has been profound, with far-reaching implications for exchange rates, bond yields and equity prices.

Foreign portfolio flows, often in the form of investments in government bonds and corporate equities, have been particularly influential. These investments have had a direct and immediate impact on the dynamics of Indonesia's financial markets. As foreign capital flows into government bonds, they exert pressure on bond yields, affecting interest rate movements in the domestic market. Similarly, investments in corporate equities influence equity prices, contributing to the overall market sentiment.

Moreover, the rapid increase in foreign capital flows, especially during periods of economic expansion characterized by robust consumption and high commodity prices, has fuelled bank lending. Global capital flows have injected liquidity into the Indonesian economy mainly through financial markets. This liquidity has notably influenced interest rate setting and bank lending, creating an environment where the banking sector plays a central role in financial intermediation. The shallowness of domestic financial markets, however, has occasionally amplified the volatility of financial asset prices, especially during times of market stress.

In 2023, higher for longer global interest rates prompted a rebalancing of capital flows from emerging market economies (EMEs), including Indonesia, to advanced economies. However, liquidity remained ample in the banking system and the economy. Base money (M0) growth contracted 1.5% yoy in December 2023, driven by the increase in the Macroprudential Liquidity Incentives Policy (KLM) and due to the base effect of government financial expansion at the end of the year. Meanwhile, money in circulation in a narrow (M1) and broad (M2) sense grew by 2.1% yoy and 3.5% yoy, respectively. M2 development was mainly influenced by credit, which remained strong, and the recorded expansion of the government's financial operations. Bank Indonesia continues to ensure adequate liquidity, both through the effectiveness of existing policies and by strengthening accommodative macroprudential policies, to revive lending/financing and support economic growth.

Bank-based financial system

Indonesia's economic landscape is characterised notably by a bank-centric financial system. Banking institutions play a central role as financial intermediaries, while non-bank financial institutions (NBFIs) and capital markets provide secondary sources of funding. Despite the small amount of their assets relative to the overall financial system, NBFIs have experienced significant growth, particularly in fintech lending. Therefore, funds from capital inflows are channelled mostly through the banking system.

Loose liquidity supports banking intermediation and maintains financial system stability. In December 2023, the ratio of liquid assets to third-party funds remained high at 28.73%. This ample liquidity has contributed to favourable banking interest rates, with the one-month banking deposit interest rate and lending rate maintained at 4.69% and 9.25%, respectively, in December 2023. Adequate banking liquidity is also supported by the implementation of the Macroprudential Liquidity Incentives Policy (KLM), effective from 1 October 2023, offering a maximum incentive of 4% of the statutory reserve requirement. As of December 2023, KLM provided additional liquidity to 120 banks, amounting to IDR 55.13 trillion, marking an increase from IDR 108.15 trillion to IDR 163.28 trillion. Anticipated to rise further, this additional liquidity aligns with stronger credit growth in priority sectors as indicated in the primary policy objectives. Bank Indonesia continues to ensure adequate liquidity to maintain financial system stability and increase lending/financing to support sustainable economic growth.

The bank intermediation function continues to improve. Bank loans grew by 10.38% yoy in December 2023, supported by eased bank lending standards and early indications of rising demand for financing in line with sound corporate performance. By sector, credit growth was mainly supported by the business services, trade and social services sectors. Sharia financing also continues to increase, reaching 15.80% yoy in December 2023. In the micro, small and medium-sized enterprise segment, credit growth reached 8.03% yoy, supported by, among other things, People's Business Loans. Bank Indonesia will continue to encourage the distribution of bank lending/financing and strengthen synergy with the government to maintain the momentum of economic growth, especially in priority, inclusive and green economy sectors. Considering these developments, Bank Indonesia anticipates credit growth to accelerate in the 10-12% range in 2024.

Banking resilience has been maintained, supported by strong capital and low credit risk. The capital adequacy ratio was at a high of 27.66% in December 2023, with effectively managed credit risk reflected in the non-performing loan (NPL) ratio of 2.19% (gross) and 0.71 % (net). Banking liquidity has been maintained, supported by growth in third-party funds of 3.73% yoy in December 2023. Bank Indonesia's stress test results also show that banking remains resilient in the face of global pressure. Bank Indonesia will continue to strengthen synergy with the Financial System Stability Committee in mitigating various risks that have the potential to disrupt financial system stability and economic growth momentum.

The effects of global factors on banking

Indonesia's bank-based economy has been influenced by global factors and capital flows through financial markets, primarily in the form foreign portfolio investments in government bonds and corporate equities. In 2023, higher for longer global interest rates accompanied by increases in long-term government bond yields prompted a rebalancing of capital flows from EMEs to advanced economies. Such conditions were linked to a build-up of global economic risk in line with ongoing global geopolitical tensions, the growing risk of economic recession, high inflation, aggressive policy rate hikes and the strong US dollar.

Increasing uncertainty in the financial markets triggered risk-averse behaviour among global investors, which led to capital outflows of portfolio investments from developing economies. Consequently, investors began to rebalance portfolios from securities to readily convertible cash equivalents. This required an optimal policy response to mitigate the adverse impact of global spillovers on domestic macro-financial resilience in EMEs, including Indonesia. However, the resilience of the domestic financial system was maintained in line with solid capital, ample liquidity and effectively managed credit risk. Financial system resilience and manageable interest rates supported the intermediation function. Credit growth accelerated as risk perception in the banking industry improved along with corporate and household sector performance through improving repayment capacity and fewer loans at risk.

Bank Indonesia, therefore, continues to strengthen a consistent and innovative policy mix of monetary, macroprudential and payment system policies to maintain stability and revive sustainable growth. The accommodative macroprudential policy stance has been strengthened by the effective implementation of the Macroprudential Liquidity Incentives Policy and by lowering the Macroprudential Liquidity Buffer to support lending/financing for national economic growth. Additionally, Bank Indonesia continues to innovate to increase the effectiveness of monetary policy in controlling inflation and ensuring the Rupiah exchange rate remains stable. In this regard, interest rate policy was strengthened by the issuance of the Bank Indonesia Rupiah Securities (SRBI), to strengthen efforts to deepen the money market and support efforts to attract portfolio inflows, by optimizing the underlying government securities owned by Bank Indonesia. The market welcomed the issuance of SRBI, which was reflected in the high offer compared with the target (oversubscribed). As of 19 December 2023, an SRBI auction had been held 27 times, with an outstanding amount reaching IDR 229.95 trillion. This development was also followed by active transactions in the secondary market. The issuance of SRBI also supported the inflows of foreign portfolio investments, as reflected in the net purchase of SRBI by non-resident investors of IDR 9.81 trillion. These developments generally show that SRBI can replace the reverse repo SBN as a pro-market contractionary monetary instrument and at the same time attract capital inflows to strengthen the Indonesian economy against the impact of global spillovers.

Impact on monetary transmission

The impact of global factors on monetary transmission in Indonesia has manifested mainly through exchange rate and asset price volatility. This volatility has a direct bearing on various macroeconomic aspects, including inflation, the current account deficit, economic growth and financial stability. Additionally, the effects of global factors on domestic liquidity are primarily felt within the banking sector, where they have provided a degree of additional financing for the domestic economy. The relative shallowness of domestic financial markets has often exacerbated the impact of these global factors on exchange rate and asset price volatility. This underscores the need for measures that strengthen the effectiveness of monetary transmission in Indonesia.

To navigate the challenges posed by global capital flows, Bank Indonesia has adopted a strategic policy mix. This mix combines the use of interest rate policy, flexible exchange rates and macroprudential measures. The policy mix was also supported by financial market deepening. These policy approaches are targeted at mitigating excessive lending in specific sectors and addressing external vulnerabilities to enhance monetary and financial stability.

1. **Interest rate policy:** One of the key tools at the disposal of the central bank is the interest rate policy. Bank Indonesia has utilized this tool to adjust the policy rate, aiming to meet inflation targets while addressing the complexities of the global economic environment.
2. **Exchange rate flexibility:** The adoption of a more flexible exchange rate regime is designed to help the country adapt to current account deficits. This flexibility allows for adjustments in response to changing economic conditions and external pressures.
3. **Macroprudential measures:** The central bank has also implemented macroprudential measures, designed to curtail excessive lending in specific sectors of the economy. These measures aim to enhance the overall stability of the financial system.
4. **Deepening Indonesia's financial markets:** Recognizing the need for a more diversified and resilient financial system, Bank Indonesia has intensified efforts to deepen the country's financial markets. This endeavour includes the introduction of interbank repo and swap markets, which strengthen the market mechanisms for setting interest rates and exchange rates. Additionally, these initiatives enhance the term structure and liquidity management of both banks and NBFIs.

Conclusion

The impact of global capital flows on financial intermediation and monetary transmission in Indonesia is a multifaceted phenomenon. Indonesia's journey as a bank-based economy demonstrates the complexities of navigating the global financial landscape. Global capital flows, while contributing significantly to economic growth and resilience, also bring volatility and challenges that require astute policy responses.

Bank Indonesia's policy mix, which encompasses interest rate policy, flexible exchange rates and macroprudential measures supported by financial market deepening, represents a thoughtful and strategic approach to managing these challenges. Efforts to deepen Indonesia's financial markets are a step towards achieving a more diversified and resilient financial system.

Indonesia's experience serves as a valuable case study for emerging economies, highlighting the importance of adaptability and a multifaceted approach to maintaining monetary and financial stability in an ever-evolving global economic environment. As Indonesia continues to evolve, it stands as a testament to the interplay between global capital flows, economic resilience and sound policy responses in shaping the future of a nation's financial landscape